Gilbert G. Lenssen · N. Craig Smith
Editors

Managing Sustainable Business

An Executive Education Case and Textbook

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An Executive Education Case and Textbook

A book of 32 Texts and Case Studies
from across a wide range of business sectors around
a managerial framework for Managing Sustainable
Business

Developed for and tested in Executive Education
Programmes at Leading Business Schools

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ISBN 978-94-024-1142-3 ISBN 978-94-024-1144-7 (eBook)
https://doi.org/10.1007/978-94-024-1144-7

Library of Congress Control Number: 2018935248

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Printed on acid-free paper

This Springer imprint is published by the registered company Springer Science+Business Media B.V. part of Springer Nature.
The registered company address is: Van Godewijckstraat 30, 3311 GX Dordrecht, The Netherlands

Foreword by Doug Baillie

This book provides an excellent framework for managers to pursue sustainable business in a strategic way. At the same time, it is a learning model, starting with the foundations of risk management and stakeholder management and moving on to the more complex challenges of strategic differentiation and business model innovation. The most challenging part however is the organizational change management and talent development which needs to follow or go hand in hand with the strategic processes.

The wealth of case studies and supporting texts is derived from the legacy of ABIS – The Academy of Business in Society where business schools and companies are working together to enhance the knowledge base for sustainable business. The book follows the rationale of the business manager in a very practical manner, and I hope it will be widely used in executive education and become a core part of learning and talent development.

ABIS – The Academy of Business in Society
Brussels, Belgium

Doug Baillie

Foreword by Daniel Janssen

Before I joined Solvay S.A., I was the CEO of a pharmaceutical company, the chairman of the Belgian Employers Association and one of the hundred founders of the Club of Rome in 1968. I was convinced of the necessity of sustainability whether environmental, social or ethical.

During my stay at the helm of Solvay S.A. (1984–2006), our global company became even more global and even more conscious of the rising global sustainability challenges. As a 150-year-old family-controlled company, we understood very well what sustainability meant. My management colleagues and I, with the support of my family shareholders, decided increasingly to take strategic decisions and operational execution only when we could grow profitably in a sustainable way, with due respect for environmental, social and ethical issues. With these principles in mind, we have reorganized some businesses, we have sold businesses where we could no longer see profitable growth with sustainability, and we have acquired businesses where we could see growth with sustainable profitability.

This book offers managers a systematic approach for pursuing sustainable profitability by integrating economic, social, environmental and ethical dimensions in business strategy and decision-making. As a member of the INSEAD Advisory Council, I have argued for a long time that the future of capitalism is in peril if – despite its global and remarkable successes – business cannot control and minimize its failures and excesses (greed, inequality, corruption, climate change, social injustice, etc.). The solution must be a more sustainable market economy. I am convinced that businesses, when profitable, sustainable and innovative, are a force for good, for a better world. I think therefore that the business schools curriculum should address the sustainability challenges in serious ways. I am very happy to see that this book offers a down-to-earth framework for making this happen. I congratulate the editors and the authors for their unique contribution to business education.

Solvay S. A. Daniel Janssen
Brussels, Belgium

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Managing Sustainable Business in a Global Context

Gilbert G. Lenssen and Joris-Johann Lenssen

In this chapter, we are presenting an outline of the conceptual framework for this book. This framework is also a step-by-step model for managers to identify risks and opportunities for sustainable business and therefore also a managerial framework for decision making, as well as a supervisory framework for the board.

As set out in the introductory chapter, the key to sustainable business is in achieving the right balance between managing competitiveness and profitability for attractive returns to shareholders with managing the political, social and ecological context of the business which in turn can enhance competitiveness and profitability. Managing the context of the business is focused on both protecting value against sustainability risks and creating new value from sustainability opportunities. In managing context, the business is perceived as generating benefits for all stakeholders (including its shareholders) and as a credible and trustworthy player for these stakeholders.

Sustainable business is achieved by integrating context issues into the business model and competitive strategy, laying the foundations for long-term profitable growth. The model we propose is designed in six steps which are the six modules of the book:

1. Risk Management focusses on the "accountabilities" of the business and consists of knowledge management of "inside-out" impacts of the business model and the business strategy. Risk management is about managing accountabilities for impacts (externalities) in shifting social contract environments. Oil companies like Shell and BP are held accountable for all environmental impacts, even if they operate within the law and governmental regulation (Shell) or if the impacts have been caused by a subcontractor (BP).
2. Issues Management focusses on the more vague "responsibilities" of the business and consists of knowledge management of "outside-in" impacts of new issues from the business environment on the business. Issues management is about adopting appropriate organisational responses for latent, emerging and maturing issues of responsibility. In the face of controversy on child labour, Nike had to shift from a defensive and compliance approach to a strategic approach by changing its business model and seeking industry sector agreements as the child labour issue matured over the years.

3. Stakeholder Management for Competitiveness and Trust is about identifying, weighing the importance and prioritisation of key stakeholders within the business model and managing relationships with stakeholders as key resources for comparative strategic advantage. Companies like Johnson & Johnson invest continuously in relations with key stakeholders such as hospital managers and health care staff.
4. Strategic Differentiation: Strategic Bets for Sustainable Business Development is about developing sustainability value propositions to markets and stakeholders, including reconceiving products and services, redefining productivity in the value chain and developing partnerships. GE Healthcare high efficiency CT systems are designed to reduce electricity consumption for operation and ambient cooling by optimising energy use based on a customer's usage profile. Illycaffè redefined productivity in the value chain by engaging directly with farmers to ensure high-quality supplies combined with a better income for farmers. GSK formed partnerships with NGOs to ensure that medicines would find their way to patients instead of disappearing into corrupt reselling channels.
5. Business Model Innovations and Transformations: Taking Great Leaps Forward is about identifying and entering market spaces with high sustainable value and transforming business models and capabilities to capitalise on emerging market value. Umicore reinvented itself from a polluting steel giant into a specialty metals and materials producer and technology solutions for sustainable development. IBM radically changed its business model from a hardware producer of PCs and servers to a provider of IT-driven solutions for sustainable development in, for example, electricity grid efficiency and traffic management.
6. Managing Change for Sustainable Business: Developing Dynamic Capabilities is about developing organisational capabilities and managerial talent for sustainable business and leadership for organisational change. All the above cited examples of innovative companies display a dynamic capability for turning sustainability threats into opportunities. Unilever does so in an exemplary way with its Sustainable Living Plan and is completely redesigning HR and talent development processes to support its strategic ambition of doubling sales and halving environmental impact.

We will now elaborate on this model by providing the conceptual background and analysis for each of these six dimensons of managing sustainable business.

Part I Risk Management: Managing the Accountabilities of the Business

This first level of analysis deals with the accountabilities for inside-out impacts (or "externalities") of the company on its ecological, social and governance/political environment (ESG). Most companies have considerable **positive impacts** in terms

of technological development, quality products and services, employment, tax contributions, training of the workforce (which contributes to its employability), community support, philanthropic activities and more. However, within the context of managing the company's accountabilities, it is important to **manage the risks associated with negative impacts**, i.e. costs which are externalised and from which the company profits but the price to be paid in extreme cases might be prohibitive.

Negative impacts may be oil spills, air and water pollution (environment), poor and unsafe working conditions, human rights violations (social), corruption, entanglements in civil wars and complicity with governments which do not respect human rights or free speech (governance). However, a business will always have externalities, some with acceptable costs for society. How much costs are acceptable to society is very much dependent on the normative context of the company often described as the "social contract" a company operates with.

A "social contract" in this context of sustainable business refers to the normative framework the business operates with, which is determined by the expectations of society and government on the role and purpose of business[1]. These expectations go well beyond fulfilling legal and regulatory obligations by business.

The normative framework consists of both explicit and implicit expectations of governments and societies (often voiced via non-governmental organisations).

In our model, risk management deals with management of impacts within the context of the social contract of explicit expectations.

The informal, implicit and frontier expectations of the social contract are the subject of issues management. These so-called norms consist of the explicit and implicit expectations of governments and societies (often voiced via non-governmental organisations). In our model, risk management deals with management of impacts within the context of the **social contract of explicit expectations.** The informal, implicit and frontier expectations of the social contract are the subject of issues management**.**

Explicit expectations in relation to impact management can be legal or extralegal. Legal standards on social, environmental and financial accountabilities are provided by legislations of governments, directives of supranational bodies like the EU or supranational institutions like the WTO. Extralegal explicit expectations are shaped by guidelines from organisations like OECD, ILO, UNEP and UN Global Compact, covenants with governments or even strong demands from credible NGOs supported by public opinion.

Explicit expectations might vary from country to country and between continents, but with the emergence of the "global village", corporate activities which are in line with explicit expectations in one part of the world may be judged by the court of global public opinion and media from another more stringent set of criteria.

[1] Donaldson, T., and Dunfee, T.W. (1994). Toward a unified conception of business ethics: integrative social contracts theory. The Academy of Management Review, 19(2).

Risks are mostly inherent in the externalities of the business model and the business strategy and thus are at the heart of the company's existence. These exposures of the business model and business strategy can be life-threatening to any business.

Risk management is implemented by:

- Identifying negative impacts against the background of explicit expectations
- Understanding the liabilities and possible consequences (financial and reputational)
- Setting and continuously updating standards
- Managing compliance, assurance and control processes
- Crisis and response management (despite all of the above, something can/will go wrong)
- Communications management, transparency and media management

Business models consist of different parts and each part can carry specific risks. Typically, a business model defines the way the business creates, delivers and captures value. It consists of different parts (Al-Debei and Avison, 2010):

- The value proposition, i.e. the value created for customers (price, quality, service)
- The market segment and types of customers (sensitivity, political)
- The structure and span of the value chain from suppliers to customers
- The revenue-generating processes and systems (pricing, margin setting, exploitation of quasi-monopolistic positions)
- The position of the business in the value network or the "ecosystem" it forms part of, i.e. the vertically and horizontally extended value chain and relevant stakeholders

Consequently business models with different foci have different risks. For example, business models based on low cost and price leadership (e.g. Walmart, McDonald's and FedEx) are vulnerable in different ways compared to business models based on product leadership (e.g. Apple, Fidelity Investments, BMW and Pfizer), where the brand value is more at stake. Also different strategies have specific risks: Geographical expansion and new market development, for example, maybe risky, since companies start operating in new territories with unknown complexities in the social contract fabric and the political context, e.g. BP in Columbia, Google in China, Walmart in Mexico, Shell in Russia and GSK in South Africa.

Manifest risks can be analysed in terms of **their type** (like environmental, social, governance/political risks) and **the degree** which can be evaluated in a matrix of control and repercussions. The **areas** of risks are defined by the spans of

vertical and horizontal integration in the value chains and may be located in the supply chain, in the distribution chain (including product liabilities), in production facilities, in joint ventures, in mergers and acquisitions (hence importance of ESG due diligence) and in geographic and associated cultural risks in new markets.

Negative effects may be a combination of financial losses through costs, fines, litigation, share price erosion, market share losses, damage to reputation which increases transaction costs, diminished brand value which depresses margins and thus profitability, valuable management time spent on managing crises and the aftermaths instead of growing the business.

Underlying risks may be:

- **Managerial risks** like a too narrow short-term focus, ignorance of context of business, underestimating inherent risks in the business model and business strategies, legalism and defensiveness (or lack of proactive attitude) of management
- **Organisational risks** in organisational culture and structure, processes, systems and skills, top management driving challenging targets "whatever the costs" and middle management taking unsustainable pathways (e.g. Volkswagen emissions scandal)
- **Corporate governance risks** caused by boards not sufficiently overseeing a broad spectrum of risks in the business and the context of business and boards not questioning basic assumptions in business models and strategies and not critically questioning risk/return imbalances

Boards should be closely involved in overseeing risk management beyond the traditional concerns of financial and technical risks. This is not in the least because **regulatory risks** (governments imposing new legislation with costs of administration for companies and which might, in addition, not be effective) need to be mitigated by substantial voluntary industry sector-wide standards and practices. In order to achieve this, companies may want to assume industry sector leadership and/or establish market entry barriers for low-quality unsustainable operators. This may be tricky.

A newly emerging dimension of risk management is the growing integration of **sustainability risks into equity research** by asset managers and fund managers and the potential of future share value being risk adjusted accordingly. Boards should be alert to this new trend. (See the introduction in Chap. 2).

Boards should also seek assurances that **risk management and crisis management** capabilities are adequately provided for since total risk control at all times is not possible.

Example for risk management		
VIGEO CSR Risk Management Framework		
Business model risk areas	Standards against which impacts should be measured	Origins of explicit expectations
Human rights	4	
Human resources	5	OECD
Environment	6	UN
Business behaviour	3	ILO
Community relations	3	UNEP
Corporate governance	2	Global Compact

Source: VIGEO homepage http://www.vigeo.com/csr-rating-agency/en/methodologie

Human rights risks: prevention of violations, freedom of association, non-discrimination and child labour/forced labour

Human resources risks: labour relations, employee participation, restructurings, career management and employability, remuneration systems, safety and respect for working hours

Environmental risks: ecodesign, pollution, green products, biodiversity, water resources, impacts of energy use, atmospheric emissions, waste management, environmental nuisances, impacts of transport and product disposals

Risks related to business behaviour: product safety, customer info, contractual agreements, environmental and social factors in supply chains, corruption and anticompetitive practices

Community relations risks: socio-economic development, social impacts of products and contribution to good causes

Corporate governance risks: board performance, audits/internal controls, shareholder rights and executive remuneration

Part II Issues Management: Managing the "Responsibilities" of the Business

The second element of the model is an outside-in investigation of major trends in the immediate and wider business environment which may affect the business in the medium to long term. These **trends produce issues that exacerbate risks in the business model and the business strategy** or create new risks, thereby affecting the sustainability of the business model and strategy.

Issues management is concerned with the less formal, more implicit or even frontier expectations within social contracts. Issues management is therefore more fluid, much less predictable and more a matter of connectedness and feeling for context, judgement and opportunity assessment than straightforward analysis, standard setting and compliance management.

Major current issues such as a culture of systematic corruption, inequality, poverty, privacy, obesity, offshoring, access to medicines, resource depletion, forest destruction and climate change were not long ago widely considered to be **part of the responsibilities of governments and regulators and not the responsibility of business**. As these issues over time emerged, matured and became publicly associated with corporate responsibility, they have shifted an industry's ground rules and pose serious threats to the sustainability of the business.

However, these issues can create new market opportunities that nimble companies can identify and exploit for comparative advantage. Of course, there are first-mover business risks involved in incorporating emerging issues very early on in business models and strategies ahead of the competition, such as cost disadvantages. Thus, companies with a business model based on cost leadership and standardisation will be less keen. However, agile companies will nevertheless consider simultaneously the risks associated with lagging behind and becoming an icon of corporate irresponsibility and greed. Industry leaders are especially prone to becoming these icons.

Issues management deals with the continuously shifting grounds of *what is perceived* as the responsibilities of business by public opinion at large and specific stakeholders in particular. Issues management deals with the informal, implicit and frontier expectations of the social contract.

If issues are latent, like obesity or water depletion 15 years ago, a defensive attitude ("business cannot solve these problems, governments should") may not be damaging but alertness to the shifting grounds of perception may be necessary nevertheless. As issues emerge, positions need to be taken deliberately and managerial action is often required. At this stage, CSR departments are often tasked with **compliance management,** but this may not be sufficient. As Zadek describes in the Nike case, the issue of child labour was a type of collateral damage, an indirect effect of the business model, based on *just in time* supply policies and the remuneration policies for procurement staff. Imposing standards on suppliers by compliance officers sent by the CSR department was to no avail at first. Instead, the business model needed to be adapted. Corruption was long considered an unavoidable part of doing business, especially in developing markets. Corruption remains a challenging issue for companies and requires more than compliance management. Companies like Siemens learned the hard way that corrupt practices can be implicitly part of the business culture and business strategy and a significant overhaul of both is often required.

Issues might be linked to industry structures or even global trade conditions and again require much more exhaustive analysis and deliberate strategic action than compliance management by CSR departments. They require immediate and strong involvement of senior management and the board. In Nike's case, a global trade agreement within the WTO provided for supply quota per country in the global apparel industry. This well-intended policy (equal access to world markets) had

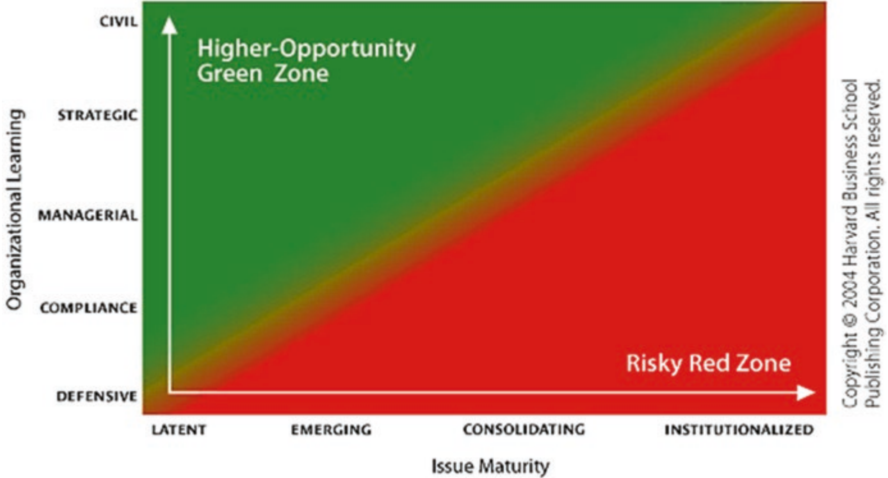
however unintended side effects which indirectly allowed child labour to persist. Companies like Nike had thousands of suppliers from many countries and found it impossible to control standards in the supply chain and concentrate on quality relations with fewer suppliers. Cooperation between the industry sector and the WTO was required to adapt trade agreements and avoid unintended consequences. Nike assumed industry leadership to help significantly in making this happen.

Companies like Walmart, McDonald's and Lidl enjoy low-cost supply conditions but have low margins in sales and distribution. Apparel brands such as Nike have of course a much more profitable business model, which is based on low cost in the supply chain *and* high margins in the sales and distribution chain. Returns, certainly without any investment in manufacturing and other assets, can be extraordinary. However, the rule often holds that considerably higher returns bear significant risks.

Many more companies, such as Apple, source from low-cost countries and sell at high brand premiums in developed markets. But such business models become threatened over time from both ends by emerging issues: the cost basis on the supply end and the brand damage which may erode margins at the distribution and marketing end.

The emerging and maturing issues of today are without a doubt climate change (especially since the COP21 Summit in December 2015) and environmental footprints in general, along with related issues such as erosion of water reserves, emissions testing and performance of automobiles. But other issues are also seemingly maturing, like inequality in general, access to medicines, corporate tax avoidance and tax competition between countries from which companies benefit, fugitives and migration and programmed obsolescence of electrical and electronic products. Executives might be tempted to be dismissive of corporate responsibility in these or only accept a small part of responsibility, but the bets are out on how long this defensive attitude can last and when it results in a "too little, too late" blame in the medium term or even short term.

Simon Zadek proposes an excellent model for use in the executive education classroom, which links issue maturity to the appropriate organisational response (see Zadek's chapter on Organisational Learning). Using the case of Nike in the 1990s, Zadek describes how companies go through an individual learning process and others can learn from its experience. He states that "Companies don't become model citizens overnight. Nike's metamorphosis from the poster child for irresponsibility to a leader in progressive practices reveals the five stages of organisational growth". Nike's business model of producing high-end consumer products in low-cost countries and selling in high-price markets is similar to that of many other companies. But under the pressure of activists, the company was forced to act. Zadek introduces five discernible stages of how companies handle corporate responsibility, relative to issue maturity. This is illustrated in the figure below and discussed in detail in the chapter.



Part III Stakeholder Management: Managing Competitiveness and Trust

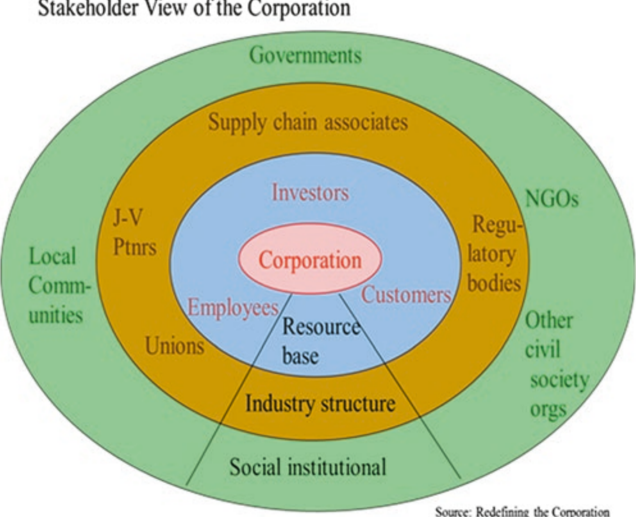
Business stakeholders are affected by the business while they also have an effect on it. The stakeholder view of the corporation allows for a clear view on all those groups and organisations with which the business is **interdependent** and which need to be closely monitored during management processes to provide checks and balances. The stakeholder view we introduce here is not opposed to a "shareholder view". Shareholders, investors at large, are also stakeholders themselves, albeit that they exert considerable powers via the financial markets and based on corporate law. But the considerable powers of other stakeholders work in different ways, often indirect and on different timescales. Moreover, stakeholders may be perceived as pulling the business in different directions, maybe ultimately tearing it apart and destroying it. The task of management is **to counteract the competing forces around common purpose and common interest**. At times, trade-offs and compromises need to be made, but more value can be created by finding new innovative solutions, new creative approaches that can go beyond pedestrian compromise.

The resource-based approach to business strategy considers all stakeholders to be sources of information and knowledge which can be key in gaining comparative advantage (Post, Preston & Sachs 2004). The entire relational capital with stakeholders can be leveraged for advantage. Furthermore, the capability to manage this and achieve **binding purpose with stakeholders is a key element of the set of capabilities that constitute comparative advantage**. This model distinguishes three types of stakeholders:

Resource base stakeholders such as investors, customers and employees.

Industry structure stakeholders such as suppliers, unions, joint venture partners and regulatory bodies. Even competitors can be seen as part of this group of stakeholders.

Social-institutional stakeholders such as governments, non-governmental organisations (NGOs), other civil society organisations and local communities.



The media including the press, TV, radio, Internet and social networks are giving voice to stakeholders but act sometimes as stakeholders in their own right. However, **stakeholders can be sources of both risk and opportunity**. A stakeholder management model of the business should distinguish between risk and opportunities with each stakeholder and manage these accordingly. Stakeholder management creates firm value by minimising risk and maximising opportunity in relationships with stakeholders.

Risks and opportunities provided by stakeholders may vary, and accordingly, different weightings of stakeholders should be undertaken. In knowledge-based industries, human resources carry more risks and opportunities compared to physical asset-based companies like oil companies, who in turn need to attach more risks to environmental activists and regulators. All stakeholders are important, but some more than others, depending on the industry sector and the specific business model and business strategy of the company.

Stakeholders of particular high risk but also of potential high opportunity are NGOs. Since the early 1990s, NGOs have been challenging companies more openly

for taking on their responsibilities towards society. This is particularly risky for companies with a home market in Europe and North America, with strong brand equity, scale and standardisation and with industry leadership status. According to Elkington and Fennel (1998), NGOs can have four roles in this regard (sharks, orcas, sea lions and dolphins) and each requires different risk-minimising and opportunity-enhancing strategies. Sharks and orcas tend to be confrontational and tend to polarise and act more (sharks) or less (orcas) by instinct and in groups. NGOs like Greenpeace, Friends of the Earth and Human Rights Watch would fall into these categories. Sea lions and dolphins on the other side are much more inclined towards co-operation. While sea lions would accept funding from companies and tend not to be very critical, dolphins see their independence as essential in a co-operation. NGOs like Oxfam, Caritas, Médecins Sans Frontières, Amnesty International and Save the Children can be fit into these categories. Many NGOs start out as sharks with confronting campaigns and as much distance from companies as possible. It is of high importance for companies to manage the different roles of NGOs carefully to mitigate the risk but also find opportunities to collaborate.

Typology of NGOs

	Polariser	Integrator
Discriminator	ORCA Scrutinises relative performance and attacks selected targets	DOLPHIN Scrutinises relative performance and selects appropriate partners
Non-discriminator	SHARK Ignores relative performance and attacks most targets	SEA LION Ignores relative performance and works with anyone

Source: John Elkington, unpublished

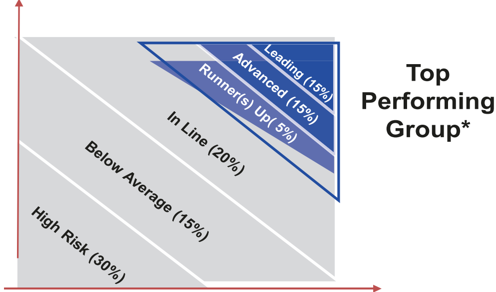
In sum, stakeholder management is a vital part of managing a sustainable business. This is also recognised by sustainable asset managers and, increasingly, mainstream asset and fund managers in the financial services industry, who evaluate each company on risks and opportunities both in the business exposure to sustainability trends and in stakeholder relationships. This is commercially sensitive information which is not published. But the authors of this chapter have been deeply involved in the development of such assessment models for asset management firms. In these models, the quality of stakeholder relationships is an important part of the assessment and makes up for 50% of the assessment rating.

Here is an example of such a model.

Sustainable Business Analysis

Assessment of companies within industry sector

Macro: exposure to key sustainability challenges and associated risk/opportunity management



Micro: quality of stakeholder relationships

- ***The top 15% are the most attractive group for investors in sustainable businesses. The bottom 45% are considered as of considerable risk by main stream asset managers. Their future financial performance outlook and asset valuation will likely be risk adjusted downwards.**

(Generic model drawn from work by ABIS in cooperation with Dexia Asset Management, not published)

Stakeholder management provides the method and channels for encompassing Risk Management (Part I) and Issues Management (Part II). Risks and issues are better managed with a smart and credible stakeholder strategy and implementation.

Leading companies like Johnson & Johnson, Novartis, Orange, IKEA, BMW and many more have implemented stakeholder-based business principles. These companies define risks and opportunities with each stakeholder and develop and evaluate key performance indicators and expectations from relationships with each stakeholder. They consistently build knowledge resources and social capital. They are keenly aware of risks from impacts/externalities and of emerging issues and proactively manage these with stakeholders. Stakeholder management becomes in this way the management model of the business.

In the past, some companies bought into a very different narrative, the so-called shareholder value model, which became fashionable in the mid-1990s. Today, the consequences of this are still being felt, not least since the banking crisis of 2008. The practices that were inspired by this model paradoxically but not surprisingly destroyed shareholder value on a massive scale. Already in 2004, John Kay, then dean of Oxford University's Said Business School, predicted:

> The financial pre-occupation of many companies have rather eroded, not enhanced competitive advantage. It diverts management attention from sustainable value creation. The Shareholder Model, solely focussed on profit maximisation and share performance, is typi-

> cally not successful, even on its own terms and has undermined the legitimacy and stability of the market economy. It will end up destroying the very shareholder value it proclaims to defend and grow.[2]

And so, unfortunately, it happened as predicted by John Kay with companies like Daimler Benz, Marks & Spencer, Vodafone and others. Shareholders, customers, staff, suppliers and other stakeholders paid dearly for the aberration Kay denounced in a radical way as "unfit for wealth creation in free markets". It took these companies often more than a decade to turn themselves around with new management, renewed business purpose and renewed attention to value creation with stakeholders and ultimately for shareholders.

Part IV Strategic Differentiation: Creating Comparative Advantage

A seminal contribution in strategy was Michael E. Porter's *five forces model* (1980) which profoundly influenced the thinking of researchers and practitioners in business strategy around the world since the 1980s. In essence, Porter argued from a rather external, industry-based perspective that the goal of the strategist is to understand and cope not only with competition but with customers, suppliers, potential entrants and, inevitably, also substitute products. These five forces define an industry's structure and shape the nature of competitive interaction within any industry sector.

Originally Porter was sceptical about social issues affecting business, but he started to integrate the idea of sustainable business in his strategy model, recognising that ESG issues form part of the competitive context in the medium and long term. His concept of *shared value* is the vehicle for this, which was first published with Mark Kramer in the Harvard Business Review in 2006. In this book, we republished the subsequent publication in 2011, again with Mark Kramer, which expands further on their **core thesis of CSV (creating shared value): that businesses can create economic value *and* value for society in mutually beneficial ways, that this creates comparative advantage for the business and that the value for stakeholders and society is more sustainable since it is underpinned with economic fundamentals.**

In an interview in 2013 with Gerard Baker, editor-in-chief of the *Wall Street Journal*[3], Porter famously made a plea "to open our thinking for creating economic value by addressing social issues". He compared what companies like Nestlé and Illycaffè are doing as examples of CSV with the fair trade approach, which is for Porter an example of CSR. Fair trade asks for a contribution from consumers in order for coffee farmers to be paid a fair price for their crops. This is aimed at the

[2] John Kay in keynote speech to EABIS colloquium 2004 at Vlerick Business School.

[3] http://unfold.tetrapak.com/research-and-reports/michael-porter-on-how-new-business-models-can-create-shared-value

ethical consumer segment which is limited in size and volatile when consumer priorities change. Instead, Illy pioneered a restructuring of the supply chain by cutting costs and investing in the skills and knowledge of farmers to produce higher-quality coffee (see Illy case study in this book). As a result, the farmers' income went up considerably and this was based on economic fundamentals, whereas in the case of fair trade, it was dependent on the goodwill of consumers. At the same time, Illy strengthened its competitive advantage by ensuring access to high-quality supplies in a sustainable way.

A growing number of noteworthy global companies (Nestle, Coca-Cola, Johnson & Johnson, IBM, Umicore, General Electric, Unilever, GSK and others) have already embraced the shared value concept through three sets of strategies:

1. **Reconceiving products and services** to better meet social and environmental needs in a profitable way
2. **Redefining productivity in the value chain** to make more efficient and more sustainable use of human and material resources, both in the supply and distribution chain
3. **Local cluster development**

They also strive for forming partnerships including NGOs who become partners instead of adversaries. Local NGOs are often very well placed to take over certain roles in the value chain, e.g. ensuring that medicines, provided by pharmaceutical companies at discount prices, find their way to the patients instead of into the black market.

Despite some irrefutable examples of companies, across many industries, benefitting from implementing shared value strategies, there still remain some lingering "yes, but" cautionary sentiments. Some fear that the consequences of shared value practices have not been fully explored and all the implications might not have been fully considered.

Furthermore, stakeholder pressure may force companies to become a more sustainable business, but it does not necessarily follow that the company or its marketplace will actually become more sustainable. An example is Hydro Polymers Limited, a division of Norsk Hydro ASA, which dramatically changed its strategy due to outside pressure from Greenpeace activists. However, the rest of the industry questioned Hydro Polymers' motivation to commit to a more sustainable solution. Moreover, China had become a major producer PVC often using environmentally unfriendly technologies. Chinese PVC is, not surprisingly, much cheaper. If European regulators do not prohibit the importation of "Made in China PVC", the question remains whether the end users will demand a shared value with a more sustainable solution such as offered by Hydro Polymers or prefer to purchase the Chinese PVC at the lower price.

The Value of "Creating Shared Value" Contested

In their critique of Porter's and Kramer's concept of *creating shared value (CSV)*, Crane and co-authors acknowledge the popularity that the concept has gained in the business and academic literature[4], its role in advancing social goals to strategic levels and its articulation of a clear government role in responsible behaviour and that it adds rigour to ideas like "conscious capitalism". At the same time, the authors also state several shortcomings: (1) the concept is unoriginal, (2) it ignores the tensions inherent to responsible business activity, (3) it is naive about business compliance and (4) it is based on a shallow conception of the corporation's role in society (Crane et al 2014). We appreciate the criticisms (*in italics*) and provide counterarguments for each, in defence of Porter, as follows:

1. *Porter and Kramer claim that the CSV concept is a novelty while at the same time it bears similarity to existing concepts of CSR, stakeholder management and social innovation.*

   Porter and Kramer integrate some dimensions of these concepts indeed but package them in a model and a language which is understood by managers. More importantly, they do not start from societal issues and how companies should be held "responsible", which results in CSR programmes. Porter follows an entirely different logic: he asks how corporate strategy can embrace ESG issues to make the business more sustainable. He sees ESG issues as strategic opportunities for the business and not as normative imperatives.
2. *Many corporate decisions that are related to social and environmental problems do not present themselves as potential win-wins but rather as dilemmas. When faced with a dilemma, world views, identities, interests and values collide and Porter doesn't address the tensions between social and economic goals; instead, he only sees "win-wins".*

   But Porter never claimed that all solutions can be "win-wins". However, he suggests, similarly to Ed Freeman, the founder of stakeholder theory, that when confronted with conflicts between economic and social goals, managers should not complacently seek for compromises and trade-offs or pursue one at the expense of the other. Instead, these conflicts should be seen as potential sources of innovation, delivering solutions that may achieve both economic and social goals. Sustainable business and sustainable economic and social development will require substantial innovations.
3. *Furthermore, the examples they provide might be pioneers in some aspects of their operations while, at the same time, being criticised for harmful effects of their products.*

   The reality is very simply that companies like Nestlé get it right in some areas of their value chain while not in other parts (yet) and should be encouraged indeed to practise continuous improvement. If Nestlé uses Porter (who is a

[4] Crane, Andrew, Palazzo Guido, Spence Laura, Matten, Dirk, Contesting the Value of Shared Value, California Management Review, vol 56/2, Winter 2014.

member of the board) and CSV to "greenwash" its more controversial parts of the business, it should be criticised for this. But this does not diminish the value of CSV itself.

4. *According to critics, research shows that initiatives with the goal of promoting sustainability for social and environmental gains only survive in economic terms, ensuring longevity of quality supply for the purchasing company over social and environmental needs of consumers or suppliers.* There are indeed examples where a CSV initiative proved not sustainable, but to generalise from this is short sighted.
5. *Despite the ambitious approach to reshape capitalism, CSV doesn't address the deep-rooted problems that are at the centre of capitalism's legitimacy crisis. Porter's own model of competitive strategy would need to be overturned.*

   Reforming capitalism is a big subject indeed and the claim that CSV is the panacea to this is indeed an exaggerated claim. The incomplete and unfinished reform and governance of financial markets that induce notorious short-termism seems more important. Business needs to pursue profitability and competitiveness within clear frameworks of fair play, transparency and the rule of law and with a perspective of long-term value creation. CSV alone will not restore the legitimacy of capitalism but it might be a major contribution to it.

   Porter and Kramer's main contribution is to have coined a concept which managers can embrace and which connects with their mindset, more than any other concept on sustainable business. It serves the purpose of advancing the mainstreaming of sustainable business as a concept for business generally and for silencing the diehards of the old school who refuse to accept any important role business can or should play in sustainable development. But of course it is not a panacea. We publish a response to Porter which gives a thoughtful commentary on the importance of a normative motivation for managers to protect the integrity of their actions in applying CSV. (See Chap. 17).

Part V Business Model Innovation and Transformation

Sustainable development with significantly reduced environmental and social impacts is a formidable challenge for business of formidable magnitude, requiring significant transformations in business models and industry structures, sooner for some, later (but inevitable) for others. It will have revolutionising effects comparable to the effects of the consumer revolution of the 1980s and the IT revolution which started at the end of the last century, when all businesses and industry sectors underwent deep transformations. Reports by the World Business Council for Sustainable Development (WBCSD 2010), with membership of over 60 major global firms, outline the challenges to come for the next 20 years. Clearly, as with previous transformations, there will be winners and losers of these developments.

Sustainable business needs to adopt business models that can sustain this transformation, capitalise on it and create competitive edges in the wake of it. This likely requires deep business model innovations.

Many managers consider the business model they are operating in as a given, the best or even the only way to be profitable in a particular industry sector. However, there are very different business models to choose from in a given industry. To begin with, there are three generic value propositions:

Operational Excellence by cost leadership, e.g. in oil exploration (Shell, BP), food chains (Mc Donald's) and retail (Walmart, H&M)

Product-Service Leadership by product development, innovation and branding, e.g. in footwear (Nike), pharmaceutical (Merck, GSK) and ITC (Google, Apple, Microsoft)

Total Customer Solutions by delivering complete solutions by integrated projects, e.g. IBM Smarter Planet, Energy Solutions Companies (EON) and Private Banks (ING)

These different value propositions might exist in the same industry. In the solar power industry, three value propositions and associated business models exist:

Operational Excellence by production and distribution of standard cost competitive solar panels

Product-Service Leadership by development, installation and maintenance of technological advanced solar systems or hybrid systems branded for high performance even under weak sunlight conditions

Total Customer Solutions by conceiving and realising customised and co-created energy provisions where no electric grid is available, including extending provisions for health care, schooling and agriculture, generally in partnerships with NGOs

These business models are not necessarily competing with each other. These are different ways of creating, delivering and capturing value in one industry. Similarly, in the IT industry, there are different business models to be found. Apple, Google, IBM, Microsoft and Lenovo not only have different value propositions to their customers. The entire business models behind their propositions are very different.

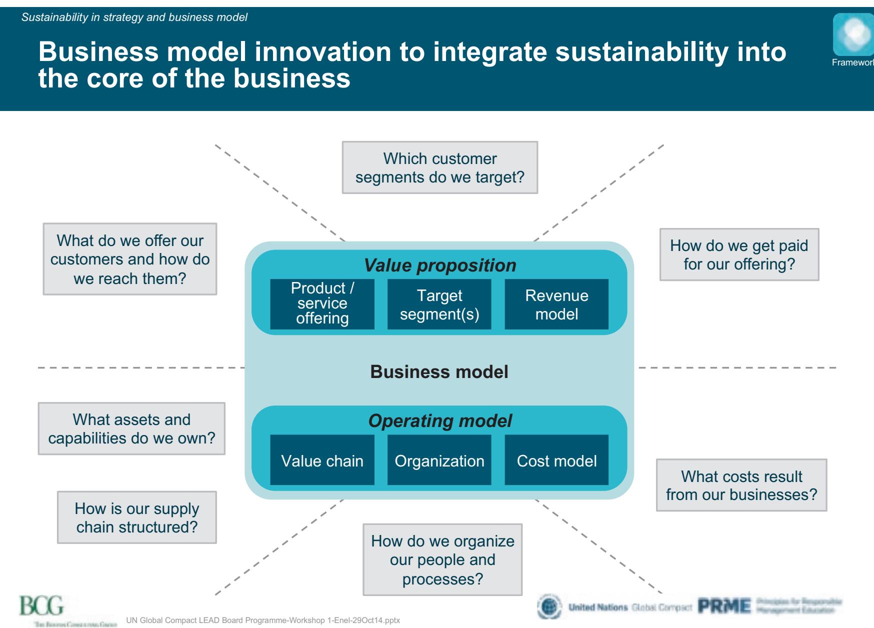
In addition to innovations in products, services and processes, as discussed in the previous chapter, business can create competitive advantage or avoid erosion of current, often highly profitable market positions by exploring new business models.

IBM realised that its PC business would over time not be able to compete with Chinese market entrants and sold the business to a Chinese newcomer Lenovo at a time when the market value of the PC business was still high. IBM moved up the value chain into a Total Customer Solution value proposition with the *Smarter Planet initiative* and a business operating model behind it which is significantly different (see Chap. 25). IBM thus positions itself in the sustainability transformation with an innovative business model.

BP Solarex was a market leader in the solar industry in 2000. It scaled back its business model to a pure Operational Excellence proposition (manufacturing and distributing solar panels), inspired by the idea of focusing on "core competences",

a fashion already on its way out. Experiments with Total Customer Solutions as described above were halted and abolished. Ten years later, BP was forced to close most manufacturing facilities at high cost in the face of stiff cost competition from China. In 2000, BP would have been able to sell these facilities at considerable market value and move up the value chain. In 2010, it was too late.

Particular interest should be paid to business model innovation for sustainability. The Boston Consulting Group has developed the following generic model:



Business model innovation may be focused on the industry sector model, the entrepreneurial model or the financial model. These three dimensions of the business model are discrete, but they may be interdependent.

The industry sector model: Business model innovation changes the entire industry: Google, IBM and Dell.

The entrepreneurial model: Business model innovation changes the value chain in major ways: Umicore, Illy and IPOed Batteries. In this last case, a move to focus on core competencies in materials development was complemented by creating a network of partnerships and outsourced activities.

The financial model: Business model innovation creates entirely new pricing models: eBay and Apple's iPod.

There are seven key questions about business model innovation[5]:

1. Which current needs will the business model address—or which new needs will it create?
2. Which innovative activities can create value by meeting these needs?
3. How can these activities be linked in innovative ways?
4. Who will perform which activities and which innovative governance will be needed?
5. How will value be created and delivered for each stakeholder?
6. How can value be co-created by engagement with the communities?
7. Which revenue models will make the business model sustainable?

Business model innovation is *neither* about minor changes to the business model to capture easy gains in costs and efficiency nor about a compliance-driven adaptation to gradually minimise negative impacts.

Business model transformations for sustainability have specific requirements in terms of significantly enhanced social and environmental positive impacts. SustainAbility's 2014 report on business model transformation for sustainability (see Chap. 22) describes 20 business model innovations for sustainability in five categories:

Environmental impact
Social impact
Financial innovation
Base of the pyramid
Diverse impact

Nigel Roome, a major contributor to the theory and practice of business model innovation for sustainability, and Céline Louche explain the key characteristics of a business model for sustainability as describing, analysing, managing and communicating:

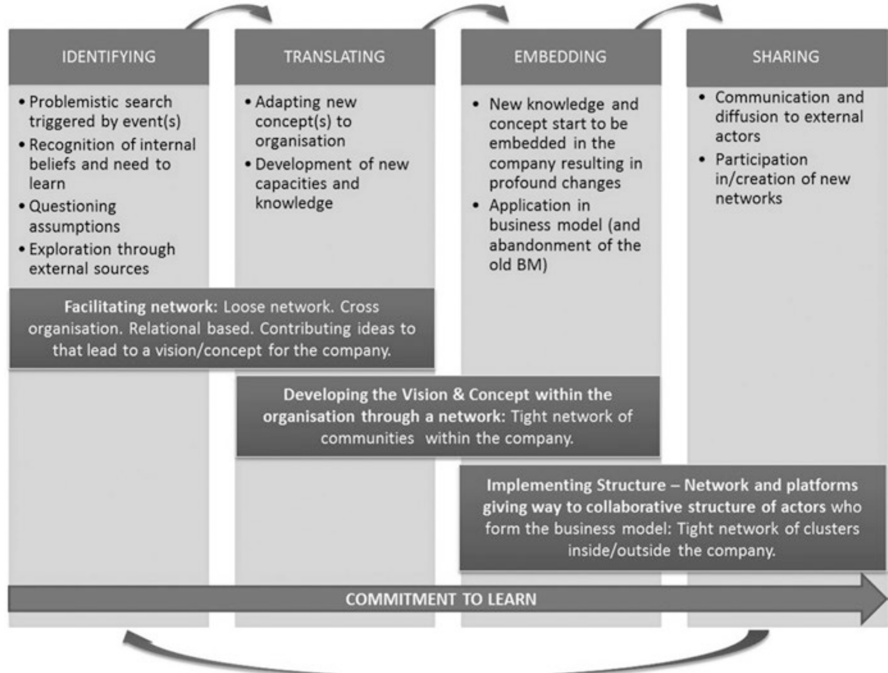
(i) A company's sustainable value proposition to its customers and all other stakeholders
(ii) How it creates and delivers this value
(iii) How it captures economic value while maintaining or regenerating natural, social and economic capital beyond its organisational boundaries

Furthermore, they argue that sustainable value for customers and shareholders can only be created by creating value to a broader range of stakeholders. A business is embedded in a stakeholder network and—in spite of the fact that a business model is a market-oriented approach—particularly a business that contributes to

[5] Raphael Amit and Christoph Zott, "Creating Value through Business Model Innovation" in MIT Sloan Management Review March 2012.

sustainable development needs to create value to the whole range of stakeholders and the natural environment, beyond customers and shareholders.

Based on a study and analysis of companies undertaking business model innovation, Roome and Louche developed the following model to describe the four connected phases (identifying, translating, embedding and sharing) for business model innovation for sustainability:



Roome and Louche page 30 (Nigel Roome and Céline Louche, "Journeying Toward Business Models for Sustainability: A Conceptual Model Found Inside the Black Box of Organisational Transformation" in the journal *Organization & Environment*, Special Issue "Business models for Sustainability: Entrepreneurship, Innovation and Transformation, volume 29 number1 March 2016 (guest editors: Stefan Schaltegger, Erik Hansen and Florian Lüdeke-Freund), Online: http://oae.sagepub.com/content/29/1.toc)

Part VI Managing Change: Developing Dynamic Capabilities and HR Talent

In response to Michael Porter's external industry structure perspective on strategy, Jay Barney (1991) developed a resource-based view focusing on internal resources. This model criticised the basic assumption behind the industry-based view, i.e. that firms have the same resources or the same access to resources to implement strategies. This assumption ignores the company's resources heterogeneity, and mobility,

as possible sources of competitive advantage. He observed that businesses develop strong competitive positions based on various resources including all assets, capabilities, organisational processes, corporate attributes, information and knowledge that enable the firm to develop and implement strategies which are designed improve its competitiveness.

Porter's five forces framework, which applied the structure-performance paradigm of industrial organisation economics to strategy, focused on evaluating suppliers, customers and the threat of new entrants and/or substitute products. This framework is still valid to a certain extent, but it does not succeed in revealing the dominant logic of value capture in newer industries and in newer fields like sustainability. This dominant logic is now recognised to be the way businesses develop core resources which are unique, rare and difficult to imitate and by definition take a long time to grow and materialise.

Core resources include **knowledge** (including manifest and tacit understanding of the dynamics of markets and social contracts), **relationships** (unique relationships with all stakeholders in the value chain and in the economic, social and political context of the business), **capabilities** (managerial, HR talent and organisational resources) and **purpose** (encompasses the basic values and beliefs shared with stakeholders and the distinctive contribution of the business to the wellbeing of stakeholders).

An overarching resource for comparative advantage is called "dynamic capability". This is the capability of the organisation for purposefully creating, extending and modifying the resource base of the business, by building, integrating and reconfiguring internal and external competences to respond to rapidly changing environments and contexts, not in the least the social, political and environmental context.

Dynamic capabilities are distinct from operational capabilities (which are based on current competencies), and it goes well beyond the popular concept of "core competencies". The demise of companies like Kodak and Nokia demonstrated the limitations of the latter.

Success of today is the greatest enemy of tomorrow's success, Peter Drucker is supposed to have said (although the quote cannot be traced). So a key question follows from this: **how can executives of currently successful companies change their existing mental models and paradigms to adapt to radical and often disruptive change to come, not in the least in the face of the sustainability transformation.**

The main dilemma in the practice of management is to make the best of existing resources yet at the same time grasp the ongoing depreciation of this resource base.

The concept of dynamic capabilities, especially understood in terms of organisational knowledge processes and management culture, is a predominant concept to explain the significant competitive advantages of firms across a wide range of industries like Apple, IBM, BMW and Johnson & Johnson.

Organisations and their staff need the capability and agility to learn quickly and to build strategic knowledge assets and integrate these into business processes. This

means effectively developing capacities to sense and shape opportunities and threats, to seize opportunities and to maintain competitiveness through enhancing, combining, protecting and, when necessary, **reconfiguring the business intangible and tangible asset base.**

"Path dependency" is a term which refers to the natural reliance of organisations and managers to continue thinking and acting in patterns that evolved over time in the history of the business and the industry sector. Path dependency is a particular impediment for managers and organisations in responding to discontinuous ongoing change.

Dynamic capability is an extended paradigm explaining how competitive advantage is gained and held. Firms resorting to resource-based strategy attempt to accumulate valuable technology assets and employ an aggressive intellectual property stance. However, winners in the global marketplace have been firms demonstrating timely responsiveness and rapid and flexible product innovation, along with the management capability to effectively coordinate and redeploy internal and external competences. The sustainability transformation will require a formidable range of dynamic capabilities sizing two aspects. First, it refers to the shifting character of the environment; second, it emphasises the key role of strategic management in appropriately adapting, integrating and reconfiguring internal and external organisational skills, resources and functional competences towards changing environment.

It is often said that there is nothing more practical than a good theory. One could even slightly exaggerate and claim that there is nothing but theory, since practice is effectively only theory-in-use. John Maynard Keynes shocked politicians and business executives alike when he claimed:

> Practical men who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back.

Leaving exaggeration aside, the concept of dynamic capabilities challenges managers to question their assumptions, theories, models and beliefs, in other words, their theories in use which fashion and inform their actions. Some executives are still complacent about the formidable challenge of managing sustainable business and sustainable development. They find it difficult to grasp the full and complex picture of business and its context. They are maybe likely to get away with it for some time, but their businesses will inevitably not belong to the winners in the global economy of tomorrow.

The sustainability revolution is unfolding as one of the great transformations in global business and of a much bigger and deeper scale than the consumer revolution or the IT revolution. Since the world has embraced in Paris the idea that a zero carbon emissions economy will be the inevitable goal to be reached sometime this century, rather sooner than later, most certainties, business models, recipes for success and other beaten paths will become redundant. Businesses with the greatest reservoir of dynamic capability will be the winners in the global marketplace by

disruptive innovation, radical self-invention and relentless development of new talent.

One of the key questions "what new talent is needed to enhance the dynamic capability of the business for the sustainability transformation?" is still unresolved. Matthew Gitsham (in Chap. 31) explores this question through interviews with global CEOs, leading academics and consultants. He has clustered these talents around three poles: talents required related to grasping **context, complexity and connectedness.** These largely cognitive talents will need to be complemented by some new character traits such as curiosity and ongoing questioning, systems "feeling" and empathy, courageousness in trespassing boundaries and challenging the status quo. This will require a major departure from a CEO culture of potent self-assurance, unquestionable certainty bordering on arrogance, linear pursuit of single-minded goals and defensiveness of extant assumptions.

Participants in EMBA programmes and in programmes of executive education at large form the talent pool from which the leaders will emerge to steer businesses through the sustainability transformation which is unfolding. Their deep immersion into sustainability risk management, issues management, stakeholder management, strategic differentiation with new sustainable value propositions, business model innovation capitalising on sustainability opportunities and fostering dynamic capabilities for sustainable business development is a must if one takes the future seriously.

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Joris-Johann Lenssen

Introduction, Justification and Outline[1]

Gilbert G. Lenssen

Justification and Objectives of This Book

Over the last 10 years or so, directors of executive education, EMBA and MBA programmes have been seeking to integrate "something about business ethics, CSR or sustainability" into their programmes. While these subjects are usually optional courses in the MBA curriculum, Exec Ed and EMBA programmes increasingly feature mandatory modules in this field.

Clearly market pressures are pushing for a faster integration at the Exec Ed level. We know of many companies exerting pressure in governing bodies of business schools, such that the dean and faculty finally come to terms with the urgent necessity of paying serious attention to the wider responsibilities of the firm, its impacts on society and the environment, its role in countries with weak governance and more.

Craig Smith as the lead editor and myself published *Mainstreaming Corporate Responsibility* in 2009. It was primarily intended to support professors in strategy, accounting, marketing, economics and operations management—all the core subjects of the MBA curriculum—in integrating ESG (environmental, social, governance) issues into their courses with appropriate texts and cases.

This new book in front of you is addressed primarily at the EMBA level and Exec Ed programmes, and, as such, it is not organised by the classical MBA subjects. Instead, it follows the rationale of the business manager—how she/he gets confronted with sustainability challenges and how he/she and his/her organisation builds ways and means for addressing them in a practical way, yet also with methodological rigour.

We are steering clear of the term "CSR" as much as we can in this book. The term seems to be controversial with managers. CSR is often seen as the remit of the

[1] We want to acknowledge the editorial and academic support by Dr Ludwig Roger for his dedication and expertise and for keeping us, editors, on track through a process that lasted 3 years.

CSR department (and not of line management) to deal with. It is seen as rather a tactical or defensive activity or at worst a PR exercise, rightly or wrongly associated with "doing good" or philanthropy. The reasons for the controversy are manifold and often not entirely justified. However, we wish stay clear of these misunderstandings.

The subject of sustainable business stretches, in the mind of the manager, far beyond challenges of social responsibility and includes concerns about risk management in relation to externalities, strategic issues management as social trends emerge, seeking competitive advantage and transforming business models with sustainability issues, broad-based strategy generation and implementation through stakeholder management.

All these concerns are instrumental in nature driven by the pressures of markets, societies and governmental and non-governmental organisations or inspired by long-term aspirations to claim industry leadership and seek first-mover advantages or simply to be recognised among the globally most excellent companies. These companies, it is assumed, attract more easily top talent and are more trusted by regulators, partners and customers, which can substantially reduce transaction costs.

Michael Porter defined competitive advantage as dependent on the position of the firm in the value chain and on how it deals with the five forces that define the industry structure. However, it is now easily recognised by managers that no matter how important the position of the company in the value chain and in the industry structure, the long-lasting advantages of the firm are to be found in the intangible resources which can be leveraged beyond the industry structure. These intangible resources are embedded in **knowledge, relationships, capabilities and binding purpose**, which can be leveraged for creating value with all stakeholders.

There is, of course, a whole body of research and a school of resource-based strategic reasoning to support this, but managers come to this conclusion purely based on their observation and experiential knowledge and find the ongoing academic divide on the best way to create competitive advantage rather irrelevant. An industry sector view and a resource-based view are perceived to be complementary by managers.

Many managers find also that opposing shareholder value to stakeholder value is maybe of theoretical significance, but not of much practical significance and a misleading way of painting managerial realities. Both pressures are continuously invading processes of managerial decision making, and opposing these from the outset hinders a clear focus on long-term value creation. In other words, opposing stakeholder value to shareholder value may provoke the unintended opposite effect.

The cliché that the pursuit of profit is most of the time opposed to "responsible behaviour" does not resonate with the new generation of managers who are coming to Exec Ed programmes. They have a more balanced outlook and consider these oppositions as abstractions or even aberrations of the real-life world of management.

Of course many (top) executives are driven by power, ego and financial gain, but in my observation, most are driven by a strong nonfinancial performance aspiration. This is key for understanding managerial behaviour.

This performance aspiration is not primarily focused on financial performance but rather shaped by the desire to achieve challenging goals, to rise above conflicting agendas, to solve difficult problems and to be seen as smart by accomplishing what others find impossible to achieve. It is easy to see how this perception of managerial motivation can be conducive for facilitating learning on sustainable business. There is therefore no need for moral teaching and telling managers to be more responsible. This is generally not effective anyway.

However, the desire to be seen as smart by doing the nearly impossible does have flipsides, as the recent emissions scandal surrounding Volkswagen has clearly demonstrated. Therefore, this book pleads for an approach of developing *practical wisdom* in the subject of sustainable business by:

Starting from practical real-life concerns instead of theoretical concerns and recognising profit seeking as a natural and primordial drive for managers and businesses

Subscribing to the position that the business of business is profitable business indeed, but with the critical question of what makes business profitability sustainable

Providing texts to provoke critical thinking and critical debate on how to achieve sustainable profitability

Providing cases that are as close to the business reality and complexity as possible, where the link between financial and nonfinancial performance issues is always present

Building up a rationale for a step-by-step learning process in six different stages:

Risk management
Issues management
Stakeholder management
Creating competitive advantage
Fostering innovation and transformation
Building organisational capabilities

There is currently high interest from the corporate world in what makes a sustainable business and the large majority of participants of Exec Ed programmes and the EMBA see the subject as integral to their development and further learning. We hope we have provided a book that can help to respond to these expectations.

Managing Sustainable Business: An Introduction

What is meant by the term "sustainable business"? If one asks managers what they understand by the term—and this can be a good topic for an opening debate in an EMBA class—one typically gets the following responses:

- A business that is well managed for the long term
- A business with a robust business model, a prudent financial model and highly developed value propositions for customers and all other stakeholders

- A business that can anticipate or respond flexibly to sudden changes in the business environment, including the social and political environment
- A business that is capable of transforming its business model in the face of irreversible deep changes in markets and in the expectations of society
- A business that commands respect and trust
- A business which is aware of the contexts it operates in and the shifting requirements of these contexts

One can identify a generic use of the word "sustainable" in the sense of lasting, robust, long-term oriented, which encompasses the entire business. Most managers sense that their business should stay clear of opportunistic, high risk, short-term-driven motives determined by profit maximisation only. They have seen the spectacular failures of this approach in the past with respected companies like Daimler Benz, Marks & Spencer, Citigroup and others, whose managers abandoned pride and purpose for power and stock options and in the end almost ruined their company and destroyed shareholder value on a massive scale. These concerns are about *corporate sustainability*.

At the same time, managers associate *sustainable business* with *sustainability*, which is a term that can be traced to the Brundtland Report (*Our Common Future*, 1987) on *sustainable development* and refers to accountability of the company for its impacts.

Managers recognise that managing impacts and issues (economic, social, ethical, political, environmental) is often ignored in mainstream courses on strategy and business environment in EMBA programmes. However, managing impacts and issues is but a part of the entire challenge of sustainable business. Excelling in sustainable HR and talent management, sustainable finance, sustainable marketing, sustainable expansion into new markets, needs to be part of an overall approach to sustainable business. Effective stakeholder management, innovation and developing dynamic capabilities are key in this broad based approach. (See Parts III, IV, V and VI).

Sustainable Business: An Outline

Given the above assumptions of managers and our reflections, we can attempt to outline an agenda for sustainable business:

- *A sustainable business is highly responsive to the demands and challenges of both markets and societies.*
- *It optimises competitiveness as well as legitimacy and mutually beneficial relationships with key stakeholders by constantly adapting and renewing its value propositions through its portfolio of products, services, brand positioning and communications.*
- *It also pays attention to the long-term shifts in the political, social and ecological environment on which it depends for its resources.*

- *It is concerned about its reputational capital and the trust (social capital) it needs to keep transaction costs low and to benefit from a favourable licence to operate.*

Managing sustainable business has become increasingly complex. There are several causes:

Globalisation has heralded new opportunities for companies but also causes new complexities in global supply chains, global competition, cross-cultural complexities and clashes of values and norms, weak governance environments, challenges to the power and legitimacy of big business and anti-globalisation movements.

The ICT revolution has transformed the way business is done and managed, but it has also made the global critical village possible. Global interconnectedness makes news travel fast and endangers reputational capital by sound-bite-driven media. Social, environmental and political issues can emerge and spread quickly and pose risks as well as opportunities for nimble companies.

Macro trends such as climate change, resource depletion, environmental depletion, demographic change, geopolitical change, talent shortages and increasing rich-poor divides between and within societies affect business models in the medium to long term and create new winners and losers.

This affects all business functions: procurement, marketing, finance, accounting, human resource management, product development and R&D. It will also affect the economics of the business models and the valuation of equities through risk assessment and risk mitigation and will change the competitive context of entire industries by the bets companies are likely to make to take advantage of changing circumstances.

The challenges to the governance of the firm are thus formidable, not in the least because investors are looking increasingly at the sustainability risks and opportunities underlying the business model and the long-term strategy of companies. Firms are well advised to take a strategic approach to these challenges in order to identify threats and opportunities as well as their strengths and weaknesses.

Resources need to be allocated, capabilities need to be developed and new knowledge needs to be harnessed. This requires sound judgement beyond normative rhetoric on leadership and corporate responsibility.

The normative rhetoric which is so pervasively used by activists within and outside the business schools is a serious impediment for mainstreaming the sustainable business agenda in executive education and executive practice, since this does not connect with the life world of executives and at best leads to tactical responses to activists' demands.

On the other side, some CEOs might be posturing and paying lip service to the "urgent needs" of "concerted action" and the "transformational change required" but fail to lead and manage change internally, not in the least because management development for sustainable development is not adequate and because only a limited number of business schools seem capable of supporting this.

A Managerial Framework for Sustainable Business

Fundamental in this framework is the understanding of business imbedded in its context.

1. Risk Management: Managing the Accountabilities of Business
   Knowledge management of inside-out impacts of the business model and the business strategy and managing accountabilities for impacts (externalities) in shifting social contract environments
2. Issues Management: Managing the "Responsibilities" of Business
   Knowledge management of outside-in impacts of new issues from the business environment on the business and adopting appropriate organisational responses for latent, emerging and maturing issues of "corporate responsibility"
3. Stakeholder Management: Managing Competitiveness and Trust
   Identifying, prioritising and weighing importance of key stakeholders and managing relationships as key resources for comparative advantage
4. Strategic Differentiation: Creating Competitive Advantage
   Developing sustainability value propositions to markets and stakeholders, including reconceiving products and services, redefining productivity in the value chain and developing partnerships
5. Innovation and Business Model Transformation: Taking Great Leaps Forward
   Identifying and entering market spaces with high sustainable value and transforming business models and capabilities to capitalise on emerging market value
6. Managing Change: Developing Dynamic Capabilities and Managerial Talents
   Developing organisational capabilities and managerial knowledge, skills and mindsets for sustainable business

Closing Reflection

A final reflection in this introduction concerns the instrumental/strategic versus the moral/normative case for sustainable business. My co-author Craig Smith who is an eminent professor of CSR and business ethics at INSEAD and I have had long debates on this, and we come from different perspectives. However, in the end we concluded that the opposition between both perspectives may be false and that they are rather complementary.

A purely strategic approach without any moral compass may not be sustainable since it may appear to stakeholders as not entirely sincere and trustworthy. A normative approach without strategic business underpinning may appear to shareholders as naive, unrealistic and a moral luxury and fall victim to the next round of cost-cutting.

But a normative framework like the UN Global Compact on Sustainable Business seems the minimum indispensable requirement.

We agreed that win-win solutions may not be possible all the time and that trade-offs made by managers in favour of short-term profits will be difficult to resist or avoid but should be criticised nevertheless.

In any case, the question whether sustainability is part of business ethics or rather that addressing ethical issues is part of sustainable business in a very "academic" question indeed.

I'd like to thank Craig for his enduring commitment to this book and his relentless production of new interesting case studies and for the enlightening debates we had in the 3 years leading up to the publication of this book. He is a fine scholar and an admired colleague in the field.

Further Reading on the Themes Touched on in This Introduction

Pearlstein, Steven. 2013, September. How the cult of shareholder value wrecked American business. *The Washington Post Wonkblog*.

Goedhart, Marc., Tim Kolter, and David Wessels. 2015, March. *The real business of business*. McKinsey and Company.

Rancay, France
July 2016

Gilbert G. Lenssen

Part I

Introduction: Risk Management – Managing the Accountabilities of the Firm

Gilbert G. Lenssen

Risk management is based on timely knowledge management of the inside-out impacts of the business model and the business strategy on the social, environmental, economical and governance/political context (ESG context). It forms the basis, the very first step of managing sustainable business.

These impacts are from a business economics perspective "cost externalities" which enhance the cost advantages of the business but may sooner or later become controversial if they touch on the formal and explicit social contract(s) the business operates under. The informal social contract of implicit or emerging expectations is the subject of the next chapter on issues management.

The formal social contract context(s) the business operates in determines explicit expectations which require compliance with the letter and the spirit of legislation, with international codes and standards, both hard law and soft law, from, for example, the ILO, OECD, and the UN Global Compact.

Manifest risks include social risks, environmental risks, political risks, regulatory risks, even cultural risks, and may be located in the supply chain, the distribution chain, in product liabilities, in production facilities, in joint ventures, in mergers and acquisitions (hence importance of ESG due diligence), and may be specific to geographies like conflict zones and cultural risks in new markets.

Apart from manifest risks, there are always underlying risks such as managerial risks related to competencies and management attitudes, risk/return balances, organisational risks in organisational culture and structure, processes, systems and skills as well as corporate governance risks in lack of oversight of Boards, and in not critically questioning.

Risk management requires in the last instance proficient crisis management and communications.

Key Questions to Ask (Applicable to All Part I Cases)

What is the business model of the company?

What are the ESG impacts of the business model and business strategy?

Which are the inherent risks (social, environmental, political, regulatory) in this model?

Apart from manifest risks, can one identify underlying risks?
Which risk prioritisation and risk mitigation processes are being applied?
Where could/did the risk management process derail?
What improvements can you suggest to risk mitigation management? To crisis and communications management?

Chapter 1: The Scenario Approach to Possible Futures for Oil and Gas by Jeremy Bentham and James Schofield
The externalities of the business models of oil exploration, transportation, refining and distribution are considerable, hence the importance of risk management in this industry. Scenario planning is a useful tool for charting possible future risks and to prepare management for adequate responses to whatever scenario materialises. In addition, Shell's scenario planning charts geo-political and cultural risks and how they play out in different parallel scripts. This forms the basis for strategic decision making, but foremost for preparedness for different risks to the business model, according to different scenarios. Shell's scenario scripts include economic, social, environmental, (geo-) political and even cultural factors that play into the futures of the energy markets.

Chapter 2: Beyond BP: The Gulf of Mexico Deepwater Horizon Disaster 2010 by David Grayson
This BP case is illustrative of many of the troubling risks an oil company can be exposed to. Deep water drilling enhances risks, especially so if involving joint-ventures with other companies on the same platform. If the safety and environmental policies of the mother company (BP) are not wholly supported by merged or acquired businesses (Amoco), risks are exacerbated. If continuous signals from the acquired businesses (e.g., Alaska pipeline affair, Texas refinery incident) fail to be addressed in a structural way, disaster is waiting to happen. If the crisis management and crisis communication by senior management adds disaster to disaster, the very existence of the company is put at risk. BP lost 52% of its share value, an equivalent of $105 billion in the aftermath of the Gulf of Mexico disaster in 2010. In the meantime, the share price has recovered but it is still hovering at 35% below 2009 levels.

Chapter 3: Wal-Mart's Sustainable Product Index by N. Craig Smith and Robert Crawford
Walmart is a successful business offering every-day low prices and thereby conveniently serving urban and rural communities, including many poor people who otherwise would not be able to afford the goods provided. Walmart also employs hundreds of thousands of low-skilled people who find it otherwise difficult in the labour market. Crucial to its success as a low price/low cost leader is the rigorous elimination of costs in both the supply and the distribution chain, which can give rise to negative environmental and social impacts. This has created serious challenges in the court of public opinion in the past and Walmart was forced to

implement policies reducing these impacts, whilst keeping the business model largely intact. In this case study, Walmart tries to mitigate the ongoing risks by rallying consumers into a more sustainable way of consumption. Will it work? Is Walmart trying to shift part of the blame on to consumers? Is this a credible and sustainable risk mitigation strategy?

Chapter 4: Tetra Pak in China by Fu Jia, Zhaohui Wu and Jonathan Gosling
Tetra Pak in China is deeply integrated into the dairy supply chain and its main customers are the biggest domestic milk (and other dairy) producers in China in a market with exponential growth up to mid 2008, when the melamine milk contamination scandal hit the domestic producers. The supply chain in China is highly fragmented beginning with millions of dairy farmers and an extensive network of milk processing plants. Tetra Pak finds itself in a typical emerging market risk situation: rapid (unsustainable) growth, local production (but of variable quality and safety standards) preferred by the socio-political context, and an underdeveloped regulatory framework. Moreover, despite its track record of engaged stakeholder management and a long-time commitment to a life cycle approach to packaging, Tetra Pak could not straightforwardly capitalise on this track record in China as it could elsewhere. Risk mitigation in emerging markets needs to be very much locally tailored.

Chapter 5: INEOS ChlorVinyls (A): A Positive Vision for PVC by N. Craig Smith and Dawn Jarisch
This risk management case is particularly interesting from a number of perspectives. First come the risks associated with a product and a production process with considerable alleged hazardous impacts. Responding to NGO pressures and mitigating EU regulatory risks was key in the first phase. External relations management and internal change management were quite good. But getting the rest of the industry to join in to mitigate the risks of looming cost disadvantages is key in a second phase. However, embarking on a high quality sustainability journey creates new global risks, especially if Chinese producers enter the global market without adopting high standards, and global trade agreements prevent European regulators from imposing tariffs on low quality market entrants.

1 The Scenario Approach to Possible Futures for Oil and Natural Gas

Jeremy Bentham

Introduction

From blackouts around the globe to the boiling tensions in the Middle East, recent events have thrown up many uncertainties about how the world will meet its growing future energy needs. While these dramatic events have grabbed the headlines, they come on top of several relentless trends that have been shaping our global energy future.

The worldwide financial crisis ushered in an era of macro-economic volatility and accelerated the shift in influence from West to East. As wealth levels rise in the emerging economies, hundreds of millions of people are emerging from poverty. And the global population, which is growing by more than 200,000 people every day is projected to reach over nine billion by 2050.[1] That is like adding one more China and India to the world, with basic needs for food, water, and energy that will have to be met.

At the same time, many countries are making the journey from rural to urban societies. According to one projection, the world will build the equivalent of one new city of 1.3 million people every week for the next 40 years.[2]

The upshot of these trends? Surging energy demand and growing environmental stress. If we continue to use energy in the same ways we do today, global energy needs could triple in the first half of this century. At the same time, many scientists agree that CO_2 emissions must be halved by mid-century if we are to avoid dangerous changes to the global climate.

Of course, over the coming decades we will surely find creative ways to improve the energy efficiency of our cars, homes, and factories. And technology will help us

[1] Based on UN data.

[2] Based on UN data.

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© Springer Science+Business Media B.V. 2019
G. G. Lenssen, N. C. Smith (eds.), *Managing Sustainable Business*,
https://doi.org/10.1007/978-94-024-1144-7_1

unlock additional sources of energy. But those gains still may not be enough to keep up with the pace of underlying demand growth.

Closing this gap in energy supply and demand will require a dramatic ramp-up in energy production or a drastic moderation in energy use – or, more likely, some mix of both. But just how this might be achieved remains unclear, giving rise to a 'zone of uncertainty'.[3] This could turn out to be a zone of extraordinary misery or extraordinary opportunity, depending on how the world responds.

For over four decades, Shell has developed and applied scenarios as part of its strategic thinking to help grapple with such uncertainties. Most companies monitor changes in their business environment, but Shell is one of the few that routinely employs alternative outlooks as a core strategic tool. Given the long lifetimes of investments in the energy industry, decisions made today have consequences for decades. Long-term scenario considerations are helpful in shaping those decisions.

The success of the scenarios is not just their ability to provide strategic insights, but their approach to developing and sharing these insights. They enable the company's decision-makers to think about the possible wider and longer-reaching implications of unfolding trends and potential discontinuities. They stretch and clarify thinking, helping to improve the company's prospects, not only through enriching the context for decision-making, but also by developing a leadership cadre that is more sensitive to changes in the external environment.

Scenarios in Shell

From the outset of the practice in the company, scenario developers embraced intuition, uncertainty, and engagement. They did not shy away from talking about what could be considered 'unimaginable'. Producing neither rigid predictions nor wild fantasies, scenario building is a craft that holds real commercial value for Shell.

"While we can't predict the future, science-based creative thinking can give us some clues," says Dr. Angela Wilkinson, from the Smith School of Enterprise and the Environment at Oxford University.

Shell's scenario analysis focuses on four main areas – economics, (geo)politics and socio-cultural issues, energy, and the environment – to understand how consumers, governments, oil energy producers, and regulators are likely to behave and respond to change in the decades ahead.

Today's scenario builders use complex econometric modeling and sophisticated methodologies. The scenarios development process now includes a multitude of short-, medium-, and long-term portraits of global energy developments, but also individual country analyses and consideration of major trends in areas like public health and urbanisation. Scenarios can take a global view or focus on specific issues in specific countries, such as the future for the emerging democracies of Libya or Iraq. They often look decades ahead, but can also have a shorter-term focus, such as with the financial crisis in the Eurozone.

[3] Shell Scenarios Team, 2011. Signals & Signposts, page 10.

The ultimate goal of scenarios for Shell is to encourage and equip business decision-makers to consider the factors that shape their choices right now. That is important for an industry investing billion-dollar sums in infrastructure which can operate for decades. Today scenarios continue to influence thinking across the company, from the Board and Executive Committee right across the operating businesses.

Many important strategic decisions taken over the last four decades have the fingerprints of scenario activity on them. Of course, all major choices involve multiple inputs from many people, but scenarios have explicitly highlighted specific threats and opportunities or, more frequently, implicitly informed the fundamental mind-sets underpinning decisions.

Scenarios under discussion in 1973 first established Shell's reputation for using this hitherto academic approach to inform strategic business planning. When the Yom Kippur War broke out in October of that year, the West's support for Israel angered oil-rich Arab states, triggering an oil embargo. Fuel shortages sparked a global recession and a massive stock market crash. The world reeled. But Shell's decision makers were mentally prepared for the worst because they had already imagined such a scenario. This helped the company weather the volatility of the 1970s, bringing financial gains running into the billions of dollars thanks to the re-configuration or sale of refineries and installations, or decisions not to replace them.

Scenarios contribution to strategic thinking helped the company to anticipate, adapt, and respond to another oil shock in 1979, as well as to the decline and eventual collapse of the Soviet Union in the 1980s. It also prepared the company for the rise of environmental concerns linked to carbon dioxide in the 1990s and to explore the dynamics of recession and recovery in the 2000s. In the past two decades, scenarios prepared the company for the impact of technology, terrorism, and globalisation in a rapidly changing world.

Long before the collapse of the Berlin wall in 1989, scenarios workshops had imagined potential new opportunities in new markets opening up behind the old Iron Curtain – not only in the Soviet Union, but also across Eastern Europe. Shell not only opened refineries in Eastern Europe, it closed down or sold some in Western Europe.

In the 1990s, growing social and environmental stresses were highlighted, helping Shell develop a constructive, pro-active attitude to the threat of climate change.

In 2005, scenarios also raised the probability of a looming gap between the world's surging demand for energy and global supplies and reinforced the significance of natural gas in the company's energy mix.

A few years later they highlighted a mix of circumstances that made sustainable biofuels appear to be an attractive business opportunity. In 2011, Shell moved into the production of low-carbon bio-ethanol from Brazilian sugar cane.

In Shell's 2011 *Signals & Signposts* publication, one of the key factors raised was the impact of heightened political tension in the developing world. In early 2011, the Arab Spring took the world by surprise with popular revolts toppling rulers in Egypt and Tunisia and sowing the seeds for reform throughout the Middle East.

While scenarios couldn't, of course, predict the exact date of the uprising in the Middle East and North Africa, they had highlighted conditions that would make the rebellions increasingly likely: growing resentment, youthful populations with little

opportunity for employment, economic volatility, and rising unemployment and inflation.

Shell has shared at least half a dozen far-reaching global scenarios with the wider world since the 1990s, probing the impact of profound developments like the fall of the Iron Curtain and the war in Iraq, as well as the evolution of alternative energy resources like biofuels, shale gas, and wind, solar, and other renewable energy resources. In 2013, a summary of recent work entitled *New Lens Scenarios* was published (www.shell.com/scenarios).

Scenarios and Executive Decision-Making

Drawing on the knowledge of a network of specialists – both within and outside the company – is central to the process of building scenarios. But engaging the company's own decision-executives throughout the development process is vital to scenarios' impact.

Scenarios provide quantified insights and a language for executives to apply when grappling with increasingly unfamiliar and challenging conditions. They aim to be thought-provoking yet plausible, highlighting matters already in the foreground and also, crucially, background developments that should be brought to the fore. Used effectively, these alternative outlooks can help organisations address difficult issues that need to be explored collaboratively even though there may be deeply divided opinions about them.

Such an approach also helps equip decision-makers with a deeper awareness of the very different perspectives others may have, the need to engage with these perspectives effectively, and the significance to their own future of the choices made by others. In that sense, scenarios are deeply relational as they focus on people and their behaviour, and not only on seemingly impersonal economic, political, and social forces.

The scenario alchemy as we experience it in Shell is a combination of a strategic thinking process, a mode of analysis, a social process of engagement and influence, and, at its most powerful, an enabler of individual and group exploration and discovery.

At least one of the functions of scenario work is to bring people together to explore areas in a way that may reveal 'unknown unknowns,' in the words of former US Secretary of Defense Donald Rumsfeld. This exploration is not primarily intended to produce attractive booklets or reports, nice though those can be. It is most importantly about helping people take a journey that guides them into better choices based on richer considerations of the world around them.

This journey can be difficult. As the philosopher Schopenhauer pointed out, new truths are first ignored or ridiculed, then vehemently opposed, and then, ultimately, taken to be self evident – so at different points specific scenarios may be considered irrelevant, foolish, irritating, or even unnecessary. Nevertheless, experience in Shell has deepened our belief of the value to our company of taking this journey.

The journey is never simple or linear. Fresh insights are rarely absorbed from a single reading of a report or from attending a presentation – no matter how brilliant. Understanding this fact helps to avoid the disappointing fate of scenario approaches that are separate from the central strategic deliberations of an organization. While such deliberations are generally embedded in a formal strategic process, much reflection and influence also occurs through parallel channels. In Shell, scenario activity is intrinsically bound up with ongoing assessment of economic, political, and market signals, and the strategic conversations that take place around these. Hundreds of conversations, often informal, with decision-executives over many months prepare fertile ground for the crystallization of insights into scenarios, and also shape the understanding of how scenarios can be best shaped to be impactful.

The Energy Outlook and the Zone of Uncertainty

As an energy company, developments affecting this industry will always be a central concern of Shell scenarios. Our energy modeling looks at over 80 individual countries, with regions to cover the smaller countries, and 14 different sectors of energy demand within each country. Analysis suggests that underlying global demand for energy by 2050 would triple from its 2000 level if emerging economies follow historical patterns of development and if there were no supply constraints.

Natural innovation and competition could spur improvements in energy efficiency to help moderate underlying demand by about 20% over this time. Ordinary rates of supply growth – taking into account technological, geological, competitive, financial, and political realities – could naturally boost energy production by about 50%. But this still leaves a gap between business-as-usual supply and business-as-usual demand equal to approximately the size of the whole industry in 2000.

This gap – this Zone of Uncertainty – will have to be bridged by some combination of extraordinary demand moderation and extraordinary production acceleration. So, we must ask: Is this a *zone of extraordinary opportunity* or *extraordinary misery*? For example, smart urban development, sustained policy encouragement and commercial and technological innovation can all result in some moderation. But so can price-shocks, knee-jerk policies, and frustrated economic aspirations (Chart 1.1).

Timescales are a key factor. Buildings, infrastructure, and power stations last several decades. The stock of vehicles can last a couple of decades. New energy technologies must be demonstrated at commercial scale and require three decades of sustained double-digit growth to build industrial capacity and grow sufficiently to feature at even 1–2% of the energy system.

The policies and possibilities in place in the next 5 years will shape investment for the next 10 years, which will largely shape the global energy picture out to 2050. How fast will tensions rise? How fast can we make the right choices, and how quickly can positive developments happen?

In considering these questions, previously published Shell scenario work has highlighted our entry into an era of volatility and transition – economically, politically, socially, and within the energy and environmental systems:

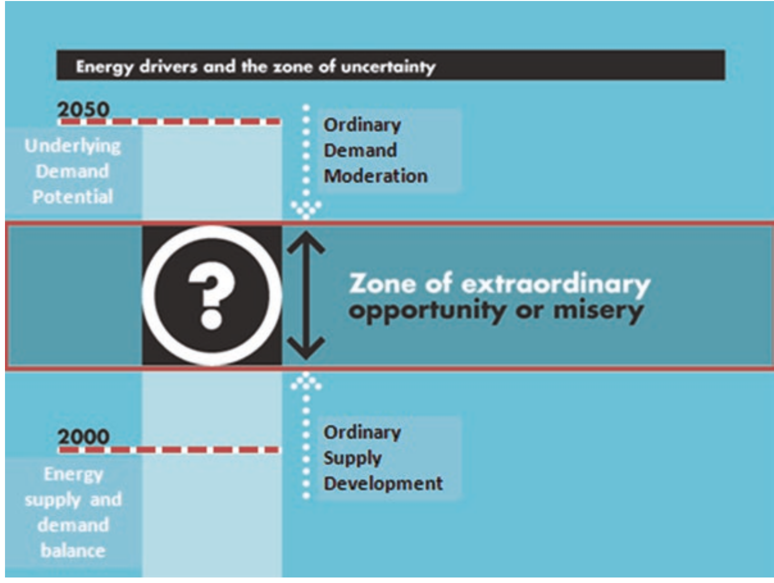

Chart 1.1 Shell Scenarios Team (2011). Energy drivers and the zone of uncertainty, signals & signposts, page 9. See more on www.shell.com/scenarios

- Intensified economic cycles as the conditions have changed that underpinned the period from the mid 1980s to mid 2000s – referred to as 'the great moderation' in the advanced industrial economies.
- Heightened political and social instability, stimulated in part by economic volatility.
- Tensions in the international order, as multilateral institutions struggle to adjust to shifts in economic power, and other arrangements proliferate.
- Significant demographic transitions involving ageing populations in some places, youth bulges in others, and relentless urbanisation in both fast-emerging and less-developed economies.
- Surging energy demand driven by growing populations and prosperity, with new energy supplies emerging while others struggle to keep pace, and greenhouse gas emissions increasing, particularly from growth in coal consumption.
- The deployment of technological advances enabling rapid growth in resource plays such as shale gas and liquid rich shales in, for example, North America, with ripples across the globe, but uncertain prospects elsewhere. The technology for using renewable resources, such as solar photovoltaic, also advances with rapidly growing supply from a small but established base.
- Better defined and significantly challenged planetary ecological boundaries, including pressures arising from the energy-water-food 'Stress Nexus', as each component experiences supply/demand tightness. Because of their linkages, these resources feed off each other and accelerate the combined growth in stress.

New Lenses

Inevitably, given these developments, any plausible outlooks will be messy and patchy. Nevertheless, we have found that a number of new lenses can help us view familiar landscapes from fresh angles so that we can focus and clarify possible futures.

The Paradox Lenses

Paradoxes embody tensions. Three paradoxes highlight key features of the emerging landscape.

The *Prosperity Paradox* – Economic development raises living standards, but also imposes environmental, resource, financial, political, and social stresses that can undermine the benefits of prosperity. Globalisation reduces income inequality between nations while increasing inequalities within them.

The *Leadership Paradox* – Addressing global stresses requires coordination among increasing numbers of constituencies, but the more groups involved, the more vested interests block progress. Fresh forms of collaboration need to cut across familiar national, public-private, and industry-sector boundaries, but there are no strong models for such collaborations, and they are difficult to get off the ground as different parties remain focussed on their individual responsibilities.

The *Connectivity Paradox* – Growing connectivity stimulates creativity but also puts intellectual property at risk, threatening creativity. Connectivity facilitates individual expression and empowerment, but also encourages herd behaviour and amplifies swings in confidence and demand.

Two Archetypal Pathway Lenses

The tensions inherent in these paradoxes fuel an emerging era of transitions. Through examining a range of historical transformations and various models of transition, two archetypal 'Pathway Lenses' may help bring clarity and insights to current circumstances.

For example, countries around the world face challenges to their current economic models, political regimes, and social arrangements. The US is dealing with a long term decline in relative global power, economic recession, and a deadlocked political system. China and the other large emerging economies, which appeared resilient in 2008, are now grappling with a range of uncertainties in their search for stability and continued growth. Europe appears to be postponing the challenge of fundamental reform, "kicking the can down the road." Countries face divergent paths. Will they respond to the challenges they face through adaptation and reform, following a *Room to Manoeuvre* pathway? Or will change be postponed and a *Trapped Transition* pathway ensue, until there is either a fundamental reset or collapse?

New Lens Scenarios for the Twenty-First Century

Of course, not all countries or actors will follow one single *Trapped Transition* or *Room to Manoeuvre* pathway. Nevertheless, the pathway lenses highlight patterns recurring throughout the broader panorama.

Of particular prominence is the crucial relationship between those who are more or less privileged under current arrangements, and the influence this will have on future developments. In fast-emerging nations, a growing middle class will make increasing demands on governance and welfare entitlements. In developed countries, we see globalisation 'hollowing out' the middle class as average household incomes stagnate while the top tier prospers. In global geopolitics, there are growing tensions between established and emerging powers, within an increasingly inadequate multilateral institutional structure.

Two vistas present themselves – high *Mountains* where the benefits of an elevated position are exercised and protected, and wide *Oceans* with rising tides, strong currents, and a churning of established perspectives for new ones. A detailed evaluation of these scenarios has been published elsewhere (www.shell.com/scenarios) and a summary of key features follows.

***Mountains** – an outlook in which current advantages and influence lock-in further future influence, and concentrate prevailing power, benefiting the already advantaged*.

Latent opposition is minimised through a combination of 'carrots and sticks'. Supply-side investments are stimulated, and philanthropy flourishes. But growing rigidities and a lack of structural adjustment begin to moderate economic development and even limit international trade. Some fast-emerging economies fall into the *middle-income trap*, ratcheting up social and political stresses.

The moderation of economic growth takes some pressure off energy demand, and this looser supply/demand boundary can be pushed further if progress is made with supply-side energy policies that unlock resources.

New shale and tight gas resources enjoy widespread success and grow to form a new 'gas backbone' to the global energy system. Major oil resource holders fear market loss, and some face severe political/social stresses in periods of modest prices. Supply-side incentives, the abundance of gas, and policies that encourage smarter compact city development open the route to transport electrification and enable hydrogen infrastructure to be developed for storage and transport of energy from intermittent or remote renewables. Oil prices remain elevated and volatile, but grow only modestly, and global gas pricing emerges due to high levels of liquidity and inter-regional transport.

Sluggish economic growth in the early period, the relative displacement of coal growth by gas over the longer term, and the incentivisation of carbon capture and storage (CCS), all contribute to a moderation in greenhouse gas emissions. Nevertheless, these still remain consistent with a global average temperature rise in excess of 2 °C aspirations over the longer term. By the end of the century, however, there is the potential for net zero annual emissions from the energy sector, and even net negative emissions as the result of the contribution of CCS with a proportion of

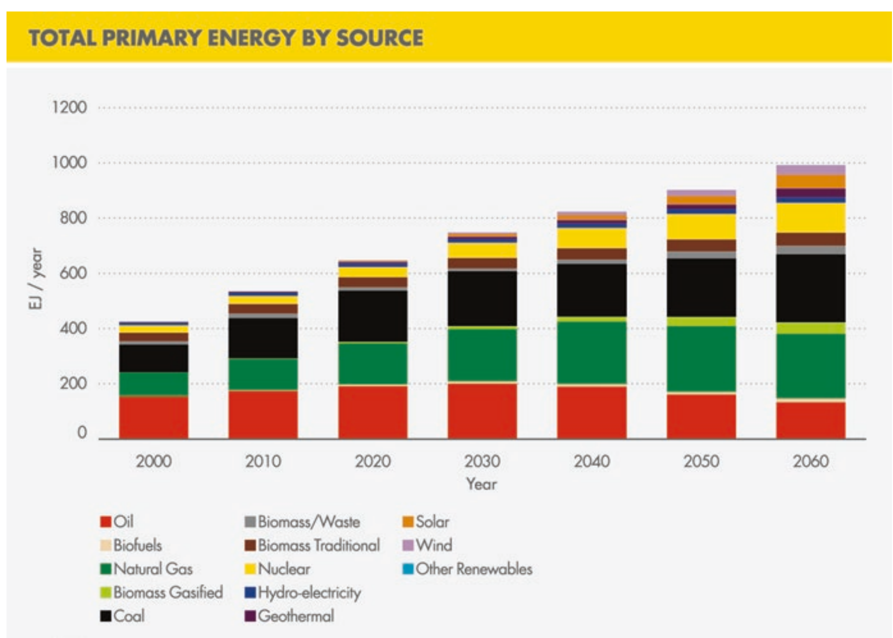

Chart 1.2 Shell Scenarios Team (2013). New lens scenarios, 'Mountains' scenario total primary energy by source, page 34

biomass feedstock. This opens the longer-term prospect that the cumulative build-up of greenhouse gas emissions in the atmosphere may overshoot aspirations but could then be repaired (Chart 1.2).

***Oceans** – an outlook in which there is greater accommodation of competing interests and broader diffusion of influence*.

At first, economic pressures strain social cohesion, forcing changes in economic and political structures. A refreshed philosophical narrative of 'accommodation' or 'social coherence' arises, consistent with reforms to welfare and other social structures. Productivity is boosted, as is catch-up growth by developing countries. An ethos of accommodation and compromise promotes growing aspirations and rising confidence, reinforcing pressures for continuing reform and for further accommodation.

Globalisation strengthens, and the key emerging economies move to more balanced growth. But over time, the 'newly advantaged' eventually become more defensive, even reactionary, when faced with new policy choices and the impact of rapidly rising resource and social stresses further ahead.

With emerging economies continuing to surge and boost energy demand, this tighter supply/demand boundary can be pushed further if energy policies lag on the supply side – partly due to newly empowered populist sentiment – and some resource developments ultimately disappoint.

Scenarios and the 'Stress Nexus'

Over the next couple of decades global demand for energy, water and food is expected to increase by between 30% and 50%[1], placing growing pressure on supplies of these vital resources and the environment. In recent years, the Shell scenarios team, together with academics and other organisations, has researched the complex relationships between these interdependent systems. The work has yielded important insights and influenced both the way Shell runs its own operations and how it works and engages with others to address these issues.

Water is essential to the energy industry. It is used in various stages of oil and gas extraction as well as to cool power plants. In 2009, the scenarios team started to take a close look at the growing challenge of water scarcity in many regions of the world and how it might affect operations and potential investments.

Whilst identifying likely hotspots where limited water supplies and energy demand might overlap, the team became increasingly interested in the complex interactions water has with other dynamic systems: water is used to extract energy and generate power, energy is used to purify, distribute and treat water and wastewater; and both energy and water are essential to the growth and processing of food. If there is stress on one of the three, it has an effect on the other two – a relationship that Shell called the 'Stress Nexus'.

This early work caught the attention of Shell's then CEO Peter Voser, who recognised its strategic significance and sponsored a dedicated group of specialists from the fields of energy, water, food and climate to conduct further research. Working with Dr. Eric Berlow, an expert in complexity science at the University of California, Berkeley, they mapped many thousands of interactions and identified over 100 of the most significant factors, ranging from how bio mass resources are used, to the price variability of food, to technology innovation in water efficiency.

As a result of this work, water has become an increasingly important consideration for Shell and the company has taken further steps to manage its water footprint effectively. There are numerous illustrations of how this has translated directly into the way Shell operates.

At Shell's major facilities, water management plans are in place, helping minimise water use where necessary. At Shell's Groundbirch 'tight gas' development project in Canada, for example, Shell has worked with the community to find ways to reduce the amount of fresh water that is used from local sources. The project recycles some 75% of water involved in the extraction process. Shell draws the remainder of the water required from a reclamation facility which it funded and operates with the local council. The plant treats the community's waste water to a standard suitable for industrial and municipal uses.

(continued)

In 2011, Shell partnered with the University of Utrecht to develop a new accounting methodology to improve the measurement of water use. Shell can now estimate more accurately the amount of water needed to generate energy from different sources – including oil, gas, coal, nuclear and biofuels – using different technologies in different locations. The findings were published in 2012 in a peer reviewed Elsevier academic journal titled "Water accounting for (agro) industrial operations and its application to energy pathways".

Shell has used this data to extend its proprietary 'World Energy Model' that is used for scenario planning. This gives a better understanding of the demands the global energy system will place on water resources in decades ahead, and support strategic planning for operations. It also shared this data with the wider business community through the World Business Council for Sustainable Development and with the International Energy Agency (IEA). The IEA used the data and findings in "The World Energy Outlook 2012".

The work helped Shell recognise that strong cross – sector collaboration is needed to achieve meaningful solutions to improving Shell's own water use and preparing for future water challenges. Shell is currently working with Veolia – a leading multinational specialising in waste, water, and energy management operations – to explore new water management solutions and business opportunities. For example, by combining expertise to extract and treat water from sewage systems and use it to cool power plants, and taking the waste steam from power plants and using it to heat nearby industrial zones. And together they are further developing the water accounting methodology by doing a comparative water risk assessment pilot at various Shell projects including in Canada and China.

Of course, as a shared resource, effective national and international policy is key to ensuring sustainable water resources are available for both the energy and agricultural sector. With its greater understanding of the complexity of the 'Stress Nexus', Shell has been able to engage governments and local stakeholders to encourage strategic water management plans are put in place. This is essential for Shell's business, and also the broader community. There is great opportunity to create social and commercial value through the investments required to meet the 'Stress Nexus' challenges.

1. World Economic Forum, United Nations and International Energy Agency

Shale and tight gas performance outside North America disappoint as a result of lower resource development than anticipated and policy delays, and growth in oil production from some major resource holders is constrained in the early period as leadership transitions take their toll. This is a particularly high oil-price world which economically unlocks new high-cost resources and technological opportunities and invokes a 'long liquid fuels game'. Global gas volume growth is steady but more

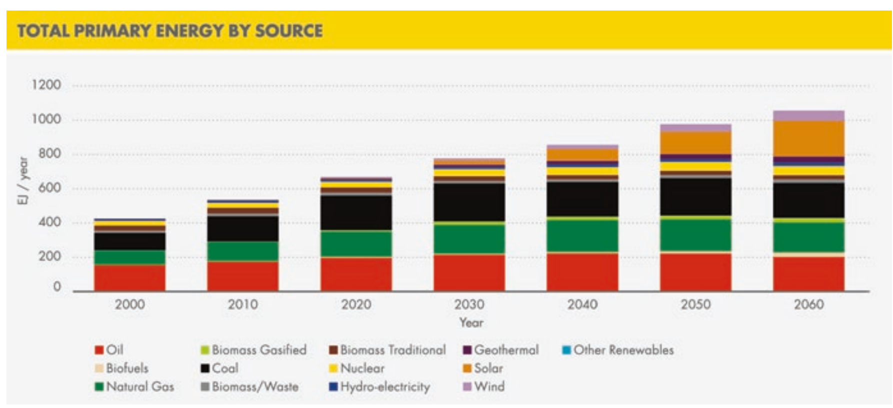

Chart 1.3 'Oceans' scenario total primary energy by source, Shell New Lens Scenarios (Shell Scenarios Team, 2013), page 59. See www.shell.com/scenarios

modest than anticipated, and prices remain regionalized but strong where there is relative scarcity.

As a result of strong growth in coal consumption and the extension of the oil age, resource stresses become severe, and prices plus crises eventually stimulate strong demand-side investment to increase end-user efficiency. Stimulated by higher energy prices, renewable energy also grows, and by the 2060s solar becomes the world's largest primary energy source. Nevertheless, greenhouse gas emissions follow a pathway towards a high degree of climate change, ocean acidification, and the need for significant adaptation. As the impact of delays in responding to resource stresses becomes apparent, there are eventually late and urgent moves to deploy CCS at scale. In combination with the growth in solar energy and biofuels, this enables net zero CO_2 emissions from energy to be approached by the end of the century (Chart 1.3).

Reflections

Each of these scenarios has different political, economic and social trajectories, with different central patterns and counter-currents. Interestingly, overall energy consumption is relatively similar, although there are significant differences in the mix of resources, the price trajectories, sector-level specifics, and levels of resource stress. Total global energy consumption by 2050 is some 80% higher than today, with the underlying upward pressure on demand due to stronger economic growth in *Oceans* offset to a large extent by higher prices.

Both scenarios exhibit extraordinary moderation of demand growth and extraordinary acceleration of supply – both of which, as was previously noted, would be necessary to bridge the Zone of Uncertainty. In *Mountains*, demand moderation occurs through economic sluggishness and the development of efficient infrastructures such as compact cities, whereas in *Oceans* the main moderators are high prices

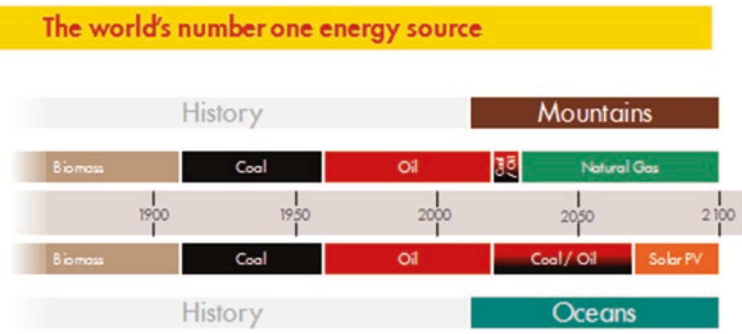

Fig. 1.1 The world's number one energy source, Shell Scenarios Team (2013)

and end-user efficiencies. On the energy production side, the main contribution to acceleration in *Mountains* is the global extension of North America's ongoing shale and tight gas revolution, while in *Oceans* this occurs through growth in enhanced oil recovery, biofuels, and other frontier developments, as well as solar eventually growing to become the single largest primary energy source.

In fact, both scenarios witness a shift in the largest global primary energy source in the decades ahead. In *Mountains*, natural gas becomes the largest source in the 2030s, ending a 70-year reign for oil. Before that, coal's reign as the number one global energy source had lasted around 50 years (circa 1910–1960), taking over from traditional sources of biomass like wood, peat, dung, and agricultural waste. In *Oceans*, solar becomes the largest source by the 2070s (Fig. 1.1).

Concluding Remarks

Shell's *New Lens Scenarios* suggest that addressing the challenges of the twenty-first century will be difficult and often uncomfortable. It may require many people and organisations to reconsider their own vested interests, to forge innovative partnerships, and to move towards more effectively accommodating the interests of others as a necessary component of their own flourishing.

The scenario approach encourages decision-makers to explore the features, uncertainties, and boundaries of the future landscape, and engage with alternative points of view. For example, it is becoming clearer that a prosperous and sustainable global outlook must encompass both energy-efficient infrastructures like compact cities as well as efficient end-use in vehicles and buildings. Similarly, a prosperous and sustainable outlook requires both cleaner fossil fuels and also a revolution in renewable energy as well. A 'both/and' rather than an 'either/or' attitude is required in policy making.

Although, of course, there needs to be a sensible understanding of the pros and cons of both approaches, the true battle is against time. Every year that passes sees,

for example, strong growth in coal burning and the ratcheting upwards of cumulative greenhouse gas concentrations in the atmosphere. The pace at which CCS technology is deployed at scale and at which natural gas substitutes for coal growth is the main driver of difference between cumulative emissions in the *Mountains* and *Oceans* scenarios. If it were possible to accelerate these developments even more than described in the *Mountains* scenario, the cumulative emissions for the twenty-first century would be closer to a level consistent with containing global average temperature rise to 2 °C.

The scenarios highlight many opportunities, but they also underline the complexity and urgency of resource stresses. Technology deployment is important, but political and societal choices are as influential as resources and technology. Both scenarios have positive and troubling features. The challenge is to see if it is somehow possible to deliver the best of both worlds.

Achieving a greater balance of positive features in the future depends on the capacity of business, government, and civil society to work more effectively together. Beyond its value within individual organisations, working with scenarios can play a constructive role in supporting the cross-sector dialogue necessary for this.

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Beyond BP: The Gulf of Mexico Deepwater Horizon Disaster 2010

2

David Grayson

Introduction

On April 20th 2010, an explosion occurred on the Deepwater Horizon – an oil rig operated on behalf of BP, in the Gulf of Mexico, 40 miles from the coastline of the American state of Louisiana. The explosion killed 11 workers and oil started pouring from the Macondo well-head, 5000 ft beneath the surface of the sea. It was to become the worst oil spill the USA had experienced with the escape of oil being the equivalent of an Exxon Valdez incident every 4 days. By June, President Obama was describing it as "the worst environmental disaster in US history." The BP CEO Tony Hayward who had taken personal charge of BP's efforts to contain the disaster was vilified in Congress and the media as "the most hated man in America" and was later to resign over the incident. At one stage, BP's share price was halved from its peak immediately before the explosion, and there was serious business media speculation about whether the company could survive without being taken over. The situation was complicated because although BP owned a majority stake in the well, and was the "responsible operator" for the US authorities, another company: Transocean, operated the drilling rig; a third: Halliburton, cemented around the well pipe; and a fourth: Cameron, made the blow-out preventer on the rig, which was meant to shut off the well in an emergency, but failed to do so. President Obama was later to say: "There's enough responsibility to go around, and all parties should be willing to accept it. That includes, by the way, the federal government."

For BP, it was the latest in a series of significant incidents in BP's North American operations such as the fatal accident at BP's Texas City Refinery in 2005[1] and a

[1] For a detailed analysis of Texas City and subsequent crises leading up to Deepwater Horizon, see PBS FRONTLINE documentary, "The Spill," produced in collaboration with ProPublica: www.pbs.org/wgbh/pages/frontline/the-spill

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G. G. Lenssen, N. C. Smith (eds.), *Managing Sustainable Business*,
https://doi.org/10.1007/978-94-024-1144-7_2

major leak in Prudhoe Bay Alaska (see extracts of a speech by the then CEO of BP Tony Hayward at Stanford Business School in July 2009 – Appendix 1). The Gulf of Mexico incident was quickly dubbed BP's Brent Spar moment or a second Exxon Valdez. Some commentators called it Obama's Katrina (after Hurricane Katrina, the mishandling of which caused massive damage to the standing of the previous, Bush administration).

Context

The Deepwater Horizon drilling platform was one of more than 3500 in the Gulf of Mexico alone – but as of 2008, only 36 were for deep-drilling below the sea-bed. There were only three in 1992 and drilling in deepwater (depths greater than 1000 ft) and ultra-deepwater (depths of 5000 ft or more) had only started becoming economically profitable and technically feasible on a large scale in the previous decade, in part due to significantly higher oil prices and a US push for "energy independence."[2] BP has been the leader in deep-water drilling in the Gulf of Mexico and, therefore, had the largest exposure. BP had grown into one of the world's largest oil companies through a series of audacious corporate take-overs under John Browne (Lord Browne of Maddingley who was CEO 1995–2007.

> Browne transformed BP from a dying corporation in the early 1990s into the world's second largest oil behemoth. He refocused BP on 'elephants' – the big oil reservoirs – and ruthlessly cut costs. He used BP's rising share price to stage audacious takeovers of failing oil companies, especially in America. His success earned worldwide plaudits…. Cutting costs became BP's obsession. The philosophy was 'More for less' – 100 per cent of a task would be completed at a cost of only 90 per cent of the previous resources. … Browne's casualties included BP's engineers. Hundreds were fired and replaced by subcontractors. Just as ExxonMobil was hiring engineers because 'drilling is the core of our business', Browne was ditching BP's in house expertise, which could second-guess every technical operation on land and under the sea...[3]

The Macondo situation was complicated, however, because although BP owned a majority stake in the well (65%), and was the "responsible operator" for the US authorities, the remaining ownership was divided between Anadarko (25%) and Mitsui (10%). Another company: Transocean, the world's largest oil drilling contractor, owned and operated the rig; a third: Halliburton, cemented around the well equipment; and a fourth: Cameron, made the blow-out preventer on the rig, which was meant to be the fail-safe device to shut off the well in an emergency, if all else failed – but which did not do so. In all, 12 different companies had employees on the rig immediately prior to the explosion. Only a few of the 126 crew members on the Deepwater Horizon worked directly for BP.

[2] (Council on Foreign Relations Backgrounder: U.S. Deepwater Drilling's Future – Toni Johnson, 25th May 2010). Indeed, only 3 weeks before the explosion, President Obama had significantly relaxed regulations relating to offshore drilling, highlighting the need for greater US energy security.

[3] Tom Bower, The Spectator, 26th June 2010.

Initial Reaction

In the immediate aftermath of the explosion, Tony Hayward initially sought to divert responsibility, observing: "This was not our accident … This was not our drilling rig … This was Transocean's rig. Their systems. Their people. Their equipment"[4] before modifying his position to say: "A number of companies are involved, including BP, and it is simply too early – and not up to us – to say who is at fault."[5] In September 2010, BP released its own report into what had happened, conducted by a team led by the BP head of operations and safety Mark Bly (see Appendix 2). While BP's investigation attempted to allocate accountability among the involved companies, Transocean and Halliburton dismissed the Bly report as incorrect, incomplete, and an attempt to divert attention away from BP's alleged flawed well design. President Obama was later to say: "There's enough responsibility to go around, and all parties should be willing to accept it. That includes, by the way, the federal government."[6] The Minerals Management Service (MMS), the federal agency that regulated offshore drilling, had claimed that the chances of a blowout were less than 1%, and that even if one did happen, it wouldn't release much oil. In 2009 the MMS had been excoriated by the U.S. General Accounting Office for its lax oversight of offshore leases.[7] A Presidential Commission appointed by President Obama to investigate the disaster which reported in Jan 2011, produced an account of events that led up to the blast which was similar to BP's. This is unsurprising since computer logs and survivor testimonies meant most of what happened was undisputed. But the Presidential Commission's assessment of who was to blame was strikingly different to BP's: of nine material decisions, the Commission said BP was to blame for seven or even eight; and all nine were about saving time and therefore saving BP money. As the co-chair of the Presidential Commission William Reilly noted: "most of the bad decisions were made by BP or with BP's approval and acceptance." (See Appendix 3).

Days after the rig sank, Tony Hayward, flew to the US to take personal charge of the incident, declaring that he would not leave until the problem was contained. However, BP initially appeared slow to release information, was at first sparing with media appearances; and some thought was projecting an arrogance for which many had long condemned the oil industry. BP appeared slow to appreciate mounting media and therefore, political interest and concern – perhaps because spillages from off-shore oil platforms around the world are not uncommon. BP was not alone in

[4] BP vows to clean up Gulf of Mexico oil slick, BBC May 3rd 2010 news.bbc.co.uk/1/hi/world/americas/8658081.stm.

[5] http://www.nytimes.com/2010/05/26/us/26rig.html?src=me&ref=us

[6] Obama Criticizes 'Spectacle' of Blame at Oil Spill Hearings – May 15 2010 – Businessweek http://www.businessweek.com/news/2010-05-15/obama-criticizes-spectacle-of-blame-at-oil-spill-hearings.html

[7] Is Another Deepwater Disaster Inevitable? Joel K. Bourne, Jr. National Geographic / ngm.nationalgeographic.com/2010/10/gulf-oil-spill/bourne-text/2 In the wake of the accident, MMS was reorganized and renamed the Bureau of Ocean Energy Management, Regulation, and Enforcement.

initially failing to appreciate the significance of the accident. The US authorities similarly played down the incident and did not appreciate the scale of the leak.

A near contemporaneous spill off Australia, for example, had generated little coverage. At this stage in the crisis, was it better to say little and let actions speak for themselves (BP's previous default communications strategy when under attack) or try to satisfy the insatiable appetite for 24-h news media attention? Hayward himself and his principal PR and media advisers had little direct experience of the US media and few contacts in Washington. It was reported that former aides to John Browne were amazed that 3 years after becoming CEO, Hayward had still not met the US president. BP's media advisers were more used to dealing with financial media – not the relentless pressure of 24/7 TV news and tabloid media.[8]

"The Well from Hell"

It was later to emerge that the Macondo well was known amongst insiders as "the well from hell!" In April, the operation was $58million over budget, 43 days behind schedule and costing BP $500,000 each day.

By May 20th 2010 – 1 month after the accident – the oil spillage was still continuing. Attempts to cap the well-head had failed. US lawmakers and scientists were accusing BP of trying to conceal what many already believed was the worst US oil spill, eclipsing the 1989 Exxon Valdez accident in Alaska, and representing a potential environmental and economic catastrophe for the US Gulf coast.[9] BP was forced by the US Congress to make available a live film-feed showing the oil spewing from the wellhead. Congress immediately put this live film-feed on the Internet and TV stations such as CNN started showing this feed every time they referred to the disaster. Within hours of the live film-feed being put on the internet, independent experts viewing the film, calculated the daily spillage to be far higher, than BP and the US authorities had been suggesting – with some, uncorroborated estimates suggesting figures 5 or 10 times higher than BP's figure – with some saying it could be of the order of 70,000 barrels per day rather than the circa 5000 barrels suggested by BP. The larger estimate gained more credence when a BP spokesman announced that measures they had successfully taken to siphon some of the leaking oil was containing up to 5000 barrels per day – but despite this partial success, the volume of the oil continuing to spew into the Gulf of Mexico seemed hardly to have been reduced.[10] CNN and other media by this time were excoriating BP *and* the Obama Administration for the continuing pollution which was threatening the livelihoods of Louisiana fishermen and tourism-dependent businesses around the Gulf of Mexico; as well as major biodiversity loss. A subsequent study of media coverage of the oil spill disaster by the Pew Research Center's Project for Excellence in

[8] Spills and Spin, Tom Bergin, Random House 2011.

[9] By June, President Obama was describing it as "the worst environmental disaster in US history."

[10] By June 14, official figures had been revised upwards to 60,000 figures daily – the equivalent of an Exxon Valdez spill every four days.

Journalism found that in the mainstream news media in the 100-day period after the explosion, the spill accounted for 22% of the US newshole – almost double the next biggest story.[11] This was particularly remarkable given competing stories such as the US mid-term elections, Obama-care, the global financial crisis, Afghanistan "surge" and immigration.

BP'S "Near-Death" Experience

By May 28th, the incident was being described as the largest oil spill in US history, dwarfing the Exxon Valdez disaster. Attempts to cap the wellhead continued to be thwarted as BP attempted solutions never tried before, a mile under water. Tony Hayward admitted that BP lacked the tools to stop the leak from the well in the aftermath of the explosion and that the company would have to look for new ways to manage "low-probability, high impact" risks such as the Deepwater Horizon accident.[12] This was the first failure of a BOP in 50,000 wells drilled in the oceans around the US coast.[13] The clean-up effort was comprehensive and technically extraordinary.[14] Several commentators drew analogies with the ill-fated Apollo 13 moon exploration which had to be dramatically rescued. Certainly, BP and the industry innovated and developed new technologies in a fraction of the time that these might have taken absent the crisis.

Tony Hayward told the BBC: "It is clear that this will be a transforming event in the history of deep-water oil exploration." The clean-up had already then cost BP $1billion plus a commitment to a $500 m environmental fund to investigate future solutions. Estimates of BP's ultimate liabilities were then variously quoted to be $8billion or even $12billion.

Less than 3 weeks later, some US legislators were calling for BP's North American operations to be put into receivership. President Obama, repeatedly referring to the company by its old name "British Petroleum," pledged to make BP pay for the clean-up. The BP chairman and CEO were summonsed to the White House where on June 16th, they announced a new fund with an *initial* commitment of $20 billion to compensate businesses and residents affected by the spill, for loss of livelihoods. It was also announced that BP would not pay any further dividends for the rest of 2010. By this stage, the market capitalisation of BP had been almost halved: see share price chart – Appendix 4. One trillion BP shares were traded in a single week (w/c June 7); and the ratings agencies had downgraded BP. In the words of industry insiders, the company suffered a 'near death experience' as its credit default swap (CDS), the cost a BP creditor would have to pay for insuring that credit, became prohibitive, effectively assessing the likelihood of BP going bankrupt as 50%. As the BBC's then

[11] www.journalism.org/2010/08/25/100-days-gushing-oil/

[12] Financial Times 3rd June 2010.

[13] BP: Beyond the Horizon, BBC Radio 4, 25th July 2010.

[14] see The Economist magazine –22nd May 2010 page 91–92: "The Gulf Oil Spill – what lies beneath."

Economics Editor Robert Peston wrote in his blog: “sometimes these CDS prices are utterly misleading, because the market in them is thin. But there is a substantial market in BP credit default swaps. And the reason I’m boring on about all this is that a number of senior BP people – including members of the board – have volunteered to me that what worried them most was what was happening to the CDS price…the Gulf of Mexico debacle has increased the cost of insuring BP’s shorter-term debt by a factor of 50.[15] Speaking 5 months after these events, Bob Dudley, who by then had succeeded Tony Hayward as CEO, was to recall:

> We couldn’t believe what was happening. We came very close to going on to the rocks. The credit markets were indicating the company was potentially going into bankruptcy. Some banks stopped trading crude oil with us. Some suppliers wanted to be paid in cash.[16]

It was noticeable how little industry support appeared forthcoming in the media and that industry associations appeared (at least publicly) inactive. Exxon Mobil and other companies had made technical experts available (by mid June 150 employees from other oil majors were seconded to the BP Houston emergency command centre) and joined a consortium of oil companies participating in the clean up, but this had not received substantial publicity in contrast to Exxon Mobil’s warnings of the threat to offshore exploration that the crisis was creating. Indeed, at televised hearings on Capitol Hill on June 14th, representatives of Exxon Mobil, Shell and Chevron criticised BP’s drilling of the well and claimed that BP had not followed industry norms on the Deepwater Horizon rig/Macondo well. There were suggestions that the CEOs’ criticisms were based partly on what their employees seconded to the BP disaster command had been reporting back about the well design.

> Macondo’s meltdown may well have been exacerbated by equipment failure in the case of the BOP, or by human error on the part of the individuals who misread the negative pressure test, but as far as the Big Oil bosses were concerned, BP’s drilling practices were primarily to blame for the explosion.[17]

Hayward’s own performance before the Congressional committee, 2 days later, was variously described as “stumbling” and “probably over-influenced by legal advice to say little or nothing of substance.”

The media and social media were rife with criticisms of BP. Clips of Tony Hayward’s gaffes were regularly posted to Facebook, You Tube etc.[18] Slogans and adverts parodying BP’s high visibility commitment to “Beyond Petroleum” first launched in 2001 were widely circulated on the internet. (Appendix 5) Many sustainability campaigners were particularly critical of BP, perhaps disillusioned by what they perceived as the failure to follow through on the *Beyond Petroleum* commit-

[15] Robert Peston’s Blog 17 June 2010.

[16] Sunday Times 7th Nov 2010: “Dudley: my plan to salvage BP.”

[17] Pages 243–4, Spills and Spin, Tom Bergin, Random House 2011.

[18] For a summary of gaffes by Hayward and BP’s chairman Carl-Henric Svanberg see: www.theguardian.com/business/2010/jul/27/deepwater-horizon-oil-spill-bp-gaffes

ment. Company leaders were subsequently to describe being taken completely by surprise, by the extent of social media coverage of the Deepwater Horizon disaster. The company had to build a social media team, presence and awareness pretty much from scratch to respond to the saturation coverage on twitter, Facebook etc.[19] BP's own website was getting 17,500 unique visitors per week immediately before the Deepwater Horizon explosion. During the crisis, it was getting 4.5 million visitors.

Capping the Well and the Immediate Crisis

In July, after frenetic media speculation that the BP chairman and/or the CEO would be forced out, Tony Hayward announced his resignation; and the American Robert (Bob) Dudley was appointed as his successor. The wellhead was finally capped on July 15th – 87 days after the explosion. A number of corporate and public investigations were under way to identify just what had happened. BP's own report into the immediate causes of the accident was published on 8 September 2010. The company also announced the sale of a number of assets around the world to help pay for the disaster. Media interest declined and the share price started to recover.

The Aftermath

However, in Sept 2014, a US federal judge Carl J. Barbier ruled that BP was grossly negligent in the disaster, and not merely negligent, thus opening "the possibility of $18 billion in new civil penalties for BP, nearly quadruple the maximum Clean Water Act penalty for simple negligence and far more than the $3.5 billion the company has set aside."[20] While Judge Barbier did find Transocean and Halliburton had acted with negligence, he concluded that only BP, which leased the well and was in charge of the operation, was grossly negligent. He apportioned 67% of the blame for the spill to BP, 30% to Transocean and 3% to Halliburton. The New York Times reported: "The ruling stands as a milestone in environmental law given that this was the biggest offshore oil spill in American history, legal experts said, and serves as a warning for the oil companies that continue to drill in the deep waters of the Gulf of Mexico, where high pressures and temperatures in the wells test the most modern drilling technologies."[21]

Ten months later, in July 2015, it was announced that BP had agreed to pay up to $18.7 billion in penalties to the U.S. government and five states to resolve nearly all claims. Under the agreement with the U.S. Department of Justice and the states, BP will pay at least $12.8 billion for Clean Water Act fines and natural resource

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[19] BP speaker at Ethical Corporation Responsible Business Summit May 3rd 2011, author's notes.

[20] BP May Be Fined Up to $18 Billion for Spill in Gulf, CAMPBELL ROBERTSON and CLIFFORD KRAUSSS. New York Times Sept 4, 2014 www.nytimes.com/2014/09/05/business/bp-negligent-in-2010-oil-spill-us-judge-rules.html?_r=0

[21] ibid.

damages, plus $4.9 billion to states. The payouts will be staggered over as many as 18 years. The settlement avoided a substantial amount of further litigation. It was the largest corporate settlement in U.S. history.

The agreement added to the $43.8 billion that BP had previously set aside for criminal and civil penalties and cleanup costs. Reuters reported BP as saying, "its total pre-tax charge for the spill now stands at $53.8 billion." (link.reuters.com/duz94w). In October 2015, the figure was reassessed upwards from $18.7 billion to $20.8 billion.[22]

Conclusion

Ultimately, Deepwater Horizon has been a disaster, not just for BP, but for many other businesses; for the 11 men who lost their lives in the explosion and their families and friends; but also *inter alia* for US tax-payers, British pensioners, many of the residents of the five US states most affected, and marine life. Like other corporate *cause celebres* like Bhopal, the legacy of April 20th 2010 may rumble on for years to come. The company itself has distilled its learning in five key areas including spill-control and crisis-management; and is sharing this learning with governments, regulators and the industry around the world. Reviewing BP asset sales since Deepwater Horizon, The Economist described BP as a "shrunken giant" and concluded: "Repairing the balance-sheet and books is one thing. Repairing BP's reputation for management excellence will take longer. The poor safety record of past years reflected over-zealous cost-cutting. The more recent legal woes in America, and previous troubles in Russia, suggested that BP has been ill-run."[23]

Appendices

Appendix 1: Tony Hayward Speaking at Stanford Graduate School of Management May 12th 2009

Speaking to an audience of graduate students, Hayward began by describing the huge change that BP went through from 1999 onwards. 'Until the later 1990s BP was a relatively small oil and gas company. In an extraordinary period between 1999 and 2003, under the leadership of John Browne, we put together a whole series of mergers and acquisitions – such that by 2003 we had created one of the largest integrated oil and gas, energy companies in the world – equal second with Shell – with operations everywhere.

Then catastrophe struck. In the space of several years we had a whole series of real disasters actually.

[22] The Economist Oct 10th 2015 http://www.economist.com/news/world-week/21672374-business-week

[23] BP:A shrunken giant" The British oil company is safer, smaller, sadder and wiser since its disaster in the Gulf of Mexico: Feb 8th 2014 | From the print edition, The economist.

- We blew up a refinery in Texas City and killed 15 people.
- Our flagship project, called Thunderhorse, almost ended upon the sea bed in 6000 ft of water in the Gulf of Mexico
- We had a major, major oil spill in Alaska
- We were found guilty by the Department of Justice for a trading manipulation in the natural gas market of the US
- And our financial performance in that period was appalling. We under-performed our major competitors by 30–50%

And so it was with that that I was given the job of being the CEO of BP.

The only thing you can do is to confront it head on – we assembled a new team, mainly internal but with some external people. We went through a critical self-assessment with the following diagnosis:

1. BP was a company which was top down, too directive and not good at listening – good stories travelled fast, bad ones travelled nowhere.
2. We had failed to recognise that we were an operating company – too many generalists, not enough skilled specialists.
3. We had created an extraordinary amount of complexity when we put all those companies together – consultants mapped 10,000 organisational interfaces- for a company of 100,000 employees that's impressive! – too much analysis and not enough decision-making.
4. Then we sat down as a team to decide what to do about it.

Firstly, we created something called 'The Way Forward'

– Safer, reliable operations
– Having the right people in the right place
– Performance: restoring revenues and reducing complexity

Secondly, we reinstated competitor benchmarking – looking at the performance of our principal competitor, Shell – an $8billion gap in Q2 2007.

Thirdly, we addressed issues of leadership and culture change.

At that time it turned out we had 36 live and operating leadership models at various parts of BP – not surprising; we had assembled all these companies from all over the place and they all had their different bits of heritage.

So my team spent 3 or 4 months, without consultants, without any external help, talking about the company that we wanted, the culture that we wanted and the leadership framework which would begin to enable that sort of culture.

The new leadership framework would need to:

1. Recognise skills and professional capability and competence
2. Recognise how important it is to energise and motivate people
3. Focus on decision-making – there had been too much introspection and not enough taking of decisions and getting on with it

4. Deliver results.
5. The culture of an organisation is shaped by what the leaders do….

We are early in that journey. It's probably a 3–5 year journey for those who work in the offices and probably a 5 plus year journey for the people who work out in the facilities…..

Is it working (2 years into the process)? Well, I would say we are making progress, we are not there yet. We've closed the performance gap, so $8billion in Q2 2007 has become no gap at all in Q2 2009. We beat the market in three out of the last four quarters, and there is a lot of momentum in the company in terms of rising revenues and falling costs. So, there's a lot of momentum but it's clear that to create the sort of company that we want to create, which will be sustainable, we have more work still to do.

Appendix 2: Bly Report Summary

On 8th September 2008, BP released its internal Accident Investigation Report on Deepwater Horizon, compiled by Mark Bly, BP's Head of Operations and Safety. The report concluded that 'the team did not identify any single action or inaction that caused this accident. Rather, a complex and interlinked series of mechanical failures, human judgments, engineering design, operational implementation and team interfaces came together to allow the initiation and escalation of the accident. Multiple companies, work teams and circumstances were involved over time.' The main failures were a combination of engineering design and human judgment.

The main engineering design failure identified in the Bly Report concerns cement for which Halliburton is accountable. Two quotes from the report highlight this:

'The investigation team concluded that there were weaknesses in cement design and testing, quality assurance and risk assessment.' 'The investigation team has identified potential failure modes that could explain how the shoe track cement and the float collar allowed hydrocarbon ingress into the production casing.'

The cause of the critical failure of the blowout preventer (BOP), which should have provided a last resort failsafe, is still being investigated.

A series of human judgment failures take most of the blame, for which the Bly Report suggests that BP and Transocean are accountable, see quotes below:

> The Transocean rig crew and BP well site leaders reached the incorrect view that the test was successful and that well integrity had been established.
>
> The rig crew did not recognize the influx and did not act to control the well until hydrocarbons had passed through the BOP and into the riser.
>
> Through a review of rig audit findings and maintenance records, the investigation team found indications of potential weaknesses in the testing regime and maintenance management system for the BOP (blowout prevention).

It has been suggested that at each point where a test result or reading showed there might be a problem, the decision to ignore it was made because of reliance on assumed built-in compensating fail-safe processes elsewhere, including the BOP.

The main recommendations of the report, which highlight the main failings found by the inquiry are:

1. Improved technical practices, requirements and operational guidance regarding cementing, pressure testing and subsea blowout prevention (including strengthening BP's minimum requirements for drilling contractor's BOP maintenance management systems).
2. Increased capability and competency at all levels, including advanced training, competency assessment, embedding lessons learnt and shared learning throughout oil industry.
3. Strengthen BP's rig audit process to improve the closure and verification of audit findings and actions across BP-owned and BP-contracted drilling rigs.
4. Require drilling contractors to implement an auditable integrity monitoring system to continually assess and improve the integrity performance of well control equipment against a set of established leading and lagging indicators.

Appendix 3: New York Times

January 5, 2011

Blunders Abounded Before Gulf Spill, Panel Says

A version of this article appeared in print on January 6, 2011, on page A14 of the New York edition.

http://www.nytimes.com/2011/01/06/science/earth/06spill.html?_r=0

Appendix 4: BP Share Price Movement

Appendix 5

BP Spills Coffee: a PARODY by UCB Comedy
www.youtube.com/watch?v=2AAa0gd7ClM
For Additional Background Information on the Case
Timeline of disaster from April 20th to July 30th prepared by Thompson Reuters:
www.cnbc.com/id/37448876/Timeline_of_the_Gulf_of_Mexico_Oil_Spill

The Financial Times, BBC, and CNN websites all contain detailed analysis and contemporaneous reports:

www.ft.com

http://www.bbc.co.uk/search/bp_oil_spill

http://news.bbc.co.uk/1/hi/world/us_and_canada/

http://edition.cnn.com/2010/US/04/29/interactive.spill.tracker/index.html?hpt=T1 – for an animation day by day of the surface area of the spill

For visuals and graphics:

http://google-latlong.blogspot.co.uk/2010/05/keeping-up-to-date-on-gulf-of-mexico.html

For documentaries:

The Great Invisible (2014) directed by Margaret Brown

www.youtube.com/watch?v=LDw1budbZpQ

One particularly valuable resource is a US PBS-Frontline ProPublica documentary. www.pbs.org/wgbh/pages/frontline/the-spill/. This was a meticulously researched programme, also made available in "chapters" – segments covering the evolution of BP through a series of mergers and acquisitions in the 1990s, previous safety lapses, the accident and aftermath. PBS backed this up with substantial, additional supporting evidence and materials posted on-line.

This case was initially developed as a "live-case" taught as the crisis continued from May to July 2010, written by David Grayson from contributions from members of the Global Network for Corporate Citizenship: Michael Buersch, Derick de Jongh, Bradley Googins, Susanne Lang, Phil Mirvis, Mario Molteni, Christopher Pinney, Bill Valentino.

A subsequent version of the case was developed with fellow Cranfield School of Management faculty: Dr Steve Carver, Prof David Denyer and Chris Marsden OBE for the Pears Business School Partnership.

The author wishes to thank these contributors and the industry and sustainability specialists who commented on earlier texts.

The case relies on published sources.

Wal-Mart's Sustainable Product Index

3

Robert J. Crawford and N. Craig Smith

As I look back at our progress over the past few years, I think the most difficult challenge has been to measure the sustainability of our products. It's in this area that I believe we can truly accelerate and broaden our efforts…with a more elegant, research-driven approach.

Mike Duke, President and CEO, Wal-Mart (Remarks prepared for Mike Duke at Wal-Mart's Sustainability Milestone Meeting, Bentonville, Arkansas, July 16, 2009, Walmartstores.com/9279)

On 16 July 2009, Wal-Mart CEO Mike Duke announced an ambitious plan to develop a "Sustainable Product Index" that would enable customers to access reliable, standardised information on where its products came from, what resources they required for manufacture and delivery, and how they should be disposed of and/or re-cycled. He went on to explain –

> *[T]he human footprint, our use of natural resources for everything we grow, eat, drink, make, package, buy, transport and throw away…all of that is outpacing the earth's capacity to sustain us…[Today,] we see only bits of information, but not the full picture across the supply chain. We don't know the patterns, hidden costs and impacts...Nor do we have a single source…for evaluating the sustainability of our products.*[1]

[1] Ibid.

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© Springer Science+Business Media B.V. 2019

G. G. Lenssen, N. C. Smith (eds.), *Managing Sustainable Business*,
https://doi.org/10.1007/978-94-024-1144-7_3

For example, as the world's largest jewellery retailer, Wal-Mart planned to work with its suppliers to develop sustainable packaging and create a tracking system regarding the diamonds, gold, and silver used in its jewellery, thereby ensuring that its suppliers adhered to responsible mining criteria.[2]

Duke was speaking at a meeting of suppliers, Wal-Mart employees (or "associates"), and outside stakeholders. The initiative, he explained, would come in three phases. First, the company would ask 100,000 suppliers to answer 15 questions regarding the sustainability of their operations. Second, Wal-Mart would contribute to the creation of a consortium of academics to collaborate with suppliers, non-governmental organisations (NGOs) and governments to "develop a global database of information on products' lifecycles". Third, this information would be translated into "a simple rating system for consumers" as they made their purchasing decisions.[3]

In some quarters Duke's announcement was seen as a signal that Wal-Mart was fulfilling its 2005 promise to become a global leader in sustainability. With annual revenues of over $430 billion, it had surpassed Exxon to become the world's largest company, wielded enormous power over its suppliers and served as a bellwether for the direction global capitalism was taking. Building on a growing record of environmental achievements and consultation with outside stakeholders, the Sustainability Index represented an entirely new departure, empowering consumers as well as embracing a policy of enhanced transparency. It was an additional sign, supporters believed, that Wal-Mart was placing sustainability at the heart of company strategy, initiating a win-win-win cycle that would also increase profits and efficiency. To remain competitive, they argued, other companies would have to adopt similar policies.[4]

However, many of Wal-Mart's critics – from labour unions, social and environmental activists, to a variety of media outlets – took a more skeptical view. They argued that Wal-Mart's methodology was riddled with conflicts of interest and was merely a public relations ploy, in large part to deflect attention from its low wages and harsh labour practices, labor rights issues in its supply chains, and destructive impact on the communities it entered when opening new stores.

Background

Sam Walton, Wal-Mart's founder, grew up during the Great Depression in the Ozarks, the southern Midwest of the United States. It was a poverty-stricken region that was "pre-industrial, pre-urban, pre-immigrant", and strongly Evangelical Christian. The economy was overwhelmingly agricultural, with independent families growing livestock, grain and fruit on small plots, in contrast to the large-scale mechanized farms that grew commodity crops further to the east.[5] In 1945, Walton purchased a failing

[2] Wal-Mart press release, Walmartstores.com/9137

[3] Wal-Mart press release, Walmartstores.com/9292

[4] See Rosabeth Moss Kanter, "Wal-Mart's Environmental Game-Changer," blogs.hardvardbusiness.org/kanter/2009/07

[5] Bethany Moreton, To Serve God and Wal-Mart: The Making of Christian Free Enterprise, Harvard University Press, 2009, pp. 11–13.

Ben Franklin 5&10 Store as a franchisee. After 4 years of creative experimentation and careful study of other retailers, he turned it into the most successful branch in Arkansas.[6] Gradually expanding his Ben Franklin franchises to 16 branches, Walton began to envision a new kind of retail strategy. "Here's the simple lesson we learned," he wrote. "[S]ay I bought an item for 80 cents. I found that by pricing it at $1.00 I could sell three times more of it than by pricing it at $1.20…the overall profit was much greater."[7] When the Ben Franklin supplier-owners refused to allow him to develop this super-discount strategy, Walton decided to start his own chain. On 2 July 1962, he opened Wal-Mart Discount City in Rogers, Arkansas, offering the same items as nearby stores at prices that were consistently 20% lower. By 1985, with over 1,000 stores, Walton was recognized as the richest man in America.[8]

Initial Achievements To implement his strategy of "everyday low prices", Walton and his successors pursued a two-pronged approach: a relentless search to cut costs and the creation of a logistics and distribution system of unprecedented efficiency. Walton's timing was lucky. In the prosperous 1960s, the United States was developing a culture of mass consumption. Retailing was becoming standardised by huge organisations that set a new standard for economies of scale, consumers were enticed to purchase "status" brands by television advertising, and automobiles offered consumers the option of shopping outside traditional downtown commercial centres.

Walton chose rural America as his market, a region his competitors were neglecting.[9] However, it was his bare-bones management style that enabled the company to grow into the world's largest corporation by 2002. "Now, when it comes to Wal-Mart," Walton wrote, "there's no two ways about it: I'm cheap….We exist to provide value to our customers."[10]

Beyond pioneering direct purchase from manufacturers, Wal-Mart cut costs through a number of stringently controlled labour practices. First, to keep wages low and safeguard management flexibility in its employment practices, Wal-Mart opposed organized labour to the point that it would close stores that unionized. Second, the company deliberately understaffed its stores: since there were never enough associates to accomplish their assigned tasks, they had to work very hard, enhancing productivity but also – as many would later charge in class-action lawsuits – forcing them to skip rest breaks and meals, as well as working overtime without compensation.[11] Third, Wal-Mart tended to provide fewer benefits, such as health insurance, than its competitors. This was due to the cost of health insurance, which workers with low salaries could not support, an unusually high rate of

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[6] See Robert Slater, The Wal-Mart Triumph: Inside the World's #1 Company, Portfolio, 2003, p. 25.

[7] Sam Walton with John Huey, Sam Walton: Made in America, Bantam Books, 1993, pp. 32–33.

[8] Slater, op. cit., pp. 28–41.

[9] Susan Strasser, "Woolworth to Wal-Mart: Mass Merchandising and the Changing Culture of Consumption", in Wal-Mart: The Face of Twentieth Century Capitalism, Nelson Lichtenstein (ed.), pp. 52–53

[10] Walton, op. cit., p. 12.

[11] Ellen I. Rosen, "Wal-Mart: the New Retail Colossus", in Wal-Mart World, Stanley D. Brunn (ed.), p. 93.

employee turnover (estimated at over 50% per year) combined with a year-long waiting period for the right to obtain benefits, and (it was alleged) a systematic policy to encourage employees to enter public assistance programmes, from Medicaid to food stamps.[12] Fourth, store managers and executives faced constant pressure to keep costs low, from sharing rooms while on the road to bonuses based on cost containment results and productivity enhancement.[13]

Wal-Mart grew with a small town "saturation" strategy, spreading out slowly, "like molasses", to nearby communities as distribution centres were established further and further from its Bentonville, Arkansas headquarters. By the late 1960s, Walton had recognized the need to develop an efficient logistics system, not only to warehouse and deliver goods when needed on a massive scale, but as an entirely new system of management control. With a team of information-technology specialists, Walton eventually established a monopsony-like power over its suppliers, which enabled Wal-Mart to:

- Anticipate consumer demand with unparalleled precision, removing a key advantage that producer/manufacturers had enjoyed over retailers;
- Establish a just-in-time delivery system that was far more cost-efficient than its local rivals could achieve;
- Develop integrated solutions along the entire supply chain, in effect shifting much of the risk (of over-production, late delivery, etc.) to its suppliers and middlemen.

While keeping costs low, Wal-Mart was also able to demand a greater variety of goods with pinpoint accuracy in terms of consumer demand, from suppliers. The retailer even began to scrutinize the books of its suppliers in order to impose cost and efficiency "improvements" in their business practices as well as dictating pricing and even marketing strategies to them. For their part, suppliers recognized that they had little choice but to conform to Wal-Mart's dictates; for example, by 2003 Wal-Mart accounted for 17% of Procter and Gamble's global sales.[14]

The Wal-Mart Way True to its roots in the rural Ozarks, Wal-Mart developed a folksy culture that admirers believed was genuine. As Walton wrote: "We thrive on a lot of the traditions of small-town America, especially parades with marching bands, cheerleaders, drill teams, and floats."[15] The result was a brand of "pro-corporate populism" of low prices and an oasis where the courtesy and friendliness of Wal-Mart employees were supposed to offer a contrast with the outside world. While not an Evangelical Christian company, many Wal-Mart executives claimed to operate in accordance with "the values of Scripture".[16] Via intensive training and peer pressure,

[12] David Karjanen, "The Wal-Mart Effect and the New Face of Capitalism", in Lichtenstein, op. cit., pp. 154–155.

[13] Rosen, loc. cit.

[14] See Edna Bonacich and Jake B. Wilson, "Global Production and Distribution: Wal-Mart's Global Logistics Empire", in Brunn, op. cit., pp. 229–237.

[15] Walton, op. cit., p. 207.

[16] Moreton, op. cit., pp. 40–41, 89.

Wal-Mart associates learned that they should appear happy and open, to view themselves as "servant leaders", with reference to Christ's work, and to expect "equality and solidarity" from their colleagues.[17] During its first few decades, Wal-Mart operated almost exclusively in the conservative rural setting later to be known as the "red states", where media scrutiny and labour laws were weak, trade unions and government regulation were viewed with suspicion, and consumers were grateful for "low prices", while employees were described as "appreciating good jobs". In this atmosphere, outside critics were ignored as a matter of company policy.[18]

For their part, Wal-Mart managers and executives faced a number of exacting requirements, some of which were rigorously quantified, others a question of touchy-feely leadership. First, the core of their job was to achieve – perhaps even surpass – their revenue and profit goals, as well as make efficiency gains, all with an eye to the company's quarterly results. With their year-end bonuses closely tied to meeting these goals, managers were under pressure to perform. Second, they were supposed to act as the guardians of the company culture, which they should instill in their associates. This included an order to "Push responsibility – and authority – down" to regional managers and associates, who were empowered to think on their own. Third, they were mandated to pay attention to economic and social trends that would affect the company, which they were expected to transmit to the top as well as address on their own initiative.[19] Routinely working 60–80 h weeks, including obligatory Saturday morning meetings at headquarters for regional managers, they often suffered "early burn out".[20]

The Critics As Wal-Mart grew, its reach and power attracted determined opposition. Critics began to mount protest campaigns against the company. Individual and class action lawsuits from a huge variety of organisations made Wal-Mart the "most sued" company in the world, severely undermining its reputation.[21] They argued that the company, which competitors felt compelled to imitate if they were to survive, was a principal mover in the "race to the bottom" in the new global economy. They raised a wide range of issues, including the need to:

- Mitigate its impact on the communities it entered. At its worst, they charged, Wal-Mart decimated local retailers who could not compete on price, closed down once-vibrant downtown shopping areas that were also social centres, and generated secondary effects such as increased traffic, reduced demand for local businesses and increased infrastructure demands, while placing outlets beyond the city limits, simultaneously raising costs and lowering tax revenues.[22]

[17] A. Jane Dunnett and Stephen J. Arnold, "Falling Prices, Happy Faces: Organizational Culture at Wal-Mart", in Brunn, op. cit., pp. 82–84.

[18] Moreton, op. cit., pp. 1–5.

[19] See Walton, op. cit., pp. 282–294.

[20] Moreton, op. cit., p. 82.

[21] Slater, op. cit., p. 202.

[22] See Bill Quinn, How Wal-Mart is Destroying America (and the World) and What You Can Do About It, Ten Speed Press, 2005, pp. 1–26.

- Ameliorate labour practices that they believed were brutal, often illegal, and failed to provide a living wage. In their view, the company should allow associates to unionize, raise wages, offer better health insurance benefits, and treat them more humanely.
- Provide both a more equitable and ethical management of its supply chain, from the treatment of “sweatshop” workers in supplier countries such as China and Bangladesh, to treatment of the company’s truckers.[23]
- Loosen its grip on supplier/manufacturers, many of whom bore the brunt of price cuts and risk. For example, Wal-Mart’s pricing policies were alleged to have caused the bankruptcy of the Vlasic pickle company. As it depended on Wal-Mart for 30% of its gross sales, the company had felt compelled to accept the sales price that Wal-Mart imposed, even though it was too low to re-coup expenses and ruined the brand’s reputation for quality.[24]

Increasingly, critics targeted Wal-Mart’s basic business model, which in their view was the root cause of these issues. To transform itself into a more responsible corporate citizen, some argued, Wal-Mart would have to attenuate its cost-cutting policies and invest far more in the communities it entered and in environmental initiatives. This meant that the company might have to charge its customers more, and that its brand image for “every day low prices” would no longer be tenable as originally implemented. Any other ethical measures, many opponents argued, merely represented a public relations diversion from the real issues.[25]

The Greening of Wal-Mart

By the mid-1990s, Wal-Mart stores had more or less saturated rural markets in the US To continue growing, the company would have to enter new markets both in urban areas and abroad. However, these markets differed fundamentally from the Ozarks: they were more cosmopolitan, had pockets of highly-educated consumers who felt politically empowered, and had long operated under stricter regulatory regimes; they tended to have large unions, living-wage controls, and zoning laws to protect parks and other public spaces. When Wal-Mart executives entered these areas, they were shocked to learn that the company was viewed less as a “consumer advocate” promising jobs and lower prices, but rather as a damaging presence to be resisted.[26] Moreover, with notable exceptions in Mexico and Canada, Wal-Mart stores proved far less successful in international markets, where they came up against unionized workers with strong political ideologies as well as regulatory

[23] See Liza Featherstone, “Wal-Mart’s P.R. War,” Salon.com, 2 August 2005.

[24] Charles Fishman, “The Wal-Mart You Don’t Know: Why Low Prices Have a High Cost”, Fast Company, December 2003, p. 73.

[25] Michael Barbaro, “A New Weapon for Wal-Mart: A War Room,” The New York Times, 1 November, 2005.

[26] Charles Fishman, The Wal-Mart Effect, Penguin Press, 2006, p. 62.

restrictions that undermined the basic tenets of Wal-Mart's traditional strategies, for example in constructing big box stores in low-tax areas at the edge of towns.[27]

From 2004, Wal-Mart faced a growing storm of protest in such vehicles as the film "Wal-Mart: The High Price of Low Cost", directed by Robert Greenwald, but also in grassroots campaigns to legally bar the company from opening stores in major urban areas. For example, a broad coalition of activists defeated a Wal-Mart-sponsored referendum in Inglewood, California (in the Los Angeles area) that had sought to turn public into commercial land. Wal-Mart lost a number of similar political battles in other major US cities.[28] To take the fight to a national level, union-sponsored organisations such as 'Wal-Mart Watch', devoted themselves to opposing the company in what some saw as an ideological crusade.

Wal-Mart soon found itself the target of higher expectations of corporate social responsibility, the "bad example" that warranted attack from the left. Critics of the company, Wal-Mart's top leadership came to recognize, were beginning to have a serious impact on its long-term prospects. This prompted several Wal-Mart board members to bring the issue up with CEO Lee Scott.[29]

A New Way Behind-the-scenes developments had long been percolating at Wal-Mart. After a trip to Africa in 2002, the founder's eldest son, Robert Walton, began to seek ways that the family foundation might preserve wilderness areas. This led to a friendship with biologist Peter Seligman, co-founder and CEO of Conservation International (CI), an environmental organization in Washington, DC. CI's advisory clients included Starbucks and McDonald's. Over the next 2 years, Seligman took Robert Walton and his sons on a series of exotic trips, including hikes in Madagascar and scuba diving in the Galapagos. While Seligman was seeking donations for CI, he was also building the case for Wal-Mart to fundamentally transform its business practices in a way that could make the company "a driver of tremendous change". This would involve the "greening" of the company in the areas over which it had control: in the US it was the largest private consumer of electricity and had the second largest truck fleet; its suppliers would strive to meet its demands, whatever they were; and it could influence the buying choices of its regular customers, who numbered some 180 million.[30]

With disappointing financial results – between 2000 and 2005 its stock price fell nearly 20% – and a series of recent PR debacles in mind, then-CEO Lee Scott was willing to listen to new ideas. Seligman and several CI colleagues came to Bentonville in June, 2004. A greener policy, they argued, would offer a way for Wal-Mart to enhance its efficiency, improve its image, and engage its employees in an exciting mission – a "win-win-win" scenario. Soon thereafter, Scott hired CI and a

[27] See Yukio Aoyama and Guido Schwarz, "The Myth of Wal-Martization: Retail Globalization and Local Competition in Germany and Japan", in Brunn, op. cit., pp. 280–286.

[28] See Tracy Gray-Barkin, "Southern California's Wal-Mart Wars", Social Policy, Vol. 35, Number 1 (Fall 2004).

[29] Marc Gunther, "The Green Machine", Fortune, July 31, 2006.

[30] Ibid.

consulting firm, Blu Skye, which would develop sustainability metrics. Over the next year, they measured wasteful practices and put forward a number of "holistic" suggestions for improvement, with the goal of creating a sustainability system rather than a series of discrete actions. Wal-Mart stipulated that their compensation, and that of other NGOs paid by the company, remain confidential.[31]

Scott also hired the PR firm Edelman in early summer, 2005, which specialized in corporate "reputation management". Edelman created a rapid-response "war room" at Wal-Mart's headquarters, which was designed to generate rapid responses and "spin" to promote a positive take on stories about the company. The group began to target "swing voters", the 60% or so of shoppers who had not yet considered boycotting Wal-Mart for environmental and/or labour reasons.[32] In addition, Edelman recommended that Wal-Mart adopt a "co-option policy", in effect bringing critics into the company – they were variously viewed as an early warning system, monitors of public opinion, and generators of innovative ideas at little or no cost. The engagement of these stakeholders, which would expand the collaboration begun with CI, was viewed as a way to legitimize the retailer, particularly if they secured endorsements of their practices.[33]

The Katrina Epiphany The war room's first major test was the company's response to Hurricane Katrina, which devastated the Louisiana coast on 29 August, 2005. Mobilizing its distribution network, Wal-Mart filled significant gaps in the efforts by various government relief agencies. Its accomplishments – providing food, water, medicine, and temporary shelter – were almost universally praised, achieving a far more positive response from the public than did the governmental authorities involved. Even the 'Wake Up Wal-Mart' campaign wrote in a letter to the company that the Katrina measures "brought out the best in Wal-Mart and we applaud your hurricane relief efforts."[34] Beyond screening the media for critical stories about the company, the war room played a crucial role coordinating Wal-Mart's communications efforts with the actors in the field.[35]

According to Scott, the Katrina experience represented "a key personal moment" regarding his commitment to environmental sustainability. It was then, he said, that he overcame the "skepticism of the company's environmental critics…We stepped back…and asked one simple question: How can Wal-Mart be that company – the one we were during Katrina – all the time?" Rather than roll out a toothless programme that was more public relations than substance, he promised to create a truly meaningful sustainability policy. Katrina relief, he said, "was only the beginning"

[31] Ibid.

[32] Barbaro, loc. cit.

[33] See Jeffrey Goldberg, "Selling Wal-Mart: Can the company co-opt liberals?" New Yorker, April 2, 2007.

[34] As cited by Kevin McCauley, "Katrina Relief Lifts Wal-Mart's Image", O'Dwyer's PR Services Report, October 2005.

[35] Barboro, loc. cit.

of Wal-Mart's charm offensive.[36] By October, 2005, Scott and his team had articulated a set of three "aspirational" goals for Wal-Mart, including:

- To create zero waste, which promised to save money via a recycling programme;
- To be 100% supplied by renewable energy;
- To sell products that sustain resources and the environment.[37]

Scott also promised to reduce greenhouse gases produced by Wal-Mart stores by 20% over the next 7 years, his first acknowledgment of the importance of climate change. In addition to engaging with other environmental groups, Scott indicated that Wal-Mart would work with anti-sweatshop groups to improve monitoring of overseas factories to guard against worker and human rights abuses. Measures to improve the treatment of its associates, he said, were also underway: health care coverage would be provided to Wal-Mart associates for $25 per month. He even called on the US Congress to raise the minimum wage.[38] However, just days after Scott's announcements, the *New York Times* reported on a leaked draft memo to Wal-Mart's board. In it, Executive Vice President for Benefits, Susan Chambers, described how many Wal-Mart employees were uninsured or on public assistance for health (and 46 percent of the children of Wal-Mart's 1.33 million US employees were uninsured or on Medicaid), and advocated a strategy to "dissuade unhealthy people from coming to work at Wal-Mart".[39]

Steps to Implementation Wal-Mart immediately undertook steps to realize Scott's vision. An early hire was Adam Werback, a former Sierra Club President turned consultant. In his first meeting with Wal-Mart executives, Werback was deeply impressed with the interest they showed for his organizational expertise. According to Werback:

> *The executives peppered me with questions about how to make sustainability attractive to the broadest set of the American public, how to engage associates, how to measure success, whom I respected, and whom they should be talking to. They spoke candidly about their challenges and called on my expertise in facing them…the company opened its [as yet unannounced] goals to me.*[40]

As part of the "sustainability network" that Wal-Mart was building, Werback and others refined, and sometimes helped to initiate, a number of organizational practices.

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[36] As cited in Gunther, op. cit., July 31, 2006.

[37] See Erica L. Plambeck and Lyn Denend, "Wal-Mart, a Case Study," Stanford Social Innovation Review, spring 2008.

[38] Pia Sarkar, "Wal-Mart's World View: Giant Retailer Says It's Ready to Tackle Hot-Button Issues," San Fransisco Chronicle, 26 October, 2005.

[39] Daniel McGinn, "Wal-Mart Hits the Wall," Newsweek, 14 November, 2005.

[40] Adam Werback, Strategy for Sustainability: A Business Manifesto, Harvard Business Press, 2009, pp. 157–158.

First, Werback praised Scott's aspirational (or "North Star") goals of October, 2005. Designed to set the company in an entirely new direction, they should also be realistic, employees should see a concrete way to work towards them, and they were connected to the core business, i.e. the distribution network and product selection. Moreover, if Wal-Mart failed to meet them, the company would have to accept the blame.[41]

Second, Werback designed a "Personal Sustainability Project" to involve and educate Wal-Mart associates through voluntary activities. It was part of a policy to engage Wal-Mart employee creativity in new ways, to make them "part of the solution" in areas that concerned them. Starting with a personal sustainability project – bicycling to work, skipping fast food meals, replacing incandescent bulbs with fluorescent ones – they would attract the interest of their colleagues, many of whom would learn about sustainability and perhaps develop their own projects. Voluntarism combined with concrete projects, Werback stressed, worked far better than preaching ideals. Eventually, they elected "sustainability captains" to transmit their goals and explain their activities to others. Their numbers grew to half a million, or just under one third of all Wal-Mart employees.[42]

Third, Werback and others advised Wal-Mart to become "transparent" as a way to advance the company's sustainability goals. In Werback's view, Wal-Mart needed to recognize its environmental "blind spots", which would encourage awareness within the company; this should enhance compliance with norms and laws. Wal-Mart would also release a series of reports on its progress toward the "North Star" goals. This could lead, according to Werback, to complete transparency, which included honest and comprehensive reporting, immediate and candid admission of mistakes by Wal-Mart leaders, and the opening of the company to all constructive outside stakeholders. This would result, Werback argued, in an influx of new ideas for improvement as well as uncover business opportunities that Wal-Mart had not yet considered.[43]

The Continuing Controversy Many in the activist community praised the steps that Wal-Mart was beginning to take, which they viewed as the opportunity of a lifetime. However, others questioned the motives and sincerity of the company, maintaining the suspicion that it would only lead to "greenwashing", that is, the appearance of environmentally-friendly measures that ultimately had only a marginal impact. Journalists also remained skeptical. Jeffrey Goldberg of the New Yorker, for example, observed in a visit to the war room that Wal-Mart managers appeared "tightly scripted" and mistrustful rather than open and available; he was repeatedly instructed "not to write down anything [he] saw".[44] Perhaps more important, critics feared that the co-option policy would create "corporate front groups" – by taking money from private corporations, NGOs were less likely to pressure their sponsors on issues of concern. Moreover, when NGOs endorsed the measures that these companies were undertaking, it created the appearance of a conflict of interest, that is, a

[41] Ibid. pp. 35–36. Werback.

[42] Ibid. pp. 132–135. Werback.

[43] Ibid. pp. 92–118. Werback.

[44] Goldberg, loc. cit.

stamp of approval upon payment. It was insidiously corrupting, the critics argued. Other NGOs that interacted with Wal-Mart, such as the Environmental Defense Fund, refused contributions from the company as a matter of policy.[45]

Finally, critics raised the problem of what was enough. How could the standard be balanced against the criticisms of Wal-Mart's social impact? Moreover, what did sustainability mean? Definitions varied significantly. For example, in the view of Stuart Hart, "going green" was essentially reactive – an incremental effort to do the minimum in order to avoid sanctions – and merely served to perpetuate the existing industrial paradigm. To be truly sustainable, Hart argued, companies had to become proactive, thinking about how they fit into the ecosystem. Eventually, he believed, as stewards of sustainability at the cutting edge, companies would find or invent entirely new industrial paradigms that would promote clean technologies, reduce their impact on nonrenewable resources to zero, and address the needs of the poor as well as the rich countries.[46] Wal-Mart, in his view, was beginning to place sustainability at the core of its business strategy, for example with its promotion of a clothing line made from organic cotton.[47] John Elkington, the visionary author of the 'triple bottom line' concept, argued that corporations must transform themselves from "locusts" – exploiting resources with little regard to their impact – into "honey bees" that worked as architects of environmentalism.[48] At a minimum, according to Adam Werbach, sustainability must become part of the culture of a company rather than a public relations effort run by a legal or corporate affairs department.[49]

Wal-Mart's Sustainability Initiatives

In 2006, Blu Skye, with the help of Conservation International, engaged in discussions with Wal-Mart executives in an effort to set actionable priorities. By combining Wal-Mart's sales data with environmental impact factors from the Union of Concerned Scientists, they chose 14 areas on which to focus, including product groups as well as functional areas (See Exhibit 3.1). In each of the 14 areas, Wal-Mart assigned an executive vice president as sponsor, along with a "network captain", who was usually a senior vice president charged to build a "Value Network". The captains contacted academics, NGOs, suppliers, and other stakeholders to join discussions on sustainability measures that Wal-Mart might undertake.[50] The meetings ended with "go-do's", i.e., requests that were directed principally at Wal-Mart's suppliers, who bore the principal responsibility to take action.

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[45] Marc Gunther, "Corporate Ties Bedevil Green Groups", Fortune, Nov. 14, 2008.

[46] See Stuart L. Hart, Capitalism at the Crossroads: Aligning Business, Earth, and Humanity, Wharton School Publishing, 2007, pp. 7–21.

[47] Ibid., pp. 102–103.

[48] See "Enter the Triple Bottom Line", in The Triple Bottom Line: Does it all add up?, Adrian Henriques and Julie Richardson (eds.), 2007, pp. 10–13.

[49] Werbach, op. cit., p. 116.

[50] See Erica L. Plambeck, "The Greening of Wal-Mart's Supply Chain", Supply Chain Management Review, 1 July, 2007.

Exhibit 3.1 Wal-Mart Sustainable Value Networks

Greenhouse Gas
Sustainable Buildings
Alternative Fuels
Logistics
Waste
Packaging
Wood & Paper
Agriculture and Seafood
Textiles
Jewelry
Electronics
Chemical Intensive Products

Source: http://walmartstores.com/Sustainability/7672.aspx

The Value Networks at Work While wide-ranging discussions addressed how to transform Wal-Mart's supply chain, cut costs, and provide benefits to the consumer, the activities of the Value Networks depended in large measure on the energy that their captains devoted to them. The Wal-Mart employees involved still had to accomplish their full-time jobs: with few exceptions, there were no new full-time staff hired to run the Networks. Some of them, such as the packaging Network, had 500 members or more; others, such as that of jewellery, consisted of only 15 or so. According to one Network member,[51] Wal-Mart strove to include relevant stakeholders, regardless of their opinions of the company. In many cases, even determined critics participated.[52]

By July 2006, Wal-Mart could point to some specific accomplishments. Examples included:

- Savings of $75 million from a 25% increase in fuel efficiency that also reduced carbon emissions by 400,000 tons. This in effect met one of CEO Scott's original promises.
- The adoption of a web-based sustainability scorecard to facilitate the evaluation of packaging against precise metrics.
- The adoption of sustainability standards for the wild seafood industry, as set by an independent third party, the Marine Stewardship Council (MSC). Wal-Mart committed itself, in three to 5 years, to apply the MSC certification to 100% of its store offerings of wild seafood. The company planned to adopt similar certification standards for other products.[53]

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[51] Author interview with Assheton Carter, then of CI.

[52] Ylan Q. Mui, "At Wal-Mart, 'Green' Has Various Shades", Washington Post, Nov. 16, 2007.

[53] Plambeck, loc. cit.

While acknowledging the potential of these initiatives, Wal-Mart critics were quick to point out that the principal burden appeared to fall on the suppliers – they were the ones that would bear the cost of the "race to the top" (of new sustainability standards) that Wal-Mart was attempting to initiate. Moreover, many activists continued to refuse to engage with Wal-Mart, which they criticized for failing to meet their basic demands regarding community and other social issues.

Nonetheless, Wal-Mart was developing a number of new processes that were under-reported in the popular press. Beyond the certification and scorecard requirements, members of the Value Networks were beginning to provide a wide range of sustainability expertise to its suppliers. To some observers this represented a fundamental transformation of Wal-Mart's engagement with suppliers: rather than merely impose conditions on end-suppliers regardless of what others downstream had done, Wal-Mart was systematically addressing issues in its entire supply chain. For example, Value Network members were beginning to educate organic cotton farmers on sustainable techniques. In addition, Wal-Mart was developing deeper, longer-term relations with its suppliers, not only by cutting out the middleman as a way to enhance traceability, but also by more carefully selecting suppliers that operated in accordance with its sustainability standards. This entailed the re-training of Wal-Mart buyers, in effect adding sustainability concerns into their job descriptions and offering them the opportunity to specialize in it. However, critics argued, it might require decades to evaluate the effectiveness of these processes.[54]

The Reports Starting in 2007, Wal-Mart began to issue reports on its sustainability accomplishments. For many this represented a step on the way to transparency, further opening the company to outside scrutiny and input. Indeed, if Wal-Mart failed to meet its goals – to reduce plastic shopping bag use by 30% in 5 years, for example, or to double its truck fleet efficiency by 2015 – the results would be very public. However, the reports' deficiencies came in for criticism as well. "Despite numerous programme descriptions, goals and statistics," one critic wrote, "careful reading reveals a surprising lack of context, undefined metrics, and goals that turn out to be meaningless." Moreover, she claimed, the reports failed to directly address both the challenges ahead and the concerns of certain stakeholders. Finally, though the report referenced the sustainability guidelines established by the Global Reporting Initiative, Wal-Mart apparently did not use them in any consistent way. "These missteps," the writer concluded, "raise the question of whether Wal-Mart's systematic lack of clarity is intentional."[55]

Furthermore, some critics argued that the omissions from Wal-Mart's Sustainability Reports were far more significant than what it claimed to have accomplished. They implied that Wal-Mart had got its sustainability criteria wrong, that its statistics were unreliable or misleading, and that Wal-Mart's growth model by its

[54] Plambeck, loc. cit

[55] Kathee Rebernak, "What's Wrong with Wal-Mart's Sustainability Reporting", www.sustainabilelifemedia.com, 2 Sept., 2008.

very nature was unsustainable. For example, one report stated that by calculating energy use required for additional consumers –

> *Wal-Mart's new stores will use more energy than its energy-saving measures will save. Even if Wal-Mart meets its goal to cut 2.5 million metric tons of CO^2 emissions at existing stores by 2013, new stores built in 2007 alone will consume enough energy to add approximately one million tons of CO^2 to the atmosphere [which would add] 28 metric tons of new emissions within the same period.*[56]

The report then catalogued Wal-Mart's environmental transgressions, from destruction of wetlands and degradation of water supplies from construction-site hazardous waste, to increased transportation needs. (See Exhibit 3.2 for an example of criticisms.)

Exhibit 3.2 Is Wal-Mart Really A "Green" Company? (Press Release from Wal-Mart Watch)

Over the past 40 years, Wal-Mart has contributed significantly to the degradation of the environment. Then, 2 years ago, McKinsey and Company advised Wal-Mart to do the following:

> *"Take a proactive stance: shape the external debate by becoming a role model on a significant societal issue." [August 2004 McKinsey Memo]*

Since then, Wal-Mart has taken some commendable steps to clean up its impact on the environment, promising to reduce food product packaging, sell more energy efficient light bulbs, and improve fuel efficiency in its trucking fleet. However, as the following facts show, Wal-Mart's massive size and its voracious need for growth mean that the company's current green efforts are to the health of the planet what cleaning one store is to its global maintenance operations.

Wal-Mart Supercenters Contribute to Sprawl and Pollution

Wal-Mart's Growth Will Offset Its Planned Energy Savings Wal-Mart's new stores will use more energy that its energy-saving measures will save. Wal-Mart hopes to cut 2.5 million metric tons of CO_2 emissions by 2013, by making its existing stores 20% more efficient. New stores built in 2007 alone, however, will consume enough electricity to add approximately one million metric tons of CO_2 to the atmosphere. At that rate, (adding one million metric tons of CO_2 per year because of new stores), by 2013 Wal-Mart will be

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[56] It's Not East Being Green: The Truth About Wal-Mart's Environmental Makeover, Wal-Mart Watch, Sept. 2007, p. 3.

Exhibit 3.2 (continued)
offsetting its cut of 2.5 million metric tons of CO_2 by adding 28 million metric tons of new emissions within the same time period. [Stacey Mitchell. "Keep your eyes on the size: The impossibility of a green Wal-Mart." www.grist.org, March 28, 2007.]

Wal-Mart Has Over 2,300 Supercenters in the United States The average Wal-Mart Supercenter is mammoth, averaging 200,000 square feet and occupying 20–30 acres of land – about as large as a football stadium. There are over 2,200 Supercenters in the United States, in addition to thousands of standard WalMarts, Neighborhood Markets, Sam's Clubs, distribution centers and warehouses. It is the largest commercial entity in the United States, both physically and economically, and its stores require massive amounts of land, energy and labor to function. [http://www.walmartfacts.com; San Diego Union-Tribune, 5/21/07]

Wal-Mart Leaves Empty Buildings Behind It is estimated that Wal-Mart alone has abandoned over 300 of its stores across the country in order to build newer and larger Supercenters, all the while leaving empty concrete shells behind resulting in over 500 million square feet of unused retail space, the approximate amount of industrial space in the entire city of Atlanta,. [Erin Zeiss, "Wal-Mart devastates the environment," *Eco-Mind, UVM Environmental Council,* 1/23/07; http://www.southeastrebusiness.com/articles/JUN05/cover2.html]

Wal-Mart Parking Lots Contribute To Water Pollution A Wal-Mart Supercenter may cover several acres, but its parking lot can be three times the size of the store itself, placing its footprint at well over 18 acres. A 2005 report by the Institute for Local Self-Reliance estimated at the time that Wal-Mart stores and parking lots covered roughly 75,000 acres (or 117 square miles) in the U.S., equal to the land size of Tampa, Florida, a figure that has continued to rise as Wal-Mart continued to expand over the last 2 years. Parking lots contribute directly to what is referred to as "non-point source water pollution," the leading cause of water pollution in the United States. [http://www.sierraclub.ore/sprawl/reports/big_box.asp; Institute for Local Self-Reliance, 7/21/05; St. Petersburg Times, 3/25/05]

Wal-Mart Is A Major Factor In The Dramatic Increase In Amount Of Distance Americans Drive To Fill Their Shopping Needs Wal-Mart has contributed to a jump of more than 40% in the amount of vehicle miles American households travel for shopping purposes since 1990. The jump is not attributable to consumers going to the store more often, however, but instead that the average trip is two miles longer. Studies also have found that the size of a store is directly related to the amount of traffic it generates.

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Exhibit 3.2 (continued)
Larger stores pull customers from a larger geographic area which results in increased traffic – a 200,000 square-foot Supercenter on average generates over 10,000 car trips during a week, and even more on a weekend . [Institute for Local Self Reliance; Stacey Mitchell. "Keep your eyes on the size: The impossibility of a green Wal-Mart." www.grist.org, 3/28/07; Big Box Toolkit – Impact of Big Box Stores on Traffic – www.newrules.org]

Wal-Mart Supercenters Use An Enormous Amount Of Energy When Compared To Other Retailers Even with a 15% reduction over the current average energy use, a Wal-Mart Supercenter, open 24 h a , uses 96.5 MBTU or 96,500 British thermal units of energy per or nearly three times the average use by a residential home in the United States each year. This is almost double the rate of energy of Wal-Mart's nearest competitor's "superstore," which opens 12–14 h daily. However, Wal-Mart's nearest competitors only run a handful of superstores. Wal-Mart's energy use and carbon footprint, (the company estimates that its U.S. operations were responsible for 15.3 million metric tons of CO2 emissions in 2005), is significantly more than its competitors stores based on its 24-h operations and push for rapid expansion of the Supercenter format. To put Wal-Mart's 15.3 million metric tons of CO2 emissions in perspective, this number represents the approximate emissions of Chile and is larger than Rhode Island, Vermont, South Dakota, and Idaho. [Aly Courtemanch and Lani Bensheimer, Conservation Biology, April 29th, 2005; F-E-S Associates, APD Engineering, Northern Ecological Associates, "Draft Environmental Impact Statement for Wal-Mart Supercenter." Submitted to Town of Potsdam, NY, October 19, 2004; Target Developer Guide Edition 2.7; www.grist.org, 3/28/07; Carbon Dioxide Information Analysis Center, 5/31/06; www.eredux.com]

Wal-Mart Truck Fleet Adds Major Traffic to the Roads and Pollution to the Air For example, a Wal-Mart Distribution Center in Merced, CA Is Projected To Have 900 Daily Truck Trips. Using average emissions rates calculated by the EPA, the 900 truck trip estimate works out to around 2.4 extra tons of particulate matter and 83 extra tons of nitrogen oxides entering the atmosphere each year because of Wal-Mart trucks. Since Merced is an area with significant air pollution problems already, residents living closest to this distribution center would be at an increased risk. Wal-Mart currently has 135 distribution centers in 38 states, which translates to approximately 120,000 daily truck trips or equal to the approximate number of vehicles that use the Lincoln Tunnel on any given in New York City. [http://www.warnwalmart.org/index.php?id= 126; http://www.mercedalliance.org; http://www.walmartfacts.com; http://www.nycroads.com/crossings/lincoln/]

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Exhibit 3.2 (continued)
Wal-Mart Violates Environmental Laws

Environmental Fines Across the Country In 2004, Wal-Mart faced fines for violations of environmental laws in nine states: California, Colorado, Delaware, Michigan, New Jersey, South Dakota, Tennessee, Texas and Utah. [Associated Press, 5/12/04; New York Times, 4/13/05]

Air Pollution Claims in Eleven States In 2004, Wal-Mart agreed to pay $400,000 to the government to settle claims that Sam's Club had flouted federal air pollution regulations in eleven states. [The Business Journal, 1/30/04]

Widespread Water Pollution In 2001, the EPA and Justice Department for the first time fined a company –Wal-Mart – for violating newly adopted standards for storm water runoff. Wal-Mart paid $5.5 million in fines for violations at construction sites in four states: Massachusetts, New Mexico, Oklahoma and Texas. Four years later, however, Wal-Mart signed an agreement with the Connecticut Department of Environmental Protection over storm water violations occurring over 7 years at 20 stores, and agreed to pay $1,550,000 in penalties. [Underground Construction, 8/1/01; Forbes, 8/15/05]

Contaminating Water in Georgia Georgia's Environmental Protection Division (EPD) fined Wal-Mart for letting polluted storm water run free into state waters – resulting in $170,000 in penalties for pollution at two sites. Wal-Mart failed to take basic steps to help clean storm runoff, such as maintaining silt fencing around construction zones, installing ponds to catch storm water, and failure to keep records. The fines ranked among the highest paid in Georgia for violations of the Clean Water Act. [Atlanta Journal-Constitution, 2/10/05]

Oil Storage Problems in Florida Florida forced Wal-Mart to pay $765,000 in fines for operating outside safety restrictions on petroleum storage at its auto service centers. The Florida Department of Environmental Protection flagged the company for failing to register its fuel tanks with the state or install devices that prevent gasoline overflows. According to the state, Wal-Mart also failed to perform monthly safety checks, lacked current technologies to prevent overflows, blocked state inspectors from reviewing records and failed to show proper insurance documentation. [Associated Press, 11/18/04]

Wal-Mart Under Investigation Regarding Hazardous Waste

Wal-Mart Is Under Investigation For Environmental Violations Related To Hazardous Waste Wal-Mart, Inc., is currently the target of criminal, civil and administrative investigations for environmental violations by the United States Attorney's Office for the Central and Northern District of California (U.S. Department of Justice), Nevada Attorney General, California Attorney General, the Los Angeles County States Attorney and The California

(continued)

Exhibit 3.2 (continued)
Department of Toxic Substances Control. The company is accused of violating the Resource Conservation and Recovery Act (RCRA, 42 USC §6901), The Clean Water Act (33 USC §1251), and the Hazardous Materials Transportation Act (49 USC §5101). The company is also accused of violating state environmental and transportation laws in California and Nevada. [Wal-Mart 2006 Annual Report, p 44]

What is Wal-Mart's hazardous waste policy? Wal-Mart's official policy is to ship all unsold and returned products to "Return Centers" and sort out the products for disposal there. Wal-Mart has used company vehicles to do this task. [Las Vegas Review-Journal, 12/21/05]

What exactly did Wal-Mart do wrong? Wal-Mart is under investigation for ignoring laws designed to protect the public from the dangers of hazardous materials to human health and the environment, including:

- ***California Hazardous Waste Laws***. California state law requires businesses to handle and dispose of hazardous waste in a specific way, including paying fees for disposal and using designated hazardous materials trucks for transport. Wal-Mart may have avoided paying disposal fees, and is being investigated for using its own trucks to transport hazardous waste.
- ***Nevada State Law***. Wal-Mart may have violated Nevada law by bringing hazardous waste into the state and disposing of it in a facility permitted to only accept waste that originated inside Nevada.
- ***Federal Law***. Federal law prohibits transporting potential hazardous waste across state lines without a permit. Wal-Mart may have violated these statues by bringing hazardous waste into Nevada from California.
- ***Federal Clean Water Act***. Wal-Mart is also accused of violating the Federal Clean Water Act, a law designed to preserve the integrity of lakes, rivers and wild lands. The fact that Wal-Mart has been accused of violating this Act points to questions of more serious environmental infringements.

In spite of these criticisms, many stakeholders defended Wal-Mart's record as a worthy exercise of its power. For example, in order to overcome consumer reluctance to purchase concentrated laundry detergents, which would hugely cut transportation costs without impacting their cost-effectiveness, Wal-Mart forced all of its suppliers to convert to them; once the concentrated variety was all that appeared on the shelves, consumers came to prefer them. According to A.G. Lafley, CEO of Proctor & Gamble, "Lee [Scott] pushed me…we totally, totally changed the way we manufacture liquid laundry detergents." Wal-Mart also eliminated up to 50% of packaging on such items as prescription drugs, again lowering resource requirements as well as costs, savings that were passed on to consumers.[57] (See Exhibit 3.3 for an example.)

[57] Quotation cited in Stephanie Rosenbloom and Michael Barbaro, "Green-Light Specials, Now at Wal-Mart", The New York Times, Jan. 25, 2009.

Exhibit 3.3 Wal-Mart Is Bringing More Sustainably-Sourced Food to Customers. Retailer Is Working to Build a Better Future for Agricultural and Fishing Industries. (Press Release from Walmart)
At Wal-Mart Stores, Inc., we believe that being a profitable and efficient business goes hand-in-hand with being a good steward of the environment. One of our goals is to sell products that sustain our natural resources and the environment. Our **Food, Agriculture and Seafood Sustainable Value Network** is working with farmers, ranchers and fisheries to provide our customers with access to fresh food at affordable prices. One way we are able to do this is by purchasing more produce from local farmers and purchasing products that are grown and produced by people who use sustainable practices in their businesses.

Food, Agriculture and Seafood Sustainable Value Network Goals

- Create a long-term supply of reliable agricultural and seafood products harvested in a sustainable way.
- Walmart plans to purchase all of its wild-caught fresh and frozen fish for the U.S. market from Marine Stewardship Council (MSC)-certified fisheries by 2011.
- Work with Global Aquaculture Alliance (GAA) and Aquaculture Certification Council, Inc. (ACC) to certify that all foreign shrimp suppliers adhere to Best Aquaculture Practices (BAP) standards in the U.S. by 2011.

Walmart is Working to Sustain the Future of Food, Agriculture and Seafood We have taken on a number of projects and goals under our Food, Agriculture and Seafood Network that will provide our customers with the opportunity to purchase fresh and sustainably-produced food.

- In 2008, we launched even greater efforts to purchase locally grown produce in the U.S. With our locally grown initiative, we can provide high-quality, low-priced fruits and vegetables while supporting farmers and their local economies. By reducing the number of miles food travels between the farm and our shelves, we can decrease greenhouse gas emissions and conserve fuel, while providing our customers with the freshest produce.
- We are working with suppliers to offer more socially-responsible products on our shelves. As a part of Walmart's first Earth Month in-store campaign in April 2008, we launched the sale of six coffees carried under our exclusive Sam's Choice brand that are either certified organic, Fair Trade Certified or Rainforest Alliance Certified. These coffees enable customers to get gourmet coffee at a great value while providing benefits to farmers, their communities and the environment.

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Exhibit 3.3 (continued)

- Sam's Club was one of the first retailers to offer Fair Trade Certified wine. Since November 2008, Sam's Club members have been able to purchase Fair Trade Certified Malbec wine from Argentina in more than 400 Sam's Club facilities. A portion of the sales are collected by Transfair USA and used to build schools, medical facilities and other community projects.
- We are committed to featuring more sustainably-harvested seafood in our Walmart stores and at Sam's Club. Our efforts have included collaboration with the Marine Stewardship Council (MSC), Sustainable Fisheries Partnership (SFP), the World Wildlife Fund (WWF), Environmental Defense Fund (EDF) and the Alaskan salmon industry for wild caught seafood and with Global Aquaculture Alliance (GAA) for all farmed seafood. Together, we are encouraging our seafood suppliers to implement plans that strengthen fishery management practices, rebuild stocks, reduce environmental impacts and encourage support for broader marine ecosystem management and protection efforts.
- As of January 31, 2009, in aggregate, 49% of the total pounds of fresh or frozen seafood sold at Walmart and Sam's Club have the MSC or ACC certification with many more fisheries currently progressing through the certification process. We currently have 28 products in our stores carrying the MSC certification with more selections underway. And 100% of the farmed shrimp products we purchase meet factory processing criteria established by the ACC, and we are in the process of having shrimp, catfish, tilapia and salmon farms become ACC certified as well.
- In 2008, Walmart de Mexico sourced 99% of the fruit and vegetables sold in its stores from Mexican suppliers.
- Together with the global relief and development organization Mercy Corps and the United States Agency for International Development (USAID), we launched the Inclusive Market Alliance for Rural Entrepreneurs in Guatemala which is focused on improving the lives of small-scale farmers. During a 3 year project, the Alliance will help small-scale farmers move from traditional crops, such as corn and beans, to growing demand-driven crops such as tomatoes, peppers, potatoes and onions that will be sold to major retailers like Walmart.
- Our ASDA stores in the U.K. are working to put more locally grown and locally produced items on their shelves as well. ASDA currently works with approximately 500 local food producers in the U.K. who provide more than 5,000 products to ASDA stores across the country.
- Walmart China is working to bring customers better quality and sustainably-harvested produce through its Direct Farm Program. This program helps farmers in China place their sustainably-grown produce in local Walmart stores and receive better financial returns on their products. They aim to expand the Direct Farm Program to include as many as 1 million farmers by 2011.

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Exhibit 3.3 (continued)
What Others Are Saying

- "The impact of Walmart **committing itself to a sustainable source of its fish is profound in several different ways**. It's profound in that it ensures that populations of fish survive—that they're not mined but that they're harvested in a way that will survive over time." (Peter Seligman, CEO, Conservation International in Walmart's 2008 "Sustainability 2.0" DVD)
- "Perhaps most importantly, because of the tremendous volume that Sam's and Walmart are moving on fair trade terms, **they're lifting tens of thousands of farmers out of poverty.** They're having a huge impact on the ecosystems, on the environment in those countries and in those communities where this product is grown. So, the impact of Walmart and Sam's in fair trade **is proving to be tremendous."** (Paul Rice, President and CEO, Transfair USA in Walmart's 2008 "Sustainability 2.0" DVD)
- "Wal-Mart would not be the first" to buy local, said Rich Pirog, associate director of the Leopold Center for Sustainable Agriculture at Iowa State University. "But they're obviously, without question, the largest retailer to go down this route." (**Wal-Mart branches out into locally grown produce, Associated Press, July 1, 2008)**
- "All across South Carolina, you will be able to go into Wal-Mart and make an easy buying decision – knowing you are doing something **great for yourself, great for your health and great for the economy**." (Hugh Weathers, South Carolina Commissioner of Agriculture, WYFF-TV, June 25, 2008)
- "Wal-Mart's new local sourcing effort **benefits the company two-fold – it reduces transportation costs and supports its sustainability goals** to sell products are earth-friendly and ethically sourced. It will also mean **customers will find produce that is fresh and ripe**, and **helping support the local economy**. ("Wal-Mart sourcing produce from local farmers," Kimberly Morrison, *The Morning News,* June 18, 2008)
- "Wal-Mart has been going green, but not entirely for the reasons you might think. By sourcing more produce locally – it now sells Wisconsin-grown yellow corn in 56 stores in or near Wisconsin – it is able to cut shipping costs…Marc Turner, whose Bushwick Potato Co. supplies Wal-Mart stores in the Northeast, says **the cost of shipping one truck of spuds from his farm in Maine to local WalMart stores costs less than $1,000, compared with several thousand dollars for a big rig from Idaho**. Last year his shipments to Wal-Mart grew 13%." ("Wal-Mart puts the squeeze on food costs," *Fortune,* May 29, 2008)

(continued)

Exhibit 3.3 (continued)

- "The endorsement drew attention; Wal-Mart buys more shrimp than any other U.S. company, importing 20,000 tons annually – about 3.4% of U.S. shrimp imports. With Wal-Mart's nod, 'we went from trying to convince individual facilities to become certified to having long waiting lines,' says George Chamberlain, president of the Aquaculture Alliance." *(**The New Wal-Mart Effect: Cleaner Thai Shrimp Farms**," The Wall Street Journal, July 24, 2007)*

Walmart is working diligently toward achieving its sustainability goals. For information about Walmart's sustainability initiatives, please visit: ***www.walmartstores.com/sustainability****.*

# # #

While the evidence was anecdotal, many saw it as proof that Wal-Mart was beginning to place sustainability at the core of its business model. The company couldn't, in this view, accomplish Scott's aspirational goals merely by incremental improvements, by "greening". Finally, because of the savings the company was realising, it helped Wal-Mart's bottom line – the company had proved it could do well while it was doing good.[58]

The Future of the Approach Many in the environmental movement applauded the company's efforts. As Michelle Harvey, Programme Manager of Corporate Partnerships at the Environmental Defense Fund, observed: "It's hard to hate Wal-Mart. The company is far from perfect and there's a long way to go, but the effort is genuine." However, she acknowledged, a comprehensive methodology to evaluate the results was not yet available. Furthermore, it was uncertain what the company would do once the "low-hanging fruit" was picked and harder choices had to be made. "Right now," she said, Wal-Mart "was doing the things that could be justified in terms of costs. [Moreover,] much of it remains the responsibility of the suppliers, which Wal-Mart is pressuring to meet certain standards."

In particular, Harvey noted, there were many areas where there was no clear business case. There were also issues for which the data were more ambiguous or even speculative, but where long-term impacts could be very high. For example, while it was easy to target carbon emissions, the anti-bacterial agent triclosan was becoming pervasive in the environment, appearing even in human breast milk. "[Its] effects are not quite proven," Harvey explained, "but many of us are concerned." What about alternative energy sources, she asked? What about products, such as bottled water, that sold well yet were bad for the environment? "Solutions to those problems," she concluded, "could bring higher costs or higher prices for consumers."

Ultimately, how Wal-Mart chose to wield its power could expose the company to criticism. For example, Wal-Mart unilaterally decided to discontinue the sale of

[58] Hart, op. cit., pp. 102–103.

BPA, a (legal) plastic liner in baby bottles, because of a potential cancer risk. Not only did this cause problems for BPA suppliers, but the health implications were uncertain at best. Moreover, critics pointed out, the company would continue to sell cigarettes – the health risks of which were proven scientifically – because customers wanted them.[59]

The Sustainability Index

During the economic recession that began in 2008, Wal-Mart sales rose 1.7%, while those of most of its competitors fell, sometimes precipitously. Other news was mixed. Contradicting its reputation for "never settling out of court", Wal-Mart agreed to pay $54.25 million to settle a class-action lawsuit with workers claiming unpaid compensation for off-the-clock work.[60] In a precedent-setting agreement for North America, eight Wal-Mart autoshop workers in Gaineau, Canada were allowed to sign a union-sponsored contract with the company, ending a 3-year legal dispute.[61] However, the company also continued to generate its own PR disasters. In the Deborah Shank case, Wal-Mart dropped its claim to $US470,000 for reimbursement of the employee's medical expenses met under Wal-Mart's medical insurance plan – half the compensation she had won in court for a motor vehicle accident that left her permanently disabled. Although Wal-Mart was legally entitled to claim it in accordance with her insurance policy, the lawsuit became a viral-news sensation, particularly after Wal-Mart beat Shank in a US Supreme Court judgment.[62]

Wal-Mart's Sustainability Index represented the largest attempt by a retailer to develop a green-labelling system for the products it offered. The entire process was estimated to be completed in approximately 5 years. In step 1, Wal-Mart would collect data from over 100,000 suppliers regarding the sustainability of their operations. The questions focused on: (1) energy and climate, (2) material efficiency, (3) natural resources, and (4) people and community. While the survey results would serve the stakeholder consortium in the next step, it was always designed as a tool to get suppliers to investigate and understand practices more deeply. No other major company, it was claimed, had attempted to reach so deeply into such a varied supply chain. Top suppliers were instructed to deliver the surveys to Wal-Mart by 1 October 2009, with the others following soon thereafter. In step 2, Wal-Mart would help to organise a consortium of stakeholders to develop a database on the entire life cycle of products. Wal-Mart provided seed funding for this task, with the expectation that the suppliers as well as other retailers would contribute – it would be an effort to establish global, agreed-upon standards of sustainability. In Step 3, these standards would be encapsulated into labels that consumers could consult before making the purchase decision. (See Exhibits 3.4 and 3.5.)

[59] Marc Gunther, "Wal-Mart: the New FDA", Fortune, July 16, 2008.

[60] Julianne Pepitone, "Wal-Mart: $54 Million to Settle Workers' Suit," Money.CNN.com, Dec. 9, 2008.

[61] "Gatineau Wal-Mart workers awarded contract", The Ottawa Citizen, Aug. 8, 2008. No byline.

[62] Anthony Mirhaydari, "Wal-Mart's public relations disaster", blogs.moneycentral.msn.com/2008/04/02

Exhibit 3.4 Sustainable Product Index: Fact Sheet.
On July 16, 2009, Walmart announced plans to develop a worldwide sustainable product index, which is expected to lead to higher quality, lower costs and measure the sustainability of products and help customers, live better in the twenty-first century. One of the biggest challenges we all face is measuring the sustainability of a product. Walmart believes a research-driven approach involving universities, retailers, suppliers and non-government organizations (NGOs) can accelerate and broaden this effort.

The Need for an Index

- The world's population is increasing.
  - It is estimated that the global population will reach 9 billion by 2050.
- The world's natural resources are decreasing.
  - Natural resources for everything we grow, eat, drink, make, package, buy, transport and throw away is outpacing the earth's capacity to sustain it.
- Customers want more efficient, longer lasting, better performing products. They want to know:
  - the materials in the product are safe
  - that it is made well
  - the product was produced in a responsible way

Index Step 1: Supplier Assessment Walmart will provide each of its 100,000 global suppliers with a survey of 15 simple, but powerful, questions to evaluate their own company's sustainability. The questions are divided into four areas:

- Energy and Climate
- Natural resources
- Material efficiency
- People and Community

Under these categories are some familiar questions on greenhouse gas emissions and location of factories, but the list also includes some new areas, such as water use and solid waste produced. For a complete list of the questions, visit walmartstores.com

Walmart will ask its top tier U.S. suppliers to complete the survey by Oct.1. Outside the United States, the company will develop timelines on a country-by-country basis for suppliers to complete the survey.

These are not complicated questions, but we have never systematically asked for this kind of information before. This is an important first step in assessing the sustainability of suppliers, but for true transparency, we also need a tool for the sustainability of products.

(continued)

Exhibit 3.4 (continued)

Index Step 2: Lifecycle Analysis Database As a second step, Walmart is helping create a consortium of universities that will collaborate with suppliers, retailers, NGOs and government to develop a global database of information on the lifecycle of products – from raw materials to disposal. Walmart will provide the initial funding for the consortium, but it is not our intention to create or own this index.

The company will also partner with one or more leading technology companies to create an open platform that will power the index.

Arizona State University and the University of Arkansas will jointly administer the consortium. Talks are underway with additional universities to join the newly formed consortium.

Index Step 3: A Simple Tool for Consumers The final step of the index is to provide customers with product information in a simple, convenient, easy to understand rating, so they can make choices and consume in a more sustainable way. How that information is delivered to consumers is still undetermined, but could take the form of a numeric score, color code or some other type of label. The sustainability consortium will help determine the scoring process in the coming months and years.

"The index will bring about a more transparent supply chain, drive product innovation and, ultimately, provide consumers the information they need to assess the sustainability of products. If we work together, we can create a new retail standard for the 21st century."

Mike Duke, President and Chief Executive Officer, Wal-Mart Stores, Inc.

Walmart Sustainability Milestone Meeting, July 16, 2009

Exhibit 3.5 Sustainability Product Index: 15 Questions for Suppliers

Energy and Climate: Reducing Energy Costs and Greenhouse Gas Emissions

1. Have you measured your corporate greenhouse gas emissions?
2. Have you opted to report your greenhouse gas emissions to the Carbon Disclosure Project (CDP)?
3. What is your total annual greenhouse gas emissions reported in the most recent year measured?
4. Have you set publicly available greenhouse gas reduction targets? If yes, what are those targets?

(continued)

Exhibit 3.5 (continued)
Material Efficiency: Reducing Waste and Enhancing Quality

1. If measured, please report the total amount of solid waste generated from the facilities that produce your product(s) for Walmart for the most recent year measured.
2. Have you set publicly available solid waste reduction targets? If yes, what are those targets?
3. If measured, please report total water use from facilities that produce your product(s) for Walmart for the most recent year measured.
4. Have you set publicly available water use reduction targets? If yes, what are those targets?

Natural Resources: Producing High Quality, Responsibly Sourced Raw Materials

1. Have you established publicly available sustainability purchasing guidelines for your direct suppliers that address issues such as environmental compliance, employment practices and product/ingredient safety?
2. Have you obtained 3rd party certifications for any of the products that you sell to Walmart?

People and Community: Ensuring Responsible and Ethical Production

1. Do you know the location of 100% of the facilities that produce your product(s)?
2. Before beginning a business relationship with a manufacturing facility, do you evaluate the quality of, and capacity for, production?
3. Do you have a process for managing social compliance at the manufacturing level?
4. Do you work with your supply base to resolve issues found during social compliance evaluations and also document specific corrections and improvements?
5. Do you invest in community development activities in the markets you source from and/or operate within?

Critics quickly stepped forward. According to blogger Philip Mattera, the proposed index appeared "rather thin" – yet another PR attempt at "greenwashing"; at the very best, its measures would merely tinker with a system that required far more fundamental change. Moreover, he argued, it would do little to overcome Wal-Mart's "abysmal record with regard to labour relations, wage and hour regulations, and employment discrimination laws. It also wants us to forget its scandalous tax

avoidance policies and its disastrous effect on small competitors."[63] Others criticized the consortium approach, which they viewed as riddled with potential conflicts of interest. Not only did it appear to call on manufacturers to create the methodologies by which they would be rated, but – for an admission price between $US50,000 and $250,000 per year – they might stand to gain an insider's advantage over non-participating manufacturers, regardless of whether or not the results were made public.[64] At this early stage, however, these criticisms remained speculative.

Furthermore, there were the methodological difficulties inherent to any attempt to evaluate – in a rigorously quantitative framework – the entire life cycle of a given product or product group. They included:

- The quantification of all the relevant interactions of the product with its surroundings. Not only would this entail an enormous amount of data to cover the exchanges and transportation involved in the global economy, but it necessitated assumptions to fill statistical gaps, lessening its accuracy.[65]
- Agreement or consensus would have to be achieved on methodological standards for time horizons (i.e. what "cradle" and what "grave" would be measured), impact assessments, etc. Without such agreement, data might well be incompatible, hence impossible to aggregate.[66]
- The gaps in life cycle assessments must be addressed, including: (1) developing more effective coverage of hazardous materials; (2) taking account of the complexities involved in recycling issues, e.g. tracking materials, such as paper, whose quality degrades with each recycle; (3) creating more dynamic measurement tools, i.e. cumulative problems over the long term, in particular the interaction of materials in waste dumps.[67]

Other observers offered a more positive assessment of the index's prospects. First, Wal-Mart's green labeling would offer consumers the opportunity to choose, initiating a process of education for up to two-thirds of its customers. At present, only 10% of shoppers actively cared about the sustainability of their purchases, up to 25% would never care, but 65% were undecided. Second, while rarely imposing its standards on particular products, Wal-Mart was signalling to suppliers that their practices on sustainability must become more transparent. If they refused to do so, it would impact their business prospects with Wal-Mart in the competition for shelf space. Third, the suppliers themselves would learn about their own processes, introducing many of them to sustainability concerns that they would need to address systematically. If viewed correctly, this would enable them to understand their own

[63] www.corpwatch.org/15416

[64] Joel Makower, "Inside Walmart's Sustainability Consortium", www.wakeupwalmart.com/new/article/2343

[65] See http://scp.eionet.europa.eu/themes/lca

[66] See http://www.tececo.com/sustainability.life_cycle_analysis.php

[67] Mark Rossi, "Reaching the Limits of Quantitative Life Cycle Assessment", June 2004, http://www.healthybuilding.net/pvc/CPA_EC_LCA_Critique.html

businesses better, offering them opportunities to innovate, save on costs, and find "hidden value" in their business models.[68]

At any rate, some observers believed, the process itself would lead to the creation of "innovative paths". Wal-Mart had set some ambitious goals, was getting many experts to cooperate in the formulation of new methods, and was promising to refine the index in accordance with the views of its critics.[69]

[68] See Daniel Goleman, "Wal-Mart Exposes the De-Value Chain", blogs.hardvardbusiness.org/goleman/2009/07

[69] Joel Makower, "Two Steps Forward: Wal-Mart's Sustainability Index: the Hype and the Reality", 17 Jul, 2009, http://www.tececo.com/sustainability.life_cycle_analysis.php

Check for updates

Tetra Pak: Sustainable Initiatives in China

4

Fu Jia, Zhaohui Wu, and Jonathan Gosling

Introduction

In January 2009, Hudson Lee, President of Tetra Pak China, was looking over a cliff. The company had invested €65 million to expand its packaging plant on Hohhot, the capital city of Inner Mongolia, China, on top of its initial 2004 investment of €50 m. The expansion plan was based on the inexorable rise in milk consumption in China – growing from 16 to 23 million tons between 2005 and 2012. This was a market with huge opportunities for growth, and powerful domestic brands to reach out to China's 1.4 billion consumers. The plant initially designed to produce 20 billion cartons a year now had the capacity to process 60 billion cartons.

Then the bottom fell out of the market. Powdered milk, contaminated with melamine, poisoned hundreds of children, 8 died and many others were critically ill. Confidence in the domestic brands Yili and Mengnui crashed. These were Tetra Pak China's main customers, the bedrock of the investment plan. And Tetra Pak aseptic packaging clearly hadn't prevented this contamination as it took place way before the packaging process. As millions of consumers switched to imported brands, it looked as if Tetra Pak's business was evaporating along with the industry it supplied. There could be no overnight solution: Hudson Lee and his executive team

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© Springer Science+Business Media B.V. 2019
G. G. Lenssen, N. C. Smith (eds.), *Managing Sustainable Business*,
https://doi.org/10.1007/978-94-024-1144-7_4

were forced to look beyond their own part in a supply chain, to see what they could do to repair a broken food- production system.

Hudson sat in his office in Beijing, looking at a table of display of Tetra Pak milk cartons printed in various languages. Behind these cartons are some photos of early TP managers' visits to China back in the 1970s. TP had a long history in China and was there ever since the country stepped out of a disastrous cultural revolution and began to open up to western countries. TP's success had always been building on its positive engagement with the economy and stakeholders in the host country. Hudson began to reconsider the overall business models of TP in China and posed a question: how could TP China handle the milk safety issue and what role should the company play in the milk scandals of its customers?

Background

Since its entry into China in 1972, Tetra Pak has been an influential player in the emerging Chinese dairy industry. Its business operations have expanded successfully together with the consumption of dairy products in China in the last two decades. The company leverages its packaging technology to shape the entire supply chains of various dairy producers and the dairy industry development in China. The company claims that social and environmental sustainability are integral to its business strategy. The objective of this case is to illustrate this integration of Tetra Pak's sustainability strategy, its implementation in supply chain management, and challenges the company faces in a maturing industry as local competitors become ever more sophisticated in business operations, and in the face of health risks such as that faced in 2008.

Chinese Dairy Industry Overview

Tetra Pak is located in two supply chains: packaging and dairy. The dairy producers are the company's biggest customers, with products including milk, yogurt, condensed milk, dried milk (milk powder), and icecream, using processes such as chilling, pasterization, and homogenization. Typical by-products include buttermilk, whey, and their derivatives. Consumer milk includes Ultra Heat Treatment (UHT)[1] milk and pasteurized milk. Tetra Pak concentrates on UHT milk in the China market. Currently, UHT milk accounts for 70% of the consumer milk market, while pasteurized milk has 30% market share in the consumer milk market. Pasteurized

[1] UHT milk is the sterilization of milk by heating it for an extremely short period, around 1–2 s, at a temperature exceeding 135 °C (275 °F), which is the temperature required to kill spores in milk, giving it a long shelf life of around 9 months. Pasteurization is a process of heating a food, usually liquid, to a specific temperature for a predefined length of time and then immediately cooling it. This process slows spoilage due to microbial growth in the food. Unlike sterilization, pasteurization is not intended to kill all micro-organisms in the food. Instead, it aims to reduce the number of viable pathogens so they are unlikely to cause disease. It has a refrigerated shelf life of 2–3 weeks.

milk products have distribution restrictions (e.g. short shelf life and refrigeration requirements), so are produced and sold mostly by city dairies or at most regional players.

Yili and Mengniu are the two biggest UHT milk producers; the key pasteurized milk producers include Bright, New Hope, Sanyuan and Yantang. Mengniu, Yili, Bright and Sanyuan are major milk processors nationwide. Mengniu is listed on the Stock Exchange of Hong Kong Ltd., and the other 3 major milk processors are listed in Shanghai Stock Exchange. These four companies accounts for 40–50% of the national market share. Exhibit 4.1 shows the sales volume for these 4 major milk processors. There are also about 1000 milk processors at the regional and city levels, which only supply to the areas around their plants.

According to the Food and Agricultural Organization (FAO), over the past decade, China's dairy industry has grown at 20% annually, becoming the 4th largest dairy producer globally with a small but growing export industry. This growth has been fueled by a voracious domestic market which has seen urban consumption of milk jump from just short of 5 kilos per capita per annum in 1990 to over 18 kilos in 2006, with only around 3% of demand being met by imports. Touted by many as China success stories, local brands such as Mengniu, Sanyuan, Yili and Bright quickly became industry leaders, contributing to the over RMB 30 billion spent by the dairy industry in advertising in 2008.

The rapid growth of dairy products consumption and the dairy industry in China wouldn't have been possible without the UHT technology introduced by Tetra Pak. Before that, regional players (e.g. the 6th Plant of Shanghai Dairy Products) flourished in the 1980s through to 1990s. The introduction of UHT technology in the late 1990s enabled the emergence of national players (e.g. Yili, Mengniu, Bright and Sanyuan) and changed the landscape of the liquid dairy market completely. Growth of city dairy producers was limited by the rapid expansion of the large national brands, and as consumers turned from powder to liquid products, many small powder players were squeezed out of the industry.

After a decade of strong growth, however, the future of China's dairy industry looked uncertain as the melamine[2] milk scandal hit newsstands in September 2008. Dairy sales fell across China, most notably within the milk powder category at the center of the scare. Although the drop in sales indicated that the response from the

[2] The scandal, also known as the ammonium hydrogen dimmer crisis, caused widespread distrust of all domestic dairy brands including Mengniu and Yili. Facing rapidly growing demand for dairy products in China, some dairy farmers and raw milk collection stations adulterated the raw milk with melamine in order to boost protein levels, and hence the collection prices. Melamine contains 66% nitrogen but is toxic to humans. Like most other countries, the State and Provincial Food and Drug Administration in China used the level of nitrogen as an indicator of the level of protein, which is difficult to measure directly. This practice had apparently been widespread amongst dairy farmers for some time due to their lack of knowledge about the toxic effects on humans, especially when the milk was used in formula for infants. In autumn 2008 six infants died from kidney damage, and more than 800 were hospitalized. It is estimated that adulterated milk products affected over 300,000 people, and consumers switched to more expensive but trusted international brands.

majority of shoppers was to stop purchasing dairy altogether, those that did continue to shop within the category tended to favour foreign brands.

The industry now faces a number of challenges, such as loose links between the dairy companies and farms, undeveloped market mechanisms and an ineffective management system for raw milk quality. And at the "2009 China Dairy Development Forum", there was an appeal to maintain a sustainable development for China's dairy industry through three main strategies: (1) building a good social environment for China's dairy industry to achieve the healthy development of the industry; (2) gradual development from a fragmented business to an integrated one; and (3) establishing a sound regulatory framework.

In China, the dairy supply chain is highly fragmented, with millions of dairy farmers supplying to big milk processors, a typical "Y" shape structure. The big milk processors are normally the focal companies in the supply chain. Dairy farmers and packaging suppliers are the upstream part of the supplier chain. The downstream part of the supply chain consists of various distributors, retailers (shopping malls, retail shops and dairy shops, etc.) and consumers (See Exhibit 4.2).

Major Dairy Producers in China

Yili

Inner Mongolia Yili Industrial Group Co., Ltd. (Yili) is one of Tetra Pak's largest customers. It is also one of the largest dairy products manufacturers with the broadest product line in China. Yili started from a state owned dairy producer in 1982 and was privatized in 1992. Yili was designated as the sole dairy products supplier to the Beijing Olympic Games in 2008 and Shanghai Expo 2010, successfully expanding its presence nationwide. Yili Group is made up of five business units: liquid milk, ice cream, milk powder, yogurt and raw milk. Yili Group has more than 130 branches and subsidiaries nationwide. There are more than 1000 series of Yili brand products, such as popsicle, ice cream, milk powder, milk tea powder, UHT milk, yoghurt, and cheese. The most popular products include classic organic milk, low-lactose nutrition milk, Chang Qing yogurt, Jinlingguan milk powder for infants, and Chocliz ice cream etc.

Mengniu

China Mengniu Dairy Company Limited (Mengniu henceforth), established by a former executive of Yili in 1999, and its subsidiaries manufacture and distribute quality dairy products in China. Its visionary leader, Niu Gengsheng positioned it as No.2 dairy producer after Yili at the beginning of its establishment and had a series of very successful marketing campaigns associated with China's successful launch of the Shenzhou manned spaceship in 2003. It is one of the leading dairy product manufacturers in China, with 'Mengniu' as the core brand. The Group boasts a diverse product range including liquid milk products, (such as UHT milk, milk beverages and yogurt), ice cream, and other dairy products (such as milk powder). The Group has held the top spot in the China dairy market in terms of overall sales

volume and sales volume of liquid milk products since 2006. The main product of Mengniu is UHT milk.

Bright

Bright Dairy & Food Co., Ltd. (Bright henceforth) is a listed joint-stock enterprise specializing in the development, production and sales of milk and dairy products, the rearing and fostering of milk cows and stud bulls, and the development, production and sales of health and nutrition products. The top two stockholders of Bright are Shanghai Dairy Group Co. Ltd. and Bright Group Co. Ltd. Danone, the France-based food company, was one of Bright's major stockholders, but sold its shares in October 2007. Bright boasts a world-class dairy product research and development center, dairy product processing facilities, and advanced processing techniques, and has developed various product lines including pasteurized milk, yoghurt, UHT milk, milk powder, butter and cheese, and fruit juices. It is one of the largest dairy production and sales companies in China. The main product of Bright is pasteurized milk.

Sanyuan

Sanyuan Group (Sanyuan henceforth) is a state-owned group of companies based on agriculture and animal husbandry in China. It consists of 12 state farms, 20 professional companies, 41 transnational joint ventures, 3 overseas subsidiaries and 1 public company as Beijing Sanyuan Foods, which is listed in Shanghai Stock Exchange. Sanyuan was one of the few companies which were clean in the melamine milk scandal in 2008.

All the above players apart from Sanyaun were involved in the 2008 Melamine scandal in various degrees, and the national dairy industry as a whole suffered from this.

More Milk Safety Incidents

In February 2009, Mengniu's Telunsu (brand name) milk was reported for containing Osteoblast Milk Protein (OMP, Chinese: 造骨牛奶蛋白), In February 2009, the safety of OMP was questioned by the General Administration of Quality Supervision, Inspection and Quarantine (AQSIQ), the national quality supervision department in China, when they were doing a general clean-up on the use of food additives after the 2008 melamine scandal. Mengniu first stated that the major active ingredient in OMP is Insulin-like growth factor 1 (IGF-1), but later denied adding IGF-1 and said that OMP is the same as Milk Basic Protein (MBP). IGF-1 could possibly cause cancer in extreme doses. Mengniu stopped adding OMP to its milk on February 2nd 2009, after a government order, but did not recall products already on the market. On February 13th 2009, the Ministry of Health stated that OMP is "not harmful to human health", but the ban on its use stayed in place because the importer had not submitted the necessary paperwork.

In June 2012, Yili recalled mercury-tainted baby formula milk after an "unusual" level of mercury was found by the country's product quality watchdog. A spokesperson from the local quality supervision bureau in Inner Mongolia said that two samples from Yili were found with mercury concentration of 0.034 mg/Kg and 0.045 mg/kg (BBC news).

In the latest incident (June, 2012), the Bright Dairy & Food Co. posted a recall notice on its website after consumers complained online of bad smelling and discolored liquid in the company's 950 ml cartons (about a quarter gallon) of Ubest milk. A seconds-long mechanical delay during routine maintenance at one of its Shanghai factories caused a "small amount" of alkaline cleaning solution to be flushed into 300 cartons of milk produced on Monday, the company's notice said (Reuters).

Tetra Pak Global

Tetra Pak is a multinational food packaging and processing company of Swedish origin with head offices in Lund, Sweden and Lausanne, Switzerland. The company offers packaging solutions, filling machines and processing solutions for dairy, beverages, cheese, ice-cream and prepared food, including distribution tools like accumulators, cap applicators, conveyors, crate packers, film wrappers, line controllers and straw applicators. Tetra Pak is currently the largest food packaging company in the world by sales, operating in more than 170 countries and with over 22,000 employees. Tetra Pak produces carton packaging for both UHT and pasteurized milk, but has a leading worldwide market share of over 70% in terms of number of packs in the narrowly defined aseptic carton packaging segment for UHT milk. As Tetra Pak's ex CEO Nick Schreiber put it, Tetra Pak is a big fish in a small pond. Tetra Pak was founded by Dr. Ruben Rausing in Lund, Sweden, in 1951 as a subsidiary to Åkerlund & Rausing, a food carton company established in Malmö in 1929 by Ruben Rausing and Erik Åkerlund. Tetra Pak was built on an innovation by Erik Wallenberg, the tetrahedron package, from which the company name was derived. The late 1960s and 1970s saw a global expansion of the company, much due to the new Tetra Brik Aseptic package, launched in 1969, which opened up new markets in the developing world and sparked off a virtual explosion in sales. In the Tetra Laval annual report 2010/2011, Tetra Pak announced particularly strong growth in China, Southeast Asia, Eastern Europe and Central and South America.

Mission, Strategy and Sustainability

Tetra Pak's mission and vision reflects its view of sustainable development. Tetra Pak's mission is "… to making food safe and available, everywhere". And their vision is to "…work for and with our customers to provide preferred processing and packaging solutions for food. We apply our commitment to innovation, our understanding of consumer needs and our relationships with suppliers to deliver these solutions, wherever and whenever food is consumed. We believe in responsible

industry leadership, creating profitable growth in harmony with environmental sustainability and good corporate citizenship." The company defines its corporate strategy as "to actively build and support partnerships for development; to employ the knowledge, products and expertise of Tetra Pak in development projects; to build local capacity and ensure sustainability by working actively with knowledge sharing and training; to support the development of high nutrition and cost effective products."

Different milk products use different packaging. As of 2011, Tetra Pak has around 70% market share in UHT white milk in the aseptic carton packaging. For pasteurized milk, Evergreen Packaging, formerly known as International Paper, is the key player, with about 60% market share.

Aseptic packaging technology is Tetra Pak's key innovation and has to a large extent paved the way for the Tetra Pak system's success. In aseptic processing the product and the package are sterilized separately and then combined and sealed in a sterilized environment, as compared to canning, where product and package are combined and then sterilized. When filled with ultra-heat treated (UHT) foodstuffs (liquids like milk and juice or processed food like vegetables and preserved fruit particulates), the aseptic packages can be preserved without chilling for up to 1 year, with the result that distribution and storage costs, as well as the environmental impact, is greatly reduced and product shelf life extended. Tetra Pak's most popular product is the Tetra Brik Aseptic, a best-seller since the 1970s. Exhibit 4.3 shows the key aseptic packaging produced by Tetra Pak. Tetra Pak cartons also have the advantage of consisting of 75% renewable resources, i.e., forest based fiber, making it the package with lowest carbon footprint, compared to plastic or metal packages. From a material perspective, Tetra Pak cartons are 100% recyclable and the carton recycling technologies are mature in most developed markets.

Despite the overall environmental advantages, Tetra Pak cartons have been criticized for being more difficult to recycle than tin cans and glass bottles, and recycling tends to be the most visible environmental issue for the general public. The difficulty lies in the fact that the process demands specific recycling plants that are not available in some markets and that if not recycled, the cartons may end up in landfills that are highly polluting and wasteful. The company has therefore put in place measures to reduce its overall impact on the environment, among them a carbon management plan.

Tetra Pak China and Competition

Tetra Pak started its business in China in 1972, when for the first time, Tetra Pak exhibited in China, at the Beijing Trade Fair. To date, Tetra Pak has 4 packaging material conversion plants in Beijing, Foshan, Kunshan and Hohhot and 10 sales offices in China. Its Chinese business accounts for over 10% of Tetra Pak's global sales. Exhibit 4.4 shows the milestones of Tetra Pak in China.

Tetra Pak's Competitors in China

GA Pack (ga-pack.com)

Greatview Aseptic Packaging Co., Ltd. (GA Pack) is the second largest supplier of roll- fed aseptic packaging material globally. The company operates at multiple locations across China, Europe, North and South America.

GA Pack traces its origins to late 2001 and the Tralin Paper Group in Shandong province (山东泉林纸业集团). State-of-the-art equipment was imported from Germany and Italy and a division for aseptic packaging material production was established. During the first couple of years the business expanded gradually with only smaller local dairy and beverage manufacturers as customers.

In 2003 the potential of Tralin's aseptic packaging business was identified by entrepreneurs Jeff Bi and Hong Gang, who were former employees of Tetra Pak. Drawing on their many years of aseptic packaging experience they could see that the business was poised to expand rapidly. A new team of managers was recruited and national sales teams started building customer relations across China. In 2005, leading dairy companies across China began to use Tralin Pak aseptic packaging material in their industry standard roll-fed filling machines. The company initiated export sales to Russia, Europe and South America. In November 2010, Tralin Pak changed its brand to GA Pack. GA Pack employs more than 800 people in 5 locations across China and in some European countries since 2010. On 9th December 2010, GA Pack successfully announced listing on the Main Board of Hong Kong Stock Exchange.

To date GA Pack has gained the attention of foreign equity investors. CDH Investments became the first major investor in Tralin Pak. In 2006, US Private Equity investor Bain Capital joined as a major investor in GA Pack and the company's capitalization reached US$ 60 million. GA Pack's management remained major shareholders, while the company had gained sufficient financial strength as it enters the critical growth phase. The company ranks as the second largest roll-fed supplier of aseptic packaging globally in 2009. The company's accumulated experience in aseptic packaging material manufacturing has exceeded 12 billion packages. It had about 9.6% of the aseptic packaging market share in 2011. Some of the Tetra Pak customers use GA Pack as a leveraging tool when negotiating with Tetra Pak, since GA Pack's price is about 10–15% lower than that of the Tetra Pak depending on volume.

Tetra Pak is not only facing the competition from other paper-aluminum packaging suppliers, but is also facing the challenging from the suppliers for other milk packaging, like glass bottles, plastics, metal containers, etc. While Tetra Pak takes a leading position in UHT white milk, most of its customers market both UHT and pasteurized dairy products. The popularity of either UHT milk or pasteurized milk among consumers also shapes the future of the overall dairy market, and thus the market situation of Tetra Pak.

Evergreen

Evergreen, formerly known as International Paper (IP), is the world's largest producer of plastic lids and paper cups, manufacturing for the fast-food giants McDonald's, Wendy's, Subway and coffee giant Starbucks. The Wood Products division of International Paper was sold in 2007 to West Fraser Timberland Inc., a company headquartered in Vancouver, Canada. The company currently produces printer and copier paper, envelopes, corrugated packaging and shipping containers, consumer packaging for cosmetics, home entertainment and other retail markets, and food service packaging. It also owns XPEDX, a large North American distribution and logistics company.

The liquid food (beverage) packaging business of IP was sold to the Rank Group and renamed Evergreen in 2007. The beverage packaging business includes wholly owned subsidiaries in China, South Korea and Taiwan, and joint ventures in Latin America, Israel, and Saudi Arabia.

In China, Evergreen controls 60% of the market share for pasteurized milk packaging. Evergreen's customers overlap with those of Tetra Pak, with key customers such as Bright, New Hope, Sanyuan and Yantang. In 2011, two major customers of Tetra Pak, Mengniu and Yili, also became its customers. Mr. Lin Pi, the marketing director of Evergreen China said, "…the consumption for pure pasteurized milk will definitely increase in China. Evergreen is the professional packaging supplier for pure pasteurized milk, while Tetra Pak focuses on packaging for UHT milk. We feel confident in gaining the market. If Tetra Pak produces in large scale the packaging for pasteurized milk, there will be direct competition between us and TP."

Tetra Pak's future depends largely on sustained growth of the dairy industry in China, especially on the two leading companies, Yili and Mengniu. Some dairy experts believe that pasteurized milk will gain more market share in the near future. Bright, the market leader in the pasteurized milk segment, lost its No. 1 position in China's dairy industry in 2003 and fell behind Yili and Mengniu. However, if Bright can regain its leading position with the aid of pasteurized milk, its strategic partner, Evergreen, will inevitably challenge Tetra Pak's market position.

SIG Combibloc

SIG Combibloc Packaging is one of the world's leading system suppliers of carton packaging (No.2 in aseptic packaging after TP) and filling machines for beverages and food. The company supplies complete systems including both the packaging materials and the corresponding filling machines therefore is also a major competitor of TP. The then Swiss based company was acquired in 2007 by the same Rank group that bought Evergreen.

SIG Combibloc started its business in China in 1985 but developed slowly. It has two offices in China and its first manufacturing facility was built in 2004 in Suzhou. The company aims to expand its business significantly in China. Its customers include Yili and Mengniu.

Other Competitors

There are also indirect competitors who produce other forms of packaging for dairy products, such as glass and plastic bottles, which normally contain pasteurized milk. Because of a view that sterilization adversely affects the taste and quality of the product, it is possible that the market share of UHT milk will drop in the future. As a result, although Tetra Pak currently dominates the aseptic packaging market, it faces competition from both growing aseptic packaging suppliers and from other suppliers of alternative packaging methods.

Environmental Challenge of TP's Packaging

The brick-shaped Tetra Brik and the pillow-shaped Tetra Fino Aseptic are classic packagings in China's dairy market (pictures in Exhibit 4.5). In comparision to alternatives such as plastic and glass bottles, Tetra Brick and Tetra Fino Aseptic have lower carbon footprints due to the use of mainly renewable resources, and advantageous environmental performance when taking a lifecycle point of view, e.g., higher storage volume; ease for packing, transportation and storage, protection of food over a long period of time, etc. Tetra Pak cartons are made of a 6-layer composite, which contains paper, aluminium and polyethylene (see Exhibit 4.6). Hence the Tetra packaging can effecitvely prevent air and light, so as to keep milk or beverage from deterioration.

However, according to the belief of many Chinese dairy experts, Tetra Pak cartons are less environmentally friendly compared to the cartons for pasterized products. They believe that as aseptic cartons are laminated with layers of paper, aluminium and polyethylene, they are not bio-degradable when waste cartons are sent to landfill, while cartons for chilled products made from paper and polyethelene are supposedly bio- degradable. While the reasoning of such belief is debatable, it is widely spread and supported by people who have a nostalgic sympathy for local brands selling pasterized products, who are suffering from the intesified competition from national UHT players.

Service-Based Sustainability Strategy at Tetra Pak

KAM-the Way of Working with Customers

Tetra Pak has in-depth knowledge and experience of the whole dairy value chain-from dairy cow to consumer. It considers itself a service provider and provides an integrated business solution to customers as a way to shape the structure of the value chain. Tetra Pak provides services spanning order processing, technical service and marketing support. It also provides business consulting service to their customers. Together with its sister company DeLaval, Tetra Pak define itself as "a full service supplier to dairy farmers, and uniquely positioned to support the development of the

entire dairy sector in any country." Its value chain activities touch multiple tiers of suppliers and customers.

By combining training of farmers and support for market development with consumer education activities, Tetra Pak helps establish a starting point for sustainable economic development. It promotes school milk programs to create demand for local agricultural products. Meanwhile, Tetra Pak also provides technical support to its customers.

Since entering the Chinese market, Tetra Pak realizes that its success depends largely on the success of its customers; hence it collaborates closely with them. Key Account Management (KAM) is the main link in its collaboration with customers. Tetra Pak will send a KAM team to a new customer's plant. Led by a key account manager, the KAM team consists of members from several functions, such as strategic development, technology, quality development, sales and administration and provide training on all aspects of customers' business activities as required.

When TP began to work with Yili in 1996, Yili bought its first filling machine from Tetra Pak and started producing UHT milk. The ability of UHT milk to survive long distance transportation allowed the company to expand to new markets across China. By 2000, the Chinese dairy market was no longer a patchwork of small pasteurized milk producers each dominant in its local market. With UHT milk, Yili expanded its business from Inner Mongolia to a nation-wide market; and it exceeded Bright in terms of sales volume in 2004. To date, Yili has purchased more than 200 filling machines from Tetra Pak and annually purchases more than 10 billion packs. After 15 years, the cooperation between Yili and Tetra Pak has expanded from mere equipment and packs to marketing, staff training, technical innovation, and product development.

TP adopted a similar way to work with Mengniu, the major competitor of Yili started in 1999 by a former Yili executive. At the beginning of its cooperation with Mengniu, instead of just focusing on selling packaging products, Tetra Pak helped Mengniu plan its plants, production lines, product development and marketing. After analysing the market situation then with TP, Mengniu decided to focus on UHT milk. This concentration differentiated Mengniu from Yili, who were more diversified in UHT milk, milk powder, and milk-tea powder. By 2007, Mengniu became No. 1 in China both in terms of liquid milk sales volume and total sales volume.

Working with Stakeholders

Tetra Pak also works closely with the other stakeholders, who are not normally involved in traditional dairy supply chains or have direct business relationships with TP. They include NGOs (e.g. WWF China) and China Green Foundation (cgf.org.cn), universities, government institutions, dairy farmers, forest owners, and even the garbage collectors.

FSC Certification

Tetra Pak promotes renewable resources as production inputs. One key component of carton packages is wood-based paper. Tetra Pak instituted a Forestry Guideline to ensure better forest management practices even though TP does not have direct business relationship with forestry companies in China. Tetra Pak's ultimate goal is that the wood fibre it uses comes from responsibly managed forests certified by the Forest Stewardship Council (FSC). Since 2006, Tetra Pak has been working with WWF and the China Green Foundation (CGF) to provide support for China's forests to build local sustainable forest management systems and to gain FSC certification. In July 2008 over 100,000 hectares of Yong An Forestry in Fujian province obtained FSC certification, bringing the total area of FSC-certified forests in China to over 700,000 hectares and making China a leader in this area in Asia. Yong An was selected for several reasons: first, WWF and TP focused on these southern forests because reform is particularly challenging as many of the forests are collectively owned by villagers or contracted to families, all of whom have to be persuaded to practice new forestry approaches. Second Yong An had an exemplary forest management record and was recommended by the State Forestry Administration. In this case, TP funded the certification and expenses of the involvement of other stakeholders (ministries, academics and the expert team from China).

In 2010, with an aim of replicating what was done with Yong An Forestry, Tetra Pak provided support for responsible forest management and certification work in the Tengchong forest in Yunnan Province. Tetra Pak introduced aseptic cartons bearing the label of the Forest Stewardship Council (FSC) in China from July, 2010.

Pasture Land Management

Tetra Pak's initiatives to support the Chinese dairy industry date back to 1985, when DeLaval and Tetra Pak established the Sino-Sweden Dairy Industry Centre to provide instruction on aseptic filling lines and other related technologies. Through the Sino- Sweden Dairy Industry Centre and other activities such as the "Green Leaves" program and "Stars of Dairy Industry," Tetra Pak has developed thousands of technical experts and managers for the industry.

A bigger challenge lay in persuading Chinese consumers to drink more milk. The National School Milk Program and the "World Milk Day" events are key educational initiatives supported by Tetra Pak. In 2000, the first conference of National Student Milk Coordination Committee (known as milk office or Guo Jia Nai Ban) launched a series of policies promoting the 'Student Milk Programme', and established a committee to coordinate and represent 8 ministries and bureaus with an interest in the dairy industry: Ministry of Agriculture, the Publicity Department of the Communist Party of China (CPC) Central Committee, National Development and Reform Commission (NDRC), Ministry of Education, Ministry of Health, Ministry of Treasury, the State Bureau of Quality and Technical Supervision, and State Bureau of Light Industry.

In 2003, the 'Upgrade plan for the student milk pasturelands' was launched to create a system of pastureland management integrating modern western management systems adapted to the reality in China; develop exemplar pasturelands; and thus to provide enough high quality milk for the 'Student milk programme' and create positive influence on the dairy industry as a whole.

In order to support raw milk development in a more systematic way, in January 2008 at the '2008 China Dairy Development Forum', Tetra Pak announced the launch of the "Tetra Pak Raw Milk Support Program". The intention was to call for government and media attention to the critical issues in the dairy value chain by demonstrating its own commitment and actions. The subsequent Raw Milk Support Program includes four main areas:

First, the "Renda-Tetra Pak Dairy Research Centre" was jointly established by Tetra Pak and the Renmin University of China ('Renda' for short). This is a strategic partnership aiming to conduct a full-scale study across the country with dairy farms, cooperatives, and dairy farming families in order to find the most appropriate way of transition to modern farming. For instance, in total 10 R & D sites at cooperatives have been established for follow-up studies.

Second, Tetra Pak trained government officials in charge of dairy farming at grass roots level. During the past 3 years, 160 local officials from 30 raw milk-producing counties have participated in the training.

Third, Tetra Pak launched the 'Virtual Dairy Farmers School' in collaboration with the Dairy Association of China (dac.com.cn) and the China Central Television Station with the purpose of helping farmers improve their technical knowledge. By 2012, the project had carried out on-site trainings in more than 10 provinces, and over 6000 dairy farmers had attended the classes and received instructions from dairy experts invited by Tetra Pak. Short film footage, specialised TV programmes and DVDs is expected to have reached about 48 million people.

Building on the Phase I activities of the 'Sino-Sweden Dairy Industry Centre' established by Tetra Pak and its sister company DeLaval in 1985, Tetra Pak China launched the Phase II activities, providing 'Dairy Farming Proficiency training', including hands-on instruction to help managers and engineers of large-scale ranches to increase the efficiency of breeding, feeding, calving, milking, veterinary practices, and farm operations.

Fourth, by the end of 2011, with the support of Tetra Pak, 101 examplar pasturelands had passed the audit from the national milk office (Nai Ban). It is expected that the number will reach 200 by 2014. These Examplars were developed with the help of training workshops in each region and direct guidance from training experts for a period of 3 months. Then a team of three experts (different from those providing training) audit the pasturelands and provide reports to the milk office on whether they have reached the standards set by the steering committee. Tetra Pak initiated provided financial support in the form of expert travel expenses, expert fees and the writing of two handbooks etc. throughout the process. A designated team led by a 'Student Milk Programme Manager' within Tetra Pak China has been implementing the programme.

Creating a Recycling System

Tetra Pak refers to used but non-recycled cartons as "Misplaced Resources", and faces increasing criticism from environmental groups and the media. In the meantime, it has to confront competition from packaging alternatives such as glass and plastic. While data shows carbon dioxide emission for a 1 liter Tetra carton is 60–90 grams and that of a same-volume plastic package is 115–199 gram, and 230–250 grams for a glass package, the sheer quantity of TP packages still pose a serious environmental issue. Tetra Pak cartons have been criticized for being more difficult to recycle than tin cans and glass bottles.

The difficulty lies in the fact that the recycling processes, infrastructure and equipment are often not well established. Tetra Pak is currently working with various stakeholders including municipalities and recyclers around the world to build up this recycling infrastructure. They also seek ways to make recycling easier by: (1) designing packages with recyclability in mind; (2) cooperating with customers, municipalities, NGOs, industry groups and community associations to ensure Tetra packages are recovered effectively; (3) recycling Tetra Pak's own manufacturing waste and supporting customers' initiatives to recycle theirs; (4) working with scientific institutions and recyclers to develop new recycling technologies; (5) sending Tetra Pak's engineers to paper mills worldwide, to help run tests and demonstrate the value of recycling cartons; (6) incorporating recycling performance into the performance evaluation of local managers.

In China, Tetra Pak works with recycling companies, schools, NGOs, waste collectors, industry associations and central and local governments to help establish a sustainable collection and recycling system. Recycling levels increased from almost nothing in 2004 to about 20% in 2011, when approximately 90,144 tons of used packages were recycled in China, which is equivalent to around 9 billion packs of standard cartons.

Although the recycling rate increases quickly in China, in comparison to global average recycling rate (30%) and the high recycling rate in some of the EU countries (70%), the recycling rate in China is still low. A 'Circular economy' law was enacted in 2009, reinforcing the impetus for recycling. Tetra Pak is well aware that a circular economy can only be achieved if there is a healthy ecosystem within which the economy thrives; and that the success of recycling schemes depends on the commitment and cooperation of all stakeholders. Furthermore, Tetra Pak needs to (1) identify where its support can be most useful – in areas like technology development, the growth of recycling infrastructure and increased consumer awareness; (2) establish a carton collection system in China where there is currently a rather vague waste classification system; (3) Collaborate with China Packaging Federation, which represents the government, to monitor the packaging industry.

Tetra Pak takes three steps to promote the establishment of a carton recycling industry in China. First, it works with recycling partners to establish recycling capacity. Tetra Pak provides recyclers four types of recycling technologies (see Exhibit 4.7) and sometimes also financial support for capacity expansion.

Next, Tetra Pak provides technical support to encourage recycling partners to improve technology and end product value so that the recyclers can offer higher price for the used cartons in comparison to waste paper. Tetra Pak also provides waste packages from its production process as an additional input.

Most of the recyclers working with Tetra Pak are not large in size, but they all have potential to grow. For example Beijing Xin Hong Peng Paper Co. Ltd. processes about 10,000 ton of waste packages every year, with annual output of about 6000 tons of recycled paper and 250 tons of aluminium powders. Moreover, by using new thechnolgies to separate the PolyAl (plastic and aluminium)[3] materials in cartons, the value of recycled materials has increased by nearly a third. As a consequence Xin Hong Peng plans to expand its waste handling capacity to 30,000 tons per year.

Thirdly, Tetra Pak helps establish the collection network by training waste collectors and promoting public awareness of carton recyclability. Waste cartons are usually gathered by scavengers, often migrants to the cities. In Beijing, Tetra Pak provided collection training for these collectors, cleaners and dealers, in cooperation with a waste management company. With the joint effort from the recycling partners, the price of used Tetra Pak cartons increases to the same as or even exceed the price of used cardboard box, which obviously increases the motivation of collectors. When the financial crisis entered its second year in 2009, the price of the used Tetra Pak carton surpassed the price of waste paper in China. The peak price of used Tetra Pak containers reached RMB 1500 per ton in 2009; it dropped to around RMB 1000 since then while the ordinary waste paper price is around RMB 700–800.

To further enhance the economic sustainability of the recycling value chain, Tetra Pak also introduced HB clad plate (“Caile plate” 彩乐板) technology[4] and plastic-wood composites technology to its business partners. This has been widely adopted and there are now many cities in China using garbage bins made from plastic-wood, an ideal substitute for metal ones, which are often stolen. Plastic-wood composite technology also provides construction materials for flooring, and garden furniture that is popular in South-east Asian markets.

To date, there are more than 10 companies producing recycled materials from used Tetra Pak cartons in China, and a recycling value chain is taking shape (see Exhibit 4.7). Tetra Pak wants to double its recycling rate of cartons from 20% in 2010 to 40% by 2020 globally. Their experience in China proves it can be done, even in a market lacking clear waste management legislation.

[3] When the paper pulp is removed from the waste, a mixture of plastic and aluminium remains. This use to fetch a rice of around 1200/ton. In 2007, Tetra Pak cooperated with Shandong Tianyi Plastic Co. Ltd. and Shangdong Liaocheng University to develop a Chinese version of PolyAl, the technology to separate the plastic and aluminium. In 2009, PolyAl separation technology was commercialized in China. As a result, the aluminium and plastic components can be separated with a purity of 99.5%. The separated plastic grains can be sold at a price of about RMB 2000/ton, and the aluminium can be sold at about RMB 9000/ton.

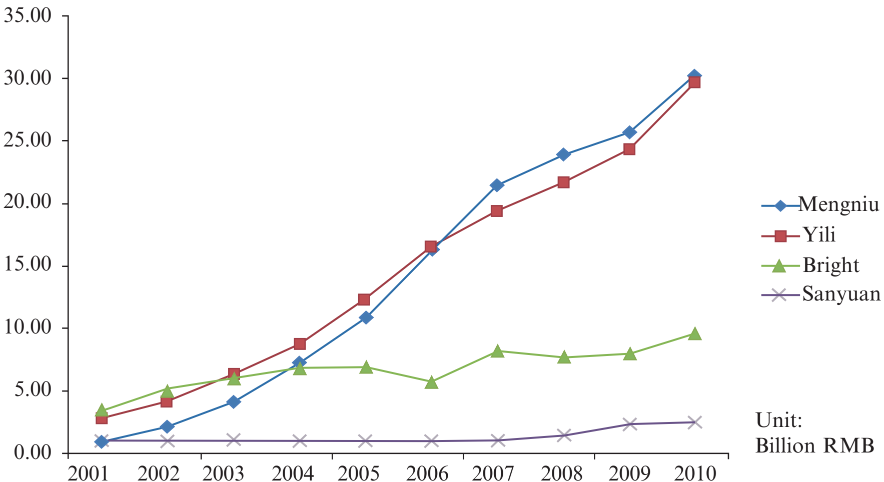
[4] HB clad plate technology: HB clad plate is made by crushing used Tetra Pak cartons and processing the material with thermo-compression. HB clad plate can be manufactured into various products, such as rubbish bins, said to be nice looking, endurable and low in cost.

Acknowledgement We would like to acknowledge the financial support of WWF and University of Exeter Business School, and a number of interviewees with special thanks to Carol Yang in Tetra Pak China. We also acknowledge the writing support of Dr. Anna Trifilova and Mrs. Yu Huang.

Disclaimer This case is written, presented and intended to be used as the basis for class discussion rather than to illustrate either effective or ineffective handling of a management situation. It is currently under development as part of a wider research project. The authors disclaim all responsibility should this case or its contents be used for any purposes other than its classroom use.

Appendices

Exhibit 4.1: Sales Volume of the Four Major Dairy Producers in China (2001–2010)



Data source: annual reports for Yili, Mengniu, Bright and Sanyuan

Exhibit 4.2: Dairy Supply Chain Structure in China

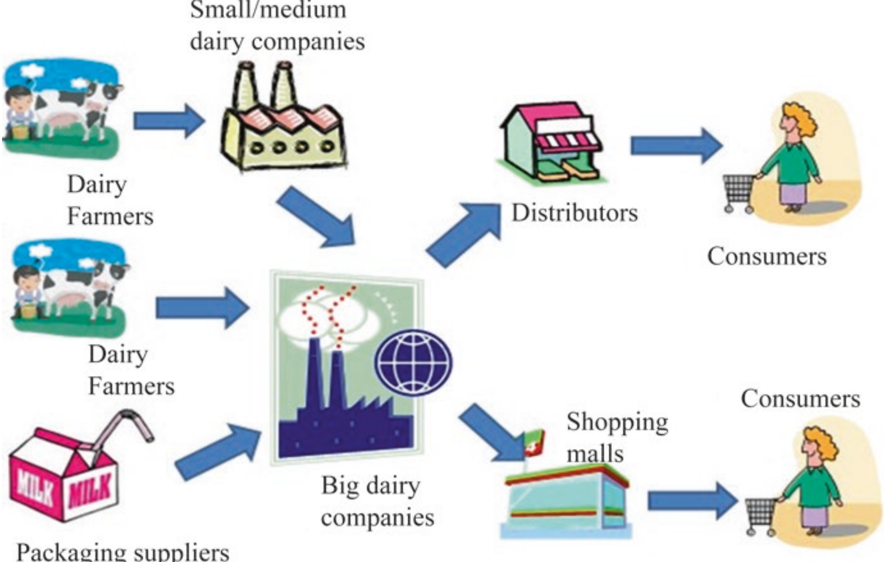


Exhibit 4.3: Packaging Made by Tetra Pak

Exhibit 4.4: Milestones for Tetra Pak in China

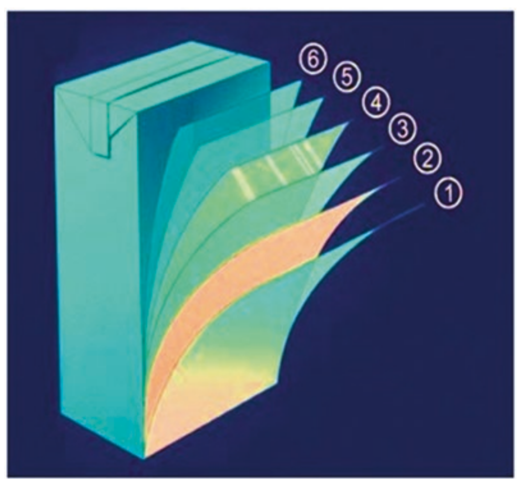
1979	The first Tetra Pak filling machine was put into use in Guangzhou.
1985	Tetra Pak (China) Co., Ltd. was established in Hong Kong.
1987	The Beijing Plant started production.
1989	The China Sweden Training and Product Development Centre was established
1991	The Foshan Plant started production.
1993	Two offices were established in Shanghai and Beijing.
1994	Three offices were established in Guangzhou, Chengdu and Xiamen.
1995	An office was established in Harerbin.
1996	The Kunshan plant started production.
1997	The Kunshan plant was opened formally. The Foshan plant got the ISO14001 certification. The Beijing plant got the ISO90021 certification.
1998	Two offices opened in Nanjing and Xi'an. The Kunshan and the Beijing plants got the ISO14001 certification.
2000	Tetra Pak (China) Co. Ltd. was moved to Shanghai.
2003	The Shanghai Pudong Processing Equipment centre was established.
2004	The second plant in Beijing was opened formally.
2005	The 1000th filling machine was put into use.
2011	The Tetra Pak China beverage R&D centre was opened formally in Shanghai.
2012	Phase two of the Hohhot plant was accomplished and put in production.

Exhibit 4.5: Tetra Brik and Tetra Fino

The brick-shaped Tetra Brik

The pillow-shaped Tetra Fino

Exhibit 4.6: Structure of a Tetra Pak Carton



Six-layer structure

1. Polyethylene–preventing water

2. Paper board – stabilizing and supporting

3. Polyethylene - bonding

4. Foil: blocking oxygen, light and odour

5. Polyethylene - bonding

6. Polyethylene - sealing

Exhibit 4.7: Location of Tetra Pak China's Recyclers

Technology	Application of renewed materials
Hydro-pulping	Renewed paper, materials for plastic and aluminum items
Wood Plastic Composites	Garbage bin , Indoor furniture, gardening, industrial
pallets Chip-tech	Garbage bin
PolyAl de-lamination	Plastic granular and aluminum power

INEOS ChlorVinyls: A Positive Vision for PVC (A)

5

N. Craig Smith and Dawn Jarisch

Introduction

Following a Greenpeace campaign in the late 1990s to boycott PVC products because of environmental concerns, Hydro Polymers Limited decided to embrace the challenge and work with The Natural Step (TNS), an international non-profit organisation promoting a scientific, whole-systems approach to sustainability (Framework for Strategic Sustainable Development; FSSD).[1] TNS spurred and assisted Hydro Polymers on its journey towards sustainability, a proactive approach that produced pioneering innovations, incorporated sustainability into the overall business, and generated major cost savings.

In 2007, Hydro Polymers was acquired by INEOS ChlorVinyls, Europe's largest PVC manufacturer. Aware that the rest of the European PVC producers were taking a less radical approach, the new parent company insisted that any drive to sustainability be part of a Europe-wide cross-company programme. For Dr. Jason Leadbitter, Sustainability Manager at INEOS ChlorVinyls, a passionate advocate of taking a more proactive sustainability approach since 2000, the challenge was to convince the new management, the customer and the wider PVC community to embrace sustainability. Could the tangible progress to date persuade them that an industry-wide transition to sustainable PVC

[1] The Natural Step has developed its work around the world and has been key for the development of a science-based methodology for strategic sustainable development for more than 20 years. This methodology is available to all, continues to be developed in a scientific process, and is known as the Framework for Strategic Sustainable Development (FSSD). See, for example, Robèrt K-H., Broman G., Waldron D., Ny H., Byggeth S., Cook D., Johansson L., Oldmark J., Basile G., Haraldsson H., MacDonald J., Moore B., Connell T. and Missimer M., *Sustainability Handbook*, Studentlitteratur, Lund, Sweden, 2012.

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© Springer Science+Business Media B.V. 2019
G. G. Lenssen, N. C. Smith (eds.), *Managing Sustainable Business*,
https://doi.org/10.1007/978-94-024-1144-7_5

was realistic and that the above-mentioned approach was the best way to accelerate the pace of change in the industry?

How It All Started

Polyvinyl chloride (PVC) was the material of choice for many consumer and industrial purposes, as it was durable, light weight and economical. But for Greenpeace, PVC was a highly toxic material to manufacture and dispose of. In August 1996, shortly after Leadbitter took on the role of Environmental Manager at Hydro Polymers, he was stunned to see a Greenpeace advertisement in the national press entitled ‘Saving our skins’ criticising the PVC retail market (see Exhibit 5.1). Demonstrations outside retail stores were staged to raise public awareness and gain support for the idea of regulations to eliminate PVC, by being phased out in the same way as chlorofluorocarbons (CFCs). In an effort to counter these claims, the European PVC resin industry, which represented 25% of a global PVC resin market worth €20 billion, was accused of deception and threatened with a boycott.

The PVC manufacturing process combined ethylene, derived from natural gas, with chlorine, derived from the electrolysis of salt, to produce an intermediate product known as ethylene dichloride (EDC). This was “cracked” via a chemical process to produce vinyl chloride monomer (VCM), which was polymerised in water to produce PVC resin. Resin was combined with additives (typically stabilisers, plasticisers and fillers) in myriad combinations to form PVC compounds. These were ‘converted’ by processes such as extrusion and moulding into products tailored for different applications.

Firms which converted PVC compounds into end products for sale or made components for downstream companies were known as ‘converters’. The resin industry, additive manufacturers and the compounding/converting sector were collectively referred to as the PVC industry.

PVC resin production consumed over a third of global chlorine gas production. The energy-intensive process consumed 1% of global electricity production (mostly carbon-based). Older plants were based on mercury cell technology, which released mercury into the environment. By attacking the PVC industry, Greenpeace threatened the entire chlorine industry. As Pete Roche, a Greenpeace campaigner in the UK, explained: “We held actions at various chlorine plants for a few years but got nowhere, so we switched attention to PVC, at the other end of the production chain.”[2]

Environmentalists argued that plasticisers and stabilisers (responsible for PVC’s properties such as its flexibility and thermo stability) and the accumulation of by-products from the manufacturing process (primarily dioxins) were unsustainable. They were accused of damaging ecosystems and human health by disrupting the endocrine, reproductive, nervous and immune systems, since they could be emitted into the air, soil and water during production, waste incineration and via leakage from landfill sites. Resistant to natural decomposition, they built up as global pollutants, were absorbed by living organisms and accumulated in the food chain.

[2] Pete Roche, Greenpeace UK, Chemical Week, February 26 1997.

Exhibit 5.1: 'Saving Our Skins'

August 1996

Saving our skins

Skincare products
Alternatives to PVC packaging

If you are buying skincare products, think about the packaging too. If you see that the container is marked with: △3 V then avoid it and choose an alternative instead.

If you shop at the Body Shop you can be sure of avoiding PVC packaging as they don't use it at all. Don't, however, be fooled by other similar 'natural' ranges sold in other places. Our research showed that some of those were packaged in PVC plastic.

The following lists show products that we found packaged in PVC and those that we found packaged in alternative materials. Choose the alternatives.

It's a simple switch – go PVC free!

✗ Skincare products which we found packaged in PVC plastic

Banana Boat skin care gel range
Boots Natural Collection sunflower body lotion
royal jelly moisturising body spray
Carex antibacterial moisturising hand wash
Galenco antibacterial creme handwash
peach creme handwash
Garnier Nutralia soap free hand wash
Marks & Spencers moisturising body lotion range
royal jelly & honey moisture replenishing body milk
Sainsburys moisturising handwash
Natures Compliments body mist
Natures Compliments eye make-up remover
Natures Compliments facial toner
Natures Compliments foot lotion
Natures Compliments gentle cleansing milk
Natures Compliments light body moisturiser
Natures Compliments light moisturising lotion
Natures Compliments massage oil
Natures Compliments rich body moisturiser
Simple moisturising hand wash
St. Ives chamomile face wash gel
Superdrug moisturising cream wash range
moisturising hand & body lotion
Synergie eye make up remover
Ten-O-Six deep cleanser
medicated cleanser
Tescos Active Response revitalising cleanser
Active Response refreshing toner
antibacterial moisturising handwash
camellia moisturising cream wash
Mild & Gentle pure wash gel
rose moisturising cream wash
Tisserand face lotion
Waitrose Natural Extracts elderflower & yarrow cleanser
Natural Extracts mallow & almond moisturiser
Natural Extracts willow & mountain clover toner

Eliminating PVC would be disastrous for Hydro, whose main products were PVC resin (representing 80% of turnover) and downstream PVC compounds (20%). Moreover, in 1997, the year after the Greenpeace campaign, it had launched a £30 million investment to expand and modernise its PVC resin manufacturing plant at Newton Aycliffe in the UK.

PVC Coordination Group

In response to the campaign and other critics, a number of leading UK retailers, including the Body Shop, Tesco, Asda and the Co-op, came together with Greenpeace to form the UK PVC Retail Working Group. The group commissioned a study of PVC by the National Centre for Business and Ecology (NCBE), a partnership between the Co-operative Bank and four UK universities, to investigate the scientific validity of the anti-PVC claims. When the report was published in September 1997, Greenpeace was surprised by its conclusion: "The study team concludes on balance that the careful manufacture, use, recycling and disposal of PVC products to the highest standards can control the risks associated with the material to acceptable levels."

The working group was then enlarged to include two UK PVC resin producers, Hydro and EVC, and representatives from the UK Environment Agency and Forum for the Future, a leading environmental think-tank co-founded by Jonathan Porritt, who was asked to chair the group. Forum for the Future had taken on the development of the TNS organisation in the UK. Each time Greenpeace representatives articulated arguments against PVC, Porritt asked them to explain how PVC as such was problematic and why the alternatives were better.

> Greenpeace: "There are heavy metals in PVC-production." Porritt: "So, what would happen if PVC was manufactured without heavy metals?"
> Greenpeace: "PVC manufacture is an energy-intensive process requiring 1% of global electricity production." Porritt: "How much energy is used in the manufacture of alternative raw materials?"

As it became clear that the (now named) PVC Coordination Group didn't have the answers to these questions, Porritt pushed them to commission a 'gap analysis' using the FSSD and its principles for sustainability. While this was a risk for the PVC industry (companies such as IKEA and the Co-op had used the same methodology arriving at a conclusion to phase out PVC), the principles were based on science, the mistrust and suspicion surrounding PVC had to be dealt with, and Porritt was at least trying to play fair. Hence the resin producers had little choice but to participate in the gap analysis. TNS was engaged to undertake a detailed study of PVC with the theme "Does PVC have a place in a sustainable society?" This involved all the key stakeholders – the manufacturing chain, end-users, regulators and NGOs.

The Framework for Strategic Sustainable Development

The Framework for Strategic Sustainable Development (FSSD) has been developed through, and continues to be refined in, a comprehensive scientific process. It was continuously developed and scrutinized theoretically, used and tested in reality, and then refined and scrutinized theoretically again. This process was initiated in Sweden in 1989 by cancer scientist and cancer clinician Professor Karl-Henrik Robèrt, who founded The Natural Step (TNS) – a non-profit NGO with the mission of facilitating a learning dialogue between scientists and business. Frustrated by the prevailing piecemeal approach to addressing environmental problems, Robèrt brought leading scientists together to achieve consensus on the basic requirements for a sustainable society. This scientific consensus process has led to basic principles for socio-ecological sustainability and a systems-based strategic planning and management framework that is extensively used by business, municipalities and other organizations around the world. In the PVC context, borrowing Robèrt's words: "There are no sustainable materials, just as there are no non-sustainable materials. There are only sustainable and non-sustainable management practices."

The Sustainability Principles are as follows:

In a sustainable society, nature is not subject to systematically increasing:

1. Concentrations of substances extracted from the Earth's crust (such as fossil carbon and metals);
2. Concentrations of substances produced by society (such as nitrogen compounds, CFCs, and endocrine disrupters);
3. Degradation by physical means (such as deforestation and over-fishing);

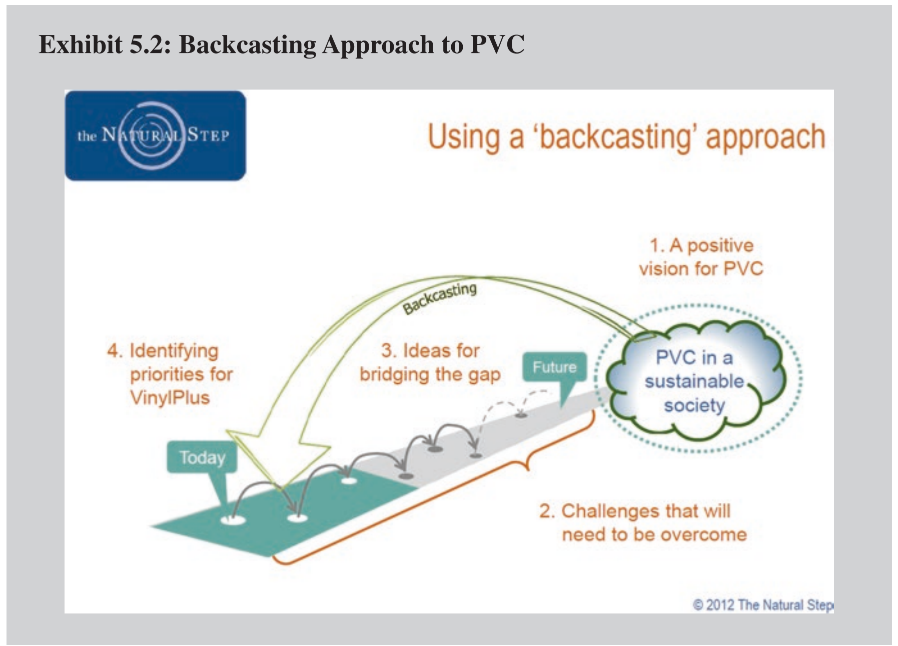
and, in such a society,

4. People are not subject to conditions that systematically undermine their capacity to meet their needs (such as from the abuse of political and economic power).

The FSSD includes a technique called 'backcasting' (see Exhibit 5.2), which entails creating a vision of success (framed by the sustainability principles) in the future, looking back from that vision to today's situation, and figuring out how to bridge the gap.[3] This differs from pure 'forecasting' – which extrapolates from prevailing trends to the future and then attempts to fix any foreseen problems, an approach that Robèrt claims is "bound to lead to more problems further ahead and even more confusion".

[3] See video: Sustainability plan: How might Einstein solve our problems? (backcasting) https://www.youtube.com/watch?v=DeDm-HTFuiY&list=PLEXqjIYY5zi6hWCvm5idXYLH2Qtv7fT-f&index=6

Exhibit 5.2: Backcasting Approach to PVC



Backcasting in the FSSD entails:

A (Awareness) – participants learn about the basic principles for human society to be sustainable (using the FSSD), share and discuss the topic or planning endeavor and agree on a vision of success.
B (Baseline mapping) – participants explore the current situation. They list the main current challenges in relation to the sustainable vision as well as current assets to deal with those challenges.
C (Creating possible solutions) – participants brainstorm possible solutions to the challenges discovered in step B.
D (Down to action) – participants prioritise actions developed during step C. Decisions and plans are evaluated for being flexible enough to handle change without losing overall direction, likely to produce progress to the vision, and adequate return on investments.

July 2000, Consensus-Building Report

TNS (UK) published its findings in a consensus-building report in July 2000. Having tested PVC in relation to the sustainability principles, the report asked the question – "Is there a place for PVC in a sustainable world?" What would it mean for PVC and its management to comply with the principles and bridge the gap between the existing situation and the future vision? Based upon in-depth research, and using consensus based workshops for all stakeholders including supporters and opponents, the final report concluded,

with the backing of participants, that PVC has a role in a sustainable society provided five specific and systemic challenges for the material and its use, were to be overcome[4]:

1. To become carbon neutral;
2. Closed-loop recycling;
3. No accumulation of emissions in the environment;
4. The industry to adopt sustainable additives;
5. Challenging the value chain to collaborate to become more sustainable.

To the relief of the PVC resin producers, The Natural Step study concluded that although PVC was currently unsustainably managed, none of the five challenges was technologically insurmountable. But even if the potential existed, the industry had to assess whether the challenges could be overcome in a commercially viable way. Porritt averred that,

> PVC may or may not have a place in a genuinely sustainable future (depending on whether or not it can meet the challenges outlined in our evaluation), but exactly the same questions must be asked of all materials, man-made or natural, before leaping to what are often ill-judged and unscientific conclusions.

Greenpeace, however, insisted that the goals were unattainable and withdrew from the PVC Co-ordination Group.

Vinyl 2010

In addition to the pressures from Greenpeace, the European Commission published a green paper, urging the PVC industry to address environmental concerns.[5] In response to this, in March 2001, European resin producers and converters made a voluntary 10-year commitment to minimise the environmental impact of production, an industry initiative known as 'Vinyl 2010'.[6]

Vinyl 2010 focused on recycling and substitution of heavy metals. With 17 million tonnes of plastics entering the waste stream within Europe, and landfill constraints developing in many member states, further pressure to recycle PVC could be expected. Consequently, Vinyl 2010 set a target to recycle 200,000 tonnes p.a. of post-consumer PVC waste by 2010. Vinyl 2010 also set a voluntary target for the industry to be lead-free by 2015 in the hope of avoiding anticipated European legislation. Both the recycling and the heavy metal substitution targets set for 2010 were exceeded.

[4] July 2000, "PVC: An Evaluation Using The Natural Step Framework", The Natural Step.

[5] See: http://ec.europa.eu/environment/waste/pvc/green_paper_pvc.htm

[6] See: http://www.bpf.co.uk/Members/Vinyl_2010_Voluntary_Commitment.aspx

Hydro Works with The Natural Step

Leadbitter was convinced that going beyond Vinyl 2010 and embracing the challenges of the consensus-building report would not only enable Hydro to pre-empt future regulation but provide a competitive advantage on sustainability issues. It was not an easy decision given the dilemma facing Hydro at the time:

> We had to think whether to build the walls higher or engage with the environmentalists. Do we invite them into the boardroom? Can we get them to sit round the table? This was what we did and it was a changing point in the whole culture and mentality of Hydro.

Following publication of the consensus-building report, Hydro's President, Anders Hermansson, was keen to meet Robèrt. The two men hit it off immediately and agreed to bring in a wider group of managers involved in the PVC resin production process. Robèrt and his team at TNS were engaged to undertake a deeper analysis of what it would take to create a sustainable PVC resin business, and to educate the top 40 managers in The Natural Step approach (the FSSD) and the related five challenges for PVC so that they understood the scale of the task.

Robèrt visited all of the Hydro sites, where he hosted workshops, coached and presented to senior, middle and junior management. Mapping flows of raw materials and energy, workshop participants were challenged to think about "What could we do, in a step-by-step fashion, to make PVC fully sustainable and meet the five key sustainability challenges for Hydro?"

In seeking to demonstrate that PVC could be safely manufactured and used, TNS compared itself to a "critical friend" – one who could be trusted to ask provocative questions, provide data to be examined through another lens, and to critique Hydro's efforts constructively.

Eager to inject a stimulus to get sustainability projects off the ground (notably the energy reduction project and any 'low-hanging fruit' which Hydro decided to tackle first) as well as convince the cynics in the company, Hermansson committed to provide NOK25 million (approximately €3 million) per year for 3 years from 2002, mainly for longer term projects. This was in addition to normal capital expenditure. A board was set up to allocate funding to the best projects. Additionally, Hermansson instigated an annual Sustainability Summit (that Robèrt attended), which allowed dissenters to voice their opinions and concerns. Once won over, they were often among the strongest advocates of the process.

Once employees got to grips with the framework as a means to achieve the end goal of sustainability, they learnt to plan, act, and apply the approach to their everyday work by undertaking manageable short projects. This generated a sense of purpose and achievement, accelerating the implementation process. From 2001 to 2004, senior management gave high priority to sustainability and maintained a close interest in it, inviting Robèrt and the TNS team back regularly to scrutinise investments, run workshops and education sessions, and give assurance on the steps taken.

Hydro employees identified and implemented numerous internal initiatives. The five key sustainability challenges were addressed at both the local and Hydro-wide

level. At any one time there could be four company-wide projects running for each challenge, as well as smaller local projects and further suggestions in the pipeline. Up to 120 people were involved in one or more projects (10% of the workforce). Local teams had five to six people per site/challenge and competition occurred among the scientists. Project leaders posted minutes from their meetings and spreadsheets with their creative ideas in a database.

An annual meeting provided an opportunity for team leaders to pitch their ideas to the board for potential capital investment. To quantify the value of each sustainability project, they had to provide details such as benefits vs. cost and likelihood of success. For example, for the Carbon Neutrality project (challenge No. 1), local teams were asked to both create and measure ideas of how to reduce carbon emissions from their plants, prompting a flood of potential project ideas. Employees had apparently thought about this for some time but had never been given the opportunity for creative thinking (or funding) until carbon neutrality became a strategic priority. Projects were assessed on the basis of the highest CO_2 savings per Norwegian Kroner invested. Funding was awarded to projects that provided the best value in this respect in combination with their chances of success.

The decision to put the company on a path towards sustainability gave individuals the creative freedom to think outside the box. One experienced chemical engineer came up with a speculative idea known as “adiabatic volume”, a breakthrough innovation with the potential to increase yield from the VCM cracker without further heat input. Despite the high investment required – with a payback period up to 3 years – estimated savings of 8800 tonnes of CO_2 per annum meant that the project was executed at a cost of around £1 million. Ironically, immediately after installation, energy prices soared unexpectedly. Although the carbon savings were marginally lower than predicted, the payback took less than a year. Within 3 years, all three of Hydro’s VCM crackers had the new technology, yielding combined savings of £3 million and 24,000 tonnes of CO_2 annually.

Other projects were less easy to quantify. For example, a project to reduce traces of dioxin formation (Challenge No. 3) proved difficult to quantify, yet this did not prevent significant investment. Some projects were more strategic. For example, phasing out lead stabilisers with more expensive alternatives did not make economic sense, but Hydro was keen to differentiate itself from competitors with lead-based formulations. A couple of projects proved unsuccessful, such as the purchase of two wind turbines for £140,000 which were never put into operation due to objections from the local electricity company and problems obtaining planning permission.

Prior to starting the sustainability journey, every tonne of PVC resin produced by Hydro emitted 1.8 tonnes of carbon dioxide. Investments in green energy achieved a 20% reduction in CO_2 emissions between 2001 and 2006, reaching Kyoto Protocol targets for 2012 in the first 4 years.

Corporate newsletters highlighted the progress toward the five challenges and employees took pride in what was achieved, in contrast to the frustration felt when they had been under attack by Greenpeace. By 2004, when Jan-Sverre Rosstad became Senior Vice-President of Hydro, a significant shift in internal culture had

occurred. The annual employee survey (September 2004) reflected a 15% increase in employee recognition of the company's environmental commitment in response to the question "Does Hydro put the environment first?" Not only were employees buying into the process as a result of actions witnessed first-hand (with visible support from top management), but the resulting innovations had reduced some of the risks to which competitors were now exposed.

Hydro's proactive approach had produced pioneering innovations to address the challenges ahead of its competitors and the regulators. By 2005, sustainability was no longer treated in isolation; targets were fully integrated into the business planning process and were generating cost savings. Hydro had demonstrated that the sustainability challenge could be met: it could measure the gap between the current position of PVC resin in relation to the end goal of sustainability, and spell out how it was systematically being closed.

Nonetheless, Rosstad wondered how to keep capitalising on Hydro's sustainability initiatives as the early wins were realised. For PVC resin to be fully sustainable, the entire value chain would need to align with the sustainability challenges over time. Rosstad felt that Hydro was "well positioned for this next phase of the challenge, gaining momentum in the marketplace which will hopefully translate into a snowball effect." He decided to embark on the fifth challenge by hosting workshops with suppliers in Hydro's value chain "to extend the business benefits of addressing sustainability implications of PVC to a wider range of stakeholders" as well as to "demonstrate PVCs long-term ability in becoming a fully sustainable material". (Hydro Polymers' *Environmental Newsletter*, October 2005).

The PVC Resin Market in 2005

In 2005, the global PVC resin market was worth over €36 billion, with annual consumption exceeding 36 MT. Over 60% of PVC resin was used in the manufacture of pipes and window frames for the construction sector. Although losing ground across some product applications, global production capacity was expected to exceed 40 million tonnes by 2010, driven by accelerating demand from Asia. In 2005, Asia accounted for 43% of PVC resin demand, with China increasingly making its influence felt. Between 1998 and 2005, China's annual PVC resin consumption had increased from one million to over seven million tonnes. On the supply side, China was ramping up its domestic PVC resin manufacturing capacity with little concern for environmental sustainability. It envisioned production increases of one million tonnes year-on-year from 2006 to 2010, relying on its cheap labour, vast coal reserves, and more energy-intensive and polluting acetylene process technology. This technology had been phased out and replaced by ethylene-based production in Europe in the 1960s.

It was a cyclical market. PVC resin prices varied from month to month, driven by the price of raw materials and manufacturers seeking to keep capacity utilisation high. Consequently, the value of the market changed each year even if production

capacity and volumes remained static. In Europe, ethylene accounted for half of production costs, with energy costs the next highest cost component.

Europe's PVC resin market represented over 25% of global consumption in 2005, supplied by ten European producers. European production capacity was 9.1 million tonnes. The top 3 producers were INEOS (1.3 MT), Solvay (1.2 MT) and Arkema (0.8 MT). Hydro in fourth place (0.7 MT) had the lowest costs in Europe, benefiting from its integrated supply chain. Given the capital-intensive nature and relatively low margins of the sector, this was a significant advantage. In 2005, Hydro's operating income was €8.6 million, while competitor EVC/INEOS[7] reported losses of €13.2 million.

For decades, market growth in Western Europe had been driven by applications for door and window frames and pipes, but as the market matured, growth was projected to be only 0.5% per annum to 2008. Running on tight margins, many players wondered how sustainability could be good for business when their only priority was survival.

Engaging Suppliers and Customers

Both Leadbitter and Rosstad believed key suppliers must understand Hydro's approach to sustainable PVC based on the FSSD if future partnerships to address the sustainability challenges were to succeed. In April 2005, Hydro invited its ten top strategic raw material suppliers to Stenungsund, Sweden, to explain the sustainability challenges facing PVC and communicate Hydro's strategy. The workshop offered an opportunity for them to grapple with the sustainability implications for their own product development set against the practical realities of creating sustainable products in a commercially viable timeframe.

Feedback from those attending was positive. Hydro's commitment to sustainability virtually guaranteed demand for suppliers' sustainable product innovations – their ideas would be taken seriously because of Hydro's sustainability drive. One company produced a new stabiliser system that offered an alternative to using lead and a reduced environmental footprint. Suppliers also began to develop their own sustainability initiatives. For example, The Natural Step worked extensively with Rohm and Haas, one of Hydro's top strategic suppliers, helping them at strategic and operational levels to apply the FSSD including a new vision and 'Six Commitments for Sustainability'.

Hydro now had to convince its customers that sustainable PVC was a viable long-term option over alternatives such as wood, plastic or aluminium. It had to demonstrate the tangible added-value of its increasingly sustainable PVC resin products, and position the brand accordingly. In March 2006, as Leadbitter and Rosstad prepared for a crucial workshop with Hydro's key UK customers (see Exhibit 5.3). They felt it was time to talk openly about what Hydro had achieved and create demand for further innovations by showcasing its strategy for sustainable PVC and progress to date.

[7] EVC had been acquired by INEOS.

Would customers understand the process the company had embarked on in 2001, and appreciate the advantage of full sustainability as opposed to the issues-driven approach of its competitors? How could Hydro enhance their perception of Hydro's brand without alienating them? If customers weighed up the implications of the sustainability challenges for the industry, would they contemplate making the transition to fully sustainable PVC or dispute its viability on commercial grounds? If PVC was seen to be a losing battle, they might devise exit strategies to cut their losses. Given the availability of alternative materials (e.g., for products like window frames), would they switch to substitutes and exit PVC-based manufacturing? (see Exhibit 5.4).

Exhibit 5.3: Background on Key Customers Attending the Sustainability Workshop

The key customers attending the workshop included the following major product areas.

Building and construction

The most significant group of workshop participants, in terms of volumes sold by Hydro Polymers in the UK, was suppliers to the construction industry. These customers purchased either PVC resin and/or PVC compounds to fabricate extruded profile in applications such as pipes, window frames, facia and soffit boards.

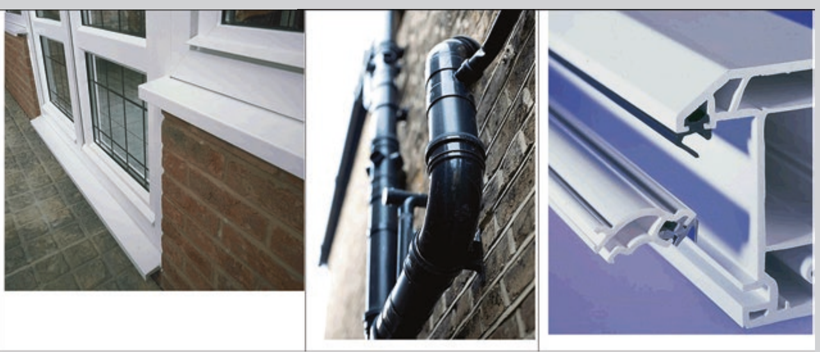
They were faced with increasing pressures to demonstrate the sustainability of their products through increased regulation, especially in relation to social housing, including new sustainability drivers being developed from the Offices of the Deputy Prime Minister (ODPM), requirements from bodies such as English Partnerships, and private finance initiatives. In addition, they experienced pressure from many of their own customers, house builders and architects increasingly being required to demonstrate that they were using sustainable materials in construction.

Their expectations of the workshop were to learn how sustainability could be implemented within their businesses – more especially whether it could help towards the increasing requests for "sustainable materials". They were also looking towards collaboration with their suppliers and across the industry over recovery of PVC for recycled applications. For most participants, the workshop was seen as a new way of looking at their respective businesses and most were keen to learn from the experience.

These customers were heavily dependent upon PVC, which remained the only viable plastic for use in window frames and plastic profiles. On that basis any loss of PVC markets would be a direct loss of business to them. Alternative products for use in window frames (timber and/or aluminium) required vastly different processes of fabrication from the invested infrastructure in their own companies already dedicated to processing PVC.

(continued)

Exhibit 5.3: (continued)



Pictures courtesy of ECVM (Plastics Europe)

Flooring

Other participants were manufacturers supplying vinyl-based systems to a diverse range of customers in the flooring industry. They had many of the same issues as participants in building and construction. However, unlike construction, these manufacturers could offer alternatives such as linoleum and wood laminate to their customers. Nevertheless, PVC (or vinyl as it is usually referred to within the flooring industry) remained a hugely important material in their portfolio, offering advantages over the alternative materials. These participants were under increasing pressure to demonstrate the recycling potential of their products. For them the workshop served as an opportunity to highlight the need for supply chain engagement in order to address the recycling challenge jointly.

Picture courtesy of Polyflor

(continued)

Exhibit 5.3: (continued)

Medical

There were several participants from the medical industry, supplying PVC-based devices for use in a wide range of disposable but critical healthcare applications, such as blood tubing and containers for blood and intravenous solutions. Their main expectations were to gain a better insight into the sustainability implications for PVC. In the main, the threats to their business came from one of the additives used within the PVC rather than the PVC itself, i.e. the plasticiser known as DEHP (di 2-ethylhexyl phthalate, the softening agent to make PVC flexible). While there have been many attempts by other material producers to provide PVC alternatives based on other plastics, PVC still offered the best overall combination of properties and was cost-competitive.

Pictures courtesy of ECVM (Plastics Europe)

Moulding products

Several participants supplied the industry with mouldings for a wide range of applications. Unlike profile manufacturers, who extrude PVC in continuous lengths, these manufacturers processed PVC for a diverse range of applications using injection moulding. They also used a range of other thermoplastic

(continued)

Exhibit 5.3: (continued)

materials and were less dependent on PVC than profile producers. Like flooring, PVC offered some advantages for certain applications compared to alternative thermoplastics. It cost less and, unlike other thermoplastics, did not require the use of anti-flammables such as brominated fire retardants. These participants saw the sustainability workshop as a mechanism to learn more about the positive aspects of addressing sustainability. They planned to use these in their promotional literature.

Pictures courtesy of ECVM (Plastics Europe)

Exhibit 5.4: Sustainable PVC Versus Competing Materials
Hydro Polymers had recognised the need to accelerate the pace of change of addressing sustainability within the PVC industry. One of the key drivers in the UK had been the increasing pressure from the Building Research Establishment (BRE) whose model, "The Green Guide on Construction Materials," was starting to appear widely. The guide, initially designed for the Post Office to rate materials in specific applications, was based on a complex set of environmental profiles, yet the outcome was a simple rating of either A, B or C, where A was good and C poor from an environmental perspective. Architects, construction companies and other specifiers turned off by the complexities of life cycle analysis could see the benefit of using such a tool as a simple means of materials selection.

At the time of the workshop, the generic rating for PVC for use in window profiles was C, while timber windows had an A rating. For other applications such as flooring, PVC scored favourably and so the BRE rating was not seen as a threat. Hydro Polymers' window customers had highlighted that the threat of a poor rating was directly impacting their business, and the threat itself was likely to increase. Other influential bodies such as English Partnerships had already decided that they would not use C-rated materials for new build applications. PVC was losing market share as a direct result of this rating. There was clearly a pressing need to undertake a review on improving the rating of PVC for use in windows and this was being addressed by a joint effort across the industry. The main options to improve the rating were identified by Hydro Polymers as:

- Extend the life of PVC windows within the Green Guide from its current estimated length of 25 years (an estimate the industry was confident was wrong)
- Reduce the environmental footprint of PVC
- Introduce recycled PVC into new profiles

The first option was being tackled across the UK industry via demonstrations to BRE that PVC windows lasted significantly longer than 25 years, i.e., at least 35 years. However, the second and third options were clearly dependent on product sustainability initiatives and demonstrated the need to address sustainability challenges from a real business perspective.

So while the BRE assessment was clearly a threat to the industry, Hydro Polymers also saw it as an opportunity ultimately to improve PVC's rating versus competing materials such as timber. If the industry generic rating was insufficient and PVC continued to lose ground to competing materials, there was still the option of a specific rating for Hydro Polymers' own PVC – not its first choice but a potentially shrewd business differentiator if needs be.

Even if customers accepted that an industry-wide transition to sustainable PVC was possible, would they support Hydro's strategy when other European PVC resin producers were taking a less radical approach? Would they see a cost advantage to the more incremental approach (despite Hydro's experience to the contrary)? Would they choose to 'wait and see' or perceive added value for their own customers and embrace the drive for full sustainability?

As Leadbitter and Rosstad pondered these questions, they knew they must give the meeting their best shot. Getting just one or two big customers to buy into the sustainability initiative was critical if Hydro was to embark on the next stage.

At this point, Hydro's sustainability programme (in conjunction with TNS) was beginning to be recognised. Employees had embraced its values and goals enthusiastically and many felt that the programme had been beneficial. For example, it had featured in a leading environmental journal, *Environmental Data Services*,[8] a publication traditionally hostile to PVC. The October 2005 edition of Hydro Polymers' *Environmental Newsletter* summarised the company's progress on the key sustainability challenges as follows:

1. Carbon neutrality: "Significant progress has been made over the last 4 years to reduce our CO_2 emissions from our manufacturing processes. To date this has led to over 80 Kg of CO_2 reduction per tonne of PVC produced… [achieving] our "Kyoto Protocol" target (12% reduction) in just 4 years… with the introduction of our new chlorine plant at Rafnes… the predicted reduction by 2007 will be 28% lower than the CO_2 emissions in 2000."
2. Closed-loop recycling: "Steady progress has been made on developing our EcoVin product line. The compound is manufactured from post-industrial scrap… to date we have had nearly 2500 tonnes of sales that could have otherwise been destined to landfill."
3. Elimination of persistent organic pollutants: "The reported dioxin levels across the whole of our operations continue to reduce" (a graph included in the newsletter indicated levels had halved in 4 years). "Levels are anticipated to be extremely small on the basis that the new [chlorine] plant uses new materials that have less propensity for catalysing dioxin formation."
4. Sustainable additives: "Hydro Polymers… will be lead-free by the end of 2007" (well in advance of the 2015 deadline under Vinyl 2010). "The main stabilisers used to replace lead will be based either on Calcium/Zinc and/or OBS based systems."
5. Raising awareness across the industry: "Complementing the raw material supplier event in April, invitations were also extended to our customers to attend a Marketing/Sustainability workshop during the official opening of the new chlorine plant at Rafnes in Oslo at the end of August." A DVD of the key presentations at the supplier event was also made available to those unable to attend.

[8] ENDS, May 2005, "Hydro Polymers: Searching for a more sustainable PVC", Environmental Data Services, Report 354, p. 25–28.

Nevertheless, some dissenters remained. Also in October 2005, *Green Futures*, a Forum for the Future publication, interviewed Mark Strutt of Greenpeace UK, who had left the PVC Co-ordination Group back in 2000. His stance remained unchanged:

> Unless Hydro can show it can make PVC without chlorine, and without using toxic and persistent additives, then we are not interested in small improvements. We still believe that PVC is inherently unsustainable and completely unnecessary, as alternatives exist for virtually all its applications.

Hydro Polymers pressed on, all the same. At one of its FSSD workshops, it decided to develop a distance-learning course with actors in its value chain, thereby enabling a more cohesive approach to support each other's sustainability approaches. Hydro Polymers and TNS joined forces with Blekinge Institute of Technology, Karlskrona, Sweden. A semi-distance course was developed and delivered and in this way the key suppliers and customers were trained in the FSSD. Attendees also received 7.5 university credits. Based on the shared mental model for systematic planning incorporated in this training, a cascading effect of actions and business developments occurred across the supply chain, eventually leading to a 10-year sector agreement. The companies agreed to embark on a joint venture to eventually comply with the FSSD sustainability principles.

The INEOS Takeover

In 2006, Norsk Hydro, Hydro's parent company, decided to dispose of the PVC business. Chris Welton, Hydro's European Head of Communications, felt that the sustainability programme would be perceived by potential buyers of the company as an attractive business proposition and should help to sell the business. Europe's largest European PVC resin producer and the UK's largest private company, INEOS, expressed an interest.

Culturally, INEOS was driven by business efficiency. Its main owner, Jim Ratcliffe, had started INEOS in 1998 by purchasing an ethylene oxide chemical plant in Antwerp, Belgium, previously owned by BP. Subsequently, INEOS had acquired a number of other commodity chemical businesses from blue chip companies seeking to divest these assets. Ratcliffe believed that big chemical businesses could be inefficient and aimed to double the earnings of the businesses INEOS acquired over 5 years. He ran a lean operation and had a reputation for being a hard-nosed businessman. According to the *Financial Times*,

> The formula was simple: take on a lot of debt to fund the purchase, reduce it through cost savings and other measures, and start all over again. Once in charge, INEOS would go in hard, stopping spending overnight. Many of the companies would have excessively high costs and the aim was to stop waste immediately.[9]

[9] Financial Times, February 7, 2014.

At the time of discussions, INEOS was heavily involved in the industry's Vinyl 2010 programme. Hydro was a member of Vinyl 2010 whilst also pursuing the five key challenges from The Natural Step analysis. Both approaches were respected because an outside party set the agenda with which the participants complied.[10] Vinyl 2010 required PVC producers to pay a membership subsidy (the size of which increased according to the volume they produced). As the largest producer in the European PVC industry INEOS was therefore the largest financial contributor. As such it had a political interest in Vinyl 2010 initiatives and wanted to ensure that its hard-earned cash was invested wisely.

Hydro was the only company in the PVC industry following the FSSD approach to sustainability and was way ahead of the rest of the European PVC industry, whereas for INEOS the Vinyl 2010 programme was working well and had the added advantage of industry backing and support from the European Commission. The Commission had set criteria for product stewardship and the industry was complying. Indeed most of the companies involved in Vinyl 2010 were reluctant to adopt the FSSD approach because it went so much further. Since Greenpeace and other activists were no longer pressing the industry to reduce its carbon footprint, why bother to invest in seemingly unnecessary reductions?[11] Rather than seeing Hydro's efforts as complementary to the existing Vinyl 2010 voluntary commitment, it was seen as 'going off at a tangent' or 'in conflict'.

The potential merger required two rounds of negotiations with the European Commission, so the acquisition process lasted many months, during which there was considerable uncertainty within Hydro. Executives wondered whether the journey with TNS would be cut short. Leadbitter recalled:

> The 'bedding in' process took a number of months. Whilst no one from INEOS said they would throw out our sustainability approach, they took a cautious approach to it, preferring to look at the best practices of each of the companies. The whole process took a lot longer than anticipated, during which time we wondered how our jobs would be affected.

In May 2007, INEOS acquired Hydro for NOK5.5 billion, (€670 million). Leadbitter and the PVC resin business became part of INEOS ChlorVinyls, while the PVC compound business became part of INEOS Compounds. Ex-Hydro executives wondered whether they would be able to persuade INEOS of the value of the TNS approach. Would sustainability even have a role in the new organisation?

In some instances, sustainability was accommodated within areas of business efficiency. For example, Ashley Reed, Business Director of INEOS ChlorVinyls (and later CEO of INEOS Enterprises), though a tough operations guy, was willing to listen if a good business case could be made. But overall INEOS felt that it was not possible to make just one company out of a whole supply chain sustainable. For a sustainability agenda to have an impact, it needed to be part of a broader European cross-company programme.

[10] In the case of Vinyl 2010, the third party setting the agenda was the European Commission. For Hydro Polymers it was The Natural Step.

[11] Greenpeace was pursuing other agendas.

Moreover, as INEOS was contributing so much to Vinyl 2010, any sustainability ideas should be developed within the scope of that industry-wide initiative. At the outset, Leadbitter didn't see the benefits of this approach, but he gradually came round to the idea:

> Initially I felt torn. I selfishly didn't want to hand over our sustainability approach to the rest of the PVC industry, as I had seen how well the approach had worked to give a competitive advantage to our own company. However, I also realised that it was the right thing to do, and it would give us greater exposure and more credibility with customers. The more I thought about it, the more attractive it became. We had reached a point where it would be a natural progression for us to broaden the programme and involve the whole of the European industry. I realised the benefit of capturing both approaches and demonstrating to the wider community how well it had worked for Hydro.

But the timing was bad. INEOS had taken on a vast amount of debt to fund its many acquisitions and was badly hit by the 2008 financial crisis. Long-term decisions would have to wait – cost-cutting was the first priority.

Part II

Introduction: Issues Management – Managing the "Responsibilities" of the Business

Gilbert G. Lenssen

This second level of management is based on an "outside-in" investigation of major trends in the immediate and wider business environment. These trends produce issues that exacerbate risks in the business model and the business strategy, or create new risks thereby affecting the sustainability of the business.

Issues are related to the less formal, more implicit or even frontier expectations within social contracts, that are vague when latent but can become more concrete as they mature. These issues often serve as social symbols, channelling critique of business and its perceived lack of responsibility or a lack of regulatory intervention by public authorities in the face of global business dominance. Backlash over social issues may appear disproportionate and helpless executives can be left bewildered by accusations of a lack of corporate responsibility.

Issues may be mature like corruption, inequality, poverty, privacy, obesity, offshoring, access to medicines, resource depletion, forest destruction, climate change. Issues may be emerging like tax avoidance and tax competition, fugitives and migration, emissions testing and performance of cars, programmed obsolescence of electrical and electronic products. Issues might be linked to industry structures or even global trade conditions. (see WTO rules playing a major part in the Chap. 8 Nike case).

Adopting appropriate organisational responses to major trends in the business environment and to the latent, emerging and maturing issues of "corporate responsibility" and developing the organisational capability for timely responsiveness is key. As a consequence, issues management should be on the agenda of top management and boards.

Ethical issues, such as corruption are particular challenges. Corruption is a mature issue. The past 15 years provide ample evidence of the risks of engaging in corrupt practices. A list of the top 10 settlements (Merrill Goozner, *The Fiscal Times*, December 13, 2011) reveals names (with DOJ settlements in brackets) such as: Siemens ($1.6 billion), KBR/Halliburton ($579 million), BAE Systems ($448 million), Daimler Benz ($195 million), Alcatel Lucent ($137 million), and even Johnson & Johnson ($70 million)

With the anti-corruption stance of the Chinese government since 2013, companies take on significant risk in the Chinese market by not following strict anti-corruption policies. Recent examples include GSK and Roche in 2014. The US courts maintain vigilance in fighting corruption in America (e.g., United Continental in 2015) as well as abroad on the basis of the FCPA (Foreign Corrupt Practices Act). A recent example is HP, which settled out of court for alleged corruption in Poland, Mexico and Russia in 2014.

Key Questions to Ask (Applicable to All Part II Cases)

What are the current major trends in the business environment?

Which major issues – latent, emerging or maturing – are affecting the business model and exacerbating the business model risks?

How is the company managing these issues: is it defensive, compliance, managerial, strategic in approach?

How will the business model be affected in the long term by major macro trends like climate change, resource depletion, demographic change, geo-political change, and the way these interact and reinforce each other?

How should the company protect and enhance value in the face of these issues and trends?

How is organisational capability and leadership developed to respond in a timely and appropriate way?

Chapter 6: Expect the Unexpected by KPMG

Ten sustainability mega-forces will impact business over the next 20 years, requiring strategic stances by businesses to cope in a timely and effective way. These megaforces are systemically linked: climate change, volatile energy markets, material resource scarcity, water scarcity, demographic growth, the emerging global middle class, urbanisation, food security, declining ecosystems, deforestation. Trend projections prepared without consideration of the entire system of mega-forces are increasingly inadequate. The authors identify three nexuses which represent the challenges of sustainable growth which companies need to address: the footprint nexus, the erosion nexus, the innovation nexus. A sector analysis of external impacts and pressures to internalise costs for these is provided for the following sectors: airlines, automobile, beverages, chemicals, electricity, food, industrial metals, marine transportation, mining, oil and gas, ITC.

Chapter 7: The Path to Corporate Responsibility by Simon Zadek

The key issue in this case is child labour. Child labour was rampant in Europe and the US until the early twentieth century, merely 100 years ago. It still persisted in small family businesses in France, Germany the UK and Italy till WWII. It was estimated by the ILO in 1999 that child labour still accounts for 1% of the work-force in Europe, the US and Canada. But in Africa it accounts for 32%, in Asia 22%, and in Latin America 17%. Nike's suppliers used child labour which is an endemic practice in many Asian societies. "Do not use child labour" is a simple policy

statement which may be backed up by an ethical code for managers, but it is hard to implement the policy. At Nike, installing a CSR department to implement compliance policies was wholly ineffective. Nike went through 4 stages of organisational learning over many years to come to a more or less positive outcome. It lost considerable brand value and incurred considerable costs before it realised it had to change its business model and rally the industry sector around a campaign to change an international trade agreement. To its critics, Nike's business model amounted to a license to print money: the lowest possible cost in the supply chain, no capital employed in production, nor in working capital thanks to just-in-time supplies, high margins in sales and marketing with exclusively branded products. But the party did not last forever. Impressively high profitability and returns mostly always hide high risks in the business model which can be exacerbated by emerging issues and pose serious threats to business sustainability .

Chapter 8: GSK: Profits, Patents and Patients by N. Craig Smith and Dawn Jarisch

The key issue in this case is access to medicines. Access to medicines as a universal human right is now a mature issue. Providing medicines to poorer countries at affordable prices may make economic sense because it enhances economies of scale in production and extends global brand reach. But it can undermine the very business model of a pharmaceutical business which requires high margins to remunerate extremely high investment levels in research and development before the patents run out and the medicine becomes "generic". High prices in developed markets can be obtained, but practice showed how parallel trade from low margin developed countries into the high margin Western countries undermined the integrity of the business model. GSK needed to ensure that medicines which it provided in South Africa at affordable prices would arrive in the clinics with the patients and not disappear into parallel trade to Europe. Partnerships with NGO's to extend its distribution chain to patients appeared to be the answer. The case also poses the question how far a company needs to go to solve social issues. How to deal with the ever extending demands of "corporate responsibility" is central to Issues Management.

Chapter 9: Revenue Flow and Human Rights: The Paradoxes of Shell in Nigeria by Aileen M. Ionescu-Somers

Human rights is a key issue in this case, along with environmental harm, government corruption and poverty. Oil companies often require 30-year payback periods to fund the huge investments required in exploration and production. It is therefore surprising that these companies do not take more account of the social, environmental and political issues likely to emerge over such a long timeframe. Is it the "can do" engineering mindset? Ignorance of context issues while rolling out a business model which was elsewhere successful? Complacency by refraining from getting embroiled in thorny issues like civil wars? Lack of courage to stand up to corrupt host governments? In Nigeria, Shell got almost everything wrong by ignoring the social, environmental and political impacts of its business. In 2013, CEO Peter Voser admitted that trouble in Nigeria continued to depress financial performance

and announced that Shell would pull out from the Niger Delta oil production. Shell did learn from this experience in three ways. First, it implemented a comprehensive risk assessment model, charting all the potential costs required to mitigate these risks, including social, environmental and political risks BEFORE a major investment decision would be taken. As a result, some highly promising projects from a technical and (at first glance) financial perspective were abandoned. Second, environmental and social impacts of running projects are continuously monitored and are redressed by targeted programmes (also see chap. 15). Third, Shell became the founding partner in EITI, Extractive Industries Transparency Initiative, an industry wide initiative to curb corruption by governments.

Chapter 10: Ziqitza Health Care Limited: Responding to Corruption by N. Craig Smith and Robert J. Crawford

The key issue here is clearly bribery and corruption. Are bribes to be considered as a cost of doing business in emerging and developing countries, or is the social cost of corruption so disruptive that it stands in the way of economic and social development and therefore in conflict with the medium term interests of businesses? The case illustrates the challenges of a social enterprise business in an emerging country like India, where Ziqitza took a decisive stance to make anti-corruption part of its brand, its value proposition and its legal policy.

The company found itself in a difficult balancing act with on the one hand a business brand and mission to fight corruption and on the other hand a public sector where corruption is rampant. Corruption is an ethical issue with destructive social impacts and which is very much mature but many businesses fail to abstain from the practice and can suffer heavy financial and reputation losses as a result.

Expect the Unexpected: Building Business Value in a Changing World

6

KPMG International

Introduction

For 20 years or more the world has recognized that the way we do business has serious impacts on the world around us. Now it is increasingly clear that the state of the world around us affects the way we do business.

The resources on which business relies are becoming more difficult to access and more costly. Increasing strain on infrastructure and natural systems is likely as patterns of economic growth and wealth change. Physical assets and supply chains will be affected by the unpredictable results of a changing climate. And businesses can expect an ever more complex web of sustainability legislation and fiscal instruments.

But this is not the whole story. The central challenge of our age – decoupling human progress from resource use and environmental decline – can also be one of the biggest sources of future success for business. More corporations are recognizing that there is value and opportunity in a broader sense of responsibility beyond the next quarter's results; that what is good for people and the planet can also be good for the long term bottom line and shareholder value.

In this report, KPMG's network of firms analyzes a system of ten sustainability megaforces that will impact each and every business over the next 20 years. These forces do not act alone in predictable ways. They are interconnected. They interact.

It is important for business leaders to understand this system of forces; assess the implications for their own organizations; and devise strategies for managing the

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These forces do not act alone in predictable ways. They are interconnected. They interact.

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© Springer Science+Business Media B.V. 2019
G. G. Lenssen, N. C. Smith (eds.), *Managing Sustainable Business*,
https://doi.org/10.1007/978-94-024-1144-7_6

risks and harnessing the opportunities. We can never know the future. But it is good business sense to be prepared for the possibilities: to expect the unexpected.

This report cannot provide all the answers, and does not set out to, but it does suggest approaches that we at KPMG believe will help to build business value in a changing world.

Global Sustainability Megaforces Will Affect the Future of Every Business

For this report dozens of forecasts have been analyzed to identify the changes that will have the greatest effects on business

Over the next 20 years businesses will be exposed to hundreds of environmental and social changes that will bring both risks and opportunities in the search for sustainable growth.

For this report dozens of forecasts have been analyzed to identify the changes that will have the greatest effects on business.

The result is a set of ten global **sustainability megaforces** that we believe will impact every business over the next two decades. They are:

- **Climate Change:** the one global megaforce that directly impacts all others discussed in this report. Predictions of annual output losses from climate change range between 1% per year, if strong and early action is taken, to at least 5% a year if policymakers fail to act.
- **Energy & Fuel:** fossil fuel markets are likely to become more volatile and unpredictable because of higher global energy demand; changes in the geograph-

ical pattern of consumption; supply and production uncertainties; and increasing regulatory interventions related to climate change.

- **Material Resource Scarcity**: as developing countries industrialize rapidly, global demand for material resources is predicted to increase dramatically. Business is likely to face increasing trade restrictions and intense global competition for a wide range of material resources that become less easily available. Scarcity also creates opportunities to develop substitute materials or to recover materials from waste.
- **Water Scarcity:** it is predicted that by 2030, the global demand for freshwater will exceed supply by 40 per cent.[1] Businesses may be vulnerable to water shortages, declines in water quality, water price volatility, and to reputational challenges. Growth could be compromised and conflicts over water supplies may create a security risk to business operations.
- **Population Growth:** global population is predicted to be 8.4 billion by 2032 in a moderate growth scenario.[2] This growth will place intense pressures on ecosystems and the supply of natural resources such as food, water, energy and materials.[3] Businesses can expect supply challenges and price volatility as a result. This is a threat, but there are also opportunities to grow commerce, create jobs, and to innovate to address the needs of growing populations.
- **Wealth:** the global middle class (defined by the OECD as individuals with disposable income of between US$10 and US$100 per capita per day)[4] is predicted to grow 172% between 2010 and 2030.[5] The challenge for businesses is to serve this new middle class market at a time when resources are likely to be scarcer and more price-volatile. The advantages many companies experienced in the last two decades from "cheap labor" in developing nations are likely to be eroded by the growth and power of the global middle class.
- **Urbanization:** in 2009, for the first time ever, more people lived in cities than in the countryside.[6] By 2030 all developing regions including Asia and Africa are expected to have the majority of their inhabitants living in urban areas[7]; virtually

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[1] United Nations Environment Programme. (2011). *Towards a Green Economy: Pathways to Sustainable Development and Poverty Eradication.*

[2] United Nations, Department of Economic and Social Affairs, Population Division, (2011). *World Population Prospects: The 2010 Revision.*

[3] Behrens, A. et al. (2007). The material basis of the global economy. *Worldwide patterns in natural resource extraction and their implications for sustainable resource use policies.* Ecological Economics 64.

[4] Kharas, Homi. (2010). *OECD Development Centre Working Paper No. 285: The Emerging Middle Class in Developing Countries.* January 2010.

[5] Ibid.

[6] UN Habitat. (2009). *Global Report on Human Settlements 2009: Planning Sustainable Cities.* London, UK and Sterling, VA, USA: United Nations Human Settlements Programme (UN-Habitat).

[7] UN Habitat. (2010). *State of the World's Cities 2010/2011 – Cities for All: Bridging the Urban Divide*.

all Population Growth over the next 30 years will be in cities. These cities will require extensive improvements in infrastructure including construction, water and sanitation, electricity, waste, transport, health, public safety and internet and cell phone connectivity.

- **Food Security:** in the next two decades the global food production system will come under increasing pressure from megaforces including Population Growth, Water Scarcity and Deforestation. Global food prices are predicted to rise 70–90% by 2030.[8] In water-scarce regions, agricultural producers are likely to have to compete for supplies with other water-intensive industries such as electric utilities and mining, and with consumers.
- **Ecosystem Decline:** historically, the main business risk of declining biodiversity and ecosystem services has been to corporate reputations. However, as global ecosystems show increasing signs of breakdown and stress, more companies are realizing how dependent their operations are on the critical services these ecosystems provide. The decline in ecosystems is making natural resources scarcer, more expensive and less diverse; increasing the costs of water and escalating the damage caused by invasive species to sectors including agriculture, fishing, food and beverages, pharmaceuticals and tourism.
- **Deforestation:** Forests are big business. Wood products contributed $100 billion per year to the global economy from 2003 to 2007 and the value of non-wood forest products (mostly food) was estimated at US$18.5 billion in 2005. Yet forest areas are predicted to decline by 13% from 2005 to 2030, mostly in South Asia and Africa.[9] The timber industry and downstream sectors such as pulp and paper are vulnerable to potential regulation to slow or reverse deforestation. Companies may also find themselves under increasing pressure from customers to prove that their products are sustainable. Opportunities may arise through market mechanisms and incentives to reduce the rate of deforestation.

These cities will require extensive improvements in infrastructure including construction, water and sanitation, electricity, waste, transport, health, public safety and internet and cell phone connectivity.

[8] Oxfam International. (2011). *Growing a Better Future: Food justice in a resource-constrained world.*

[9] OECD. (2008). *OECD Environmental Outlook to 2030.*

The Systems Approach to Sustainability: Planning for Change

Existing projections provide some insights about a possible future, but should not be relied upon to provide the whole story. Many predictions extrapolate current rates of change without taking full account of the fact that sustainability megaforces reinforce, compete with, or balance the effects of others.

For example, increasing wealth and the growth of the global middle class will accelerate demand for consumer goods and services, putting further pressure on the natural and material resources needed to produce them. Regional freshwater availability could struggle to keep pace with the agricultural production necessary to feed the growing population. Urbanization predictions generally do not account for the potential impacts of climate change refugees migrating from areas where water and food scarcity hit hardest. Food production projections rarely factor in deteriorating soil quality and the competing demands for agricultural land.

Trend projections prepared without consideration of the entire system of sustainability megaforces no longer provide an adequate basis for strategic business decisions.

Systems thinking around sustainability embraces the entire structure of megaforces rather than its individual constituents. It is an important way to assess and manage new risks and uncover risks that were previously unidentified. For example, a company may understand its direct dependency on water, but may not have thought about how the supply of its material resources could be impacted by increasing water scarcity.

Companies may already be using systems thinking, for example in strategic planning, revenue management or supply chain planning but in KPMG's view it should be applied as part of a proactive sustainability strategy.

> Trend projections prepared without consideration of the entire system of megaforces no longer provide an adequate basis for strategic business decisions.

The Nexus Approach

The nexus approach has been widely used by the World Economic Forum and others to explore the driving forces behind the challenge of water security.

For the purposes of this report we have developed three nexuses which together represent the challenges of sustainable growth. KPMG believes companies will benefit from exploring these nexuses in their own organizational context.

The Footprint Nexus

The forces behind mankind's escalating "footprint" on the planet are interlinked through a complex network of relationships. The Footprint Nexus is a useful planning tool to help business leaders envision the future world and market conditions they will be operating in and to develop appropriate strategies (Fig. 6.1).

> For the purposes of this report we have developed three nexuses which together represent the challenges of sustainable growth.

The Erosion Nexus

The Erosion Nexus helps executives to explore in greater detail the many challenges and opportunities their businesses could face as a result of the interactions between sustainability megaforces. By considering the full system of megaforces, executives are more likely to avoid sustainability "quick fixes" that can result in unforeseen problems and greater risks later on (Fig. 6.2).

The Innovation Nexus

The Innovation Nexus is an example of how executives can use the systems approach to develop business opportunities by innovating solutions to sustainability problems. This example suggests that sustainable lifestyles, ecological restoration, renewable energy, resource productivity, and the use of ICT to create "smart" cities, are among the key innovations required to avoid dangerous levels of climate change (Fig. 6.3).

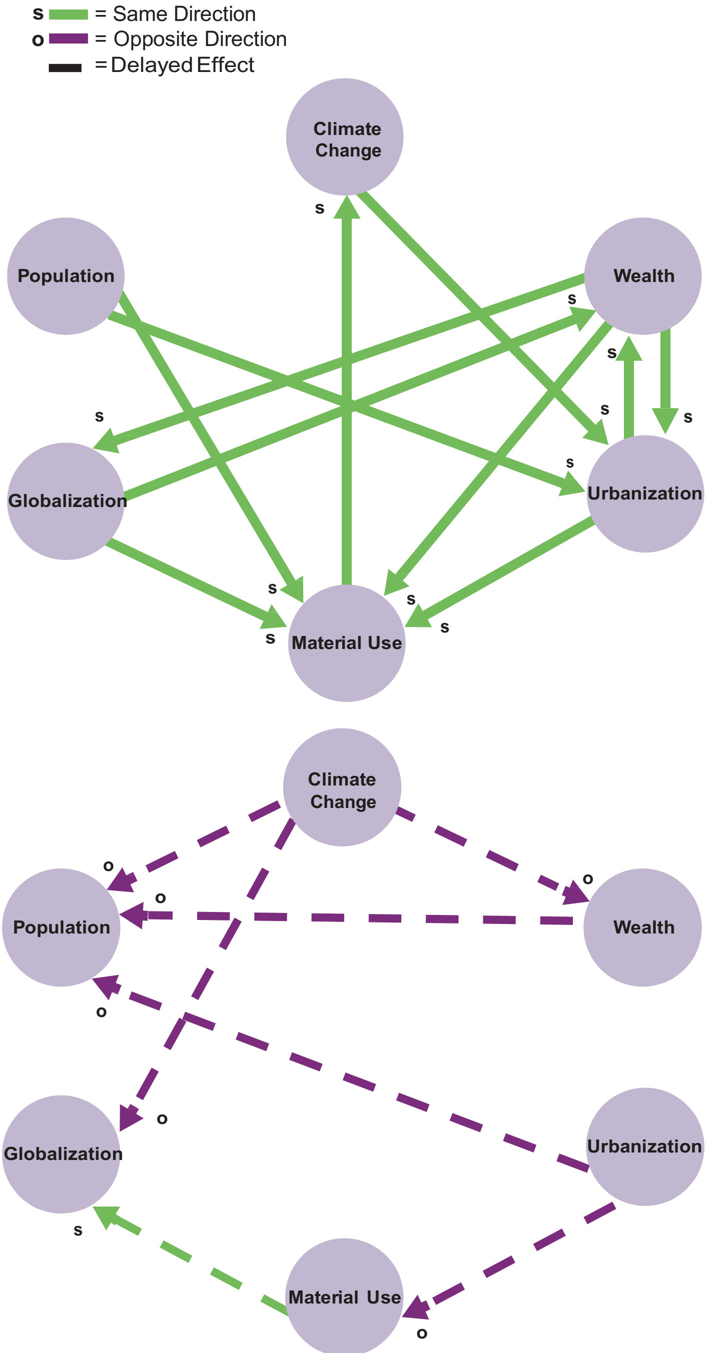

Fig. 6.1 The Footprint Nexus (Source: KPMG (2012). Expect the Unexpected: Building business value in a changing world)

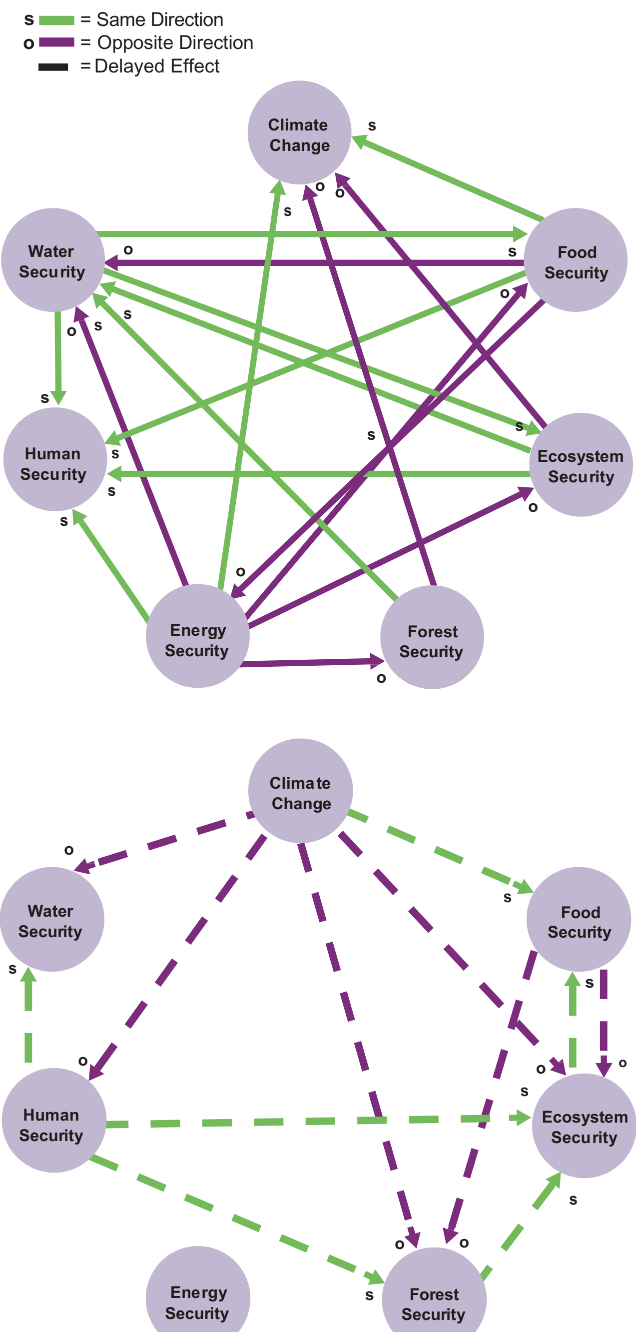

Fig. 6.2 The Erosion Nexus (Source: KPMG (2012). Expect the Unexpected: Building business value in a changing world)

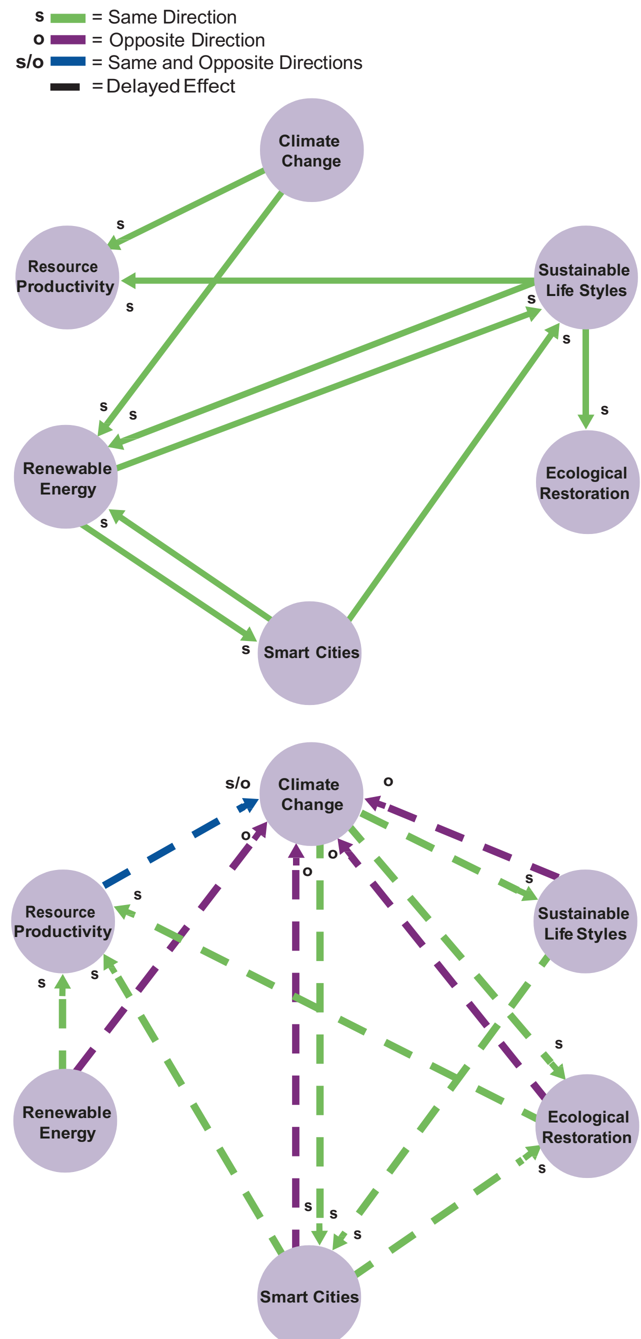

Fig. 6.3 The Innovation Nexus (Source: KPMG (2012).Expect the Unexpected: Building business value in a changing world)

Global Sustainability Megaforces: A Sectoral View

> It is prudent for companies to expect to pay in the future a rising proportion of their external environmental costs.

Over the next 20 years there is likely to be increasing pressure for the price of resources, products and services to reflect the full cost of their production including the cost of environmental impacts. Such pressure is likely to grow as governments address the effects of sustainability megaforces.

Possible futures include the removal of subsidies on input commodities (such as fossil fuels and water) and the wider introduction of mechanisms to increase the cost of environmentally damaging outputs.

It is therefore prudent for companies to expect to pay in the future a rising proportion of their external environmental costs which today are often not shown on financial statements.

Costs of Environmental Impacts Are Doubling Every 14 years

- Data provided by Trucostand analyzed for this report suggests that the external environmental costs of 11 key industry sectors (including upstream supply chain) rose by 50% between 2002 and 2010, from US$566 billion to US$854 billion.[10]

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[10] For the purposes of this report, Trucost, an independent environmental research agency, has provided a data set based on the operations of over 800 companies between 2002 and 2010 (2010 being the most recent available data) and representing 11 sectors. In this analysis Trucost converts 22 environmental impactsinto financial value, drawing upon current environmental-economic research. They include greenhouse gases, water abstraction and waste generation. Together these

- The sectors analyzed were: Airlines; Automobiles; Beverages; Chemicals; Electricity; Food Producers; Industrial Metals & Mining; Mining; Marine Transportation; Oil & Gas; Telecommunications & Internet (defined in line with the Industry Classification Benchmark system).[11]
- The data suggests that the external environmental costs of business operations are doubling every 14 years: a rate that is unlikely to be sustainable even in the medium-term.

Value at Stake: Sectors Could See Profits Lost

- External environmental costs could account for a considerable proportion of earnings (EBITDA) and thus represent significant business value potentially at stake: across the 11 sectors, the average external environmental costs per dollar of earnings would have been approximately 41 cents in 2010 (Fig. 6.4).
- According to the data, Food Producers had the largest external environmental cost footprint of the 11 sectors in 2010 at US$200 billion, followed by Electricity at US$195 billion and Oil & Gas at US$152 billion.
- External environmental costs of the Food Producers could outweigh the sector's entire earnings. For five other sectors (Electricity, Industrial Metals, Mining, MarineTransportation and Airlines) environmental costs could account for more than half of earnings.

Exposure Reduced But Driven Mostly by Rise in Earnings

- For most sectors covered in this report, earnings rose far more steeply than external environmental costs over the period 2002–2010, thereby reducing the proportion of EBITDA at risk (average external environmental costs across the 11 sectors would have accounted for 91 cents for every US dollar of earnings in 2002 vs 41 cents in 2010) (Fig. 6.5).

---

22 indicators represent the bulk of the environmental footprint for most companies. The physical totals of these inputs and outputs are converted into financial values and aggregated to achieve a total environmental cost value. These costs, which for the most part do not appear on corporate financial statements, are known as **external environmental costs.**

EBITDA data come from independent financial data providers and are checked by Trucost analysts against company financial statements.

The conversion of environmental impacts into dollar sums of external environmental cost is a relatively new practice but one that is gaining momentum. The data is not yet 100 percent exact and for this reason the analyses should be taken as indicative rather than absolute.

[11] See http://www.icbenchmark.com/

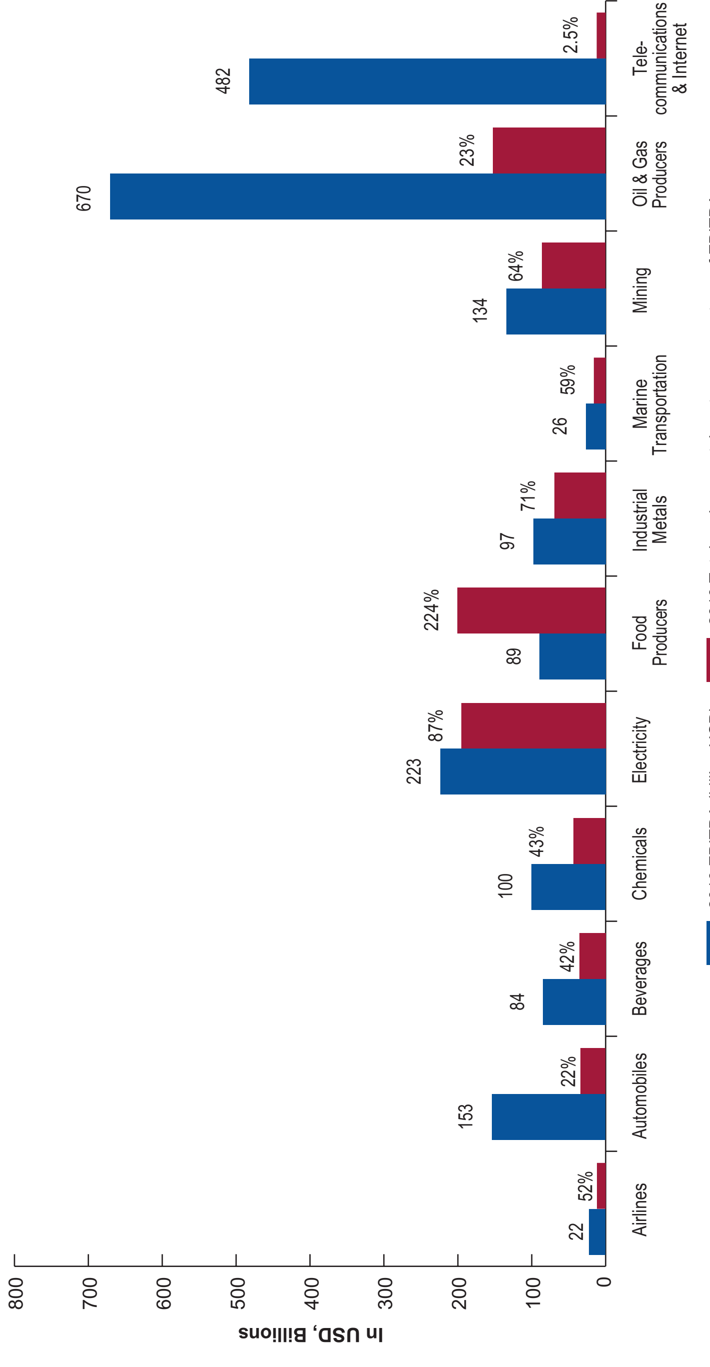

Fig. 6.4 2010 EBITDA vs external environmental costs (Source: Trucost 2012)

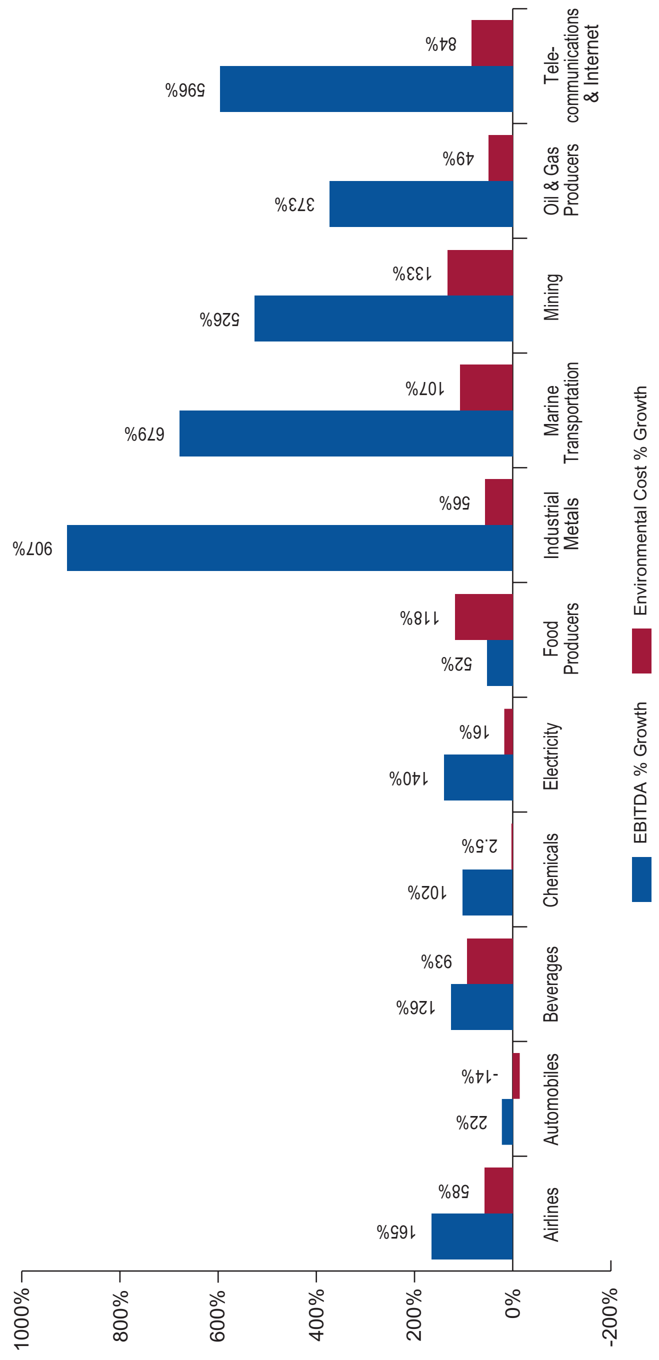

Fig. 6.5 Growth in EBITDA vs growth in external environmental costs, 2002–2010 (Source: Trucost 2012)

- The only sector of the 11 to demonstrate an absolute reduction in its external environmental costs over the 8-year period was Automobiles, which achieved a drop of 14% against an earnings increase of 22% over the period.
- Chemicals recorded a minimal rise in environmental costs of 2.5%. Electricity was the third lowest in terms of growth in environmental costs over the period, with an increase of 16%.

Environmental Intensity: A Clearer Picture

- Relative performance of sectors was explored by calculating how their **environmental intensity** (external environmental costs per US dollar of earnings) has changed between 2002 and 2010.
- Industrial Metals has achieved the greatest improvement of the 11 sectors in terms of its environmental intensity, however the sector's significant growth in earnings over the period helped it to gain this position (Fig. 6.6).

Mining has achieved a similar improvement in its environmental intensity but has also recorded the largest increase of all 11 sectors in its external environmental costs.

- Mining has achieved a similar improvement in its environmental intensity but has also recorded the largest increase of all 11 sectors in its external environmental costs.
- A cluster of sectors – Automobiles, Chemicals and Electricity – have improved their environmental intensity while also achieving negative or low growth in the external environmental costs they incur. This suggests that these three sectors are coming the closest to decoupling their economic growth from environmental impact.
- Food Producers and Beverages have shown the lowest rates of environmental intensity improvement. Food Producers is the only one of the 11 sectors that, according to the data, has not improved its environmental intensity at all over the last 8 years.

Perceptions of Sectoral Risks and Readiness to Deal with Them

- KPMG has analyzed more than 60 sector reports and aggregated their findings on the sustainability risks faced by individual sectors and the readiness of busi-

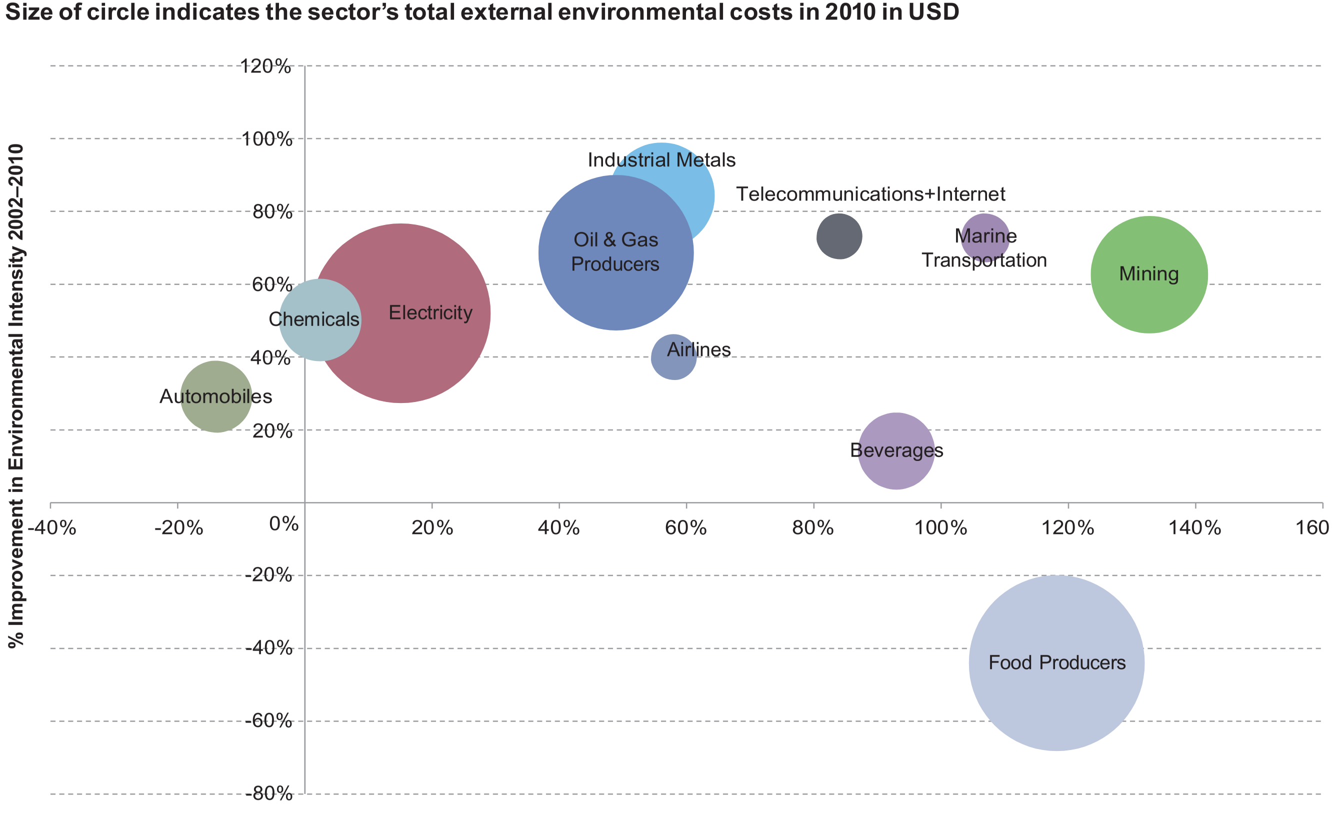

Fig. 6.6 Total external environmental cost 2010 vs growth in external environmental cost since 2002 vs environmental intensity improvement (Source: Trucost 2012)

nesses to deal with those risks.[12] Given the methodology used, the risk exposure and readiness levels presented here are perceived, rather than actual and so findings should be taken as indicative not absolute.

- The two sectors perceived as being at highest risk from sustainability megaforces, but least ready are Food Producers and Beverages. This supports the findings of the environmental intensity analysis which shows they have made the least progress in reducing their environmental intensity while their exposure to environmental cost is growing rapidly.
- The Automobiles and Telecommunications & Internet sectors are perceived as being the least at risk and the most ready.
- The cluster of sectors in the center of the risk-readiness matrix indicates that perceived sustainability risk remains high for Oil & Gas, Electricity, Mining & Metals and Airlines. Electricity is seen as the most ready among these (Fig. 6.7).

[12] The risk types assessed were: Physical; Competitive; Regulatory; Reputational; Litigation; and Social.

Physical Risks include the risk of damage to physical assets and supply chains from climate change-related weather events and exposure to long-term environmental trends, such as variations in water availability or rising sea levels. **Competitive Risks** include the risk of exposure to cost increases or cost volatility of key input commodities such as energy, fuel, water and agricultural products as well as exposure to shifts in market dynamics. **Regulatory Risks** include the risk of increased costs and complexity for business from policies and regulations designed to limit the long-term effects of sustainability megaforces. Examples include carbon taxes, emissions trading systems and fuel tariffs. **Reputational Risks** include the risk of damage to corporate reputation and brand value among stakeholders when a company is perceived as failing to act appropriately in response to sustainability challenges. **Litigation Risks** include the risk of litigation over environmental damage or insufficient corporate disclosure on sustainability. **Social Risks** include the risk of serious disruption to business operations and supply chains due to the societal effects of sustainability megaforces. Examples include mass migration as "climate refugees" try to escape the worst impacts of climate change; conflicts over scarce resources such as water; and civil unrest driven by population growth and wealth inequality. The level of sector readiness was also assessed using data gathered for the KPMG International Survey of Corporate Responsibility Reporting 2011.

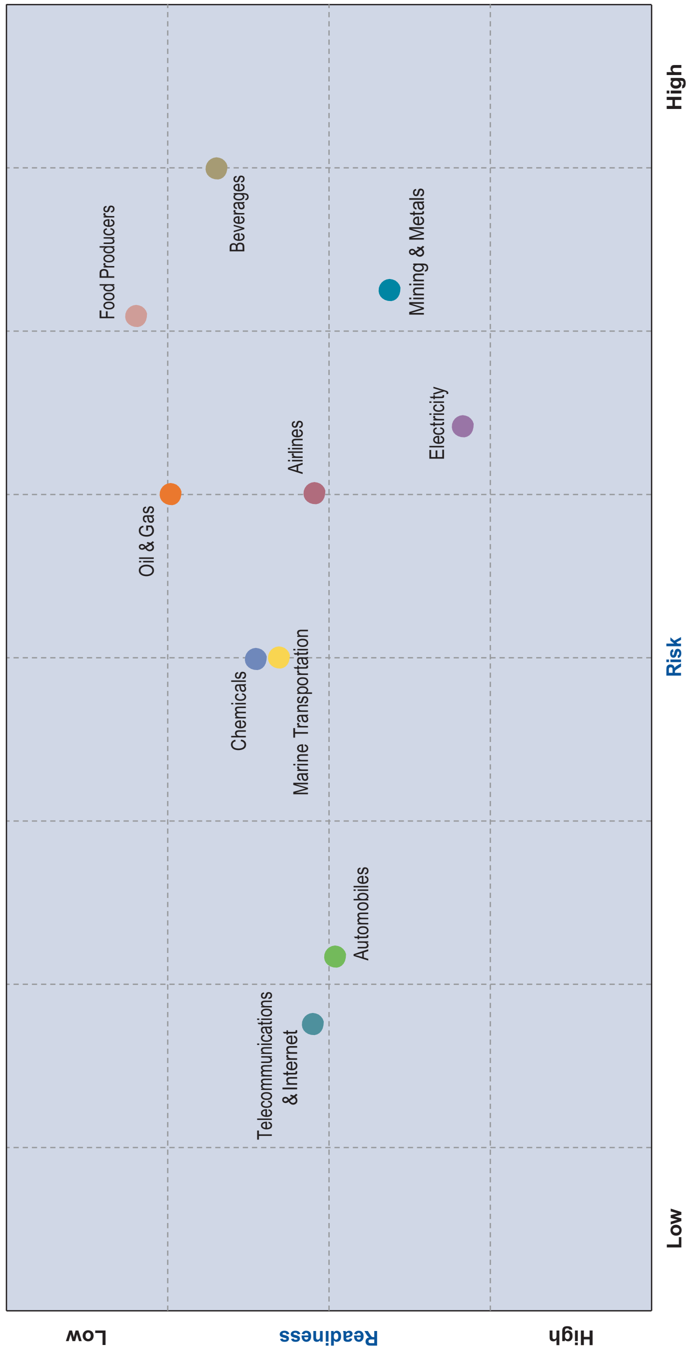

Fig. 6.7 Risk and readiness matrix (Source: KPMG (2012). Expect the Unexpected: Building business value in a changing world)

Call to Action: Business Strategies & Policy Formation

> Without action and planning for the complex future that lies ahead, risks will multiply and opportunities will be lost.

With potentially far reaching impacts on the horizon as a result of global sustainability megaforces, businesses and policymakers together must take strategic decisions now and promote changes in long term thinking. Without action and planning for the complex future that lies ahead, risks will multiply and opportunities will be lost.

Sustainable growth requires action from both economic sides: supply and demand. The supply side must make more with less, increasing resource efficiency and minimizing the environmental footprint of processes and operations. The demand side must make less do more, managing growing demand for goods and services, while addressing pressure on dwindling natural resources.

Recommendations: The Essentials of Business Action

Global sustainability megaforces will mean constraints, complexity and risks for business. But business leaders can do much more than simply survive the risks. With foresight and planning they can turn risks into new opportunities and pioneer actions to prepare for an uncertain future:

- **Understand and assess risks.** Businesses are advised to use Enterprise Risk Management tools and sustainability systems thinking to (a) assess and under-

stand future risks from sustainability megaforces and (b) define responses to deal with them through efficiency, substitution or adaptation.

- **Use integrated strategic planning and strategy development.** Strategic planning for sustainability requires the involvement of the business management and should encompass a wide range of corporate functions.
- **Turn strategic plans into ambitious targets and actions** for energy and resource efficiency, sustainable supply chain management, innovation and access to new markets for greener products and services.

Explore tax incentives tailored to alternative energy, energy efficiency and other areas related to sustainability.[13]

- **Measure and report on sustainability.** Sustainability reporting, although largely still unregulated, will become increasingly important in the future. Integrated reporting, where sustainability information is included in the full picture of the company's business performance, is a growing trend. For integrated reporting companies need to build a framework for sustainability reporting processes, stronger information systems and appropriate governance and control mechanisms on a par with those currently used in financial reporting.
- **Seek collaboration with business partners on sustainability issues.** This will be critical to increase leverage and improve the cost-benefit ratio of action.
- **Build strategic partnerships:** seek opportunities for genuine dialogue with the governments and demonstrate new and innovative approaches to Public-Private Partnerships. Improved dialogue could focus on economic instruments and market barriers that could be reduced to make sustainable business operation easier (Fig. 6.8).

Recommendations: The Essentials of Government Action towards Sustainability

Policymakers are urged to deliver the overarching policy goals that will be crucial for business to make a timely transition towards a sustainable society.

The global sustainability megaforces of the coming decades will bring shocks and surprises. As governments in all regions will be called upon to take more steps to limit or reverse negative environmental and social impacts, businesses will be confronted with an ever more complex web of sustainability-related fiscal instruments and legislation. Policymakers are urged to deliver the overarching policy goals that will be crucial for business to make a timely transition towards a sustainable society.

[13] KPMG (2011). *KPMG International Survey of Corporate Responsibility Reporting 2011.*

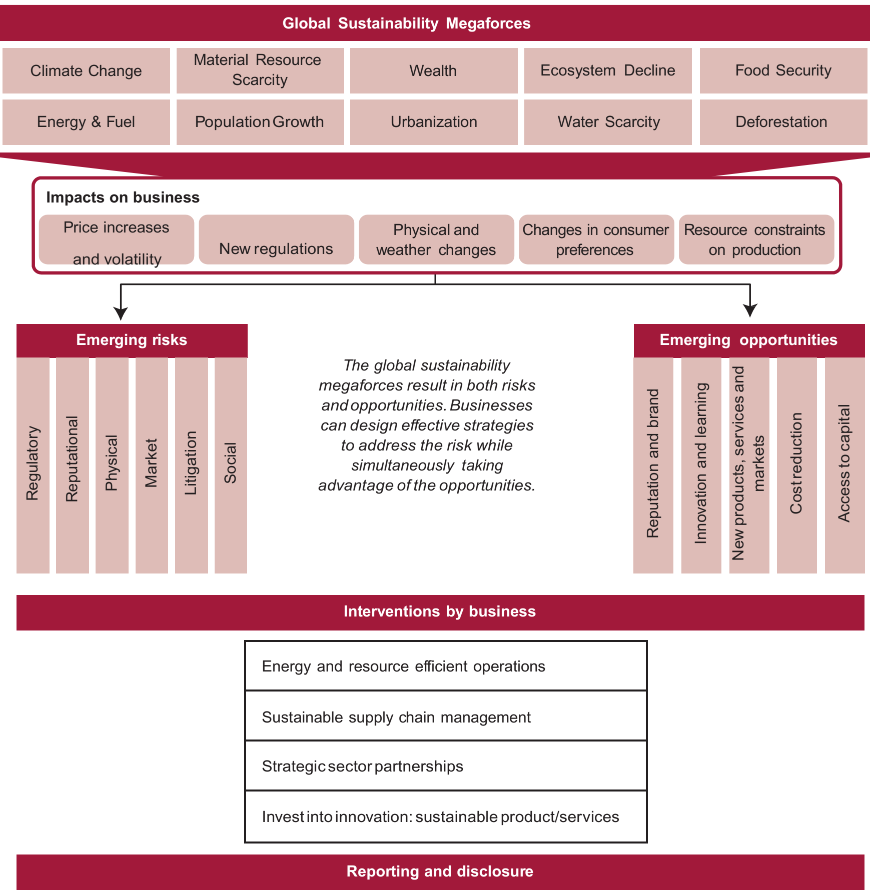

Fig. 6.8 Global sustainability megaforces – Addressing the risks while realizing the opportunities

- **Continuity and coherence in policy:** Clear, well planned and secure government policies are crucial for scaling-up investment and facilitating the transition to green economy. Strong collaboration across governmental bodies and ministries on sustainability issues will be key.
- **Reducing complexity in policy:** Reducing regulatory complexity and improving transparency is another key area for action, as businesses frequently cite regulatory complexity as one of the main sources of risk and uncertainty surrounding sustainability.
- **Coordinated international collaboration:** Multilateral coordination across countries and regions, particularly for carbon markets and any future climate treaty, is needed to reduce regulatory complexity.
- **Creation of enabling "green" investment environment:** Policymakers need to remove barriers to green investment and establish the essential enabling condi-

tions in all areas: national-level regulations, policies, subsidies, incentives and legal frameworks, as well as international market, legal infrastructure, trade protocols and development aid measures. In creating an enabling environment, governments must seek to use a variety of policy tools – including taxation.

- **Increased collaboration with private sector through Public Private Partnerships (PPPs)**: If properly designed, PPPs can provide an effective architecture for promoting sustainability in a way that mobilizes private sector finance, rather than relying on public funding alone.

Business and Government Working Together: Public- Private Partnerships as a Tool for Green Growth

To achieve their strategies, governments need corporations to provide low-carbon and green technology, the skills to deploy and operate it, and the funds of financiers to invest in delivering it. Given that many national budgets remain stretched as a result of the global financial crisis, the conditions seem ripe for the wider introduction of PPP structures using private finance.[14]

KPMG has engaged in many PPPs over the past 15 years. Based on this experience, the key points for developing successful PPPs are[15]:

- The PPP process cannot be rushed – it takes time to develop properly;
- PPPs sometimes require significant upfront costs, but meeting these costs will make it much more attractive, particularly if investors can see that the right resources have been applied;
- Governments must play an active role in monitoring and regulating the project;
- PPP structures must be designed to include clear and formal methodologies for reviewing contracts over the term of the project (particularly those that last 10–30 years or more);
- A single-minded focus is essential for developing transparent and competitive procurement procedures.

Imperatives for Achieving Sustainable Growth

The transition to a sustainable economy is possible, but it requires widespread global support from businesses, governments and civil society. This transition requires solutions that address both how and which goods and services are produced. Both the public and private sectors have a vital role to play and a coordinated approach holds the key to success (Fig. 6.9).

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[14] United Nations Framework Convention on Climate Change Secretariat (2007). *Investment and Financial Flows to Address Climate Change*. Bonn.

[15] KPMG (2011). *Insight – Urbanisation: The massive challenge facing cities and innovative ways it's being addressed*

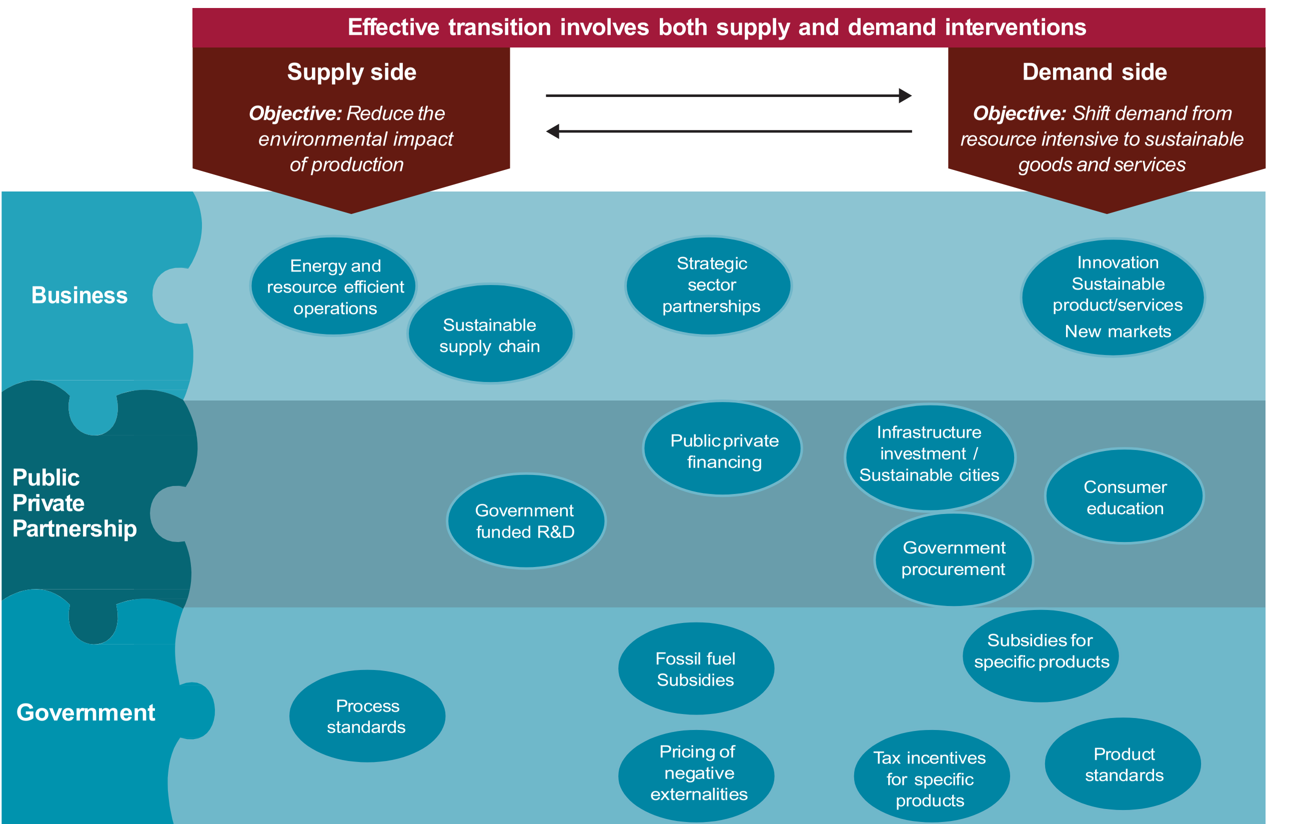

Fig. 6.9 Imperatives for concerted action on sustainability (Source: KPMG (2012). Expect the Unexpected: Building business value in a changing world)

The transition to a sustainable economy is possible, but it requires widespread global support from businesses, governments and civil society.

Disclaimer Throughout this document, "KPMG" ["we," "our," and "us"] refers to KPMG International, a Swiss entity that serves as a coordinating entity for a network of independent member firms operating under the KPMG name, KPMG's Climate Change and Sustainability practice, and/or to any one or more of such firms and/or to KPMG's Climate Change and Sustainability practice. KPMG International provides no client services.

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7 Pathways to Corporate Responsibility - Revisited

Simon Zadek

2020 Vision – In Retrospect

The death of 1129 workers resulting from the collapse of the Rana Plaza garment factory in Bangladesh on 24th April 2013 may well mark the end of an era of corporate responsibility, and perhaps the onset of a next generation of activities involving different and improved instruments and activities.

Almost two decades of intensive engagement with the apparel and textiles sector in efforts to improve labor standards have delivered a multitude of principles, commitments, codes, auditing and disclosure mechanisms, as well as a veritable industry of business-led, civil society and multi-stakeholder initiatives (Zadek 2000). Such investments, in the main, were made in good faith by all parties seeking to improve worker conditions. Broadly they fell within the envelope of the prevailing features of global value chains that leverage international cost differentials to benefit consumers and the globally integrated enterprise. There is no doubt that the approach delivered some tangible benefits to all. Capitalism was not tamed, but these tangible benefits brought with them a sense of optimism that companies and markets could be encouraged without the need to engage the state as regulator to internalize and so mitigate at least some, hopefully the most serious, negative social and environmental externalities.

Such so-called "civil regulatory" (Zadek and Forstater 1999) approaches blossomed throughout the end of the 1990s and the noughties, and spread like wildfire from the test-bed of apparel and textiles to virtually every visible sector, from codes governing big pharma's clinical trials to the extraction and sale of gold and diamonds to the rise of sustainability-focused certification for everything from palm oil

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G. G. Lenssen, N. C. Smith (eds.), *Managing Sustainable Business*,
https://doi.org/10.1007/978-94-024-1144-7_7

to salmon and soya (Grayson and Nelson 2013). Although each with their unique aspects, the underlying 'pathways to corporate responsibility' looked remarkably similar:

1. Brand leaders were publicly accused of profiting from poor ethical practice, or at best negligence;
2. Such companies eventually sued for peace, seeking to bring in their, equally vulnerable, competitors in creating coalitions that established non-statutory rules that would appease their more engaged critics;
3. Such rules would be implemented subject to accountability mechanisms generally focused on public disclosure and the on-going threat of civil re-action to substandard performance;
4. Growing attempts by coalition members to bring in other parts of the industry, both to extend the societal benefits and to level the competitive playing field;
5. Eventually in many instances statutory enforcement would be seen positively as the costs and limitations of maintaining a purely voluntary approach became increasingly apparent on all sides.

Apparel and textiles was not the first sector to be subject to such approaches, there is a long and noble history, from anti-Apartheid civil sanctions through to the long and perhaps ever-lasting baby milk campaign targeted particularly at Nestle (Zadek et al. 1998). Yet there has been a particular cache associated with actions associated with the apparel and textiles sector. This special role of this sector arose because of it's intensity and scale, the often-controversial involvement of the international trade union movement, the linkage to international trade agreements, and ultimately the iconic importance of the sector in the classical industrialization pathway of many developing countries.

Such efforts yielded some positive results for many workers in premium product value chains, as well as protecting the premium brands most vulnerable to the public eye. Yet the events of April 2013 in Bangladesh highlighted in terrible fashion the limits of such approaches. The end of the Multi-Fiber Arrangement in 2005, a sector-specific trade access agreement, led to a rapid consolidation of Bangladesh's role in the global value chain. Cost considerations dominated the growth of Bangladesh sourcing, with brand buyers increasingly willing to turn a blind eye to endemic transgressions of their own code commitments. Two years on from the disaster, the restitution by brands and the government of Bangladesh, both to the families of the victims and more broadly in improving labor conditions, has fallen short of both commitments and even modest expectations. The funds established to serve the needs of those directly impacted have remained under-filled and inadequately disbursed, echoing experience subsequent to the Bhopal disaster and elsewhere. There is little evidence, furthermore, of systematic improvements in labor conditions in Bangladesh.

Unexpectedly, at least for some, these market dynamics, underpinned by Bangladesh's failure to enforce its own labor laws, has seriously damaged confidence in voluntary labor and perhaps broader sustainability standards. That is not to

say that they do not continue to make a difference to specific groups and circumstances. Furthermore, it is not to say that they should not be encouraged to deliver what they can. However, it is to raise the inconvenient truth for many of us that have invested over decades in making them work the question of how much they can really deliver in the bigger scheme of things.

It is in the light of such experience that the usefulness of the method and messages contained in my article ‘Pathways to Corporate Responsibility’, published in 2004 by the Harvard Business Review, needs to be considered (Zadek 2004). Anecdotal evidence suggests that the article has been used productively to model industry-wide, individual company progress, as well as broader societal processes, as well as being used in business education (Zadek 2006). At the same time, civil society actors with a more aggressive, skeptical or cynical attitude have pointed to the dangers of the arguments underlying this and comparable articles as promoting corporate white and green-washing. Whilst my personal attitudes or interests are not relevant here, what is interesting is whether the underlying micro-to-macro learning framework proposed in the article remain relevant and if so how. Ultimately, should it be dismissed in the face of available evidence. Addressing these questions is the focus of this paper, which reside within a wider analytic lens of whether and if so when and how corporations are “titans or titanics” in the struggle for an inclusive, sustainable economy (Zadek 2012).

The next section,“Pathways to Corporate Responsibility”, briefly reviews the framework presented in the original article, providing examples of its application in practice. The third section, “Critical Analysis of Pathways Framework” provides a critique of the framework, drawing on discussions and experience both with academics and practitioners subsequent to its publication. The final section, “The Civil Corporation” draws some basic conclusions and looks forward to how the micro-to-macro learning framework might be evolved to work more effectively.

Pathways to Corporate Responsibility

> Companies don’t become model citizens overnight. Nike’s metamorphosis from the poster child for irresponsibility to a leader in progressive practices reveals the five stages of organizational growth.

Typically for an HBR article, this two-line kick off suggested a focus on the company’s growth and ultimately financial success. Whilst not wrong, the full and more ambitious purpose of the article was to explore the complex and arguably more enduring issue of the learning dynamic between a company and its shifting societal context.

The heartland of the article set out a simple framework that connected five stages of organizational development with an equivalent set of societal learning stages. Set against each other (Exhibit 7.1) for any specific issue, such as labour standards, the article suggested that one might track and even predict the course of events as companies and societies evolve their appreciation of an issue and the associated locus of accountability.

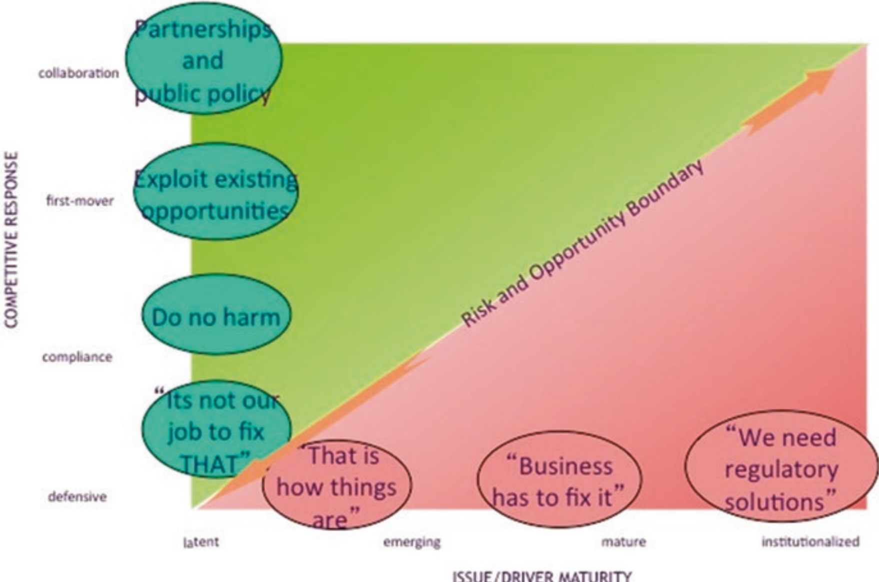


Exhibit 7.1: Corporate and Societal Learning

- For companies, they moved from a stage of denial that the issue in question was their legitimate concern to a point in time when it was firmly embedded in the very fabric of the markets within which they operated, whether through voluntary or statutory action, or some combination of the two.
- Simultaneously, society went through its own learning experience, starting with low awareness of the issue, and gradually evolving to a stage where it demands that business should be held accountable for related outcomes.

Set against each other on a two-dimensional plane, the framework suggested that a company would be increasingly at risk if it failed to evolve through its staged learning in the face of growing societal demands. For example, energy companies refusing to acknowledge the role of carbon emissions in global warming might for a long time be safe given the immature state of the associated debate and science, but would eventually be challenged through pubic debate. Ultimately, they could find themselves on the wrong side of policy developments, and perhaps even face the consequences of their denial in court. The framework indicated that companies could proactively design pathways along which they managed their scope of visible accountability for broader societal issues in ways that were consistent with the demands of their (ever-changing) stakeholders. In this way they could more effectively manage their risks, which should over time benefit their financial bottom line. Energy companies, to continue the case in point, which joined forces with those fighting for ambitious, international efforts to address climate change would find themselves on the right side of public opinion, and potentially benefit from first

mover opportunities in advancing cleaner technologies, perhaps by shaping such markets though collaborative initiatives that leveraged enabling consumer and investor and policy responses.

Suggesting such linear, two-dimensional, non-reversible pathways was always going to be a simplification at best, a matter to which we will return in section three. First, however, it is useful to highlight possible uses of the framework. Below are outlined three such uses: for public debate, internal to a major company, and the third used for management consulting and linked to business school teaching. On the first, it is interesting to note the comparative Apple-Nike mapping offered in the face of Apple's first encounter with civil regulatory pressure over labour standards in its Taiwanese, mainland-China based supplier, Foxconn (Exhibit 7.2). The mapping sought to demonstrate Apple's lagging but closely tracking practice compared to Nike's formative experience almost a decade previously. Whilst in no sense a scientifically robust comparison, it does suggest that over time and between differing contexts, the same evolutionary patterns can emerge. Sadly, it also suggests in some instances limited meta-learning even when, as in this case, some of the same civil society organisations were involved in both cases, such as the Fair Labour Association, and indeed in some instances even the same individuals.

On the second, use has been made of the tool to establish progress measurement across diverse business units and for the business as a whole for the company in question, the AXA Group. (Exhibit 7.3). The French insurance company has used the tool over a number of years to develop a relatively detailed scoring system that it applied annually to several dozen business units across the world. The scoring system is then linked to a planning, budgeting and senior management reporting process. In this instance, the company's corporate responsibility team had engendered a degree of friendly competition between business units, reinforced by the fact that the results of the annual scoring was presented to, signed off by, the company's senior management team.

As a final illustration, the framework has been adapted by myself for use in a strategic management consulting context, an approach subsequently exposed

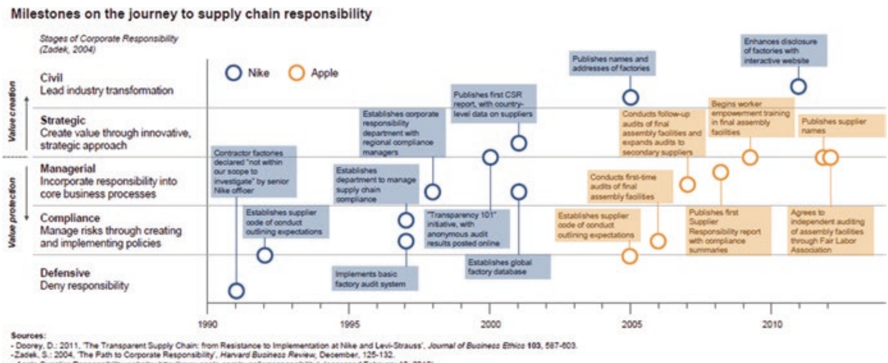
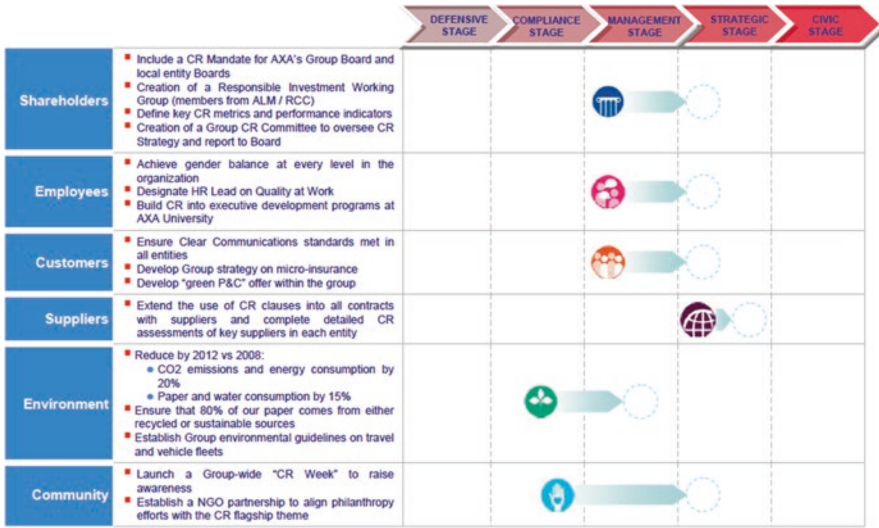


Exhibit 7.2: Apple Following Nike - Slowly



Stakeholder	Actions
Shareholders	▪ Include a CR Mandate for AXA's Group Board and local entity Boards ▪ Creation of a Responsible Investment Working Group (members from ALM / RCC) ▪ Define key CR metrics and performance indicators ▪ Creation of a Group CR Committee to oversee CR Strategy and report to Board
Employees	▪ Achieve gender balance at every level in the organization ▪ Designate HR Lead on Quality at Work ▪ Build CR into executive development programs at AXA University
Customers	▪ Ensure Clear Communications standards met in all entities ▪ Develop Group strategy on micro-insurance ▪ Develop "green P&C" offer within the group
Suppliers	▪ Extend the use of CR clauses into all contracts with suppliers and complete detailed CR assessments of key suppliers in each entity
Environment	▪ Reduce by 2012 vs 2008: • CO2 emissions and energy consumption by 20% • Paper and water consumption by 15% ▪ Ensure that 80% of our paper comes from either recycled or sustainable sources ▪ Establish Group environmental guidelines on travel and vehicle fleets
Community	▪ Launch a Group-wide "CR Week" to raise awareness ▪ Establish a NGO partnership to align philanthropy efforts with the CR flagship theme

Exhibit 7.3: Axa - Measuring Progress

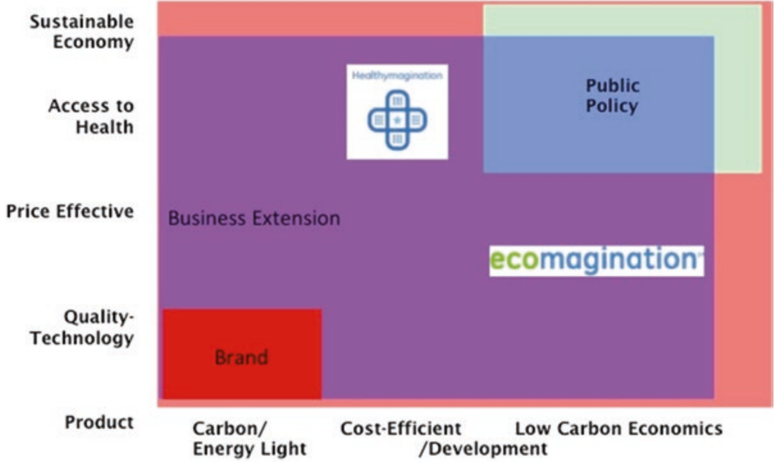


Exhibit 7.4: GE's Product2Sustainability Strategy

through a course entitled 'Business Performance and Sustainability' delivered at Tsinghua School of Economics and Management in Beijing, as well as through a course entitled 'Tri-Sectoral Collaboration' delivered at the Singapore Management University. The approach (Exhibit 7.4) below for the case of General Electric, maps the inter-connectivity between product innovation (bottom left hand) and public policy goals. In this case, the societal and organizational learning and engagement is implicit to the analysis of the nexus between product, policy and brand.

Critical Analysis of Pathways Framework

The framework presented in the original HBR article embodies some important, simplifying assumptions that are worthy of greater exploration. Implied in the framework is a linearity and apparent non-reversibility of the organizational and societal learning. Clearly this is an inadequate reflection of reality, and may be a problematic over-simplification. For example, the Bangladesh case of apparel and textiles provided in the opening part of this essay demonstrates the dangers of assuming continuous improvement. Indeed, not only are reversals possible, but also possible is a simple levelling out or capping of improvements, such as we have witnessed in the area of anti-corruption, despite a decade of intensive, international efforts through a combination of collaborative and legislative approaches. The case can be made, at least for some corporate examples, that companies can lead on aspects of responsible business practices for a period of time, and then decline in energy, leadership and positive outcomes. BP provides a case in point, which under John Brown's leadership opened new avenues for corporate responsibility in the field of anti-corruption through its role in forming the Extractive Industry Transparency Initiative (EITI) and climate change, and his infamous Stanford School speech on the influence of fossil fuel use in climate change. Today, however, following a series of unfortunate and often self-inflicted disasters, the company is at best an ailing oil and gas-focused multinational that has essentially no leadership role in shaping tomorrow's energy transition, let alone the broader global political economy. Similar arguments can be presented for earlier iconic ethical brands such as The Body Shop and Ben & Jerry's, and perhaps in the future will be relevant for today's leaders (Zadek 2012).

Further limitations of the framework, at least in its published form, can be understood best through a game-theoretic lens. The framework is focused on market-societal dynamics that encourage pre-competitive and collectively-competitive collaborative advantage, that in turn may lead to changed market conditions that reward more responsible behaviour. Whilst there are many such cases, such a pathway is certainly not the only option. Under some circumstances, positively, the need for collaboration to create the potential for first mover advantages in overcoming negative societal externalities becomes redundant in the face of positive market dynamics. The falling cost of solar is a case in point, as the earlier need for public-private collaboration to overcome cost disadvantages is superseded by the simple dynamic of market-based competitiveness. In other instances, free riding makes collaboration less advantageous and in the limit undermines such approaches. Financing coal-fired power stations is a case in point, where international cooperation in cutting off financing for carbon-intensive power generation has been undermined by sources of finance unwilling to impose such restrictions. In fact, the case of Bangladesh is a great illustration of the destructive power of free riding in that many brand companies concluded that they could not afford <u>not</u> to source in Bangladesh given the associated cost advantages.

The point here is not that the published version of the framework is wrong *per se*. It is that it is a simple modelling of what is at its core a complex dynamic between market, policy, political and broader societal forces. The challenge with such models is of course to ensure that it has value because and despite such simplifications, and so does not dilute the power of more specific, evidence based analysis.

The Civil Corporation

The strengths and weaknesses of the framework can be still better understood by adding political economy to that of competitiveness and strategy analysis. The original HBR article was informed by the thinking expressed in an earlier piece of writing, *The Civil Corporation*. Finalised in early 2000, its opening lines highlight its focus on a business' degrees of freedom to act, and enabling capabilities:

> Judging and ultimately guiding corporate performance requires an examination of whether a business is *doing what it can do* given its range of external options and internal competencies. Internally, this concerns the formal, explicit policies and processes, organizational cultures and values, and patterns of leadership. Externally, this is a question of the multitude of business drivers, from direct, short-term market pressures through to longer-term strategic challenges and opportunities.
>
> A business's contribution to sustainable development therefore needs to be understood in terms of its viable options and what it makes of them. Internal and external factors together create a spectrum of possibilities at any point in time – that define a corporation's practical scope for making decisions between viable choices. Whether and how a corporation acts within its degrees of freedom must be the test of responsibility, and indeed the basis on which management decisions are framed.
>
> *These are the fundamentals of the civil corporation. A corporation that is said to be civil is understood here as one that takes full advantage of opportunities for learning and action in building social and environmental objectives into its core business by effectively developing its internal values and competencies* (Zadek 2001; italics added)

Reflecting 5 years later in a new introductory chapter to the second edition of the same book, that is, after the publication of the HBR article, my argument focused more on the tougher issue of accountability as compared to the softer processes of engagement and collaboration, and the linkages between business accountability and the broader political economy:

> Extending accountabilities of business place it and the state increasingly on a par with each other in key respects. We see a convergence in their legitimacies despite their very different historical foundations, one in security, mediation and political representation and the other through their production of material needs and returns to finance capital. Such a convergence is accelerated by several factors, including the declining legitimacy of traditional electoral routes to the politics of representation, the emerging political empowerment of citizens through their roles in markets, notably as owners of capital, and the growing prevalence and visibility of complex partnerships involving public and private actors tasked to deliver public and indeed private goods (Zadek 2007).

That is, the process simply described in the framework *could* lead to fundamental changes in societies' institutional landscape. Notable in this could be the unintended

erosion of the specialized distinctions of market and non-market actors and their associated basis of accountability and legitimacy, particularly as businesses became legitimate partners in the development of market-governing rules. Such concerns are far from pure theory. It lay at the heart of heated public debate, for example, as to whether the now-collapsed trans-Asian and trans-Atlantic trade agreements being proposed by the US should allow for businesses to directly challenge the legality of government's rights to impose laws within their own sovereign jurisdiction through a distinct dispute mechanism established independently of, and not subject to review by, any one state's judicial process.

Such a political economy lens is very much on the radar of senior executives of companies whose political influence has become visibly greater in the face of market concentration, globalization and economic and financial muscle. It has proved uncomfortable to many energy and mining companies, for example, that the EITI essentially uses them as conduits to improve the public accountability of, in the main democratically elected, host governments. Similarly for the Global Network Initiative, that seeks to leverage the brand sensitivity of companies like Microsoft, Google and Facebook to call into question the rights of governments to acquire information about citizen's using the internet.

In effect, the pathways to corporate responsibility presented in the framework suggest a growing tension between the 'intensive' and 'extensive' basis of accountability. The former, in a corporate context, concerns the primacy of financial shareholders, typical of Anglo-Saxon corporate governance approaches. Extensive accountability, on the other hand, provides for accountability to multiple interests, that could indeed go well beyond requirements imposed through the rule of law. Far from reducing companies' competitive dynamics, this tension extends its scope and places new pressures on the modern corporation that can only be met through the development and application of new capabilities and indeed forms of accountability.

Such reflections led me to reflect, 5 years further on, in 2012, whether there was now a need for:

> A 'public fiduciary' *(to)* replace the current, narrow focus of corporate governance of optimizing solely in favour of financial stakeholders. The dominant corporate governance model for publicly-listed companies, broadly the Anglo-Saxon approach, would be overturned in favour of a pluralistic approach where corporate directors' fiduciary responsibility required them to address financial and broader sustainability outcomes.

Once again, such a view is far from being abstract. Adjustments to corporate governance and associated decision-making to incorporate broader sustainability issues are increasingly a mainstream discussion and in some instances practice, from changes to South Africa's pension legislation to broader trustees' fiduciary responsibility to the growing influence of state-owned companies, particularly in emerging markets, and from ownership innovations such as the US-inspired 'B Corporations' through to the expansive policy debate about 'sustainable capitalism'.

Enhancing the Pathways Framework

My review of the original framework presented in the HBR article published over a decade ago highlights both its uses and arguably usefulness, as well as some of its flaws, or at least limitations. On the former, the framework reasonably describes the direction of travel in many instances of the organically extending sphere of responsibility of business, and the manner in which market and societal dynamics over time internalize market outcomes that were previously externalities to business strategies and the financial bottom line. Moreover, the framework breaks down the apparent polarity of individual and collective action, and market collective and policy and regulatory-framed actions, pointing to their interactive dynamic over time. These strengths have led to the framework being used in varied contexts, with a modestly productive effect as far as one can see.

On the matter of limitations, two in particular have been highlighted: the framework's over-simplified, linear, teleological assumptions and its associated lack of depth in considering alternative competitiveness dynamics; and its failure to spell out the potential, political economy feedback effects and deeper institutional implications. Of course, such flaws and limitations could equally be described as issues and aspects brought to light by the framework, enabling discussion and analysis. Indeed, such a, more positive, view would be supported by the experience of applying the framework in practice, as in the ways highlighted in the preceding section. That said, these limitations also constrain the effective application of the framework, and invite further theoretical developments to underpin future iterations of this or comparable frameworks for practical use. Of interest, that is, is how to improve our analytic capabilities in understanding, and actively promoting, the more effective incorporation of sustainable development considerations into business strategy and the broader political economy that shapes markets and associated outcomes.

It is a mute point as to whether work at this nexus can be usefully subject to a singular, analytic framework given the very different, and often contested, narratives governing each of these domains. More likely, is that the intersections of these narratives will be approached through experimentation and associated analysis, the deliberate juxtaposition of different narratives, and experiential work to enable deeper, practitioner learning. That said, any or all of these approaches might benefit from some simple analytic rules of the road that draw from and extend beyond the original framework, including a focus on the:

- Dynamic interactions between organizational and societal learning.
- Merits and dynamics of diverse forms of collective action.
- Evolving product-to-public policy strategies for both business and public interest bodies.
- Developing decision making at the intersection of intensive and extensive accountabilities.
- Shifting macro-institutional architectures, often precipitated by micro-dynamics.

Finally, the shifting geo-political context provides an important macro-driver for reconfiguring our understanding of the territory crystallized through the framework

and framed more broadly by narratives, analysis and practice regarding responsibility, accountability and collaboration in the pursuit of private benefits and public goods. Much of what has been written seeks to do no more than explain and guide markets that exist within broadly liberal political economies. In these contexts, we understandably focus on associated forms of societal learning and organization. As a result, we tend to model the evolution of collaboration between private and public actors from an assumed starting point of their separate and distinct activities and realms of accountability.

Such assumptions were always simplifications of liberal political economies. Yet as I have argued above and elsewhere, such assumptions have often proved reasonably useful frames of reference. Civil society clearly does make a difference, and many spheres of business have taken on aspects of social and environmental responsibility that would have been unthinkable in the past (Zadek 2012). With each step forward into the twenty-first century, however, such assumptions become more suspect. Inter-twinned relationships between business and government can no longer be usefully modeled as distinct, necessitating the darker side of collaboration to be more clearly understood in the context of any narrative about public-private partnerships in pursuit of public goods. From Delhi to London, the power of civil society to shape markets and political processes is under threat. At the same time, decidedly un-civil politics may deliver positive outcomes. The success of the climate negotiations in Paris, for example, depends largely on the leadership of un-liberal societies and political leaderships, notably China.

Shaping corporate responsibility going forward will need to take place, and hopefully succeed in this changing context. Learning pathways and associated institutional innovations and actions in the context of competition and collaboration will remain fundamental to any change processes. In this sense, the framework discussed in this essay does contain the core elements that we will continue to work with, both as analysts and activists, albeit configured to a changing world.

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GSK: Profits, Patents and Patients: Access to Medicines

8

N. Craig Smith and Dawn Jarisch

Introduction

On April 22nd 2014, after a difficult year in which GlaxoSmithKline (GSK) had been accused of bribery in China and fined $3 billion by American regulators for marketing malpractice in the US, the pharmaceutical company announced a complex three-part restructuring deal with Swiss giant Novartis. The deal, one of a slew of multibillion-dollar deals in the global pharmaceutical industry, would allow GSK to focus on four key business areas – HIV, vaccines, respiratory conditions and consumer healthcare. It was seen as a win-win deal, offering both companies economies of scale that were increasingly vital for 'big pharma'. Analysts believed it would 'unlock significant shareholder value', not least because it would allow GSK to return £4 billion to investors through a B share scheme.

But would it be a win-win deal for patients? Particularly patients in developing countries where, despite a dramatic drop in the price of first-line antiretroviral (ARV) medicines following a sensational court case in South Africa from which GSK and other pharmaceuticals had withdrawn, millions of people still lacked access to essential medicines and vaccines.

"Today we live longer, healthier lives on average than at any time in history. Global life expectancy increased faster in the last 40 years than it did in the preceding 4000 – but not all groups benefited equally".

Challenging inequalities in health – from ethics to action. Rockefeller Foundation

GSK's mission: "to improve the quality of human life by enabling people to do more, feel better, live longer. We are doing this by developing innovative products and improving access to health care for patients around the world."

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© Springer Science+Business Media B.V. 2019
G. G. Lenssen, N. C. Smith (eds.), *Managing Sustainable Business*,
https://doi.org/10.1007/978-94-024-1144-7_8

While refocusing and re-energising its business portfolio, how best could GSK respond to calls that it had a social responsibility to provide affordable and appropriate medicines and vaccines? How could it reconcile the demands of patients' for treatment with its need to earn profits and protect its patents? Would it pass CEO Andrew Witty's key test of "whether you make decisions that are applauded by society or condemned by society."[1] What would be the effect on GSK's operations in other countries and its business model if it allowed the existing patent regime to be selectively ignored, or it didn't earn enough to finance further drug innovation? It seemed as if the pressure would continue no matter what the company did.

Background Events from 2000

GSK in the Early Years and the HIV/AIDS Pandemic

When GlaxoSmithKline (GSK) was formed on 27 December 2000 through the merger of Glaxo Wellcome and SmithKlineBeecham,[2] both leading pharmaceutical companies in Europe, the idea that providing access to medicine in the world's least developed countries (LDCs) was a corporate social responsibility was beginning to get media and NGO attention. A campaign for access championed by Médecins Sans Frontières was alerting society to the health needs of LDCs. For the World Health Organisation (WHO), health was a fundamental human right; three of the UN's eight Millennium Development Goals[3] were related to health, aimed at reducing child mortality (MDG 4), maternal mortality (MDG 5)and the spread of HIV/AIDS and malaria (MDG 6).

On 11 January 2001, the new CEO of GSK, Jean-Pierre Garnier, made his first in-house address, broadcast to employees around the world by satellite. Describing his aspirations for the company, he said: "The pharmaceutical industry today sells 80% of its products to 20% of the world's population. I don't want to be the CEO of a company that only caters to the rich… I want those medicines in the hands of many more people who need them." Garnier's statement struck a chord with many employees, glad to be working for a company committed to improving health and lives around the world.

At the time, GSK dominated the global market for HIV/AIDS therapies, with a 40% market share. It was the only company involved in R&D on all three top priority diseases of the WHO – malaria, tuberculosis (TB) and HIV/AIDS. Not only was resistance of TB and malaria to treatment increasing, it was estimated that more than 53 million men, women and children had HIV, 3 million had died of AIDS and

[1] Andrew Witty interview WSJ, 2011: http://live.wsj.com/video/does-a-company-have-a-soul/BF2AC683-9FC8-493C-9089-6EEB09646F97.html#!BF2AC683-9FC8-493C-9089-6EEB09646F97

[2] with Glaxo and SmithKline shareholders holding approximately 58.75% and 41.25% of the share capital of GSK respectively. The deal created the second largest research-based pharmaceutical and healthcare company in the world, with a global workforce in excess of 100,000 and a combined market capitalisation of £114 billion.

[3] The eight Millennium Development Goals (MDGs) were established following the Millennium Summit of the United Nations in 2000, with targets to be achieved by 2015.

40 million were living with AIDS.[4] Two thirds of HIV cases were in sub-Saharan Africa. Recognised as a real threat to global social and economic progress, AIDS was declared by the US government to be a threat to international security.

Although it could take several years, most people who were HIV-positive would develop full-blown AIDS as the body's immune system shut down, and there was no cure. Without access to treatment, people could die within 6 months, leaving families and the community devastated. For LDCs the effects were particularly acute, crippling their economies by depriving them of millions of productive employees and orphaning millions of children.[5]

Drug treatment could increase the quality and duration of life for HIV-positive individuals, but cost $10,000–15,000 per patient per year, and required ongoing medical supervision, particularly for the complex "triple drug cocktails". Treatment was therefore beyond the reach of LDCs, where, according to the UN, more than 1.2 billion people (including 291 million in sub-Saharan Africa) were living on less than $1 a day.[6] Less than 1% of HIV/AIDS victims in need of ARV treatment in sub-Saharan Africa were receiving it.

Drawing attention to the price of HIV/AIDS drugs in LDCs, activists argued that patent protection regimes resulted in premium prices that restricted access to essential drugs, resulting in unnecessary suffering and millions dying in the developing world. As James Sherry, then Director of Programme Development for UNAIDS, put it: "The bottom line is that people who are dying from AIDS don't matter in this world."[7]

Glaxo had worked voluntarily with government in LDCs to progressively reduce prices on HIV/AIDS drugs on a country-by-country basis. It even published its discounted price list (other companies kept their lists confidential). But such actions failed to silence the critics, who argued that these price reductions were small and did not constitute a long-term framework to ensure essential drugs reached the world's poor. Garnier was favourably disposed to addressing the HIV/AIDS crisis and the issue of access generally. He felt the industry could do more in partnership with governments and that GSK should be at the forefront, but the sheer scale of the pandemic was overwhelming.

On February 12 2001, Oxfam International, a confederation of 12 NGOs, launched a 'Cut the Cost' campaign aimed at pressuring pharmaceutical companies to make HIV/AIDS treatments available and affordable for people in LDCs. The campaigners argued that enforcement of global patent rules kept drug prices high in LDCs – which they considered morally wrong. Oxfam challenged GSK to offer comprehensive access to essential medicines and redress the balance between treatment in the developing and developed world. Joined by other prominent NGOs such as the Nobel Prize-winning Médecins Sans Frontières and Treatment Action Campaign (a champion of the access issue in South Africa) it became clear that this was a challenge to

[4] International AIDS Vaccine Initiative (IAVI), 2001.

[5] "AIDS in Africa: the Orphaned Continent," BBC News Report at http://news.bbc.co.uk

[6] United Nations Basic Facts, December 2000

[7] Barton Gellman (2000), "The Belated Global Response to AIDS in Africa," Washington Post, July 5 2000, p. A1

the industry's traditional business model. Determining how to respond would have profound strategic implications for GSK and the industry as a whole.

The South African Court Case

In South Africa, where the AIDS pandemic was the main cause of death, the Medical Research Council estimated that over 4 million (20%) adults were HIV-positive, yet only a fraction were aware they had HIV. AIDS activists under the banner of the Treatment Action Campaign, lobbied the government to disregard patent protection of specific drugs to allow generic copies to be made, in contravention of the WTO's Trade-Related Aspects of Intellectual Property Rights (TRIPS) agreement, due to come into effect from 2000.

Under intense public pressure, the Minister of Health authorized generic versions of patented drugs to be manufactured or imported and distributed, inciting a consortium of 39 pharmaceutical companies, including GSK, to take court action for violating the TRIPS agreement. The highly publicised case was heard in Johannesburg on 5 March 2001. Dating back to 1998, the dispute about the enforcement of drug licensing and regulatory systems in South Africa was now perceived as a conflict between 'big pharma' defending its intellectual property (patents) and President Nelson Mandela, defending poor people dying from AIDs.

The resulting anger and contempt for drug companies convinced many people that there was a case for patent infringement to give access to lifesaving HIV/AIDS drugs. But there was also another agenda, as Pien later observed, "The geographies have become intermingled and the South African court case made it so. Opinion leaders in the US, Europe and the developing countries have shifted their focus of concern. Availability of a drug was not the core of the problem, but how a company behaved as a corporate citizen. That was the real problem."

In April 2001, the drug companies dropped the case. The *Boston Globe* commented, "With their boardrooms raided and their executives being hounded in the streets, 39 of the world's largest drug makers caved in to public pressure… It was hailed as a stunning triumph for the developing world: A $360 billion industry was brought down by a country that represents just half of one percent of the pharmaceutical market."[8]

Post-merger: Facing the Challenge

But criticism of the industry continued despite its withdrawal. At GSK's AGM on May 21, 2001, campaigners from Oxfam wearing lab coats called for GSK to do more for LDCs by donating a percentage of drug revenues to a "global health fund" of the UN Secretary General. CEO Garnier's unprecedented response took some

[8] Kurt Shillinger, "AIDS Drug Victory Sours in South Africa: Government Still Refusing to Supply AZT," The Boston Globe, 23 April, 2001, p. A8

analysts by surprise. Defending GSK's actions on the access issue, he asserted that the company's priority was public health, not simply shareholder value: "We have to make a profit for our shareholders, but the primary objective of any policy put forward in the industry is public health."

On June 11 2001, in a policy document entitled 'Facing the Challenge: Our contribution to improving healthcare in the developing world', GSK made commitments in three areas:

1. Continuing investment in R&D on diseases that affect the developing world.
2. Offering sustainable preferential (not-for-profit) pricing arrangements in LDCs and sub-Saharan Africa for 'available medicines that are needed most'.
3. Taking a leading role in community activities to promote effective healthcare.

The main emphasis was on developing and providing HIV/AIDS and anti-malarial medicines at preferential prices. Sustainability – the ability to deliver over the long term – would be the key criterion for any action. Pien explained the approach:

> *In the establishment of the preferential price, we don't intend to make any profit from it. What we want to do is make it sustainable. So, our internal decision algorithm in determining the preferential price involves fully charging the components of manufacturing, including overhead—so variable costs plus overhead. But we don't try to recover R&D expenditures, we don't try to recover commercial expenses—sales and marketing expenses. But then we get into this problem that is at the crux of health care delivery for HIV/AIDS. How do we get the products into the hands of the people who say that they are going to be in a position to take this drug and do something good with it? In certain ravaged parts of the world, it is impossible to get the products in the hands of the clinics.*

Several NGOs welcomed the GSK policy document. Sophia Tickell, Senior Policy Advisor to Oxfam, commented: "This is really positive. It is better than all the other initiatives the industry suggested." Others remained sceptical.

Access to Medicines and Implementation of the Access Policy

Implementing access proved to be a tough challenge. On 3 October 2002, the Dutch authorities were forced to recall GSK's Combivir and Epivir AIDS drugs after discovering that, "AIDS drugs supplied to Africa at cut rates have been illegally resold in Europe, threatening to undermine a system of preferential medicine pricing for poor countries."[9] More than 35,000 drug packets intended for Africa (with a market value of approximately €15 million) had been resold in the Netherlands and Germany. A GSK spokesman said, "We are appalled and saddened to see this. The victims of this illegal trade are the HIV/AIDS patients of Africa." Because the

[9] AIDS in Africa: the Orphaned Continent, BBC News Report at http://news.bbc.co.uk

packaging intended for Africa was identical to that used in the Netherlands and Germany, all packets had to be recalled from the market for safety reasons.

A 2002 Oxfam[10] report entitled 'Beyond philanthropy' challenged the pharmaceutical industry to adopt policies in five areas: R&D, patents, pricing, joint public/private initiatives and the appropriate use of medicines. Treatment Action Campaign (TAC) and MSF campaigned to 'Fix the Patent Laws'. Protesters said that patents on drugs and prohibitive prices prevented access to affordable medicines for people in developing countries. They argued that big pharma charged the highest price the market would bear, even if that made the product unaffordable for government health programmes and the poor.[11] With its slogan 'Life is priceless: medicine is not', Christian Aid captured the indignation felt when activists asked 'Are profits more important than people's lives?' Big pharma, they insisted, had both the means and a moral obligation to do something, citing article 25 of the Universal Declaration of Human Rights: "everyone has the right to a standard of living adequate for the health and well-being of himself and his family, including… Medical care… Motherhood and childhood are entitled to special care and assistance."

Big pharma countered that patents only represented a small portion of total healthcare costs and that poverty was the real problem, not patents,[12] pointing out that over 95% of the 325 drugs on the WHO's Essential Drugs List were not patent-protected. GSK faced a number of complex dilemmas. If they offered differential prices for people within poor countries, governments elsewhere would ask for the same prices. Not all people within developing countries were poor – why should a millionaire pay less because he lived in a poor country? Countries like India had huge disparities in terms of wealth: how could they assist people living below the poverty line in these countries? What about poor people in rich countries? If they offered lower prices in LDCs, what would stop someone re-exporting and selling at a higher price and pocketing the difference?[13] And which medicines should be selected for lower prices?

Activists advocated the development of generic medicines (infringing patents by copying medicines) as a solution, but pharmaceutical companies argued that if their monopolies/profits were eroded in this way, it would restrict their R&D in the future, and ultimately lead to fewer new drugs and more lives being lost as a result.

GSK felt that an alternative approach was more sustainable, as explained in its second Social and Environmental Report (2003):

> We set our preferential prices for ARVs and anti-malarials at levels that cover direct costs but on which we do not make a profit. In this way we can offer these prices for as long as patients need treatment." By 2004, GSK had supplied 120 million preferentially-priced

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[10] In collaboration with Save the Children and Voluntary service Overseas

[11] http://www.globalhealthcheck.org/?p=591

[12] Attaran 2004, how do patents and economic policies affect access to essential medicines in developing countries?

[13] This had happened to GSK when they offered 50% lower prices in Kenya than in UK. As 80% of pharmacy shops in Kenya are run Indians. These Indians resold to cousins with pharmacy shops in UK—Source: Klaus Leisinger 10/4/2011: http://www.youtube.com/watch?v=9drMaDVg2eY

> ARV medicines to the developing world. While some welcomed GSKs approach of "opening up developing-world markets to expensive drugs", others charged that "the reality is that preferential pricing is simply a market penetration and patent protection strategy,"[14] or felt that the figures were not set in context, asking "Is the provision of anti-retrovirals… a large percentage of those needed in the developing world or not?[15]

Once the TRIPS agreement[16] came into force in 2005, copying patented medicines became illegal and companies could no longer produce new medicines generically. Some industry observers suggested that hostility between pharmaceutical companies and activists could be avoided if "restricted voluntary licenses were offered for essential medicines in developed countries. This would allow competition to lower prices for branded medicines in developing countries, while preserving profitability in the core pharmaceutical markets in rich countries."[17]

Nevertheless, Oxfam claimed that pharmaceutical companies prevented poor people from accessing inexpensive generic versions of essential medicines through "persistent inflexibility on intellectual property protection, and in some cases active lobbying for stricter patent rules and legal challenges to governments' use of TRIPS public-health safeguards".[18] It argued that: "Society expects pharmaceutical companies – with their privileged access to a global market – to develop necessary products at prices that are affordable, in presentations that are usable, and to market them ethically. The pharmaceutical industry is expected to fulfil these requirements reliably and sustainably, and by so doing, play its part in the wider responsibilities to improve the health of all."

As of 2007, Oxfam applied stringent assessment criteria for access to medicines on which it measured each company's performance on three key dimensions: R&D, pricing strategy and intellectual property (see Exhibit 8.1). GSK was assessed to have achieved "management buy-in" within R&D, to be seeking to "manage reputational risks" in its pricing strategy, and to be "adopting a defensive attitude" towards intellectual property. Helena Vines Fiestas, policy adviser for Oxfam,[19] commented that "GSK is probably the leading company within the sector. But it still falls far short of a desirable position."[20]

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[14] http://www.ethicalcorp.com/content/pharmaceutical-industry-cross-section-cr-practice, Nov 17, 2003

[15] GlaxoSmithKline's CR Report 2005 – Ignoring the big issues, Jan 15, 2007: www.ethicalcorp.com/content/glaxosmithkline%E2%80%99s-cr-report-2005-%E2%80%93-ignoring-big-issues

[16] The Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), an international agreement administered by the World Trade Organization, set minimum standards for many forms of IP, including patents

[17] Attaran 2004, how do patents and economic policies affect access to essential medicines in developing countries?

[18] November 2007, Oxfam briefing paper: 'Investing for life'

[19] In 2007

[20] http://www.ethicalcorp.com/content/glaxosmithkline-%E2%80%93-big-pharma-big-risks

In 2009, when Andrew Witty succeeded Garnier as CEO of GSK, he stated that it was "unreasonable to expect people in poorer countries to contribute to Western shareholders."[21] Witty pledged that GSK would cap prices for its drugs in the world's 50 LDCs at 25% of developed world prices, share patents for dozens of compounds, tackle neglected diseases in the developing world, and invest in health infrastructure. He explained that "Price cannot be a barrier to access. So we need to get the price right and we need to work with the international community to mobilise the resources to pay for it and the infrastructure needed to deliver, not least to remote communities."

But although GSK reduced the price of vaccines and a number of patented medicines in LDCs to no more than 25% of those charged in developed countries, providing that this covered the manufacturing costs, for millions of people its medicines were still not cheap enough. Duncan Learmouth, GSK's SVP of corporate Communications and Global Community Partnerships, admitted: "We are under no illusions that even at 25% of developed world prices, those prices are still high for the developing world."[22] To address the lack of healthcare infrastructure, GSK reinvested 20% of the profits it generated in LDCs back into the countries for strengthening healthcare infrastructure and community programmes.[23] Between 2009 and 2013, this amounted to £15 million (via partners) donations to train frontline community health workers who were the key to getting medicines and vaccines to remote rural areas.

On 30th October 2009, GSK and Pfizer launched a global specialist HIV company, ViiV Healthcare (GSK held 85%, Pfizer 15%), aiming to build on their successes to develop and provide access to HIV treatments and care for people living with HIV. Through ViiV Healthcare, GSK granted voluntary licenses to generic companies for the manufacture and supply of ARV medicines destined for sub-Saharan Africa. ViiV Healthcare made three commitments:

1. A 'not-for-profit' price commitment for its ARV portfolio to government and international procurement agencies such as the Global Fund for AIDS, Tuberculosis and Malaria
2. A £10 million seed fund to "to improve the diagnosis, treatment and care of infants and children living with HIV"
3. To give grants to the Positive Action for Children Fund (PACF) and Positive Action programmes to support a community response to the HIV epidemic

Whilst GSK recognized that "transferring the technology to produce drugs and vaccines is one of the most sustainable ways to breach the access gap between the

[21] Excerpted from Andrew Witty quote during BBC Newsnight, June 13, 2011: https://www.youtube.com/watch?v=AshbyUghJTo

[22] http://www.ethicalcorp.com/communications-reporting/how-gsks-access-medicine-plans-will-shake-big-pharma

[23] *Ibid*.

developed and developing world,”[24] it saw voluntary licenses as a “specific response to a particular set of circumstances” rather than a universal solution.

From 2010, the ‘Access to medicines index’ ranked big pharma’s performance on sharing patents, pricing policies and developing medicine for neglected diseases that affected the poor. This served to give big pharma an incentive to improve access since it could be used as a benchmark to guide investor decisions and drew attention to the notion of social responsibility.

Founded in August 2010, the Developing Countries and Market Access (DCMA) operating unit within GSK aimed “to increase patient access to GSK medicines and vaccines for around 800 million people in least developed countries, while expanding our market presence and ensuring that our business continues to be sustainable.”[25] To achieve this, GSK adopted different pricing models in different countries based on wealth[26] and ability to pay. In developing countries it adopted a lower priced/higher volume approach and rewarded salespeople based on volume of medicines delivered rather than sales targets. In middle-income countries it adopted flexible and tiered pricing. In high-income countries, GSK offered support for low-income patients, including pricing according to patient income, monthly payment plans and discount cards. For vaccines, GSK offered tiered pricing.

GSK recognised that while Africa’s need for medicines was immense, it did not have the means to pay for them. As Jon Pender, Vice President of Government Affairs for GSK, explained “Africa suffers 24% of the global disease burden, it has 3% of the world health workers and it has 1% of the world’s health budget.”[27] In April 2011, when GSK issued a statement detailing its policy on Intellectual Property & Access to Medicines in Developing Countries, its commitments had expanded to four:

1. Preferential pricing of our medicines and vaccines
2. Investing in (R&D) that targets diseases particularly affecting the developing world, including pursuing an open innovation strategy
3. Community investment activities and partnerships that foster effective healthcare
4. Innovative partnerships and solutions, such as voluntary licensing

Nevertheless, GSK still did not accept the activists’ view of patents: “It is misleading and counter-productive to focus on patents in the access debate. Patent protection stimulates and fundamentally underpins the continued research and development for new and better medicines for diseases including those which occur in the developing world. Without adequate intellectual property protection, the medicines that are needed in the developing world are far less likely to be developed.”[28]

[24] GSK corporate social responsibility report 2013

[25] *Ibid*.

[26] Countries where gross per capita income was less than US$1570 would get the lowest prices

[27] Documentary patent or patients for Dutch TV, July 2011

[28] GSK Position on IP-and-access-to-medicines-in-developing-countries, April 2011

It argued that "Companies would not incur the risk and cost of innovative R&D if, shortly after launch of their products, a cheaper copy could be launched by a competitor who had the competitive advantage of not incurring developing costs and risk and who did not develop the market for the product."[29]

In 2012, the Financial Times[30] noted: "Global health programmes, in short, reflect a mixture of philanthropy and self-interest, with recognition of the potential for sales (in the developing world) and the need to maintain a good image a decade after South Africa's legal action against the drug companies over the price of HIV medicines did so much damage to the industry's reputation."

India, a major producer of generic medicines, was dubbed 'the Third World's pharmacy'. Contravening the 2005 TRIPS regulations and at odds with big pharma, India supplied generic drugs[31] to sub-Saharan Africa at prices much cheaper than branded drugs. In 2012, when a controversial EU trade agreement with India sought to stop these copycat medicines, opponents claimed the "IP rules would serve the interests of multinational pharmaceutical companies in Europe while drastically increasing medicines prices for millions of poor people in India and other developing countries."Trade treaties, they insisted, would force people in the developing world to either buy the brand-name products at high prices or die. MSF research found that companies restricted voluntary licences to LDCs and sub-Saharan Africa[32] and the Medicines Patent Pool (MPP) was "limited in its ability to convince patent-holding companies to include developing countries which are at the forefront of bearing the impact of the TRIPS agreement."[33]

In April 2013, the Indian Supreme Court ruled against Novartis's intention to overturn a law that allowed a popular patenting practice in the pharmaceutical industry known as 'evergreening,' which entailed filing and then obtaining multiple patents relating to different aspects of the same medicine. MSF welcomed the landmark ruling: "The Indian government will continue to be able to protect public health against abusive patenting practices and unwarranted monopolies and keep the door open as much as possible for access to affordable medicines for millions of people in developing countries who rely on quality generics made in India."[34]

By 2013, ViiV Healthcare had offered royalty-free voluntary licenses to 16 generic manufacturers to enable them to produce and sell low-cost versions of the full range of GSK's ARV medicines for public sector and donor programmes.[35]

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[29] GSK policy on Intellectual Property & Access to Medicines in Developing Countries, April 2011

[30] April 23, 2012:
http://www.ft.com/cms/s/0/0d2b135a-887b-11e1-a727-00144feab49a.html#ixzz35YxsjQR2

[31] Including over 80% of all medicines used to treat HIV and AIDS

[32] Untangling the Web of ARV Price Reductions, released July 2013 by the international medical humanitarian organisation Médecins Sans Frontières/Doctors Without Borders (MSF) at the International AIDS Society conference in Kuala Lumpur, http://www.msf.org.uk/article/hiv-generic-competition-pushing-down-drug-prices-patents-keep-newer-drugs-unaffordable

[33] *Ibid*.

[34] *Ibid*.

[35] In 2011, ViiV Healthcare and its licensees supplied an estimated 1.1 billion ARV tablets.

Additionally ViiV Healthcare offered not-for-profit pricing to HIV-positive patients in low-income countries and LDCs. It also supported community awareness and training campaigns, including prevention of mother-to-child transmission.

GSK used technology and innovations to improve access to its medicines for people in LDCs, as well as to prevent counterfeiting of its medicine, such as reduced pack sizes and liquid formulations of medicines for children. It partnered with Vodafone to increase vaccination rates for children in Africa by ensuring that vaccines were available when and where needed. Medicines sold in Nigeria included a scratch-off panel with a unique code on the packaging so patients could send a free SMS to check the quality and authenticity of the product.

GSK outlined a number of responsible business commitments to address global health needs as of 2012 – "health for all, our behaviour, our people and our planet". In its 2013 Corporate Responsibility Report, it reported on each area, including six behavioural and 10 health commitments (see Exhibit 8.2). Its access policy seemed to be producing results: between 2010 and 2013 GSK reported a 60% increase in the volume of medicines supplied to least developed countries.[36] Nevertheless, a study it commissioned by the International Centre for Social Franchising in 2013 identified a key problem: "...for the most part, existing healthcare delivery models target the more affluent emerging middle class, rather than the poorest."[37]

From the beginning, donations were a key part of GSKs access strategy.[38] In 2013, it donated £221 million for global community investments and £146 million in medicines. It was particularly proud of its work in actively donating tablets to support the WHO's 2020 goals to eliminate lymphatic filariasis (LF) or 'elephantiasis', a tropical disease caused by a parasitic worm, transmitted via mosquitoes, where a person's arms, legs and genitalia swell to several times their normal size. When the WHO/SmithKline partnership started out in 1997, "more than 120 million" were said to be suffering from LF. By 2013, GSK claimed that its tablet donations had reached over 600 million people.[39] Nevertheless, after 16 years of donations, there were still over 120 million infected, and about 40 million disfigured and incapacitated by the disease.[40]

GSK stated[41] that it wanted "to adapt our business model to improve the availability and affordability of high quality products" so that they could be made "accessible to as many people who need them as possible." It increased the number of pricing tiers for vaccines to seven, based on gross national income per capita (reflecting ability to pay) an approach designed to support countries which committed to vaccination for the long term.

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[36] GSK corporate social responsibility report 2013

[37] GSK corporate social responsibility report 2013

[38] GSK donated medicines and vaccines in response to natural disasters and planned programmes. In 2008, GSK valued its donations (calculated according to the industrialised retail price), in-cash social investments, and other charitable projects at £124 million.

[39] GSK Corporate Responsibility Report 2013

[40] http://www.who.int/mediacentre/factsheets/fs102/en/

[41] GSK corporate social responsibility report 2013

The supply of medicines was only part of the problem. GSK stated that "We are committed to improving access to our products –irrespective of where people live or their ability to pay– by focusing on the affordability and availability of our products, and investing in strengthening health systems." To ensure that people had access to medicines and services, GSK recognised that it was necessary to train community health workers and explore new healthcare delivery models to "drive out inefficiencies in the procurement, storage, prescribing and use of drugs."[42]GSK felt that this was a "shared responsibility between all sectors of national and global society, including national governments, industrialised donor countries, NGOs, industry and multilateral organisations such as the World Bank, WHO and UNAIDS."[43]

Consequently, collaborations were an increasingly important component of GSK's access strategy. GSK partnered with a number of government organisations and NGOs, including the Global Alliance to Eliminate LF,[44] the GAVI Alliance, the Global Fund to fight AIDS, TB & Malaria, Save the Children Fund, and the World Health Development Organisation. In 2013, GSK committed US $750,000 to the United Nations' 'One million community health workers' campaign[45] which aimed to put a million health workers in rural sub-Sahara Africa by 2015.

The reason why we are engaged in these issues is because we think it is the right thing to do for patients and because we think this is the right thing to do for business.[46]

Research in GSK

In 2013, GSK spent £3.4 billion on R&D, of which £496 million was invested in vaccine R&D, with an estimated return of 13%. This was the most productive R&D year in GSK's history, with five new medicines approved, including a new treatment for HIV (Tivicay, launched through ViiV Healthcare).

GSK operated a large research facility in Spain dedicated to R&D for diseases of the developing world, where its drug development projects were said to be "prioritised by their socio-economic and public health benefits, rather than by their commercial returns."[47] Within the facility, GSK created an 'Open Lab' where independent researchers could access resources and expertise to advance their own research projects. It allowed external researchers to screen GSK's compound library to potentially identify treatments for neglected tropical diseases. By the end of 2013, 38 visiting scientists had used the Open Lab. GSK committed to help eliminate and control 10 neglected tropical diseases affecting 1.4 billion of the world's poorest

[42] GSK policy on Intellectual Property & Access to Medicines in Developing Countries, April 2011

[43] *Ibid*.

[44] GSK were a founding member

[45] GSK corporate social responsibility report 2013

[46] Jon Pender discusses GSK's efforts in Africa, May 22, 2012: www.youtube.com/watch?v=oHKX7gkj9M0

[47] GSK – Our commitment to fighting Malaria, Oct 2013

people by the year 2020. It committed US$10 million to the Global Health Investment Fund to finance the development of medicines, vaccines and interventions for diseases that affected LDCs.

GSK vaccine research was focused on overcoming the challenges encountered during storage and transport (maintaining vaccines at an optimal temperature in remote regions often resulted in wastage) and on developing vaccines against cancer, HIV, malaria, tuberculosis and dengue fever. In 2013, GSK partnered with the Bill and Melinda Gates foundation (BMGF) on a $1.8 million effort to develop heat-stable vaccines.

GSK was the first pharmaceutical company to share its clinical trial results,[48] and shared its findings on 13,500 compounds which had a potential to inhibit the malaria parasite and tuberculosis, including 180 that were particularly promising. The malaria compound information was shared with 160 groups around the world, the tuberculosis compounds with 10 research groups. In 2013, this access to data was expanded to share its clinical study reports and anonymised patient data.

Nevertheless, opponents accused GSK of releasing material from its trials only in response to specific requests, and of hiding behind patient confidentiality to prevent a clear view of trial data, counter to its stated concerns about transparency and advancing research. As psychiatrist Dr. David Healy blogged, "If those of us who have been participants in trials thought some remote risk of a breach of privacy was being used to prevent the disclosure of details that would save someone else's life but threaten GSK"'s profits, most of us would likely be horrified."

Vaccines at GSK

Back in 2007, GSK had surprised the world by announcing that it was working on a combination vaccine called Globorix to protect children against diseases such as meningitis A and C, diphtheria, tetanus and hepatitis B. The vaccine cost GSK $400 million to develop. Designed specifically "to meet a pressing public health threat in Africa", GSK did not expect sales of Globorix to recoup the cost of R&D. Whilst Médecins sans Frontières welcomed the news, an anonymous blogger on the "Science of the invisible" blog asked whether Globorix would be "a loss leader", questioning whether GSK was responding to developing countries' healthcare challenges.

GSK was the market leader in vaccines and produced more than 30 vaccines for children and adults (see Exhibit 8.3). Vaccination prevented disease, death and disability, and was thus one of the most cost-effective preventive measures. Yet vaccines were not adequately reaching the developing world. In response, the Global Alliance for Vaccines and Immunisation (GAVI),[49] had been set up to ensure universal access to vaccines and protection against life-threatening diseases. GSK part-

[48] Through the launch of its Clinical Trial Register on the internet in 2004

[49] A public private partnership founded in 2001 between the Bill and Melinda Gates Foundation, WHO, UNICEF and the World Bank as part of the 'Decade of Vaccines Collaboration'

nered with UNICEF, who purchased vaccines on behalf of the GAVI. As vaccines were volume-dependent, this was a win-win – it increased production volumes as GSK sold to more customers, lowered manufacturing costs and improved planning; which allowed GSK to offer lower prices to GAVI.

In 2011, GSK provided the rotavirus vaccine[50] to GAVI at $2.50 per dose, and $5 to fully immunise a child – a 67% reduction on the lowest public price. When GSK sold at these lower prices, it took precautionary measures such as monitoring for unusual sales activity to ensure that low-cost vaccines were not used elsewhere. Allan Pamba, Director of Public Engagement and Access Initiatives, explained "This can, of course, only go so far, but we believe that the potential benefit of low-cost vaccines for people in developing countries outweighs the risk."

In 2013, 862 million vaccine doses were delivered to 170 countries, and over 80% of vaccines sold were used in developing countries. GSK had contributed 15.8 billion doses of the oral polio vaccine and committed to supply 500 million doses of vaccines to GAVI for use in developing countries.[51] Nevertheless, WHO estimated that 22 million children in developing countries still had no access to life-saving vaccines. GAVI estimated that only 5% of children in the world received all 11 essential vaccines. And whilst various vaccines against HIV were being developed, none had proven effective.[52]

GSK followed a three-pronged approach to malaria[53]:

1. Innovation of new malaria medicines and vaccines in partnership with the Medicines for Malaria Venture (MMV)
2. Through the Africa Malaria Partnership, GSK invested in preventative measures, such as using bed nets and indoor spraying. (£4 million between 2001 and 2013).
3. Preferential pricing for antimalarial medicines in LDCs and sub-Saharan Africa

Then in 2014, after 30 years of research, GSK announced that a vaccine against malaria –RTS,S – was ready to be launched in 2015.[54] Dr. Joe Cohen, Vice-President of R&D Emerging Diseases, told the FT[55]: "Data from a late-stage trial that is still in progress suggest the candidate vaccine can almost halve the number of malaria cases in children aged five to 17 months, on top of reductions from bed nets and other tools." In an interview with the WSJ,[56] CEO Andrew Witty said "When the

[50] A vaccine that protects children against Rotavirus

[51] (Included supplying at least 30% of the vaccines for the Global Polio Eradication Initiative (a public private partnership of national governments and the WHO) until 2017). GSK corporate social responsibility report 2013

[52] WHO website 2014.

[53] GSK – Our commitment to fighting Malaria, Oct 2013

[54] http://www.gsk.com

[55] FT, 25 April 2014: http://www.ft.com/cms/s/0/21788c96-be6d-11e3-a1bf-00144feabdc0.html#ixzz2ztByUsuq

[56] http://live.wsj.com/video/does-a-company-have-a-soul/BF2AC683-9FC8-493C-9089-6EEB09646F97.html#!BF2AC683-9FC8-493C-9089-6EEB09646F97

data for the malaria vaccine was first shared with the development team, the guys broke down crying. This shows the human emotion invested in this… which creates the soul of the company."[57] Having understood that children in Africa who would benefit from the vaccine could not pay for it, GSK made a conscious choice to develop[58] and finance the vaccine, and committed to make it available for cost of goods plus 5%. The 5% was destined to be reinvested in R&D for a second-generation malaria vaccine or vaccines against other tropical diseases.

Scandals at GSK

A series of scandals at GSK caused people to question its motives. Criminal investigations into allegations of bribing doctors and paying off competitors to stall competitive product releases undermined its claim that "being a responsible business is essential to our strategy, and how we deliver success is just as important as what we achieve."[59]

At the AGM in 2003, shareholders had voted against the remuneration report in what was seen as "the biggest shareholder revolt of its kind in UK corporate history". They were particularly angry about an estimated $35.7 million "golden parachute" Garnier would receive if he lost his job, which drew media accusations of corporate greed.

In 2004, GSK was accused of compromising the safety of patients with its antidepressant Paxil. It was discovered that GSK had failed to disclose the results of numerous trials indicating that the drug increased the risk of teen suicides. Paxil was subsequently banned for use by minors.[60]

In October 2010, GSK was ordered to pay $96 million to former employee Cheryl Eckard for failing to address the serious manufacturing contamination problems she reported at their Cidra plant in Puerto Rico in 2002, where breakdowns on production lines meant that products were contaminated with bacteria, or mixed up such that medicines produced were either too strong or too weak.[61]

In 2012, GSK pleaded guilty to criminal charges in the USA and paid $3 billion fines for illegally marketing drugs, offering doctors 'an endless list of potential

[57] http://live.wsj.com/video/does-a-company-have-a-soul/BF2AC683-9FC8-493C-9089-6EEB09646F97.html#!BF2AC683-9FC8-493C-9089-6EEB09646F97

[58] Partnering with the Path Malaria Vaccine Initiative, a non-profit group FT, 25 April 2014: http://www.ft.com/cms/s/0/21788c96-be6d-11e3-a1bf-00144feabdc0.html#ixzz2ztByUsuq

[59] GSK corporate social responsibility report 2013

[60] GSK responded by promising to reveal all its trials and to publish all its data, regardless of their outcome, and other large drug companies followed. FT April 16, 2014 -When use of pseudo-maths adds up to fraud

[61] Bad Medicine: The Glaxo Case: http://www.youtube.com/watch?v=NJh9o-MCPXw. When Eckard issued warnings to shut down the plant & detailed 9 high risk areas in the plant, no one listened & she was subsequently sacked

perks and bribes', such as yacht trips, massages and balloon rides, in return for prescribing drugs.

In 2013, GSK was accused of corruption, price-fixing and quality controls in China. The Chinese police said GSK had transferred 3 billion yuan ($489 million) to travel agencies and consultancies to bribe doctors to promote its products. GSK described the allegations as "shameful", agreed that some of its executives in China appeared to have broken the law and consequently dismissed "dozens of employees", made changes to its sales incentive schemes, and stopped payments to doctors for making speeches, and to healthcare professionals for attending medical conferences.[62]

Against this backdrop, even when GSK tried to do good, people questioned its intentions. For example, when GSK and Save the Children formed a global partnership to help save a million children's lives in the world's poorest regions, Rageh Omaar, reporting for ITV in Africa, commented:

> Global pharmaceutical companies have a long controversial record in developing countries, many wonder why things will be different now… Aid agencies and multinational corporations like Glaxo Smith Kline have the ability to come together to stop children dying needlessly from preventable diseases. But the question is what are the motives behind this partnership?[63]

Access to Medicines in 2014

In 2014, 2 billion people still lacked adequate access to medicines to stay healthy. And with insufficient understanding of health issues an estimated 10 million premature deaths occurred.[64] Under-five mortality was greatest in sub-Saharan Africa (followed by Southeast Asia). Activists claimed that millions of children were dying of preventable causes and that even small investments in health in the poor countries could make a dramatic difference to people's lives. NGOs continued to argue that compulsory licences should be granted to drive down drug prices. As Leena Menghaney, Manager of MSF's Access Campaign in India, explained, "Countries need to tackle the problem of high drug prices head on, by making sure unwarranted patents are not granted, and by issuing compulsory licences when drugs are priced out of reach so that more affordable generic versions can be made." Rohit Malpani,

[62] http://video.ft.com/2563890263001/Mild-pain-relief-for-GSK/Companies, Jul 24, 2013: GlaxoSmithKline has become embroiled in a corruption probe concerning some of its Chinese staff and FT April 2, 2014 Big pharma's rise in China not held back by scandals and Chinese woe for GSK, The Times, 5 April 2014

[63] ITV news at 10 pm, 10 May 2013: https://www.youtube.com/watch?v=B9kwBxXXXCs&list=PLvDyxtKlIcnhWNg8UevNidThqmxxtj9kU

[64] Novartis Foundation—Klaus Leisinger 10/4/2011: http://www.youtube.com/watch?v=9drMaDVg2eY

spokesman for Oxfam USA, argued that "ultimately, for least developed countries it's only generic competition that's going to get prices down to an affordable level."[65]

HIV had moved from being the key issue to just one of a number of health problems including vaccines, tuberculosis, malaria, neonatal, tropical diseases and pneumonia (see Exhibit 8.4). The difference in death rates from non-communicable diseases (NCDs) and other diseases between the developed and developing world was stark. While the developing world had addressed the problems of AIDS and people with HIV were living longer, the burden of chronic NCDs was heavier. Breast cancer, cardio-vascular disease and smoking-, alcohol- and obesity-related conditions were also affecting people in low-income countries. The WHO estimated that the number of deaths from chronic NCDs was more than four times those from AIDS, TB and malaria in low and middle-income countries. It claimed that with the right access to medicines, around 8 million NCD deaths could be prevented each year in the developing world.[66] NCDs now presented the same sort of major health challenges and global burden that AIDS once had. But while AIDS was now adequately financed and widely understood, awareness of chronic NCDs and the opportunities for health impact in LDCs were not.

By 2014, many developing countries were seeking to move towards universal health insurance coverage as advocated by the WHO, but only Ghana, Rwanda, Kenya, Nigeria and South Africa had any formal structure for health insurance. What worked elsewhere didn't work in much of Africa. The challenge was not just about making medicines more affordable but more available. Several interconnected factors determined whether patients received the right medicine at the right place and time, including diagnosis and care, remaining in care, lack of healthcare workers, infrastructure investment, individual lifestyles, education and environment. The cost of treatment was not just the price of the drugs but the cost of transport and of time taken off work for patients – often to walk long distances and queue for treatment.

GSK and the Novartis Deal

By 2014, GSK was the fourth largest global pharmaceutical company (see Exhibit 8.3). It had manufacturing sites in 86 countries and a commercial presence in 150 markets. Turnover was £26.5 billion, consisting of pharmaceuticals (67% of group turnover, including medicines for cancer, heart disease and viral infections such as HIV), vaccines (13% of group turnover) and consumer healthcare products.

GSK was proud to have held the number one position on the Access to Medicines Index from its conception. Shareholder returns also appeared to be high on management's agenda: in 2014 the dividend was increased by 6%. In a video released in

[65] http://www.ethicalcorp.com/communications-reporting/how-gsks-access-medicine-plans-will-shake-big-pharma

[66] Source: WHO 2008

April 2014,[67] Philip Thomson, SVP of Communications and Government Affairs, said healthcare was -

> *an area which fundamentally requires responsibility. It is something that the company takes very seriously. At the core of the company is innovation and access, and the two are intrinsically linked. What it should tell you is that we don't see any difference between our commercial success, our shareholder return, and our responsibility and the contribution we should make to society.*

On 22 April 2014, GSK announced the terms of a complex three-part $20 billion restructuring deal with Swiss pharmaceutical Novartis[68]:

1. GSK would sell its portfolio of cancer drugs to Novartis for up to $16 billion; ($1.5 billion in milestone payments subject to drug trial successes)
2. GSK would buy Novartis's vaccines unit for up to $7.1 billion ($5.25 bn plus a potential $1.8bn in milestone payments subject to vaccine successes.)[69] This would give GSK 29% of the global vaccine market. "GSK's late-stage development pipeline would be further strengthened with the addition of four new candidate vaccines from Novartis." The new business would have more than 20 different vaccines in development, including assets to prevent hospital and maternal infections and diseases prevalent in developing countries such as malaria and tuberculosis.
3. Novartis and GSK would combine their consumer health businesses in a joint venture, with 2013 pro forma revenues of £6.5 billion and GSK holding 63.5% of shares and 7 out of 11 seats on the board

Announcing the agreement, Andrew Witty, GSK chief executive, stated[70]:

> *Opportunities to build greater scale and combine high quality assets in vaccines and consumer healthcare are scarce. With this transaction we will substantially strengthen two of our core businesses and create significant new options to increase value for shareholders…. The acquisition of Novartis' vaccines business will significantly enhance the breadth of our vaccines portfolio and pipeline, notably in meningitis, with the addition of Bexsero, an exciting new vaccine for prevention of meningitis B. The acquisition will also strengthen our manufacturing network and reduce supply costs…*
>
> *Finally, and very importantly, this transaction strengthens GSK's offering to patients and consumers. We will expand our portfolio to both help treat illness and prevent disease, and we will broaden our scope to improve human health with the acquired R&D and innovation expertise.*

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[67] GSK: Evolving our business model- https://www.youtube.com/watch?v=j1uWVMOlhdw

[68] Regulatory News Service, Apr-22-2014:GSK announces major transaction with Novartis. It was expected to complete during the first half of 2015

[69] The deal included Novartis's promising new Bexsero vaccine for meningitis B, but excluded flu vaccines

[70] Regulatory News Service, Apr-22-2014: GSK announces major transaction with Novartis.

The deal would increase annual turnover to £26.9 billion and allow GSK to focus on four key business areas – HIV, vaccines, respiratory conditions and consumer healthcare.[71] It was perceived as a win-win deal, driving sustainable sales growth, allowing overheads to be spread over a bigger portfolio, and the companies to become more efficient and more productive in the long term. In the financial media it was perceived to benefit everyone: the companies could improve their long-term earnings, allowing shareholders to earn increasing returns, while patients would receive new drugs quicker through a speedier R&D process. As the FT[72] explained:

> *Both companies get to specialise and focus resources on areas they are good at. To paraphrase Novartis' chief executive, Novartis can get more value out of Glaxo's cancer labs than Glaxo can, while Glaxo can make Novartis' vaccines business work harder. If it works, everyone's a winner. Consumers get more new drugs, more quickly. Shareholders and management avoid the indigestion problems that always come with any big merger. And nobody has to shell out ridiculous fees to investment banks to broker the whole thing.*

Exhibit 8.1: Oxfam's Assessment Criteria for Access to Medicines

Expected behaviour in each of Oxfam's three assessment areas of a pharmaceutical company that has reached the top '*civil stage*' – when it actively pushes other companies and stakeholders within the sector to raise standards as an industry.

Research and Development

1. The company supports and participates in joint private-public initiatives (JPPIs) that address R&D, or conducts Its own in-house research For infectious diseases: collaborates with third parties (e.g. JPPIs, generic companies) working on R&D for medicines to treat neglected and abandoned diseases; and facilitates access to Its compound library for other relevant parties to conduct R&D for neglected and abandoned diseases.
2. Companies conduct R&D for diseases prevalent in developing countries as an integral part of their overall R&D strategy. This strategy should have specific targets to ensure proper monitoring and evaluation of commitments made by companies.
3. The company invests in paediatric versions and versions adapted to resource-poor settings, including heat-resistant formulations.

Pricing Strategy

1. The company applies a systematic, global approach to pricing in developing countries, overseen by an international public-health body, which addresses public-health needs and real purchasing power for each country.

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[71] These revenues would be split across Pharmaceuticals 62%, Consumer Healthcare 24%, and Vaccines 14%, (FT 22/04/2014: Novartis buys GSK business for up to $16bn http://www.ft.com/cms/s/0/2bc1c1c0-c9e6-11e3-ac05-00144feabdc0.html#ixzz2ziPC13dI)

[72] FT 26/04/2014

2. The company discloses its pricing rationale in developing countries.
3. The company's pricing policy ensures that products for neglected diseases developed as part of a JPPI or developed in-house, are affordable for developing countries.
4. The company applies the above pricing policies to its entire portfolio beyond neglected diseases and HIV and AIDS, and in all developing countries.

Intellectual Property

1. The company does not lobby developed-country or developing-country governments or pursue legal avenues to impose or enforce patent rules that exceed minimum obligations under the TRIPS Agreement, or that weaken the use of public-health safeguards. The company should publicly accept the use of TRIPS safeguards and flexibilities.
2. The company supports lifting TRIPS-related restrictions on the export of generic versions of patented medicines to least-developed countries and to developing countries that have insufficient or no manufacturing capacity, in line with the Doha Declaration. The company supports extending the non-implementation of patent rules for pharmaceuticals in LDCs beyond 2016.
3. The company does not apply for patents for the purpose of 'ever-greening' existing medicines, i.e. the extension of pharmaceutical monopolies beyond the initial 20-year term. Therefore, companies should not seek patents for new indications of existing medicines, new formulations, or combinations of existing medicines, nor should they seek patents for modifications of existing chemical entities or pharmaceuticals unless these changes are novel, show an innovative step, and have significant therapeutic advantages.
4. The company extends the relevant intellectual property policies to all medicines in its portfolio, and does not limit its policies only to medicines needed to treat HIV and AIDS, tuberculosis, and malaria.
5. The company renounces all patent rights on medicines developed for infectious diseases under JPPIs in developing countries.
6. The company follows Oxfam's best-practice guidelines when issuing voluntary licences (VLs).

Source: Author compilation from extracts in November 2007, Oxfam briefing paper: 'Investing for life'

Exhibit 8.2: Commitments – Progress Overview in GSK Corporate Responsibility Report 2013

Our approach | Health for all | Our behaviour | Our people | Our planet | Governance and engagement

Commitments
Progress overview continued

Area	Commitments		Progress tracker		Find out more
Our behaviour	Promoting values in sales and marketing practices	Continue to drive a values-based approach to sales and marketing practices across the world, with the interests of consumers and patients at its core.	On track	Announced changes to our global sales and marketing practices to further ensure patient interests come first, and introduced a new performance management system focused on values.	Page 43
	Rigorous patient and consumer safety	Continue to ensure the interests and safety of patients and consumers are of paramount importance in the way we design and undertake our clinical trials, our product quality assurance and our monitoring and reporting of adverse events in ongoing product usage.	Progressing well	Strengthened resources to enhance our pharmacovigilance operating model, expanded dedicated product quality teams and maintained our robust policies and governance framework on patient safety.	Page 41 and 45
	Minimising animal testing	Rigorously challenge the need for animal studies and work to minimise the impact on animal welfare, by investing in the development of alternative studies and sharing animal-based data.	On track	Reduced number of animals used in our research by 10% in 2013.	Page 41
	Promoting Human Rights	Address the UN Guiding Principles on Business and Human Rights across our own operations and our supplier relationships.	On track	Conducted a human rights impact assessment and prioritised seven areas for further analysis, and updated our human rights statement accordingly.	Page 39
	Transparency in clinical trial data	Be as transparent as possible with our clinical trial data, including publishing clinical study reports (without patient-level data) for all outcome trials of medicines conducted by GSK and, within an appropriate process, making available to researchers access to anonymised patient level data to further scientific enquiry.	Progressing well	Launched online system enabling researchers to request access to the detailed anonymised patient-level data from our clinical trials and became first pharmaceutical company to publish clinical study reports.	Page 40
	Ensuring ethical stakeholder interactions	Demonstrate that all GSK interactions with patient advocacy groups and political stakeholders are conducted appropriately, ethically and transparently.	On track	Embedded new criteria to ensure public policy groups we work with are aligned with our values and agreed relevant Standard Operating Procedures.	Page 47
Our people	Promoting inclusion and diversity	Continue to promote inclusion and diversity globally at GSK.	On track	Agreed to establish Global Disability Council and introduced gender targeted coaching and sponsorship.	Page 55
	Creating inspiring and healthy workplaces	Continue to create a working environment that inspires people to grow and perform in a healthy and resilient way.	On track	Interim employee survey results showed improvements in team leader effectiveness; continued to roll out preventive healthcare for employees; reduced injury and illness rates by 12% from 2012.	Page 57
	Community volunteering to create change	Extend volunteering opportunities to bring about positive change to communities and global health while providing individual development.	On track	Increased the number of employees taking part in PULSE volunteer partnership programme to 99 (from 58 in 2010).	Page 54
Our planet	Aiming to be carbon neutral	Reduce our overall carbon footprint by 25% by 2020 (vs. 2010) and have a carbon neutral value chain by 2050.	Work to do	Scope 1 and 2 carbon emissions from our operations up 2% in 2013, but down 7% since 2010; Scope 3 emissions (excluding raw materials) up 1.5% in 2013 and up 11% since 2010, due to strong sales of HFA propellant-based inhalers.	Page 64
	Reducing our water impact	By 2020, reduce our water impact across the value chain by 20% (vs. 2010).	On track	Used 16% less water in our operations (vs. 2010); mapped water use across our value chain; became first company to be awarded global certification to the Carbon Trust's Water Standard.	Page 65
	Reducing our waste	By 2020, reduce our operational waste by 50% (vs. 2010).	On track	Cut total waste by 6% and sent 39% less to landfill (vs.2010); achieved zero waste to landfill at 37 sites.	Page 66
	Building sustainability in our supply chain	Build sustainable supply lines for our Nutrition portfolio and work with local farmers to improve their agricultural practices, improve their yields, their competitiveness and their livelihoods.	On track	Began working with a dairy supplier in India to develop a secure supply of locally produced whey protein (from milk) to make *Horlicks*, and now source 60% of whey protein from the local supplier in India for *Horlicks*.	Page 67

Exhibit 8.3: The Pharmaceutical Market and Research Process

The global pharmaceutical market grew from $220 billion in 1999 to $808 billion in 2013,[73] with the Americas accounting for 44% of sales and an estimated 60% of industry profits. Only 1.4% of sales value came from the combined Middle East and Africa.

In 2013, with 2.8% of the global market, GSK was the fourth largest pharmaceutical company after Pfizer (7.5%), Merck (5.3%) and AstraZeneca (4.4%).[74] The industry was highly competitive but one of the most profitable. GSK had a profit margin of 20.5% (Pfizer's was 42.7%, Merck's 10.0%, and AstraZeneca's 10.0%).[75]

The global vaccine market, which represented 3.4% of the total global pharmaceutical market[76], grew by approximately 10% per annum. GSK was the leading producer with 23% of the market, followed by Sanofi (20%), Merck (14%), Pfizer (13%) and Novartis (10%).[77]

The costs of research, legal and regulatory constraints (to ensure the safety and efficacy of medicines) and patents restricted new entrants. Prices came under pressure as governments sought to reduce the financial burden of health systems, prompting investor concern that the industry might not deliver the profits they were used to. Moreover, research took years, with only a small chance of a positive outcome.[78] The research process entailed laboratory research, product development, animal experiments, and clinical trials with patient volunteers to prove the efficacy of the drug prior to obtaining regulatory approval, and marketing. According to the Pharmaceutical Research and Manufacturers of America trade group (PhRMA), out of 5000–10,000 screened compounds, only 250 entered preclinical testing, of which only five entered human clinical trials and only one would be approved. By 2012, some commentators[79] estimated that the full cost of bringing a new medicine to market had reached $1.5 billion.

The industry's business model was based on finding 'blockbuster' drugs and then protecting them by the patent system. A patent gave exclusive rights to supply the product in the country where it was granted, essentially ensuring a monopoly for 20 years, during which profits would help recoup the high cost of R&D. Multiple patents were involved, including patents for the compound, process and formulation (i.e. type of dose). Patent holders could grant voluntary licenses to other manufacturers to make or sell generic versions of their medicine within the boundaries of stated countries, in return for a royalty on these sales.

[73] Pharmaceuticals Industry Profile: Global, April 2014, 1–33, MarketLine

[74] Pharmaceuticals Industry Profile: Global, April 2014, 1–33, MarketLine

[75] *Ibid*.

[76] IMS health 2011

[77] Source –Kresse and Shah, 2010)

[78] According to the pharmaceutical industry, it cost around $1 billion to bring a new drug to market and the average time from discovery to approval of new medicine was 13 years, with a success rate of less than 5%. Source US National Institute of Health

[79] Source: J. Mestre-Ferrandiz, J. Sussex and A. Towse, The R&D cost of a new medicine, Office of Health Economics, December 2012

Once the patent had expired, other manufacturers could produce and market the same medicine under a generic name. With no R&D to cover and manufacturing costs low, they could offer generic medicines at much lower prices. For example, the arrival of generic competition to GSKs dermatology products saw its sales decline 58% to £13 million. Patent expiry was therefore a major concern. In search of a new business model, the pharmaceutical industry saw 'a splurge of multibillion-dollar deals and rumours', including 'speculation over a $100bn approach by Pfizer for AstraZeneca'..[80]

Because profitability in low and middle-income countries was small, big pharma had little incentive to develop medicines for those markets – what were significant threats to health in the developing world were of negligible market size elsewhere, such as HIV-positive mothers and children. The generic manufacturers did not have the resources to carry out clinical trials to develop these medicines. In 2012, more than 90% of people receiving ARV treatment lived in low and middle-income countries, a market estimated to be worth $1.5 billion (less than 10% of the value of the global market). The paediatric market accounted for 7% of the total ARV market and was confined to low and middle-income countries (childhood HIV having been almost eliminated elsewhere).[81] Once generic manufacturers had entered the ARV market, big pharma left them to supply this unprofitable segment. By 2012 they were supplying over 95% of first line ARV medicines in low and middle-income countries.[82]

Exhibit 8.4: Key Diseases Affecting the Developing World

At the beginning of the twentieth century, there was a 20-year life expectancy gap between the developed and developing world. A disproportionate volume of research focused on health in developed countries to the neglect of those in LDCs.[83]

Over the years, HIV/AIDS had received a lot of media attention, finance and concerted efforts from NGOs such as Christian Aid's 'Stop the AIDS' campaign and the annual 'World AID'S day'. By 2014, billions of dollars had been committed to global funds to fight AIDS, TB and malaria, and millions of people were on ARV drugs in low and middle-income countries.[84] The scale-up in ARV treatment had been impressive, from 0.8 million people in sub-Sahara Africa in 2005 to 3.9 million in 2009. The price of first and second-line ARVs to treat HIV had dropped because of increased competition among generic producers. First-line

[80] FT April 25, 2014 Drug innovation: In the recovery room

[81] HIV medicines – technology and market landscape, UNITAID, March 2014

[82] Global update on HIV treatment 2013: results, impact and opportunities published by UNAIDS, the WHO and UNICEF in June 2013

[83] *Ibid*.

[84] In 2012, an estimated US$ 18.9 (16.6–21.2) billion was available for HIV programmes in low- and middle-income countries; GLOBAL REPORT UNAIDS report on the global AIDS epidemic 2013. Care and treatment services consumed more than half (55%) of HIV expenditure in 2012, while prevention programmes represented 19% of HIV spending, 12% was spent on programme management and administration. Source: GARPR 2013

ARVs had fallen from $10,000 in the early years, to around $140[85] per person per year, and medicines used in second-line combination treatment[86] had fallen from $700 in 2008[87] to around $300 per year.[88]

The threat of AIDS drastically diminished through a combination of prevention and treatment. AIDS-related deaths peaked in 2005. Globally, new HIV infections had peaked in 1997 and continued to decline. In 2012, an estimated 9.7 million people[89]in low and middle-income countries obtained ARV therapy and the UN goal of having 15 million people in treatment worldwide by 2015 appeared reachable. Although 34 million people worldwide were living with HIV in 2014,[90] AIDS was no longer perceived as a pandemic. Drugs had transformed AIDS from a death sentence to a chronic disease: a person infected with HIV at age 25 could expect to live into their 70s.[91] Drugs were available for HIV-positive pregnant women, which eliminated the transmission of AIDS to babies and led to enormous reductions in the number of children with HIV.[92] Progress towards the goals of 'zero new infections' and an 'AIDS-free generation' prompted UNAIDS to announce "today we have the tools we need to lay the groundwork to end the AIDS epidemic."[93]

However, since AIDS still was a life-long condition, millions in the developing world would require years of sustained HIV drug treatment. Yet access to treatment varied considerably within and between countries: 3.4 million children were living with HIV and without treatment, 33% of HIV-infected infants would die before the age of one, 50% by 2 years old.[94] Only 10 of the 29 ARV medicines available in 2013 were approved for use with children. Because of difficulties supplying the liquid formulation required by infants and smaller batch sizes, they tended to be higher priced than adult formulations.[95]

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[85] Price of a WHO-recommended one-pill-a-day first-line combination (tenofovir/lamivudine/efavirenz)

[86] zidovudine/lamivudine + atazanavir/ritonavir

[87] http://www.unitaid.eu/en/resources/news/198-unitaid-and-the-clinton-hivaids-initiative-announce-new-price-reductions-for-key-drugs

[88] Untangling the Web of ARV Price Reductions, released July 2013 by the international medical humanitarian organisation Médecins Sans Frontières/Doctors Without Borders (MSF) at the International AIDS Society conference in Kuala Lumpur, http://www.msf.org.uk/article/hiv-generic-competition-pushing-down-drug-prices-patents-keep-newer-drugs-unaffordable

[89] Under the 2010 WHO guidelines, 61% (57–66%) of all persons eligible

[90] www.christianaid.org.uk/Images/Advent-2013-reflections.pdf

[91] reported at the 2012 XIX International AIDS Society conference

[92] the annual number of newly infected children in 2012 was 260,000 (230000–320,000) in low- and middle-income countries, 35% lower than in 2009; GLOBAL REPORT UNAIDS report on the global AIDS epidemic 2013

[93] GLOBAL REPORT UNAIDS report on the global AIDS epidemic 2013

[94] HIV medicines – technology and market landscape, UNITAID, March 2014

[95] *Ibid*.

In sub-Saharan Africa, where 25 million lived with HIV,[96] approximately three quarters of adults had not achieved viral suppression as a result of shortfalls at each stage of the treatment cascade.[97] In 2014, 1.6 million HIV-related deaths occurred in Africa,[98] where more than 90% of mother-to-child transmission occurred, and only 65% of pregnant women with HIV received treatment.

The earlier ART treatment was initiated, the greater its benefits. But a report published by UNAIDS, the WHO and UNICEF in June 2013 noted that "structural, operational, logistical and social barriers, including stigma, discrimination, and punitive laws and policies" hindered access to HIV testing or resulted in patient 'loss' between testing and starting treatment. WHO guidelines on HIV treatment[99] in 2013 indicated that 28.6 million were eligible for ARV therapy in low- and middle-income countries and that substantially faster scale-up was needed.

Moreover, there was a problem of resistance to AIDS drugs over time. UNITAID reported increased cases of resistance from 4.8% in 2007 to 6.8% in 2010 in low and middle-income countries.[100] As patients developed resistance to second-line ARVs, they needed to switch to a new generation of HIV drugs. According to the WHO, 3.6% of adult patients were on second-line treatments in 2012; 3% of patients on first-line ARVs needed to switch to second-line regimens annually. However, the minimum cost of these medicines in the poorest countries was $2000 per year.[101] In conformity with TRIPS regulations, medicines developed after 2005 could no longer become generics. NGOs warned that if resistance to generic drugs continued, death rates would return to the levels of the 1980s. Would history repeat itself, with access to HIV treatment again subject to the ability to pay?

Tuberculosis accounted for 1.3 million deaths in 2012 and a quarter of its victims were HIV-positive. Even with medicines and the preventive use of bednets, malaria was responsible for over half a million deaths globally every year. Christian Aid noted that "Most shockingly, despite the fact that malaria is both a preventable and curable disease, most of those deaths occur among African children."[102] The economic cost of malaria was high, consuming "around 40% of all public health

[96] *Ibid.*

[97] GLOBAL REPORT UNAIDS report on the global AIDS epidemic 2013

[98] HIV medicines – technology and market landscape, UNITAID, March 2014

[99] HIV treatment guidelines provided by the WHO (WHO), issued in June 2013, recommended starting treatment when an individual's CD4 count fell below 500 cells/μL and immediately for pregnant women, HIV-positive partners in serodiscordant couples, children younger than five and people with HIV-associated tuberculosis and Hepatitis B.

[100] HIV medicines – technology and market landscape, UNITAID, March 2014

[101] Nearly 15 times the price of first-line treatment. Untangling the Web of ARV Price Reductions, released July 2013 by the international medical humanitarian organisation Médecins Sans Frontières/Doctors Without Borders (MSF) at the International AIDS Society conference in Kuala Lumpur,http://www.msf.org.uk/article/hiv-generic-competition-pushing-down-drug-prices-patents-keep-newer-drugs-unaffordable

[102] http://www.christianaid.org.uk/pressoffice/blog/world-malaria-day-2013.aspx

expenditure in endemic countries."[103] Comparing charts of disability-adjusted life years (DALYs) by disease demonstrated that whilst AIDS was still prevalent in sub-Saharan Africa, other infections and parasitic diseases accounted for more loss-of-life-years. Non-communicable diseases (NCDs) were increasingly affecting health.

More than 1 billion people, including 800 million children, were believed to succumb to tropical diseases, and pneumonia was one of the biggest killers of under-fives.

[103] http://www.gsk.com/responsibility/health-for-all/tackling-diseases-in-developing-countries.html

9 Revenue Flow and Human Rights: The Paradoxes of Shell in Nigeria

Aileen M. Ionescu-Somers

A Nigerian "can of worms"

In February 2013, Alan Detheridge, former British vice president of Shell's External Affairs wrote an article for the reputable British broadsheet newspaper, The Guardian.[1] In it, he wrote:

> Oil companies can bring great wealth to the countries where they operate. The revenues from the industry have the potential to drive economic growth and be a powerful force in reducing poverty. However, in some resource-rich countries, these revenue flows are vulnerable to corruption and mismanagement, with little benefit going to the population at large.

Detheridge continued to point out the importance of transparency to tackle the threats of corruption and mismanagement, but also to press for oil companies, including his former employer, not to push for exemptions or oppose full and comprehensive transparency on monetary flows from extractive industry activities. He had good reason, based on long experience, to advocate for more transparency, not less.

When they retired around the same time in September 2006, Detheridge and Joshua Udofia, his senior Nigerian corporate advisor had managed issues in the Niger Delta during some of Shell's most challenging years. Their careers with Shell had both been long: 29 and 35 years respectively. They had seen it all, from NGOs pointing the finger at the environmental and social impacts of oil spills and gas flaring, to extensive media coverage of human rights issues that had occurred after the much-publicized Ken Saro-Wiwa execution in 1995. But by the end of 2006, both men would be retiring. In the run-up to retirement, they often found themselves

[1] Detheridge, Alan, The oil industry wants to water down transparency rules – Europe must resist, The Guardian, 7 February, 2013.

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© Springer Science+Business Media B.V. 2019
G. G. Lenssen, N. C. Smith (eds.), *Managing Sustainable Business*,
https://doi.org/10.1007/978-94-024-1144-7_9

discussing what the future would hold for their successors, and whether Shell's current strategies were likely to lead to successful outcomes. Detheridge and Udofia had long agreed that poverty was at the root of the problems of both Nigeria and the oil-bearing Niger Delta region. During their tenure, Shell had made significant changes in its approach to its community development program, including partnering with NGOs and development agencies. But NGOs remained generally unimpressed. Even if such programs delivered to its full potential, they knew that they alone could not improve the quality of life for most of the Niger Delta's 27 million inhabitants.

A fundamental problem was related to oil revenue flow. The corruption that was endemic to Nigeria was a serious impediment to desperately needed development. In addition, state politicians were enmeshed with war lords for the sake of political and personal gain and a new generation of more unpredictable militias had intensified hostage taking involving oil company staff. The Nigerian president's anti-corruption support had been encouraging but expected elections in 2007 might mean that efforts thus far would be jeopardized. The paradox was…no matter what Shell did, no matter how much money it ploughed into community development and programs, if revenue transparency was not sorted out, could attitudes change and life be improved for people in the Delta? But had Shell gone as far as it could to alleviate the human rights crisis in the Delta? Many of the international NGOs did not think so.

Shell and Nigeria

Royal Dutch was founded in 1890 in the Netherlands by Aeilko Jans Zijlker who first discovered oil in the Dutch East Indies. The Shell Transport and Trading Company was a British company founded in 1897 by the Samuel brothers. In 1907 the two companies merged and it was agreed that Royal Dutch would handle oil refining and production operations and Shell would deal with the transport, storage and marketing of the oil products. The two companies were separately traded holding companies owning 60% and 40% respectively of Royal Dutch/Shell Group's operating subsidiaries. In November 2004 the Shell Group moved to a single parent company, Royal Dutch Shell plc, (Shell) with headquarters in the Netherlands. Unification was completed on 20 July 2005. Shell was an impressive success story. By 2005, its revenues reached $306 billion with profits of $25 billion, maintaining its position as one of the world's top three private oil companies. Shell was a veritable "super major" with 112,000 employees operating in over 140 companies worldwide.

In 1937 Shell was authorized to prospect for oil in Nigeria during British colonial rule in equal partnership with British Petroleum (BP). Oil was discovered in the Niger Delta in 1958. On October 1, 1960 Nigeria gained independence. Its leaders faced the daunting task of holding 250 ethnic groups together as a nation. They organized a loose federation of self-governing states, each one with a large degree of constitutional autonomy. In 1973, following a period of civil war, military coups

and turbulence, the two-way partnership with Shell and BP gave way to a joint venture with the Nigerian government. The Shell Petroleum Development Company of Nigeria Limited (SPDC) held Shell's share. By 2006, SPDC was the principle operator of Nigeria's largest oil and gas joint venture (Nigerian National Petroleum Company 55%, SPDC 30%, Total 10% and Agip 5%), producing approximately 40% of Nigeria's oil from over 1000 wells in the Delta.

By the 1980s, Nigeria had become an African success story, with the 33rd highest per capita income in the world. However, subsequent undemocratic military regimes, corruption and governmental inefficiency took their toll, together with a 3% per annum population growth. By 1997, the country was ranked the world's 13th poorest country. With the dawn of the new millennium, despite being the world's sixth largest exporter of petroleum, 66% of its 131 million population lived on less than $1 per day. In 2005 the NGO Transparency International classed Nigeria as the sixth most corrupt country in the world (Shell had more trouble with corrupt employees than in any other country, sacking several staff and delisting a certain number of contractors every year in line with its business principles). The UN ranked Nigeria amongst the world's top twenty "most unlivable countries," and per capita GNI was still only at a level of $400.

In 1999 General Olusegun Obasanjo, a former military ruler of Nigeria, was democratically elected. Initially, Obasanjo was revered for his commitment to democracy and fighting corruption (before becoming president, he was the Chairman of Transparency International's International Advisory Group). The first legislation Obasanjo put forward as elected president was a corrupt practices bill. He led a drive to recuperate billions stolen during a previous military regime. In spite of these efforts anti-corruption officials estimated in 2005 that 45% of Nigeria's oil revenues were being siphoned away yearly.

In 2000 a Memorandum of Understanding (MOU) to stipulate a method for the sharing of oil revenues was signed between the government and the major oil companies working in the Delta. The MOU hedged the multinationals for risk when oil prices were low rather than enabling them to benefit when prices were high. Joint venture partners including SPDC would receive a fixed margin as long as the oil price ranged from $15 to $19 a barrel. At higher oil prices, the Government share of the profit would gradually increase to 95% (refer to Exhibit 1 for the split of the barrel between partners and government within a range of oil prices) (Fig. 9.1).

By 2006, some 2.5 million barrels of Nigerian oil per day were being pumped, including onshore and offshore operations (3% of global oil production). Crude oil prices on the world market reached an all-time high of $72.35 a barrel in April 2006, giving the Nigerian government record revenues. SPDC paid $4.3 billion in petroleum profit taxes and royalties to the federal government in 2005, representing a considerable increase on the $2.2 billion paid in 2003. By 2006, petroleum accounted for more than 80% of government revenues, 90% of foreign exchange earnings, 95% of export receipts and 40% of gross domestic product.

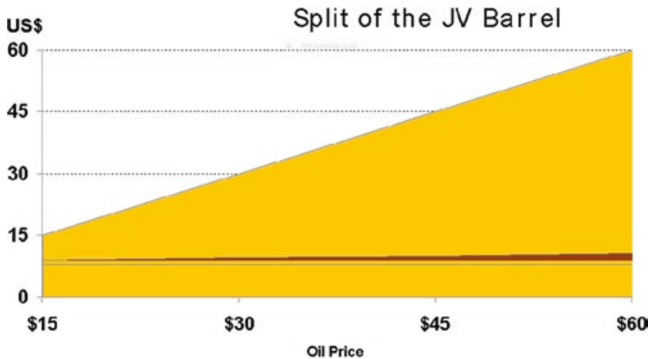

Fig. 9.1 Split of the barrel between partners and government within a range of oil prices (Source: Company information)

Human Rights in the Niger Delta

Oil majors in Nigeria operated in an extremely difficult economic and political environment, both nationally and locally. Detheridge pointed to the complexity:

> The more I know about Nigeria, the more I realize just how little I know. Some humility is not only sensible, but essential. As a Nigerian, my colleague Joshua Udofia knows more than we will ever know.

The Delta was a densely populated region that had been a major producer of palm oil in colonial times, ironically earning itself the name of "oil rivers" because of this agricultural heritage. The area was an extensive network of swamps and creeks over some 70,000 km (7.5% of Nigeria's total land mass). It included land from nine states (refer to Fig. 9.2 for a map of the area), of which four – Akwa Ibom, Bayelsa, Delta and Rivers – were the major oil producers. Of the 131 million population of Nigeria, some 20 million people (from over 40 ethnic groups) lived in the Delta. The primary activities of local people were fishing and farming.

As required under the constitution, the Nigerian government returned a significant proportion of the federal revenues it received to state governments (31.1%) and local government areas (15.2%) In addition, 13% of its revenues from oil and gas was returned to the states where production took place. But over a prolonged period, human rights groups claimed that various governments had either misspent or siphoned off into foreign bank accounts the very funds that should have gone back to develop the communities of the oil producing areas.

> Politics has become an exercise in organized corruption (….) large commissions and percentage cuts of contracts have enabled individual soldiers and politicians to amass huge fortunes.[2]

[2] "The price of oil". Human rights Watch, January, 1999.

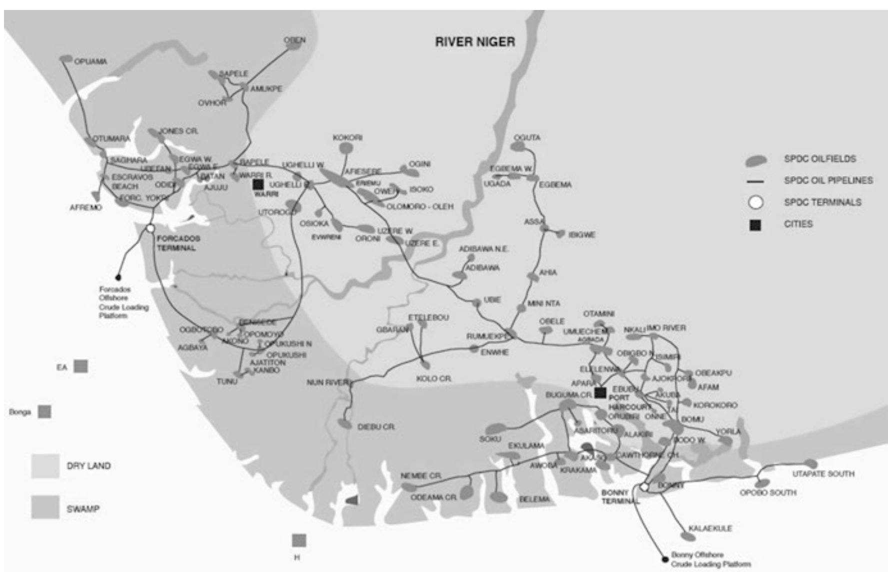

Fig. 9.2 Map of the Niger Delta area

It was a constant battle for companies to get successive governments to fund their agreed contribution to the joint ventures. It was also self-evident that oil revenues received by the government were not reaching the people that needed it most:

> Though the government is a 55–60% shareholder in oil operations and earns billions in royalties each year, local infrastructure at the source of these billions is in shambles, food shortages abound, malnutrition is common among Niger Delta children, power blackouts regularly occur, and roads are usually in terrible condition.[3]

Rising community resentment at the lack of improvement to quality of life in spite of rich resources gradually gave way to active protests against oil company activities – since protests to government had proved unfruitful. Hostage taking, closures of flow stations, intimidation of staff and even sabotage of oil installations became endemic in the Delta states as resentment increased.

During the 1990s, Shell came under immense pressure because of specific human rights issues. Confrontations between indigenous populations and Nigerian government security forces over human rights regularly occurred. In 1990, when an initially peaceful protest in Umuechem in Rivers State turned violent, Shell requested police protection. The police were attacked by the protestors, resulting in the death of a policeman, which in turn led to a large number of people being killed by the police and homes being destroyed. In 1994 the military sent security forces into Ogoniland in the southern part of the Delta where a movement for recognition of rights for the indigenous Ogoni people was growing. Ogoniland (with a population

[3] www.essentialaction.org/shell/report/section5

of 500,000) was home to the writer Ken Saro-Wiwa, a charismatic, outspoken human rights campaigner, who ultimately became leader of the Movement for the Survival of the Ogoni People (MOSOP). In 1990 MOSOP issued a bill of rights that demanded political autonomy for the Ogoni people, a fair share of the proceeds of oil extraction and the right to protect the Ogoni environment and ecology from further degradation. Saro-Wiwa and eight other Ogonis were hanged in November 1995, accused of instigating riots leading to the killings of four Ogoni elders, former founders of MOSOP. NGOs perceived the prosecution as politically motivated and the trial as unfair, but the appeal that was lodged fell on deaf ears, to some extent because the group was being judged by a military tribunal. External calls for clemency from multiple heads of state, intergovernmental organizations and human rights groups worldwide were ignored, provoking further widespread condemnation around the world and drawing international sanctions and suspension from the Commonwealth for Nigeria.

Human rights NGOs claimed that Shell, whilst not directly responsible, was heavily implicated by association with such incidents. Shell's business principles at the time of the Saro-Wiwa incident spelt out that Shell would abstain "from participation in party politics and interference in political matters." On advice from its lawyers, Shell limited its influence to pointing out the negative implications of going ahead with the executions to the government and petitioning it for clemency. But this was to no avail. Mark Corner, deputy managing director of SPDC, said:

> It took us too long to recognize that our voice should be heard. We were engineers interested in clever engineering, more introverted and conservative than we should have been. We are clearer now and feel that it is legitimate to have a more assertive position on human rights.

NGOs continued to accuse Shell of not using a potentially powerful influence to bring about change in the Delta. A conflict expert group commissioned by Shell in 2004 produced a confidential report (later leaked to the press) that stated "If current conflict trends continue uninterrupted, it would be surprising if Shell could continue on-shore resource extraction in the Niger Delta whilst complying with Shell Business principles." It also said that the SPDC "…could not ignore Niger Delta conflicts or its role in exacerbating these."

Because of Shell's close business relationship with the government, local communities perceived the company as working in cahoots with the authorities. This perception was compounded by the fact that the government seconded the so- called "supernumerary police" to Shell and other oil companies to protect staff and property. Like other oil companies Shell was dependent on the Nigerian government for security arrangements that were critically important to protect their facilities.

Local communities in the Delta objected to the degradation of their environment resulting from oil spills, much of which, according to Shell, was due to sabotage. The company argued that such sabotage was usually motivated by the desire for economic gain on the part of some, but by no means all, individuals in its host communities. The prospect of compensation (if incidents could be disguised as the fault

of the company), employment opportunities during the spill clean-up and the attempted charging of “access fees” before staff and equipment were allowed on site, were all temptations for communities that felt cheated of the benefits of local oil production.

In 1999 and 2003, to compound problems, politicians financed local warlords to intimidate local people and to help rig elections. Given his political stance on corruption, President Obasanjo and his state governors lost credibility. After the elections, some Delta state governors continued to engage war lords to deal with political rivals. The governors also turned a blind eye – and almost certainly profited from – war lords’ involvement in the theft of crude oil from existing pipelines. At the peak of the crisis, some 10% of total annual production was stolen by ethnic militias in this way. The lucrative dividends from this rich booty led to inevitable rivalry between competing groups.

The proceeds from the stolen oil helped to build up the arsenals of local militias. Over time, arms entering the Delta paved the way for violent clashes between these groups and an increasing lack of security in the area. Militancy reached a new high, and even ordinary villagers tended to want to possess arms as a measure of self-defense. Levels of corruption deepened; in January 2005, two navy rear admirals were court-martialed and ousted, implicated in the disappearance of an impounded tanker carrying stolen crude oil. Lack of employment in the Delta facilitated the recruitment into militias of numerous disillusioned and bored young men only too willing to earn some money.

During 2005, some 50 Shell employees were kidnapped. Although hostage taking of oil company staff had been commonplace since the early 1990s, the profile of these actions changed dramatically, with hostages being kept for 2–3 weeks rather than the same number of days, and increasingly difficult negotiations with kidnappers. In 2006 particularly violent militia group attacks in the Delta succeeded in cutting about 20% of Nigeria’s 2.5 million barrel per day production. The main culprit was the Movement for the Emancipation of the Niger Delta (MEND), a loose coalition of guerrilla groups that were involved in crude oil theft and claimed to have local Ijaw support (the majority tribe in the Delta). MEND demanded the release of an imprisoned war lord and even a former state governor convicted for money laundering. Becoming more powerful in the Delta towards the end of 2005, MEND later demanded $1.5 billion from Shell to compensate for environmental damage, and demanded increased access to oil revenues from the oil-producing states of Nigeria.

MEND transformed the security context of the Delta. It had well-armed units and trained supporters with the potential to destroy oil facilities more effectively than any group before them. Hostage-taking episodes were often followed by military attacks by the federal government on the guerrilla groups, who hid in villages in the area. Local resentment increased even further. It seemed that there would inevitably be more militancy, more unrest and more chaos in the run-up to new elections in 2007.

Sustainability and Human Rights at Shell

In 1996, after the Saro-Wiwa incident and also as a result of the Brent Spar debacle,[4] three Shell had moved from a risk and reputation management focus to integrating sustainable development into its general business principles strategies and operations. It reviewed its community activities in Nigeria and made changes to its philanthropic Community Assistance Program, renaming it Community Development and placing more emphasis on capacity building and the empowerment of communities. It started to engage in more extensive stakeholder discussion. This was an eye-opener for the company, as Detheridge pointed out:

> We had discussions with international NGOs, Foundations and Government officials. Everyone, including Shell, sat in meetings pointing the finger elsewhere, effectively saying; "If only you did what **I** am telling you to do, we wouldn't be in this situation." Shell came at it from the angle of "You just don't understand – get better informed." Each party thought that others could solve the problem, not realizing that solutions were beyond the reach of a single actor. Not surprisingly, it took a while for these discussions to lead to anything positive happening on the ground in Nigeria.

Eventually, however, Shell began to set up partnership projects, first with local NGOs and later with international NGOs and development agencies such as UNDP and UNAIDS. Udofia commented:

> We moved from a stance of "We want to do everything ourselves," which was impossible, to the idea that collaboration would be more effective.

In order to place more emphasis on transparency and social accountability, in 1996 the company started publishing an annual SPDC People and the Environment report and began a yearly stakeholder consultation workshop to review SPDC's environmental and community programs. Starting in 2001, the company asked a team of independent experts (from international NGOs, UN agencies, and so on) to verify and grade the projects within its community development program. The resultsof these reviews were published in the People and the Environment report and in 2005, results indicated that 86% of the projects were functional and 64% were successful. Detheridge knew from discussions with developmental organizations (none of which published such figures openly) that this was a good track record, particularly in Nigeria. But there was considerable scope for improvement. Corner commented:

> In the past we tended to over promise and under deliver. The legacy of this approach is still around today – projects that we rushed into to get things done saying that we would worry about problems later. Also, the Niger Delta Development Commission, the body charged

[4] When Shell attempted to dispose of the Brent Spar in the North Sea, the NGO Greenpeace organized a worldwide, high- profile media campaign against this plan, including calls for boycotts of Shell service stations. Under enormous public pressure, Shell abandoned its disposal plans although it later transpired that this would have been the safest option, both from an environmental and a health and safety perspective.

with doing development projects in the Delta is often under-funded, increasing reliance on SPDC. This situation is gradually improving but slowly. We have now learned that you need to work with community leaders, prepare well and hand over efficiently. Regaining the confidence of the communities is important.

The Extractive Industries Transparency Initiative (EITI)

The EITI was a voluntary partnership of companies, governments, investors and civil society organizations. It was launched by UK Prime Minister Tony Blair at the World Summit for Sustainable Development in September 2002 to improve transparency and accountability related to the payments that oil, gas and mining companies (including those that were state-owned) made to governments and the revenues that governments received from these companies. Shell was an active participant in the EITI and one of its main instigators.

Detheridge and Udofia believed from the start that this was an important initiative that was necessary, though not in itself sufficient, to improve the governance of oil revenue flows in Nigeria to ensure that they were put to good use. They realized that the $3–$40 million that Shell spent on community development could not, on its own, make a significant improvement to the lives of all the people in the Niger Delta and that better use of the substantial funds available to the state and local governments was essential.

The two men worked on bringing EITI to the president's attention, and from 2002 onwards, Shell began to publish the revenues it paid to the Nigerian government, having first obtained the requisite authorization to do so from the government. Corner commented:

In fact, there was nothing to stop Shell as an organization helping to make the case for transparent revenue flow. We should have started sooner, but we balked at appearing overly paternalistic. The question is, are we a foreign company in Nigeria or a Nigerian company in Nigeria? It is actually more helpful to think of ourselves as the latter.

The EITI Principles and Criteria

The EITI Principles

1. We Share a belief that the prudent use of natural resource wealth should be an important engine for sustainable economic growth that contributes to sustainable development and poverty reduction, but if not managed properly, can create negative economic and social impacts.
2. We affirm that management of natural resource wealth for the benefit of a country's citizens is in Lie domain of sovereign governments to be exercised in the interests of their national development.
3. We recognise that the benefits of resource extraction occur as revenue streams over many years and can be highly price dependent.

(continued)

4. We recognise that a public understanding of government revenues and expenditure over time could help public debate and inform choice of appropriate and realistic options for sustainable development.
5. We underline the importance of transparency by governments and companies in the extractive industries and the need to enhance public financial management and accountability.
6. We recognise that achievement of greater transparency must be set in the context of respect for contracts and laws.
7. We recognise the enhanced environment for domestic and foreign direct investment that financial transparency may bring.
8. We believe in the principle and practice of accountability by government to all citizens for the stewardship of revenue streams and public expenditure.
9. We are committed to encouraging high standards of transparency and accountability in public life, government operations and in business.
10. We believe that a broadly consistent and workable approach to the disclosure of payments and revenues is required, which is simple to undertake and to use.
11. We believe that payments' disclosure in a given country should involve all extractive industry companies operating in that country.
12. In seeking solutions, we believe that all stakeholders have important and relevant contributions to make – including governments and their agencies, extractive industry companies, service companies, multilateral organisations, financial organisations, investors, and non-governmental organisations.

The EITI worked toward improving transparency in government budget practices as well as empowering ordinary citizens to hold their governments to account for the use of the revenues (refer to boxed text below for the EITI Principles). The main objective was to assure country ownership of the initiative. Given his political agenda of good governance and his keenness to secure relief for Nigeria's staggering $30 billion external debt, President Obasanja was one of the first leaders to support the initiative. The Nigerians set up a country-specific, Nigerian Extractive Industries Transparency Initiative (NEITI) in February 2004.

On January 1, 2005, Basil Omiyl was the first Nigerian managing director appointed to SPDC. Up to then, the post had been filled by expatriate staff. Corner commented:

> We gained a lot of credibility with this appointment amongst our senior stakeholders. Somehow a Nigerian managing director had more leeway to openly state that the federal and state government should be more accountable to communities.

Nigeria set up two statutory bodies with powers to investigate and prosecute corruption-related crimes. By 2006, the finance minister, Ngozi Okonjo-Iweala, a former World Bank vice president and corporate secretary, was making valiant efforts to model Nigerian practice on the World Bank's integrity unit. She pushed three new corruption-related laws and set up institutions for budget control, public procurement and oil and gas transparency. British government experts praised Nigeria for going further than any other country in terms of disaggregating payments and tracing production volumes and procurement practices. From the beginning of 2004, Okonjo-Iweala started researching and recording allocations of revenue paid since 1999 to the federal government, the 36 states of Nigeria and the national capital of Abuja, and to local government authorities in each state. SPDC assisted in the process. But Detheridge had a concern:

> In civil society in Nigeria, there is no track record of holding publicly elected officials accountable. It is good to publish the numbers, but government capacity building is needed to enable these to be presented in an understandable way to citizens. The same is true for civil society so that they can make use of the information that they receive.

When the figures were published, it was clear that the four main oil-producing states in the Delta received more revenues than other Nigerian states. In the first 10 months of 2005, for example, Lagos (not a Delta state but with a population of 10.6 million) received $200 million in revenues from the federal government. By contrast Delta states Rivers (pop. 5.7 million), Bayelsa (pop. 2 million) and Delta (pop. 4.2 million) received $790 million, $710 million and $570 million respectively. In total, the federal government allocated $6.8 billion to the 36 states in Nigeria. Nearly 35% of that amount went to the four major oil-producing states of the Delta (refer to Fig. 9.3 for the federal government's revenue allocation to states from 2001 to 2005).

Partly because of moves on the transparency initiative, Nigeria was granted $18 billion debt relief by international creditors and, from being bottom of the rankings of Transparency International's corruption index in 2000, Nigeria improved marginally by 2005 to sixth among the eight worst countries (out of 159).

In 2005 a British company, Hart Nurse Group, was asked by the NEITI to audit the accounts of payments made by the oil companies against government-reported revenue for the period 1999/2004. A three-volume report was produced in April 2006 with breakdowns of payments made by each company. The audit was only partial in that the auditors did not have a mandate to look at the destination of funds once deposited in the Central Bank, and did not address the controversial issue of oil block licensing rounds and how contracts were awarded. A National Planning Commission survey of the state governments revealed significant shortcomings in accounts maintenance, controls against payroll fraud, fiscal management, service delivery and procurement procedures in general. Few States had any level of transparency. Moreover, the federal government was not in a position to insist on such transparency as the Nigerian constitution stipulated the autonomy of the states on

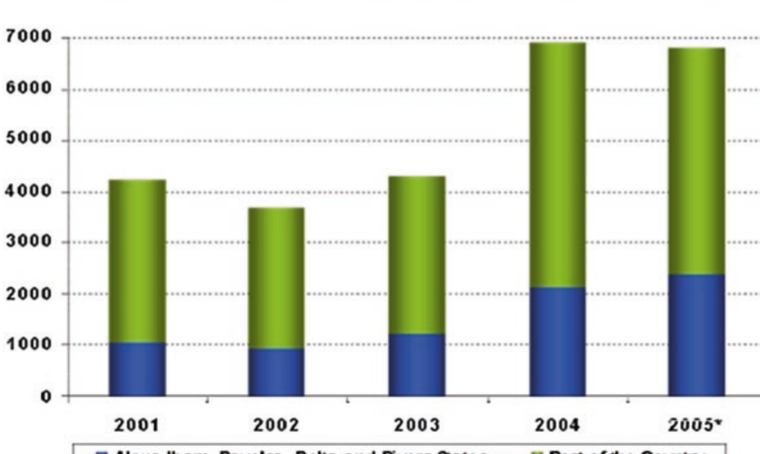

Fig. 9.3 The federal government's revenue allocation to states

matters such as revenue management. Olav Ljosne, regional external affairs manager for Africa (based in Nigeria), explained:

> The intention of the constitution is to prevent federal interference in state affairs. Only the state legislative, not even the president, has power to call state governors to account for moneys given to them.

Under the military dictatorships, control was centralized. Under civil rule, the states had considerably more power and autonomy. The Delta State's economic power was greatly strengthened by its 13% share of the federal government's revenues from oil. This did not stop its governors from campaigning at the July 2005 constitutional conference and elsewhere for an even greater percentage while diverting attention from the accountability issue that was also on the agenda.

Changing the Legacy: Shell's Next Steps

Back in 2006, Detheridge and Udofia realized that, given the complexity of Nigerian human rights challenges, a longer-than-usual series of briefing sessions with their successors would be necessary. They had to describe the learning process that Shell had gone through. Udofia's view was that Shell was at a "make it or break it" point. Where did a private company's role begin and end and where did the governments' begin – how far could Shell go with the values it espoused without exceeding its remit? What else needed to be done on the governance and transparency agenda? And crucially, what other longer term partnership initiatives, like EITI were needed?

While discussing this, they wondered what their best advice might be for Shell's next steps. They prepared an agenda for the upcoming session.

Analysis: Shell's Learning

Company Learning

Decision-making executives at Shell have learnt a great deal from the company's less successful and more reactive approaches of the past and clearly now encourage and promote proactive stakeholder-engaging attitudes that lead to more positive outcomes. Although stakeholders continue to criticize Shell for lacking a principled approach in the Niger Delta and for being slow to recognize and be vocal about ongoing corruption issues, progress has been made. Many suggested that Shell should have become more active in terms of its full social responsibility role much sooner, for example, by publicly objecting to the Ogoni executions. Although we are many years later, institutional learning from the past on such delicate issues is essential. It is important that the learning in Nigeria becomes integrated as part of Shell's corporate "DNA" This is a robust way of maintaining momentum and corporate readiness on such complex and sometimes "fuzzy" issues.

Strategy Development

Considering that Shell has now gathered some invaluable learning from mistakes made in the past, there is a real opportunity to put this into practice. However, the learning from issue management should also lead to fundamental changes in strategy, and not only contribute to risk management. Changes in Shell's actions over the last decade in particular illustrate the results of a much more reflective process where strategy and stakeholder engagement is concerned. Examples are:

– Shift from charity programs in local communities to community development activities.
– The company is more engaged, responsible and responsive.
– Shift to publishing financial figures and providing transparency on where Shell money goes.
– Promotion of a native Nigerian as head of SDPC.

Cohesive Focus

It is – still today – important that the focus on fighting corruption does not take away from other efforts on human rights issues in the field. While Shell is still trying hard to address the root problems, the situation in the Niger Delta has evolved to become even more dangerous, particularly for employees at risk of being kidnapped.

Increasing communication is a solution that the company has fully adopted, while continuing to push transparency to the utmost. However, one problem might be that some of the main actors, such as local communities and the "war lords," are not actually part of the "coalition" around the transparency issues. Power in the Delta has become increasingly fragmented, and the situation, over the past few years has gained, not reduced, in complexity. Any new actor in this scenario will find it exceedingly difficult to get to grips with this complexity, which cannot be underestimated. Continuing operations in such environments is difficult and sometimes opportunities for influencing the situation are limited. The key lies in applying that limited influence in the right way.

Stay or Go?

In the context of "risk mitigation," retaining a presence in Nigeria would still be the best option for Shell rather than considering moving out of Nigeria. Apart from the fact that the Nigerian operations are part of Shell's core business (making it difficult to withdraw from that point of view alone), Shell has over time become a much more responsible player in the Delta. Should the company withdraw, it risks being replaced by another player with much less experience in the area, which could potentially escalate the already tense situation there. It takes years to develop successful working relations with government authorities in developing countries with tenuous political situations. The company has realized that its own social initiatives/programs, while an important demonstration of its goodwill, are merely a drop in the ocean in light of the endemic corruption and the resulting continuing poverty of the population. In spite of the ongoing tensions and challenges, Shell now appears to be headed in the right direction, pushing transparency initiatives and giving the population/voters information on the basis of which they can hold politicians/civil servants accountable.

The SWOT of Shell's Position in Nigeria

Strengths and Opportunities

Shell's Experience

Shell has had long and valuable experience in Nigeria. It has gained influence as one of the government's key partners and can lead state players to better performance in oil production through special management solutions. Shell has strengthened its corporate social responsibility strategy since it first got involved in the Delta and has become a global leader in human rights/corruption issues. It has strengthened its image in communities by giving more thought to the most appropriate (or effective) social programs. It thus has increased its ability and scope to apply pressure on the government. Nigeria needs Shell's know-how and technology, and the company has complemented this with development expertise and more coherent management

systems. However, increasingly powerful Chinese/Indian companies are only too willing to step in and replace established multinational majors in the Delta, given the chance. We suggest that this would be detrimental to the tenuous situation in the Niger Delta, since an acute awareness of the complexities of working in the area and knowledge of "the playing field" are required if an even more difficult situation is to be avoided. Shell can still make a real business case for staying in the country and over the long term, Shell can invest in creating a more stable, sustainable operating environment.

Extractive Industries Transparency Initiative

International awareness of the issues of human rights and corruption is greater than ever (contributing factors are attention from the World Bank, IBLF – the International Business Leaders Forum, Transparency International, UN initiatives and the creation of the Voluntary Principles on Human Rights and Security[5] and so on). From a relatively weak earlier position as described in the case, Shell has now moved, particularly over the last decade – through the EITI – to a much stronger position. The EITI gives an opportunity to "play by the book." Also, in many ways, "a problem shared is a problem halved" – the involvement of other stakeholders serves to support Shell's moves in the Niger Delta and makes it more difficult for media and NGO players to paint the company in an entirely bad light. The EITI has demonstrated Shell's goodwill in entering into a positive dialogue with the government and other players on issues related to corruption with a commitment to transparency. In short, Shell is leading by example by being an honest corporation and good corporate citizen.

Corporate Influence: "He Who Pays the Piper…."

There is no doubt that the revenue that Shell provides to the government through the production of oil protects its position. The company is a major player and is listened to since it has the ear of Western governments to which it can provide good connections. Over time the company has come to recognize the importance of MNCs being outspoken about the need to recognize human rights issues and proactively promote anti-corruption efforts. Along with its expertise/credibility in the oil business, all of these factors will ensure that Shell's reputation will be more protected, not less. The decision to employ a local national to head up Shell's Nigerian company went a long way toward increasing Shell's credibility in Nigeria and in the outside world.

[5] See www.voluntaryprinciples.org: The Voluntary Principles on Security and Human Rights were created by governments of the United States, the United Kingdom, the Netherlands and Norway; companies in the extractive and energy sectors; and NGOs (all with an interest in human rights and corporate social responsibility) to guide companies in maintaining the safety and security of their operations within an operating framework that ensures respect for human rights and fundamental freedoms.

Weaknesses and Threats

Relationship with Government

Shell's dependence on government decision- making could, unless managed judiciously, make it a "hostage" of the government. The company is a foreign presence in Nigeria, operating as a "guest" in the country, and it has limited influence on many political levels, some of them extremely subtle. The same is true for many extraction industries. However, as mentioned above, the establishment of EITI is helping Shell to counteract the effects of earlier overdependence and inability to speak out forcefully on some issues. The company is still dependent on the government for the security of its personnel, which still constitutes a risk given past history and the continuing tense situation in the Niger Delta.

Threats to Reputation

Although the EITI has helped Shell to overcome its previously negative image in Nigeria, the company is still not always perceived as a "good citizen" by NGOs or the press. Countering the effect of this on public opinion requires a long-term effort. Rightly or wrongly, larger branded companies are constantly being attacked by NGOs that have a lot to gain from the exposure this brings to the sustainability issues they campaign for. Shell must be prepared to be under scrutiny for a long time to come. In addition, Shell represents an industry that is itself under increasing scrutiny because of climate change; media coverage is likely to continue to focus on the oil majors, thus potentially exposing any other visible issues. The boundaries of sustainability issues, therefore, may well overlap. In addition, the involvement in the EITI leaves Shell with little scope for error. Having such a strong role means that the company would lose considerable credibility if it were implicated in another scandal.

Ongoing Conflict

Nigeria is subject to ongoing political, social and economic instability. The situation in the Niger Delta is becoming even more tense, with increasingly serious breaches of the law through kidnapping and so on. There may come a stage when operating in the area will have to be seriously reviewed for security and safety reasons. There is already considerable risk to Shell employees and their families during an ongoing vicious cycle of kidnapping. The "tipping point" may be reached sooner rather than later as sabotage of installations and critical kidnapping incidents increase.

Economic Situation

Nigeria is one of the poorest countries in the world. Shell represents a capital-intensive industry that can only benefit a small number of people directly (employees). This is bound to continue to create tension in the areas affected and is exacerbated by the corruption of the feedback system, which might otherwise ensure that some wealth reaches the areas in a more indirect way. The business model is currently still not in line with public perception and, unless remedied, this will lead to a gradual loss of the license to operate in the Niger Delta area.

Cultural Divide

The cultural gaps between Shell (with a heavy expatriate weighting) and local cultures are difficult to overcome. However, by employing a local Nigerian as the CEO of Shell Nigeria, the company took an important step in the right direction. Shell's expatriate presence has been reducing over time.

Multinational Corporation Role

Some of Shell's actions may be perceived as a multinational acting in place of government. Many would question whether this is a role that an MNC should take on in Nigeria. The limits of Shell's role need constant attention and should be continuously reviewed. For example, the potency of the GmoU for sustainable development is hampered by a number of challenges such as the enormity and complexity of the development challenge in the Delta thrown up by the failings of an absentee state, the structural constraints imposed on corporations by the profit-maximizing motive and cultural factors that not only prevent effective participation but also promote disempowerment of marginalized groups such as women.

Recruitment/Retention of Qualified Personnel/Management

Given the risks to personnel in the Delta, Shell may experience increasing problems in getting qualified personnel willing to live and work there.

Political Situation

The smooth handover of government in a democratic election had as yet never happened in Nigeria. The background to the country's leadership had been fraught with conflict and violent incidents. There is no guarantee that the government's anti-corruption focus would be continued by any new incumbent, even though the

Nigerian government would lose considerable credibility by making an "about turn" (however, the history of conflict in Africa has meant that this is not always the most important criterion).

Sustainability of Oil

The fact that Shell is exploiting a non-renewable resource will remain an underlying and constant weakness of its business model, since the concept of exploiting the commodity will constantly be under attack.

Axes of Action Available to Shell

Shell's Position on Human Rights

Shell has to continue to make sure that it is not in any way complicit in the violation of human rights. This engages the company in being more vocal and adopting a rights-based approach. Conducting an ongoing human rights analysis of Shell's current situation in the Delta is pertinent and advisable.

Maintain Leadership Position in Transparency

Through a continuous improvement process and multi-stakeholder dialogue, Shell should be able to reach a position of complete transparency regarding its operations and wealth generated for Nigeria from activities in the Delta. Ensuring that Nigerian citizens (and particularly those from the Niger Delta) benefit from the EITI is a major focus of its activities. The company is involved in developing local awareness about revenue flows and thus the capacity of citizen groups to hold local (and federal) authorities accountable for oil revenue. The company can also support the Nigerian government in strengthening the judiciary system.

Act Local

Shell should continue to judiciously support local activities. Apart from a focus on money streams, there also needs to be more transparency on how to deal with problems at site, with communities. This will help the company to develop skills for dealing with the upcoming conflicts of Nigerian society. There may also be scope for being more ambitious on the local level by emulating already successful business models that, for example, provide micro-finance to women to help them own

and run small enterprises (such as those funded by the Grameen Bank[6]). This would help switch the political focus to bolstering the economy in other ways (rather than relying on oil wealth) and to diversifying industries.

Use Other Stakeholders to Support Action

Given its past history in the Niger Delta, Shell has become adept at handling media attention on the issues that have constantly come up in the Delta. Over the past 10 years, there have been opportunities to use the media in a more proactive and positive way – to advertise and broadcast efforts being made to render Nigeria corruption-free.

Engage in Stakeholder Dialogue

Shell has evolved to think of itself as "just one other stakeholder" in the Niger Delta. The company could also use other (global) organizations (for example, the World Bank and the IMF) to help improve government practices/transparency. Shell could also partner with other entities (e.g. governments such as the US and UK which have substantial influence on mobilizing the Nigerian government) and NGOs (such as Transparency International). Relationships with NGOs could help clarify and identify future issues, therefore allowing companies to be closer to the ground in understanding the issues, and help protect the license to operate by obtaining the buy-in of local communities. NGOs can also help with the implementation of projects. Collaboration brings corporate financial and managerial resources together with local knowledge of NGOs – a powerful combination. Also, because of their local knowledge, NGOs can sometimes implement aspects of a project more quickly and cheaply than a corporation. Another benefit of working with NGOs is that it can give the corporation more credibility and build trust with communities. Association with an organization that is considered – in the communities' eyes – more credible than a company will help identify common ground on which to operate. In addition, NGOs have the advantage that they are able – even expected – to speak more openly about social and environmental issues than a company.

Indeed, Shell has become a conduit for bringing stakeholders together such as militias and local communities, and federal and state governments. The company can identify local leaders to work with (sometimes behind the scenes), other African

[6]The **Grameen Bank** is a microfinance organization and community development bank initiated in Bangladesh. It makes small loans (called micro-credit) to the poor to allow them to set up small businesses, e.g. weaving, pottery, storage and transportation services, without having to put up collateral. The bank also accepts deposits, provides other services, and runs several development-oriented businesses including fabric, telephone and energy companies. The organization and its founder, Muhammad Yunus, were jointly awarded the Nobel Peace Prize in 2006.

leaders/countries (through the African Union[7] for example) and other industry partners. Such action would support the Nigerian government's efforts to fulfill its role regarding human rights. Is to help build bridges with religious leaders, usually much respected by politicians and local populations alike. Moreover, Shell could facilitate dialogue with other oil-producing developing countries. In other words, the company could form a coalition of stakeholders to bring about change. Shell's advantage is that it has the convening power to bring these parties together to discuss/analyze problems and work on solutions. Shell arguably has still not done enough to exert its influence. Now is the time to exert that influence.

Moving forward, apart from keeping production going as a business goal, the priorities could continue to be general local development, continuing to "do the right thing" through reconciliation and engagement with communities, NGOs and media, while aiming for clarity – and asking what are the limits to Shell's responsibility/accountability? Shell could be a real catalyst for change in getting government to take on its role of developing the Nigerian economy and providing for basic human needs. The direct impact of Shell's efforts will remain limited, but indirect impacts in terms of multiplying effects could be substantial. Encouraging government to do things well in the medium to long term will be better for the country and population overall.

Epilogue: Ten Years Later……

Shell's Role and Direction in the Niger Delta in 2015

Since 2006 and up to the time of writing, SPDC had greatly improved on how it engages with local communities to deliver its social projects. Firstly, in 2006 a local national was appointed as Managing Director of the SPDC and this eased the way to better relations with stakeholders overall. In the course of 2006, the company introduced a new framework for working with communities called the Global Memorandum of Understanding (GMoU). This was an extremely important shift in approach, since it placed more emphasis on transparent, accountable processes, regular communications with the grassroots, sustainability and conflict prevention.

A GMoU is an agreement between SPDC and a group (termed "cluster") of several communities. Clusters are based on local government or clan/historical affinity lines defined in consultation with the relevant state government. The GMoU brings communities together with representatives of state and local governments, SPDC and non-profit organizations, such as development NGOs, in a decision-making committee called the Cluster Development Board (CDB). Under the terms of the GMoUs, the communities decide the development they want while SPDC – on behalf of its joint venture partners – provides secure funding for 5 years, ensuring

[7] The African Union (AU) consists of 53 African states. Its aim is to contribute to securing Africa's democracy, human rights and sustainable economies for its members, especially by bringing an end to intra-African conflict and creating an effective common market.

that the communities have stable and reliable finances as they undertake the implementation of their community development plans.

The advantage of the GMoUs is that they promote better ownership and a strong sense of pride amongst communities since they are responsible for implementing their projects. They are also a robust platform for additional local or international donors to fund development projects directly through the Cluster Development Boards (CBDs). They are popular with communities, since ownership in its turn promotes better projects, increasing sustainability and trust.

Every aspect of each GMoU is implemented in partnerships with communities and also a number – sometimes up to a dozen – facilitating non-profit organizations that handle sensitization and communication of the GMoU model to the communities while also developing the capacity of CDB members to handle community development processes.

They also ensure quality delivery of the GMoU projects and programs. By end of 2012, for example, SPDC had signed agreements with some 33 GMoU clusters, covering 349 communities, which represents some 35% of the local communities around business operations in the delta. In 2012, a total of 723 projects were successfully completed, and total funding for these projects amounted to over US$117 million in 2012 alone. Furthermore, some of the 33 CDBs had grown into registered foundations receiving third party funding.

Notwithstanding these positive developments on stakeholder management and dialogue, Shell, as a high profile international company with the tumultuous track record it has in the Niger Delta, continued to attract the ire of international NGOs. In January 2015, for example, some 15,600 Ogoni farmers and fishermen were awarded some £2,000 each as part of a £55 million pollution charge to Shell because of pollution caused by two oil spills in 2008 and 2009. Communities were given millions each to build health clinics and refurbish schools. While this would help to alleviate the sharp end of poverty in the Delta, issues around damage to the environment providing the wherewithal for people to live and make a living (fishing, farming), will not be resolved quickly. The company has traditionally claimed that most of the oil pollution is due to sabotage by rebels and others that tap into pipelines illegally. Court documents used during the proceedings showed that the company was aware of corroded installations and equipment faults as a significant risk factor. Organizations such as Amnesty International accuse Shell of evading its responsibilities and of clouding the facts. Whatever the reality is, there is increasing pressure on the company to be more transparent and to generally take more responsibility for past and future contamination of the Delta.

Moreover, in …., Shell took a decision to dissolve its centralized sustainability function at its corporate headquarters in London. One executive presented appoint of view on the impact:

> We were fortunate that Shell CEOs Mark Moody Stuart and then later Phil Watts saw value in profiling sustainability quite highly. However, since their time, successive CEOs did not necessarily see the same value in strategic sustainability. Maybe dismemberment of the sustainability function happened too soon and went too deep. When a new CEO comes on board, he or she will question if this or that activity is worthwhile. Often it depends on how

well an argument is articulated to them by senior executives. The closing of the sustainability function left a gap in that respect. What you want to do is have sustainability in the hearts and minds of every employee first. Only then does devolving make any sense. Granted, having a large sustainability organization at the head office is ultimately not the way to go. Mainstreaming is necessary. However, if you dismantle thought leadership at head office level, then the senior leadership is not challenged enough on these issues. Business managers have a lot to attend to not least falling oil prices. Sustainability issues may tend to go to the bottom of the pile. Maybe this does not matter now, but if there is a scandal, it certainly will matter!"

Nigeria and the NNPC in 2015

Despite expansion in services, consumer industries and agriculture over the last 10–15 years, in 2015 Nigeria still depended on oil for in excess of two thirds of state revenues and virtually all of its export earnings. Nigeria's National Petroleum Corporation – the state oil company – continued to evolve in a web of patronage and allegations of criminality, allegedly setting up complex deals that opened up the way to fraud in fuel subsidy allocations and contracts, amounting to perhaps up to US$1 billion a month in national revenues from sales. In 2014 PwC called for the company to be urgently restructured after its audit revealed that billions of dollars were unaccounted for in its 2012 and 2013 accounts. According to a Financial Times article in mid-2015, the NNPC had amassed billions in dollars in debts to its joint venture partners (including Shell). The fact that government controls the oil through NNPC is preventing Nigeria from reaching its full potential of production of four million barrels a day of oil (almost double current output). Refineries in Nigeria are non-existent and paradoxically, the country has to import most of its own fuel.

Crude oil production in 2015 was in fact declining, and pipelines were still vulnerable to oil thieves, who were stealing about 232,000 barrels every day, costing the State further billions. The practices of "bunkering" – the trade in stolen oil – that became common in the early years of the new Millennium, has escalated. Satellite imagery reveals that artisanal refining has also increased across the Delta in the period 2008–2013 on an industrial scale. In addition, many independent, parliamentary and government sponsored investigations have found that revenues from oil sales are continuing to be siphoned off at epic levels.

In 2009, Nigeria's then-President Umaru Musa Yar'Adua had offered an amnesty deal to thousands of militants, whose vandalism, theft and attacks in six states in the Niger Delta region had cost Nigeria a third of its oil production. The Movement for the Emancipation of the Niger Delta rebels agreed to lay down their arms in return for an unconditional pardon and stipend. This was upheld by successive presidents since; in 2015, Nigeria's new president Muhammadu Buhari renewed the commitment to maintain the amnesty.

In July 2015, the NNPC banned more than 100 tankers from Nigeria's waters, under a directive from Nigeria's new president Muhammadu Buhari who is focused on tracing the large sums of money resulting from stolen oil sales. To reduce impact on its markets, companies – including Shell – asked ship owners exporting their Nigerian oil to sign off

on a “Letter of Comfort” (LoC) guaranteeing that their loads were not stolen and promising to indemnify the NNPC against illicit use of their vessel.

We can therefore deduce from recent events in 2015, that the challenges of oil exploitation in the Niger Delta and the barriers to transparency of the system as a whole are far from over.

The Extractive Industries Transparency Initiative in 2015

In terms of the case story, the EITI had just started out on its long journey, a journey that continues today. Now, 10 years later, the initiative has exceeded all expectations in terms of numbers of member companies (there are currently 48). The initiative successfully promotes multi-stakeholder dialogue on a high level and this in itself is a major contribution to resolving some of the very complex issues it is set up to address.

Two crucial questions can be asked. First, in what depth and detail should information about monetary flows be made public? Should it go right down to project level? Nigeria still produces EITI reports that disclose revenues from the extraction of its natural resources. Joint venture partners (companies such as Shell and Exxon) disclose what they have paid in taxes and other payments and the government discloses what it has received. These two sets of figures are compared and reconciled. The Nigerian government also publishes amounts being paid to Nigerian States. EITI still settles for country level transparency, but has now set up a task force to look closely at other levels of transparency i.e. state and project level. Secondly, and more fundamentally, what exactly should be disclosed? For example, should each company’s contribution be accounted for separately?

In the end of the day, there is a major unanswered dilemma: Does it make sense to have a transparency initiative at all if parts of the system remain non-transparent? Whilst the EITI is dealing with very important issues of transparency and accountability in revenue flows related to extractive industries, it is unlikely that resolving this issue alone will solve the fundamental social, environmental and economic problems of countries like Nigeria.

Ziqitza Health Care Limited: Responding to Corruption

10

Robert J. Crawford and N. Craig Smith

Introduction

After a monthly staff meeting, a young employee approached Sweta Mangal, CEO of Ziqitza Health Care Limited (ZHL). Sanjay Rafati[1] had been hired as a financial officer the previous month, in November 2011. In view of the company's strict ethical code, he was nervous about expressing his point of view, which was why he wanted to see Ms. Mangal in private:

> *The situation in one of the states where ZHL operates is getting critical. Unless the government pays what it owes us immediately, we will not be able to make payroll. We won't be able to service our new ambulances, which will open us up to more accusations of negligence. Lives may be lost. This will devastate our morale and ruin our reputation. That bureaucrat will never stop.*

Although Rafati had refrained from stating it directly, she understood that he wanted her to bribe a recalcitrant official.

This particular state had been a thorn in her side for 2 years. While the timeliness of payment varied from state to state, a delay of this length from a state government was extremely rare. The predecessor of "that bureaucrat" had asked her to fly there, only to cancel the meeting after she had arrived – a scenario that had played out no fewer than seven times. "He wanted us to bribe him," she explained, "and we refused. He also didn't like the fact that I, a woman, lost my temper and told him off."

Under the terms of the public-private partnership finally established with this state under a new official in July 2010, ZHL planned to have a total of 464

[1] Certain names have been changed for the purposes of this case. Unless otherwise noted, source material comes from interviews with ZHL employees or representatives.

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G. G. Lenssen, N. C. Smith (eds.), *Managing Sustainable Business*,
https://doi.org/10.1007/978-94-024-1144-7_10

ambulances, essentially doubling its ambulance fleet. This represented a major investment. Now, the new state official was using the financial commitment ZHL had already made to the state to up the pressure for a bribe, as she explained:

> *Whenever we submitted invoices, they would send us a series of queries. We would answer them and then they would raise a new set of queries. This followed a couple of times and the concerned person used to ask for a bribe in a roundabout manner, but we ignored the same. Then finally in Fall 2010, he asked directly: 'If you arrange to pay me 5 % of the invoice value, things will work out.' When we raised the issue with his superiors, they asked us to put the claim in writing. We did, but nothing changed, rather things worsened.*

The cycle, she feared, was never-ending.

The financial calculation, she knew, was compelling: for a bribe of 5% of the total due to ZHL, the entire payment would be made on time. Hundreds of thousands of rupees were in play.[2] While legal adjudication of such issues was theoretically becoming available through a civil court, it could take years to reach a decision; even the way of functioning of the new court was yet to be established. ZHL needed the money now. It couldn't run a business where one of its largest customers was not paying its bills. The only alternative was a loan at 15% interest – triple the cost of the bribe. But how sustainable would this be in the long term?

Ms. Mangal spoke quietly, looking into Rafati's anxious eyes: "You know that we cannot – ever – offer a bribe. That would violate our most fundamental commitment to ethics and transparency." Yes, she acknowledged, most Indian companies would have paid the bribe, but ZHL was changing Indian society, and it was part of a movement that was gaining momentum. "This is who we are," she insisted. "Be patient and contact the bank."

With that, she returned to her office, now worried that Rafati might resign.

Background

With a population of over 1.2 billion, India was the world's largest democracy, with a 2011 (est.) GDP of $1.676 trillion.[3] It ranked 95th on the Transparency International Corruption Perceptions Index in 2011, behind Albania, Rwanda and Columbia (see Exhibit 10.1). According to Transparency International, $US19 billion in illicit payments were transferred outside the country each year. To receive basic services such as a telephone, a water supply or a driver's licence, 54% of households expected to pay a bribe in any 12-month period.[4] India's bloated and inefficient bureaucracy routinely solicited bribes and extorted payments from businesses just to maintain their everyday operations. On average, it took over 1000 days for a contract to become recognized as legally binding. Many petty bureaucrats regarded these payoffs as a supplement to their meager incomes, which barely kept pace with the cost

[2] 1000 INR = $22.54 = 16.21€ (October 2010).

[3] https://www.cia.gov/library/publications/the-world-factbook/geos/in.html

[4] http://www.transparency.org/news_room/in_focus/2011/india_speaking_up_for_integrity

of living. Over 25% of all Indian politicians, it was reported, were under investigation for corrupt practices. Corruption was so much a part of the economic and social fabric that many doubted it would ever be rooted out – it was just part of the cost of doing business which no one questioned or challenged.[5]

Nonetheless, a movement of Indian citizens had begun to chip away at the problem. Not only were grassroots protests gaining international recognition – including a series of hunger strikes by anti-corruption activist Anna Hazare – but citizens and companies were increasingly using legal channels to further their demands. In polls, 75% of respondents indicated that they would support anti-corruption activities.[6] A notable initiative, "Integrity Pacts", required signatories to refrain from bribery or collusion in their dealings with public bodies. It was one of many underway.[7] Another resource was the website ipaidabribe.com, which offered information on bribes and corruption as well as a reporting mechanism to publicly document the circumstances in which a bribe was solicited or paid.[8]

ZHL

Founded in 2002 with a single ambulance, ZHL was created to respond to a pressing social need: the lack of a consistently high-quality ambulance service in India. Emergency forms of transport were available from an unwieldy combination of private companies, government bodies, non-governmental organizations and charitable groups. As a result, the death toll in India from acute illnesses, accidents and natural disasters was unusually high.

ZHL's founders – Ravi Krishna, Naresh Jain, Manish Sancheti, Sweta Mangal and Shaffi Mather – had left highly-paid private sector jobs in the US and India in order to become social entrepreneurs in health provision (see Exhibit 10.2). ZHL's founders were committed to creating a new kind of organization for India, and indeed for the developing world. According to the ZHL website[9]:

> *The name Ziqitza was derived from the Sanskrit word 'chikitsa', meaning medical treatment, and 'zigyasa', meaning quest for knowledge. Even our brand philosophy is based on the thought of Mahatma Gandhi that "Saving a life is one of the most rewarding experiences a person can undergo in his/her lifetime.*

They chose to focus on ambulance services largely because of a personal experience in founder Shaffi Mather's family: his mother had woken in the middle of the night, choking, and he had not known what to do or who to call for help. She had survived, but he was shaken. Fellow-founder Ravi Krishna was able to obtain

[5] Ashutosh Misra, http://blog.transparency.org/2012/02/13/indias-state-companies-open-up/

[6] Ishaan Thoaroor, "Anna Hazare's Hunger Fasts Rock India," Time, 7 December 2011.

[7] Mishra, op. cit.

[8] http://ipaidabribe.com/

[9] http://zhl.org.in/aboutus.html

emergency care for his mother within minutes of her collapsing in Manhattan during one of their US visits. The difference, they realized, was the 911 Emergency Medical Services (EMS) there.

They first came up with a model for the company based on Krishna's experience with 911. Services would include basic and advanced life support, administered by paramedics, and transportation to hospital for both non-emergency and accident/disaster victims. Needs were acute and growing, not least given India's unusually high rates of road accidents (16 per 1000 vehicles, compared to a world average of 0.75 per 1000), diabetes, cardiovascular disease, and disasters both natural and man-made. Of accidents of fatal consequence, 20% occurred at the site of the accident due to injuries, 30% of fatalities were due to transportation delays, and 50% died in hospital due to infection or systems failure.[10]

Unlike other service providers, ZHL's business model would combine profit making with social goals. On the one hand, it would offer a "private pay" ambulance service based on a sliding scale, depending on ability to pay and the type of hospital (private/government) to which patients went. Approximately 20% of patients would receive subsidized rates. On the other hand, in public-private partnerships with state governments, a generally free-of-charge service would be made available to anyone in need. The goal was to begin with services in Mumbai and gradually expand to all of India. In accordance with the founders' vision, the company would be accessible to all regardless of income, made financially sustainable by its work, and provide a model of a world-class ambulance service for the developing world. An additional source of revenue would be advertising on the ambulances themselves.[11] (See Exhibits 10.3, 10.4 and 10.5).

In a departure from standard practice in India, ZHL's founders pledged to categorically refuse to engage in bribery and other corrupt practices, opting instead for complete transparency. Corruption, in their view, had a symbiotic relationship with poverty, perpetuating exploitive practices and undermining fundamental societal values. Not only would this position form an integral part of the ZHL brand, it should underpin the everyday decisions of all its employees. Knowing this would be extremely challenging, the founders took the unprecedented step of setting up an in-house legal team, an expensive but essential initiative.

Growing Pains and Gains

From the start, ZHL encountered the traditional difficulties related to corruption. When the founders wanted to acquire an easy-to-remember four-digit phone number for an emergency service (1299), a bureaucrat demanded a bribe. Their categorical refusal surprised him but they could not get him to budge. Eventually, they chose the less memorable 1298 for their dial-in pay service. It was to become the identifying brand name of the company. In addition, the 108 dial-in service would serve for

[10] ZHL Ppt. presentation.

[11] *Ibid*.

public-private partnerships in which ZHL cooperated in an official capacity with the state authorities (as in Rafati's "problematic" state). Technical expertise and training was provided by the London Ambulance Service, a strategic partner and the largest metropolitan emergency ambulance service in the world to provide an Emergency Medical Service that was free to patients at the time they received it.

Once the company was up and running, the emergency services concept proved popular in Mumbai. From 2005 to 2007, ZHL added 22 ambulances to its fleet, answering the needs of over 43,000 patients under the Dial 1298 for Ambulance model. The revenue model worked well, attracting international investors for the first time.[12] However, corruption issues persisted with the government, as Sweta Mangal explained:

> *They accuse us of providing bad services, and then ask for payment to 'mitigate' the problem…We refuse to take this route… Word of our reputation travels by mouth. We serve as an example that a company can operate corruption-free.*

Even more important, she and the other leaders at the company held regular meetings to explain what they were doing and why to ZHL employees. "We continually work to create an ethical corporate culture. Employees believe in our values. Job candidates even seek us out because of them," she said. While ZHL paid relatively competitive salaries, she emphasized, that was not the only reason that their employees wanted to work there.

Thanks to its reputation for competence as well as incorruptibility, ZHL gained the attention of the Acumen Fund, an investment group which was attempting to steer a middle way between dependency-creating charities and market solutions that often ignored "bottom of the pyramid" business models. It sought to enable social entrepreneurs to challenge traditional development paradigms. As a "patient" or "philanthropic" capital investment group, Acumen's hallmarks included:

- Long-term horizons
- Tolerance for risk
- An end goal of maximizing social rather than exclusively financial returns
- The provision of management support to enable innovative business models to thrive
- Flexibility regarding partnerships between governments and corporations in the service of low-income customers.[13]

After careful due diligence and discussion with the founders, the Acumen Fund agreed to make an initial investment of $US1.5 million in 2007. This set the stage for ZHL's explosive expansion, not only of its ambulance fleet in Mumbai, but for it to begin operations in other states (see Exhibit 10.6). As part of the funding deal,

[12] http://www.acumenfund.org/knowledge-center.html?document=245

[13] http://www.acumenfund.org/about-us/what-is-patient-capital.html

Acumen also provided cutting-edge support in the form of advice. It regularly sent executives to work with ZHL on location in Mumbai.

Major Player, Minor Players

ZHL's fleet of ambulances expanded rapidly from a few dozen to over 860 by the end of 2011. Meanwhile, headaches with people expecting bribes – both high officials and petty bureaucrats – multiplied concomitantly with its new responsibilities and obligations, as Ms. Mangal recalled:

> *Always looking for a payout, they found all sorts of new ways to harass us. They demanded 'a, b, and c' right away, even though they were slow to process our demands on their end, and when we delivered, they said now they needed 'd, e, and f'. It's always different and always the same. But we would never choose to go down the road of bribes or opacity.*

For example, after the Mumbai terror attacks, officials re-interpreted the law that regulated working hours and then threatened legal action against ZHL, requesting a bribe to drop the case. This led to a long and costly legal dispute.

In 2008, ZHL's founders worked relentlessly to open up state ambulance contracts to open tender and to bring transparency to the public-private partnership tenders for EMS in India. It also helped to catapult Mather and the other founders beyond the national spotlight, where they had been tirelessly advocating an end to corruption for nearly a decade, and onto the international stage, such as with a TED (Technology Entertainment Design) talk by Shaffi Mather in December 2009. Their awards included (also see Exhibit 10.7):

- Jury's Choice, Spirit of Humanity Award, by AmeriCares, 2012
- Continuity & Recovery Initiative Award in Public Interest, from BCI and KPMG, 2011
- Jaagrath Award to Dial '1298' for Ambulance, Kerala, 2011
- Excellence in Social Entrepreneurship Award from Zee TV, to Sweta Mangal, CEO, 2011
- Tata TiE Stree Shakti Award to Sweta Mangal, CEO, 2009
- 'Special Recognition' and 'Continuity & Recovery Initiative of the Year in Public Interest', from BCI and Deloitte, 2008
- Godfrey Philips Bravery Award for a Social Act of Courage, from the President of India Pratibha Patil, 2007
- Times Foundation Recognition Award for Life Saving Service, 2007

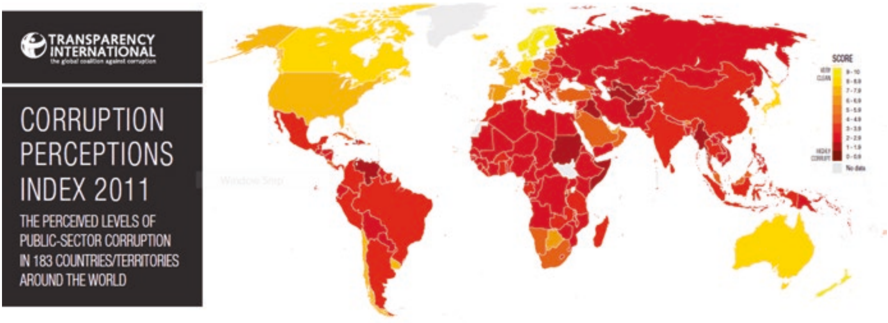
The Decision

In spite of the worried look on Sanjay Rafati's face, Sweta Mangal was resolute in her decision to refuse to bribe the official to release the payment owed to ZHL. Her response would, she believed, send the right message to her employees – it would not just maintain but reinforce ZHL's corporate culture.

For his part, Rafati was concerned that the payment delay would undermine the position he had just taken up in the ZHL office in this problematic state, as well as the nascent culture of the new office. ZHL had, he acknowledged, come very far, very fast. Perhaps it was time to compromise for the sake of receiving payment. He also knew that people had died in India fighting corruption, such as Satyendra Dubey, a project director at the National Highways Authority of India who was murdered in 2003 after exposing corruption in a highway construction project, and Shanmugam Manjunath, murdered in 2005 for sealing a petrol station selling adulterated fuel.[14]

Besides, he reasoned, paying the bribe made economic sense: he stood to save a full 10 % on the loan option, which could be used to keep people employed, to finance maintenance on the new fleet – saving money in the long run – and to retain the employees that he was hiring and training at great cost. The state official seemingly could delay payment indefinitely. Surely paying was necessary for survival if not more profitable? In the end, how much difference would such a small compromise make? Hadn't India just *fallen* on Transparency International's corruption index, from 87th to 95th – 20 places behind China which ranked 75th.

Exhibit 10.1: Graphical Representation of Transparency International Corruption Perceptions Index



[14] http://en.wikipedia.org/wiki/Satyendra_Dubey; http://en.wikipedia.org/wiki/Shanmughan_Manjunath

RANK	COUNTRY/TERRITORY	SCORE
1	New Zealand	95
2	Denmark	94
2	Finland	94
4	Sweden	93
5	Singapore	92
6	Norway	90
7	Netherlands	89
8	Australia	88
8	Switzerland	88
10	Canada	87
11	Luxembourg	85
12	Hong Kong	84
13	Iceland	83
14	Germany	80
14	Japan	80
16	Austria	78
16	Barbados	78
16	United Kingdom	78
19	Belgium	75
19	Ireland	75
21	Bahamas	73
22	Chile	72
22	Qatar	72
24	United States	71
25	France	70
25	Saint Lucia	70
25	Uruguay	70
28	United Arab Emirates	68
29	Estonia	64
30	Cyprus	63
31	Spain	62
32	Botswana	61
32	Portugal	61
32	Taiwan	61
35	Slovenia	59
36	Israel	58
36	Saint Vincent and the Grenadines	58
38	Bhutan	57
39	Malta	56
39	Puerto Rico	56
41	Cape Verde	55
41	Poland	55
43	Korea (South)	54
44	Brunei	52
44	Dominica	52
46	Bahrain	51
46	Macau	51
46	Mauritius	51
49	Rwanda	50
50	Costa Rica	48
50	Lithuania	48
50	Oman	48
50	Seychelles	48
54	Hungary	46
54	Kuwait	46
56	Jordan	45
57	Czech Republic	44
57	Namibia	44
57	Saudi Arabia	44
60	Malaysia	43
61	Cuba	42
61	Latvia	42
61	Turkey	42
64	Georgia	41
64	South Africa	41
66	Croatia	40
66	Montenegro	40
66	Slovakia	40
69	Ghana	39
69	Italy	39
69	FYR Macedonia	39
69	Samoa	39
73	Brazil	38
73	Tunisia	38
75	China	36
75	Romania	36
77	Gambia	35
77	Lesotho	35
77	Vanuatu	35
80	Colombia	34
80	El Salvador	34
80	Greece	34
80	Morocco	34
80	Peru	34
80	Thailand	34
86	Bulgaria	33
86	Jamaica	33
86	Panama	33
86	Serbia	33
86	Sri Lanka	33
91	Bosnia and Herzegovina	32
91	Liberia	32
91	Trinidad and Tobago	32
91	Zambia	32
95	Albania	31
95	India	31
95	Kiribati	31
95	Swaziland	31
95	Tonga	31
100	Argentina	30
100	Benin	30
100	Burkina Faso	30
100	Djibouti	30
100	Gabon	30
100	Indonesia	30
100	Madagascar	30
100	Malawi	30
100	Mexico	30
100	Sao Tome and Principe	30
100	Suriname	30
100	Tanzania	30
112	Algeria	29
112	Egypt	29
112	Kosovo	29
112	Moldova	29
112	Senegal	29
112	Vietnam	29
118	Bolivia	28
118	Mali	28
120	Bangladesh	27
120	Ecuador	27
120	Ethiopia	27
120	Guatemala	27
120	Iran	27
120	Kazakhstan	27
120	Mongolia	27
120	Mozambique	27
120	Solomon Islands	27
129	Armenia	26
129	Dominican Republic	26
129	Honduras	26
129	Philippines	26
129	Syria	26
134	Cameroon	25
134	Eritrea	25
134	Guyana	25
134	Lebanon	25
134	Maldives	25
134	Nicaragua	25
134	Niger	25
134	Pakistan	25
134	Sierra Leone	25
143	Azerbaijan	24
143	Belarus	24
143	Comoros	24
143	Mauritania	24
143	Nigeria	24
143	Russia	24
143	Timor-Leste	24
143	Togo	24
143	Uganda	24
152	Tajikistan	23
152	Ukraine	23
154	Central African Republic	22
154	Congo Republic	22
154	Cote d'Ivoire	22
154	Guinea-Bissau	22
154	Kenya	22
154	Laos	22
154	Nepal	22
154	Papua New Guinea	22
154	Paraguay	22
154	Zimbabwe	22
164	Cambodia	21
164	Guinea	21
164	Kyrgyzstan	21
164	Yemen	21
168	Angola	20
168	Chad	20
168	Democratic Republic of the Congo	20
168	Libya	20
172	Burundi	19
172	Equatorial Guinea	19
172	Venezuela	19
175	Haiti	18
175	Iraq	18
177	Sudan	16
177	Turkmenistan	16
177	Uzbekistan	16
180	Afghanistan	15
180	Myanmar	15
182	Korea (North)	10
182	Somalia	10

Exhibit 10.2: The Founding Team

Left to Right: Naresh Jain, Ravi Krishna, Shaffi Mather, Sweta Mandal and Manish Sancheti. (Source: Ziqitza Health Care Limited)

Exhibit 10.3: ZHL Ambulance Services

1298 Cross Subsidy Model (50+ Dial 1298 Ambulances are present in Mumbai, Bihar, Punjab & Kerala)

Ambulance Outsourcing (15+ Ambulances are operated and managed by us for reputed hospitals and organizations)

Public Private Partnership Service (800+ Dial 108 Ambulances in Bihar, Kerala, Rajasthan, & Punjab)

Source: Ziqitza Health Care Limited

Exhibit 10.4: ZHL 1298 Business Model

Dial 1298 Cross Subsidy Model depends on two revenue modes:

- User Fee: Wherein people who go to private hospitals pay the full charge and those who go to government hospitals get a subsidy of up to 50%
- Branding Revenue: To generate fixed income to service subsidized calls to 1298, allocate external advertising space to corporates on a yearly basis.

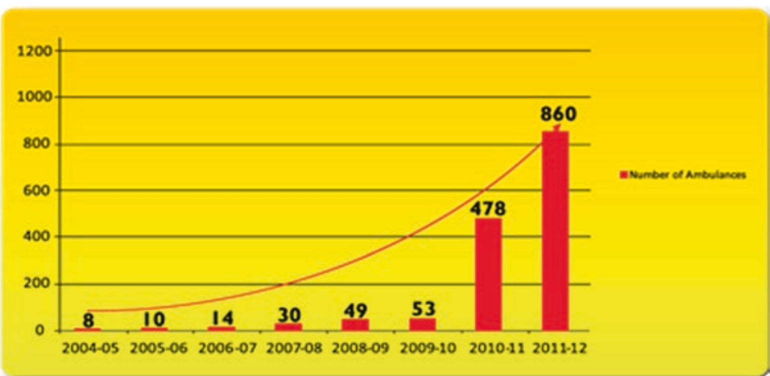
Source: Ziqitza Health Care Limited.

Exhibit 10.5: ZHL 108 Business Model

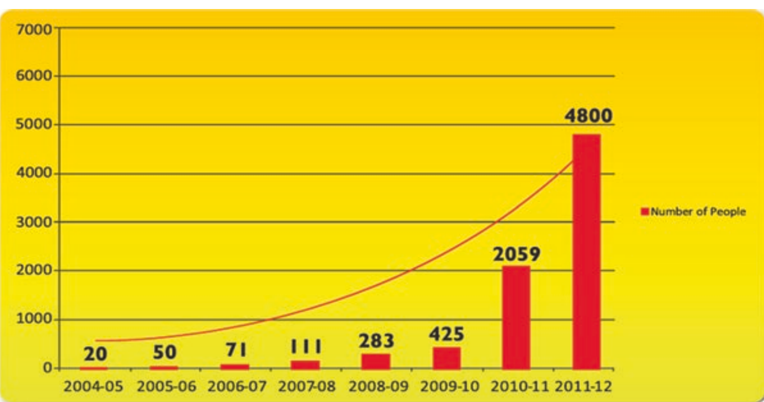
- Dial 108 in Emergency works on the principle of public-private partnership with various state governments.
- Currently, Dial 108 in Emergency operates in Bihar, Kerala, Rajasthan, & Punjab
- Dial 108 operates more than 800 ambulances across the four states.

Source: Ziqitza Health Care Limited

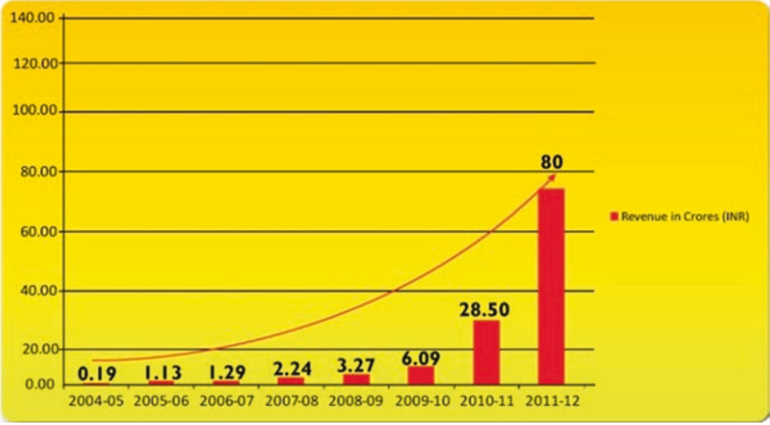
Exhibit 10.6: ZHL Performance Statistics



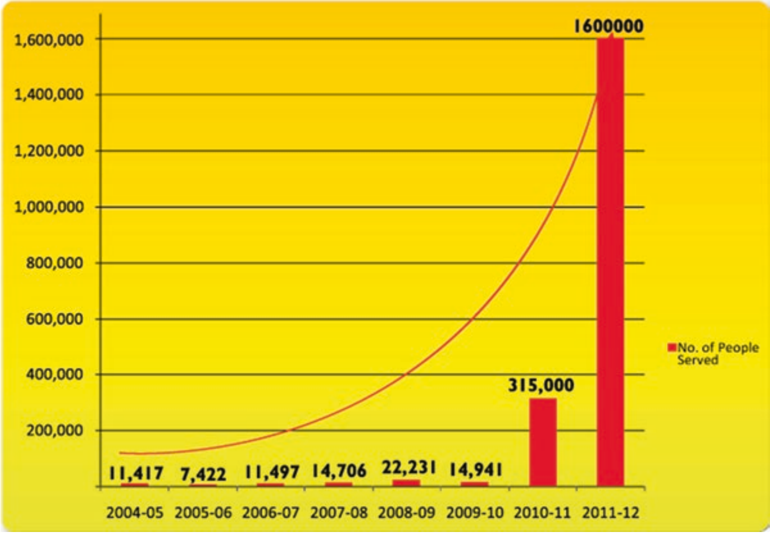
Currently 860 ambulances are operational, compared to 8 in 2005



Our current manpower is 4,800, compared to 20 in 2005



Revenue has increased 420 times since 2005



1,600,000 patients served, up from 11,417 in 2005

Source: Ziqitza Health Care Limited.

Exhibit 10.7: Awards and Recognitions

Source: Ziqitza Health Care Limited

Part III

Introduction: Stakeholder Management – Managing Competitiveness and Trust

Gilbert G. Lenssen

This third level of analysis of sustainable business focuses on finding a balance between assertive competitive strategy on one hand and on the other hand the development of social capital to underpin this strategy by building trust, credibility and legitimacy in the firm's relationships with all stakeholders, i.e. those groups and individuals who can affect or be affected by the business. Investing in these relationships is therefore key to sustained competitive advantage. Stakeholders have an important place in the business model and investing in stakeholder relationships can thus amount to investing in the business model.

Proper stakeholder management considers both resource base stakeholders (investors, customers, employees) and industry structure stakeholders (suppliers, unions, joint venture partners, regulatory bodies) But social-institutional stakeholders such as governments, NGO's, unions, local community organisations and media stakeholders should also be given attention.

Stakeholders are sources of relational risk and opportunity, as well as sources of information, so effective stakeholder management considers both maximising opportunities (including access to information) as well as mitigating risks.

However, not all stakeholders have equal importance in the business strategy or in the business model. Stakeholders need to be identified, prioritised and weighed according to their importance for a particular strategy, e.g. for a geographical expansion strategy into China: the government is a key stakeholder as well as government sponsored NGO's. In knowledge-based industries like ICT, employees as knowledge carriers have a greater importance in the business model compared to, say, capital intensive businesses like oil companies, where NGO's, for example, are likely more important because of the environmental and social impacts of the business model.

Key Questions to Ask (Applicable to All Part III Cases)

What is the business model of the firm?

Which stakeholders are key in this business model in order of value? (prioritise stakeholders in terms of power and materiality).

Which stakeholders need to be involved at which stage of the strategy process (from strategy generation to strategy implementation?
How should the company manage relationships with key stakeholders?
How can one link sustainability risks and issues to stakeholders, identify opportunities and threats?

Chapter 11: How GAP Engaged with Its Stakeholders by N. Craig Smith, Sean Ansett and Lior Erez

The Gap case is similar to the Nike case (see Chap. 8) in certain respects. It deals with labour rights and child labour in the supply chain. Both companies failed with a compliance driven approach. But while Nike adapted the business model straightforwardly and looked for industry sector solutions, GAP took an extensive strategic stakeholder engagement approach. Collaboratively identifying the material issues with stakeholders, defining objectives and commonly deciding actions gives solutions more credibility and facilitates better implementation of decisions. Moreover, this approach allows for establishing and embedding long-term relationships with stakeholders for mutual advantage. The authors present a step-by-step approach to developing strategic stakeholder engagement.

Chapter 12: Barrick Gold, a Perfect Storm at Pascua Lama by N. Craig Smith and Erin McCormick

Barrick Gold Corporation practised successfully a stakeholder engagement policy since its founding in 1980. However, the requirements for effective stakeholder management need constantly to be adapted to changing circumstances in the regulatory, financial, environmental and social environment of mining. Entering new geographies like Latin America, with different social contracts requires a careful review of whether the stakeholder policies of old will sufficiently guarantee continued success in the new context. Even a business built on strong stakeholder policies of “responsible mining” can get it wrong with the very stakeholders it pledges to give careful attention.

Chapter 13: Walmart: Love, Earth (A) by N. Craig Smith and Robert J. Crawford

Walmart’s business model based on low costs in the supply chain and a market positioning of “low prices every day” drives the business to centralise and standardise activities and exert rigid control on all business processes. Walmart became the largest corporation and the biggest employer in the world. As a result, the company acquired considerable power over many of its stakeholders. The temptation to use this power over suppliers, employees and partners to reduce costs even further was not resisted, sometimes resulting in exploitative practices. Walmart found itself in a number of controversies with its stakeholders and from 2005 onwards decided to respond differently with a strategic stakeholder management approach. This case

explores Love Earth, the sustainable jewellery product line of Walmart, from a dual perspective—that of the company as well as that of NGOs. It offers a model for NGO-business engagement, with a complex multi-stakeholder approach.

Chapter 14: Shell Nigeria: Changing the Community Engagement Model by Onajomo Akemu, Alexandra Mes, and Lauren Comiteau

Chapter 10 illustrated how Shell got into serious problems in the Niger Delta by spectacularly underestimating the costs of its social and environmental impacts. These costs, alongside the unfavourable deal it made with the government, rendered the investment far below the profitability levels once assumed. At the core of its problems was the lack of support of local communities, complicated by an environment of civil unrest and abuse of human rights. Massive oil spills with disastrous environmental impacts were largely due to theft from the pipelines that stretched over hundreds of miles from the Niger Delta to the coastal ports. Shell tackled the problem, albeit belatedly, with a new community engagement programme, as described here. Ultimately, however, it was forced to disinvest from the Niger Delta in 2013 as it could not gain control over the pipeline thefts which continued to cause considerable environmental damage.

Chapter 15: Economy of Mutuality: Equipping the Executive Mindset for Sustainable Business by Kevin T. Jackson

The economy of mutuality is a philosophy with supporting evidence such as the book, *Firms of Endearment,* a survey of firms which invested in long-term relationships with stakeholders and society at large and which in the long term generated superior financial returns compared to the S&P 500. Companies like Johnson & Johnson (since 1943), Mars (since 1947), and Novartis (since 1989) have used an explicit stakeholder model in their management systems for many years. But these surveys, the latest published in 2014, suggest that many companies have an implicit stakeholder model, which serves them very well. The success of Amazon, UPS, Colgate Palmolive, BMW, IKEA, and General Electric can be explained in part by this approach. Investing in mutually beneficial relationships with stakeholders is a long-term project that should be driven by passion and purpose. The surveys show that these companies have smart, no-nonsense business models, but equally have an emotional commitment to the stakeholder relationships.

How GAP Engaged with Its Stakeholders

11

N. Craig Smith, Sean Ansett, and Lior Erez

The pictures that came out of the southern African mountain kingdom of Lesotho in August 2009 were truly disturbing. A reporter from the London *Sunday Times* had found that a contractor to leading apparel brands, including Gap Inc., had allegedly dumped toxic materials into local landfills.[1]

Poor local children, some as young as five, had reportedly found razors and harmful chemicals while scavenging through burning refuse piles. “We itch all day and some of the sacks used to dispose the chemicals have powder that makes our hands and arms burn,” said one girl. Some children suffered from breathing problems, rashes and watery eyes. A subsequent CBS broadcast added a further, vivid twist: the contractor’s discharge of garment dyes and other contaminants into the nearby Caledon River had turned the water indigo blue, making it hazardous for local inhabitants. All in all, it was a brand manager’s nightmare – particularly in a world of instantaneous communication.

A similar crisis 10 years before had led to global protests that went on for months, at considerable cost to the San Francisco-based company, employee morale and even the child-workers themselves. However, this time the Gap responded swiftly and proactively to take steps to address the problems, and the Lesotho story soon died down.

[1] D. McDougall, “African dream turns sour for orphan army,” *The Sunday Times*, 2nd August 2009; S. MacVicar, “Jean Factor Toxic Waste Plagues Lesotho,” *CBS Evening News*, 2nd August 2009; http://www.cbsnews.com/stories/2009/08/02/eveningnews/main5205416.shtml (accessed 28 August 2010).

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© Springer Science+Business Media B.V. 2019
G. G. Lenssen, N. C. Smith (eds.), *Managing Sustainable Business*,
https://doi.org/10.1007/978-94-024-1144-7_11

What had changed? In the intervening decade, the Gap had cultivated close relationships with labor groups, human rights organizations, governments and other stakeholders through sustained and action-oriented engagement – a long, hard process that had transformed a brand associated with sweatshops and child labor into a company recognized for corporate social responsibility,[2] the kind of organization that people were willing to give the benefit of the doubt.

Gap's stakeholder engagement strategy transformed the way Gap approached inevitable ethical trading problems. However, the change did not happen overnight. Instead, management learned a number of key lessons over time that could be helpful to other brands that struggle with ethical trading concerns. In this article, based on in-depth interviews conducted with Gap management and key external stakeholder representatives during the second half of 2009, we describe how Gap developed its stakeholder engagement strategy, the work such a shift entails, and the many ways in which stakeholder engagement has benefited the company.

Why Stakeholder Engagement?

In the last three decades, corporate attitudes toward social responsibility have evolved well beyond the dictum that "the business of business is business"[3] toward a more nuanced view that business and society are inextricably linked. Now, many theorists urge management to take into consideration not only shareholders' interests, but also those of other groups, organizations and individuals who have a stake in the company. They argue that a company's failure to understand the needs of this wider group of stakeholders can create dangerous "blind spots" for managers – and conversely, that greater understanding and closer ties to stakeholders can create sustainable value, both for the company and its stakeholders.[4]

Stakeholders, to use a definition put forward in 1984 by R. Edward Freeman, are "any group or individual who can affect or is affected by the achievement of an organization's purpose," principally financiers, customers, suppliers, employees and communities.[5] Freeman argued that such stakeholders can have a significant

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[2] For example, Gap was recognized as one of the "World's Most Ethical Companies" in the 2010 Ethisphere ranking (across 35 industries there were 99 total companies and only 9 retailers on this list); Gap was ranked number 11 overall and number 3 on human rights in *Corporate Responsibility* (CR) magazine's "100 Best Corporate Citizens 2011" (out of 1,000 companies evaluated).

[3] "The Social Responsibility of Business is to Increase its Profits," *The New York Times Magazine*, September 13, 1970.

[4] For further discussion of the risks of insufficient attention to stakeholders see: N. C. Smith, M. E. Drumwright and M. C. Gentile, "The New Marketing Myopia," *Journal of Public Policy & Marketing* 29, no. 1 (Spring 2010): 4–11.

[5] R. E. Freeman, *Strategic Management: A Stakeholder Approach* (Boston: Pitman, 1984): 53. For an updated account, see R. E. Freeman, J. S. Harrison and A. C. Wicks, *Managing for Stakeholders: Survival, Reputation and Success* (New Haven, Connecticut: Yale University Press, 2007).

impact on business success, well beyond their role as factors of production or consumption. The basic premise of stakeholder theory is that management should not relegate the company's effects on stakeholders to the status of "externalities" that are irrelevant to the company's objective of creating shareholder value, but should view stakeholders as key to the company's financial performance as well as holding intrinsic value of their own.[6] In fact, a stakeholder engagement program won't work very well even on the limited level of corporate self-interest if this is not recognized and employees simply go through the motions.

As Gap's experience suggests, stakeholder engagement is not easy. (See "Lessons from the Gap Experience.") It requires careful listening and even more careful action on the part of management, including patient relationship-building with civil society, multilateral groups and global trade unions. It is often expensive and slow. However, stakeholder engagement can contribute to a company's economic performance by enabling the company to:

- *Resolve complex problems.* Stakeholders can enhance a company's perspective on issues and solutions that companies might not have access to on their own, including understanding of the local context. In fact, some problems are so complex they can't be resolved without the collaboration, knowledge, networks and expertise of stakeholders.
- *Reduce headline risk.* Stakeholders familiar with operations can often uncover situations where supply chain partners are not acting in ways consistent with company policies, giving the company an early warning about emerging challenges and the opportunity to proactively address them before the issue reaches the media.
- *Boost stakeholder trust*. Closer communication tends to make the relationship with stakeholders more cooperative and less confrontational once respect has been earned.
- *Enhance political clout*. Companies working with stakeholders to shape industry standards often gain greater access to reformist politicians and regulators, thereby increasing the likelihood that their concerns are taken into consideration in the formulation of legislation.
- *Improve the company's public image*. Successful stakeholder engagement is likely to contribute to a positive view of the company in the eyes of all of its stakeholders, including its customers and employees. Some evidence even suggests that a responsible image is beneficial for employee recruitment and retention as well as customer preference.

[6] See T. Donaldson and L. Preston, "The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications," *Academy of Management Review*, 20, no. 1 (1995): 65–91; R. Edward Freeman, J. S. Harrison, A. C. Wicks, B. L. Parmar, and S. de Colle, *Stakeholder Theory: The State of the Art* (Cambridge: Cambridge University Press, 2010).

Exhibit 1: Lessons from the Gap Experience

By engaging its stakeholders rather than simply trying to deflect criticism, Gap found it could overcome supply chain disasters, such as revelations regarding child labor, much more easily and resolve the crises in ways that were better for victims and the company. What are some key lessons from Gap's experience?

- *Be a partner.*

The traditional reactive, risk-avoidance approach to labor and environmental issues leads to more activism, weakening the brand and draining employee morale. Acting as a partner with stakeholders can lead to better crisis resolution and remediation and help prevent more crises from developing in the first place.

- *Forget Band-aids.*

Labor and environmental crises are nearly inevitable for high-profile companies with complex global supply chains. However, a strategy of engagement can help a company minimize their frequency (by making it possible to eliminate sources of risks early), and severity (by giving the company more credibility with NGOs).

- *Don't rely solely on compliance.*

Through stakeholder engagement, Gap management realized that the future was not in solely policing factories. It learned that savvier and influential stakeholders, many with years of practical experience observing conditions in the factories, had come to realize that the impact of monitoring was often negligible and that capacity-building, training and purchasing practices are also key factors. Much of the information regarding serious violations often came from external stakeholders rather than through internal factory auditing, so engagement was critical.

- *Go deep.*

Today, when media report labor rights violations such as the India child labor example, they typically find them in the second-tier suppliers or beyond, where there is less oversight and sophistication than in first-tier suppliers for major fashion companies. Reaching deeper into the supply chain requires collaboration with new stakeholders who have greater understanding, including familiarity with local languages, and the capacity to take on an advisory role.

- *Hire boundary spanners.*

Gap created a strategic unit called Global Partnerships, a team that could assume a "boundary spanner role" within the company. Such "boundary spanners" are professionals who are good at maintaining one foot firmly in the organization with the other outside in the stakeholder community.

- *Leverage your partners.*

Sustainability dilemmas are often far too complex for any one company or stakeholder to resolve alone. Developing sustainable approaches to tackling some of the world's most challenging issues – such as climate change – will require multi-stakeholder partnerships with companies, NGOs and governments.

- *Measure success*

Criteria for evaluating the depth of stakeholder engagement generally evaluate management processes and procedures. While such measures are critical to engagement, management should also look at metrics such as media stories, employee recruitment and retention and brand value. Other clues to effective stakeholder engagement include product quality, worker turnover, and declining order reject rates.

- *Ask first.*

Engagement can be most effective when the company is considering changes to products, processes or organizational strategies. Input from a variety of stakeholders enables management to have a fuller picture of risks and opportunities.

The Gap Story

Gap's commitment to social responsibility was evident as early as 1992, when it published one of the earliest set of sourcing principles and shared this with vendors in the garment industry. In 1996, Gap developed a code of vendor conduct and made it public. Gap's code covered labor, environmental, and health and safety standards throughout the company's first-tier suppliers and their subcontractors in its global supply chain, and relied mostly on the suppliers to implement the code's requirements.

Despite Gap's efforts, the National Labor Committee (NLC), a workers' rights group, exposed serious labor violations in the Mandarin International garment factory in El Salvador in 1995, including accounts of low pay, excessive overtime and union-busting. The case was a "wake-up call" for Gap, which realized that the company needed a team of internal auditors to verify that contractors were living by its code of conduct. In 1996, Gap began to assemble a diverse global compliance team which would be responsible for the inspection and the implementation of the code, an experienced group that included former NGO and trade union staff, as well as former journalists, social workers and factory managers.

But even this team of more than 100 people, operating globally, proved insufficient to catch every problem: In 1999, Gap and 26 other US retailers, including Levi's and Nordstrom, were sued over labor conditions in their supplier factories in the U.S.-administered south Pacific island of Saipan. As in El Salvador, the Saipan suit alleged cases of forced labor, nonpayment of minimum wages and other egregious violations of the rights of the island's mostly migrant workforce. The U.S.

retailers eventually agreed to pay a $20 million settlement to the suit and use the funds to establish a labor monitoring program and an oversight board to sustain change. Gap took an additional step and developed the industry's first foreign contract worker guidelines to formalize its policy and monitoring protocol.

The Limits of Policing: Cambodia, 2000

Despite the setbacks in El Salvador and Saipan, Gap still believed it was on the right track and continued to focus on supply chain auditing. Yet a further blow to Gap's reputation was still to come: In October 2000, Gap was approached by the BBC with an allegation of child labor in a Phnom Penh factory, in which Gap, among other multinational companies, subcontracted production.

A few weeks later, the documentary aired, accusing Gap and Nike (who also contracted with the factory) of ignoring the problem of child labor in their factories and of relying on ineffective monitoring systems. The Cambodian factory's management denied the accusations, and the Cambodian government declared that its own investigation had cleared the factory of any wrongdoing.[7]

Gap, however, felt that there was no definitive way to settle the dispute. Since most documents attesting to age in Cambodia were destroyed by years of war and genocide, Gap and its suppliers relied on family records to verify that workers were above the minimum working age. Yet after examining their 'family books,' Gap investigators still could not confirm the reporter's claim that the workers were underage. Nor could doctors the company consulted verify the workers' ages. "Even from a medical point of view it was not easy," said Ira Puspadewi, Gap's director of social and community investment in Asia, who at the time was Gap's regional code of conduct compliance officer.

Following the broadcast, letters flooded Gap's corporate communications and global compliance department. Anti-sweatshop student protestors picketed Gap and Nike outlets, calling for consumers to boycott the stores. Gap issued a statement in response to the strong reaction from NGOs, trade unions and the public, declaring that it did not tolerate underage labor, and asserting that "If we discover instances of underage labor, we take swift and appropriate action."

Several brands left Cambodia. Gap, on the other hand, considered the potentially negative impacts to workers if it were to 'cut and run' and decided to stay and work to improve labor conditions in Cambodia, while enhancing the age verification requirements in the factories from which it sourced.

Gap stayed because experience had shown executives that pulling out can lead to even worse outcomes for child laborers. Perhaps the most notorious example of the consequences of cutting ties with a subcontractor had occurred in the Bangladeshi

[7] P. Kenyon, "Gap and Nike: No Sweat (TV report transcript)," *BBC,* 15th October 2000. See: http://news.bbc.co.uk/2/hi/programmes/panorama/970385.stm (accessed: 27 August 2010); Associated Press, "Cambodia Rejects BBC Documentary's Allegations," Associated Press, 4th October 2000.

garment industry earlier in the decade. A 1993 NBC broadcast exposed child labor in a Bangladeshi factory supplying Wal-Mart. The Bangladesh Garment Manufacturers and Exporters Association, threatened by the prospect of U.S. legislation that would close Bangladeshi garments to the American market, announced that it would eliminate child labor in the country by the end of October 1994. Thousands of children were reportedly dismissed from the factories. But many children dismissed from the textile factories found themselves in worse situations: A 1995 report by British development organization Oxfam revealed that those children ended up in even more dangerous work, such as welding or even prostitution.

Although Gap executives believed they were taking the high road in staying on in Cambodia, the public damage had still been done. The company's compliance-oriented public statements and lack of connection with its stakeholders meant that Gap's reputation was once again tarnished.

Implementing Strategic Stakeholder Engagement

The Cambodian episode was deeply frustrating to Gap executives. Despite fielding a large labor standards monitoring team and investing millions in policing its factories, Gap remained under constant pressure from advocacy groups in the U.S. and the U.K. In fact, protests actually intensified as activists perceived that their actions were getting results. Protesters camped out in front of Gap's corporate headquarters in San Francisco for weeks on end, attracting considerable media attention, particularly when the groups engaged in such stunts as picketing in the nude. Executives realized that Gap's legalistic risk-mitigation approach to ethical trade was "broke" – policing would not bring the change in the supply chain that management desired. Clearly, the way it engaged with its critics needed a major overhaul. In the years that followed the Cambodia case, Gap embarked on a five-step path to deeper engagement with its stakeholders:

Step 1. Draw a Stakeholder Map

First, Gap developed a stakeholder map, listing as many stakeholders as possible, and then ranking them by their salience or importance.[8] "We recognized that it would not be possible for us to have a strategic relationship with each of the stakeholders, so we highlighted those who we deemed to be the most key," recalled Deanna Robinson, Gap's head of monitoring and vendor development.

Prioritizing stakeholders enabled the company to focus on developing transparent relationships with a few of the most influential organizations. "We will never be able to engage at the same level of depth with every organization that exists," explained Daryl Knudsen, Gap's director of stakeholder engagement and public policy, "but by

[8] R. K. Mitchell, B. R. Agle and D. J. Wood, "Toward a Theory of Stakeholder Identification and Salience: Defining the Principle of Who and What Really Counts," *Academy of Management Review* 22, no. 4 (1997): 853–886.

engaging with organizations who themselves have extensive networks, we have managed to receive some level of input and influence from those networks."

The mapping process at Gap was facilitated by a San Francisco based NGO-cum-consultancy, Business for Social Responsibility (BSR). The stakeholder mapping session included participants from various functional areas of the business including legal, public relations, government affairs and global compliance. The session not only produced a map of stakeholders prioritized by customized criteria developed by the team, but also served as a learning opportunity for internal team members to understand the key stakeholders, the proposed strategy and the value of engagement. The mapping exercise helped educate Gap executives about the company's many relationships and the impact the company had on thousands of lives.

Through this exercise Gap was beginning to evolve its approach from a risk-averse legalistic strategy to one based on proactive engagement that could tease out stakeholder needs, positions and motivations. This stakeholder approach was a huge shift for the company and many of the senior decision makers in the room were learning about stakeholder theory and discovering who these stakeholders were for the first time.

In 2002, once Gap had identified its key stakeholders, Gap began to meet with them to get their advice on how to improve its labor practices. One meeting in particular was to have important consequences for the company. Company executives met Lynda Yanz, of the Maquiladora Solidarity Network (MSN) in Toronto, Canada. MSN is an influential worker rights group concerned with labor rights issues in the Americas – a key sourcing market for the company. Gap managers emerged from the meeting believing they were mistaken in trying to "go it alone" in their efforts to improve labor conditions. The team became convinced they should consider developing partnerships with relevant stakeholders and consider joining the emerging multi-stakeholder initiatives.

On Yanz's advice, Gap began to engage stakeholders more holistically and stakeholders began to communicate about emerging issues directly with corporate responsibility team members. Beyond engaging MSN, Gap also joined two multi-stakeholder initiatives: the New York-based Social Accountability International (SAI) in 2003 and the London-based Ethical Trading Initiative (ETI) in 2004. Executives say joining these MSIs provided the company with a safe forum to discuss its challenges with various stakeholders and to gain their insights and perspectives on the best ways to handle particular issues.

Step 2. Identify the Material Issues

Next, Gap identified the most important social issues the company and its stakeholders faced. "We examine what our core impacts are, and we try to stay apprised of key issues in those areas and procure opportunities where Gap's contribution will make a difference," explained Knudsen.

After identifying the issues, Gap gauged their maturity. If there was weak evidence and little awareness for an issue, it was considered "latent." If it had become the focus of NGO campaigning and research, the issue was classified as "emerging." If awareness for the issue went beyond the professional community to the public and media and there existed a strong body of evidence in support, it was

"consolidating." Finally, an issue was "institutionalized" when its handling had become a normal part of regulations and business practice.[9] Two "consolidating" priorities that emerged from that work: Child labor (not surprisingly, in view of the past controversy in Cambodia), and HIV/AIDS, a major issue in Lesotho and South Africa, where up to 30 % of the population was infected.

Step 3. Define Objectives

Gap defined its objectives based on stakeholder input through the engagement process with MSN and others. One top priority that emerged: increasing transparency. A major milestone for Gap in this regard was the publication of its first Social Responsibility report in 2004. The "warts and all" report focused on code of conduct violations regarding labor rights and the supply chain and the measures being taken to prevent future violations. Although some media outlets interpreted the report as an act of contrition (e.g., "Gap Admits to Running Sweatshops"), some of Gap's toughest critics praised the effort.[10]

"I think the SR report is one of our greatest successes," said Dan Henkle, Gap's former senior vice president of global responsibility. "We really found our voice… sharing information without coming across as public relations and patting yourself on the back." In public relations terms, the report had a very positive effect: The marketing department suggested that the number of "positive impressions" the report generated may have equaled the equivalent of two Super Bowl advertising campaigns. The report also served as a "call to action" for others in the industry, particularly those that had not invested in corporate responsibility to date, as many suppliers served multiple brands.

Step 4. Resolve Issues Collaboratively

Prior to the engagement strategy, stakeholders would send letters to Gap about their concerns regarding factory issues. Corporate communications would usually reply with a "canned" response, mentioning the code of conduct and the number of internal auditors that were working to address noncompliance. This approach typically infuriated stakeholders and increased the likelihood of campaigns against Gap. Gap's Global Partnership team took a different tack and instead told stakeholders to contact it directly if they saw problems emerging.

Such a tactic paid off in 2005, the year the Multi Fiber Arrangement was phased out. Between 1974 and 2005, the MFA had governed the amount of textiles developing countries could export to developed countries. However, although initially intended to limit the rapidity of growth in the market, its country-by-country

[9] This model, originally developed by pharmaceutical company Novo Nordisk, is described more fully in S. Zadek, "The Path to Corporate Responsibility," *Harvard Business Review* 82, no. 12 (December 2004): 125–132.

[10] S. English, "Gap Admits to Running Sweatshops," *Daily Telegraph,* 13th May 2004. See: http://www.telegraph.co.uk/education/3340068/Gap-admits-to-running-sweatshops.html (accessed: 27th August 2010). Gap social responsibility reports are available at: http://www.gap-inc.com/GapIncSubSites/csr/EmbracingOurResponsibility/ER_Our_History.shtml (accessed 28th August 2010).

allotments also acted to protect the supplier markets as well. At the time, many in the apparel industry believed that once the MFA system was dismantled, China would take over the world's textile market and destroy most of the other emerging market competition. For the Gap, the multi-stakeholder dialogue led to an executive commitment to consider the implications of exiting from a country and to address negative impacts on workers and communities in labor markets the company decided to exit.

Through meetings with stakeholders, Gap learned that brand demands for supplier flexibility, such as changes in color or design elements, could have major repercussions for workplace practices.

Gap organized a series of stakeholder meetings in both the U.S. and the U.K. to elicit insights about the post-MFA era. The company invited NGOs, academics, government and trade unions to discuss Gap's program and to identify emerging concerns. Creating such a forum provided Gap with "eyes" globally, placing the company in a position to resolve issues in factories "below the radar screen," rather than in public. The stakeholder communication served as an informal complaint mechanism on factory problems, enabling the company to respond earlier to emerging issues.

For example, stakeholder feedback helped Gap identify HIV/AIDS as a key challenge in Lesotho and led the company to join singer/activist Bono's Red campaign to donate 50 % of profits on a particular line of 'Red' branded Gap products and a commitment by Gap to continue to source those products from Lesotho. Through these meetings, Gap also learned that brand demands for supplier flexibility, such as changes in color or design elements or lead time could have major repercussions for workplace practices. Although identified by Naomi Klein in her 2000 book *No Logo*, this was one of the first times in which a retailer saw that its

own practices could have negative consequences on the implementation of its own codes of conduct. This insight led to a purchasing practice pilot project in 2005, ahead of the rest of the industry.[11]

Step 5. Embed Engagement

Some Gap stakeholders were resistant to the engagement strategy. A number of employees felt the company was selling out to NGOs. At the same time, some external stakeholders dismissed Gap's efforts as more PR "spin." In the beginning, Gap's legal department was particularly unsure about the strategy. "[Gap] lawyers were extremely sensitive and cautious about anything they would say in public that could open them up for potential litigation. So, even as they developed a highly sophisticated and significantly resourced compliance system to support their code, they remained defensive, at least in public, about these issues," recalled Bennett Freeman, a consultant at that time with Burston-Marsteller, the public relations agency, which was involved in the stakeholder engagement decision.

The challenge, according to Lakshmi Bhatia, former director of global partnerships at Gap, was "narrowing down the boundaries between our internal organization and the stakeholder world." The team did that in part by hiring "boundary spanners," people familiar with the corporate as well as the civil society discourse, who helped mediate between the potential adversaries. "The typical corporate mindset is often about very clearly defined structures and boundaries," said Bhatia, "and that does not work when you are engaging [with stakeholders]."

Nor were boundary-spanning efforts important only in winning over external sceptics. Moving the Global Responsibility team from sourcing to the legal department helped win over company attorneys to the engagement strategy. Managers say that exposure to the Global Responsibility team actually helped change the legal department's approach, making the company more open and supportive of the strategy.

Beyond Crisis Management: India, 2007

In 2007, Gap's new stakeholder engagement approach was put to the test, as the media exposed another case of child labor in Gap's supply chain. A reporter from *The Observer* (U.K.) advised Gap's CSR personnel of his discoveries regarding child labor in an Indian embroidery company that produced T-shirts for the GapKids brand.[12] Gap investigated the case and discovered that one of its approved suppliers had referred handiwork to the embroidery company, a facility unauthorized by Gap.

[11] For a fuller discussion of this issue of upstream (supply chain) consequences of downstream marketer (and consumer) decisions, see N. C. Smith, G. Palazzo and C.B. Bhattacharya, "Marketing's Consequences: Stakeholder Marketing and Supply Chain Corporate Social Responsibility Issues," *Business Ethics Quarterly* 20, no. 4 (October 2010): 617–641.

[12] Dan McDougall, "Child Sweatshop Shame Threatens Gap's Ethical Image," *The Observer,* 28th October 2007.

Objectively, this case was much more severe than Cambodia. In 2000, Gap could not verify that the workers in question were in fact underage, whereas in this case there was no doubt about the age of the workers and the severity of the working conditions. Some of the children had been sold to the sweatshop by their impoverished families as bonded or forced labor. They labored 16 h a day without compensation, suffering from severe physical and verbal abuse on the part of their supervisors.

Thanks to its earlier stakeholder engagement efforts, Gap had more time to form an effective response to the allegations and a holistic approach to remediating the issue than in the Cambodian crisis, according to Deanna Robinson. Rather than arriving completely out of the blue, the news reached Gap earlier, giving the company more time to prepare its response. “If you fast forward to the case in India, we did have a direct conversation with the reporter, but we also really had more of an opportunity to assess the situation,” said Robinson.

Gap responded swiftly and effectively to the allegations. As soon as the story broke, Gap followed the guidelines it had learned from multiple stakeholders including trade unions and NGOs about how to manage a child labor incident: It took full responsibility, cancelled the product order and barred the unauthorized subcontractor from any future involvement with the company. An executive in the business, not a corporate communications or corporate responsibility person, spoke for the company. The key message the company wanted to convey was “that in the reality of an issue as complex as child labor, clearly no single company can change a societal situation, so it’s going to take an industry response,” according to Bill Chandler, Gap’s vice president of corporate communication.

After internal debate, the company decided to retain its relationship with the first-tier supplier that had hired the embroidery company. The first-tier supplier had a strong reputation for labor compliance, and retaining the company would also preserve local jobs. It also decided that the finished garments would not be sold. A summit meeting with all north Indian suppliers was held in November to reinforce the message of “zero tolerance” towards child labor and ensuring no unauthorized subcontracting.

The Indian government, working with a local child labor NGO, BBA (Bachpan Bachao Andolan), managed the initial remedial treatment of the children in question and made sure they were taken care of. Gap started funding BBA to serve as a local educator against child labor. Gap also helped create a global forum of brands and retailers, together with NGOs, trade unions and government officials, to develop industry-wide strategies against child labor.

Unlike the Cambodian case, which dogged the company for months and spurred storefront protests, the media story about the Indian case was all but ‘dead’ in a few days. Responses to the incident were substantially different compared to 7 years before. This time around, the NGOs didn’t view Gap as the enemy. “They’d worked with us, found us to be good partners, and therefore, instead, their approach was ‘how can we help?’” Gap’s Henkle recalled.

NGO and trade union representatives told us that Gap’s transparency and responsiveness in the years before the incident prompted them to take a more collaborative approach. “There is less criticism from the campaigning community around them,” said Maggie Burns, a trustee of Women Working Worldwide, a U.K.-based

organization that works with an international network of women workers. "That doesn't mean that the campaigning community has gone soft on what Gap should do, but I think there is a difference, because they are working with stakeholders in a much more open and transparent way."

Various NGO representatives emphasized to us that this does not mean that Gap will never be criticized, but it does mean that they are more confident that the company will do the right thing by taking responsibility and acting swiftly.

Gap and Lesotho

The classic response to the pictures of Lesotho children picking through burning garbage and an indigo-blue river would have been for the company to deny responsibility, blame the problems on the subcontractor, and then cut all ties with the offending company.

That was the old script. Instead, Gap responded again as it had in India – quickly and proactively. On August 2nd 2009, Henkle delivered a media statement regarding Lesotho in which he declared the company's commitment to improving the lives of workers in Lesotho and announced the steps Gap intended to take to resolve the situation. On September 18th, Gap and Levi Strauss issued a joint statement detailing the actions they had taken or requested of others. These included internal and independent investigations; meetings with their suppliers and local government officials; immediate repair of a broken municipal waste pipe; and enhancement of factory management training to ensure compliance with their codes of conduct.

Neil Kearney, former general secretary of the International Textile Garment & Leather Workers' Federation, a global union federation, placed the Lesotho story in a larger context, emphasizing Gap and Levi's role in improving working conditions in Lesotho. He also criticized those who attacked Gap and Levi's for being irresponsible, "using easy targets… without recognizing the progress that has been made and the contribution of these easy targets." For Gap, the defense by a veteran union leader who had campaigned against the company in the past was a vindication of the engagement strategy. More generally, Gap's stakeholder engagement strategy has changed stakeholder perceptions of the company, and Gap has received awards and public recognition as a leader in corporate ethics and responsibility.

Public crises are all but inevitable for major brands with extended supply chains in emerging markets. Their outcome is not. "It is not a crime to find child labor in your supply chain," said Dan Rees, former ETI director. "What is important is what you do about it when you find out." As Gap has learned over the past decade, if the level of engagement is deep enough, such crises can be turned into opportunities that leave the company and its stakeholders stronger.

Acknowledgements The authors gratefully acknowledge the research participation of Gap Inc. management and representatives of its key external stakeholders as well as research support from Dreyfus Sons and Co. Ltd., Banquiers.

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Barrick Gold: A Perfect Storm at Pascua Lama

12

N. Craig Smith and Erin McCormick

Introduction

As Peter Munk fended off calls for his resignation in the fall of 2013, the gold mining company he had founded in1980 was at the centre of what he called a "perfect storm" of environmental, community and stockholder pressures.[1] Based in Toronto, Canada, Barrick Gold Corporation had built its position as the world's biggest gold mining company on a policy of "responsible mining", which involved careful environmental planning and millions of dollars of investment in the communities where it mined. At 85, Munk still guided the corporation as chair of the board (Fig. 12.1). But now its success was threatened by tougher requirements from environmental regulators, community protests, and demands for greater profit-sharing from the governments of several nations where its most promising mining developments were underway. Furthermore, the price of gold had dropped precipitously. Shareholders were calling for a reconstitution of the Barrick's board, saying current members, like Munk, were out of sync with the current market realities.

At the centre of this storm was the huge Pascua Lama mining project that Barrick was developing high in the Andes, straddling the border of Chile and Argentina. Set in a remote region among ancient glaciers, the mine would tap into one of the world's largest gold reserves, believed to hold nearly 18 million ounces of gold and 676 million ounces of silver.[2] As the world's first mine to operate across national

[1] Peter Munk's comments to Barrick Gold Corporation's Annual Meeting, April 24, 2013. http://www.gowebcasting.com/events/barrick/2013/04/24/2013-annual-meeting-of-shareholders/play/stream/7102

[2] Barrick Gold Corporation Pascua Lama Summary http://www.barrick.com/operations/projects/pascua-lama/default.aspx

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G. G. Lenssen, N. C. Smith (eds.), *Managing Sustainable Business*,
https://doi.org/10.1007/978-94-024-1144-7_12

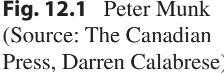

Fig. 12.1 Peter Munk (Source: The Canadian Press, Darren Calabrese)

borders, Pascua Lama would set a precedent for other ambitious mining projects which Barrick hoped to develop in the same region.

The company had already poured more than $5 billion into the giant construction project, which it listed as its top priority.[3] Start of production had been delayed to 2016, and it had already cost billions more than anticipated when it started planning in 1997. It had been a dismal year for the project. First a court had delayed construction on the Chilean side of the project, after an indigenous community in the region had alleged that the project would pollute local water supplies. Then environmental regulators halted construction on the Chilean side until Barrick could complete the installation of an improved water management system. These problems and the drop in gold prices sent the company's stock on the Toronto and New York Stock exchanges tumbling: it had lost nearly 50% of its value since the beginning of the year. Some analysts were calling on the company to get out of the business of building new mines altogether.[4]

Originally, the governments the Chile and Argentina had welcomed the Pascua Lama project as a way to bring jobs and economic benefits to a desolate and impoverished region. Barrick had gone through years of negotiations and made many concessions, including abandoning a plan to move parts of the glacier, to get the necessary environmental permits. The company had recruited support among many members of the communities nearby. But despite almost 1000 community meetings and millions spent on local improvements for those who lived around the mine,[5] not everyone had been won over.

The cost overruns and the obstacles mounted by local residents and international environmental groups who opposed the project had grown so high that, as Munk

[3] Julie Gordon, "Barrick shows progress on costs, cuts spending," Reuters, April 24, 2013.

[4] Pav Jordan, "Peter Munk confronts Barrick's 'perfect storm,'" Toronto Globe and Mail, April 24, 2013.

[5] Barrick, "Pascua Lama FAQs" http://www.barrick.com/operations/projects/pascua-lama/faq/default.aspx

Fig. 12.2 Protesters outside Barrick's 2013 AGM (Source: ProtestBarrick.net, Alan Lissner)

and other company officials explained to shareholders, they now had to consider whether to suspend the project altogether.

Outside the Barrick's annual meeting at the Metro Toronto Convention Centre in April, several dozen protesters waved banners saying Barrick's gold was a "toxic asset". (Figure 12.2) Inside, the 85-year-old Munk told the crowd of 700 shareholders and employees that the very fundamentals which had inspired mining companies to expand into developing nations – high gold prices and governments eager for international investment – had changed dramatically from when the Pascua Lama project was launched in 2004.

"Did we know then that we were going to run into, every year, more and more difficulty?" said Munk. "Did we know then that the same governments who practically begged us to invest in their remote areas to provide jobs, to provide opportunities for education, to provide foreign exchange, to provide for taxes, were going to be changed, and newcomers would say, 'Who are these foreigners? Why would they take our gold away from us?"

Even as the storm swirled around them, Munk and Barrick managers vowed to stick to the company's core philosophy that "doing the right thing is good business". The question now was: What was the right thing?

Background

Barrick Gold Corporation

Barrick had launched its gold mining business in 1983, riding the wave of social consciousness known as the anti-apartheid movement (protesting apartheid in South Africa). Thirty years later, the company was the world's largest gold producer with adjusted net earnings of $3.8 billion in 2012. It generated 7.4 million ounces of gold and 468 million pounds of copper. It had 27 mines or mining projects in Argentina, Australia, Canada, Chile, the Dominican Republic, Papua New Guinea, Peru, Saudi Arabia, Tanzania, the United States and Zambia.[6]

It started as a failing oil and gas exploration company. The Hungarian-born Peter Munk, whose family fled the Nazis to Switzerland, arrived in Canada from war-torn Europe in 1948 at the age of 18. A shell-shocked Jew with little English, a funny-looking suit and hardly a friend in the world, he expected to be shunned when he presented himself at Lawrence Park Collegiate, a high school in Toronto. Instead, the Canadians he met promptly took him in.[7]

Before long, he was pursuing big business ambitions. He launched a stereo company and a hotel chain. He and a partner founded Barrick Petroleum Corporation in 1980. They never struck oil and suffered huge financial losses, so in 1983 they decided to go into mining precious metal to take advantage of investors' deserting the gold mines run under South Africa's apartheid government.

Under a new name, Barrick Resources, the company went public on the Toronto Stock Exchange and generated $2.5 million. The plan was to target European pension funds that had investments in the increasingly unstable South African gold market. Munk sought to offer investors more stable markets in gold mines based in North America. They started by acquiring stakes in already-operating mines in Alaska's Valdez Creek region and in Ontario, Canada.

Barrick quickly earned a reputation for improving production at existing mines and for protecting investors with aggressive hedging that shielded its profits even if the price of gold went down.

For decades, it pursued growth with a series of acquisitions. It became the world's largest gold mining company in 2006, when it acquired Placer Dome Inc. with an offer worth US$10.4 billion. By 2012, Barrick had 27,000 employees around the globe. (See Fig. 12.3 for a summary of the company's financial performance as reported to stakeholders in the company's 2012 financial summary.)

One of the company's stated goals was to be the "world's best gold mining company" by operating in a "safe, profitable and responsible manner". It had a policy of

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[6] Barrick Gold Corporation Annual Report 2012.

[7] Historic details summarized from *International Directory of Company Histories* (2000) – Vol. 34. St. James Press. http://www.fundinguniverse.com/company-histories/barrick-gold-corporation-history/ and Margaret Wente, "Our World Needs More Peter Munks," Toronto Globe and Mail, June 11, 2011.

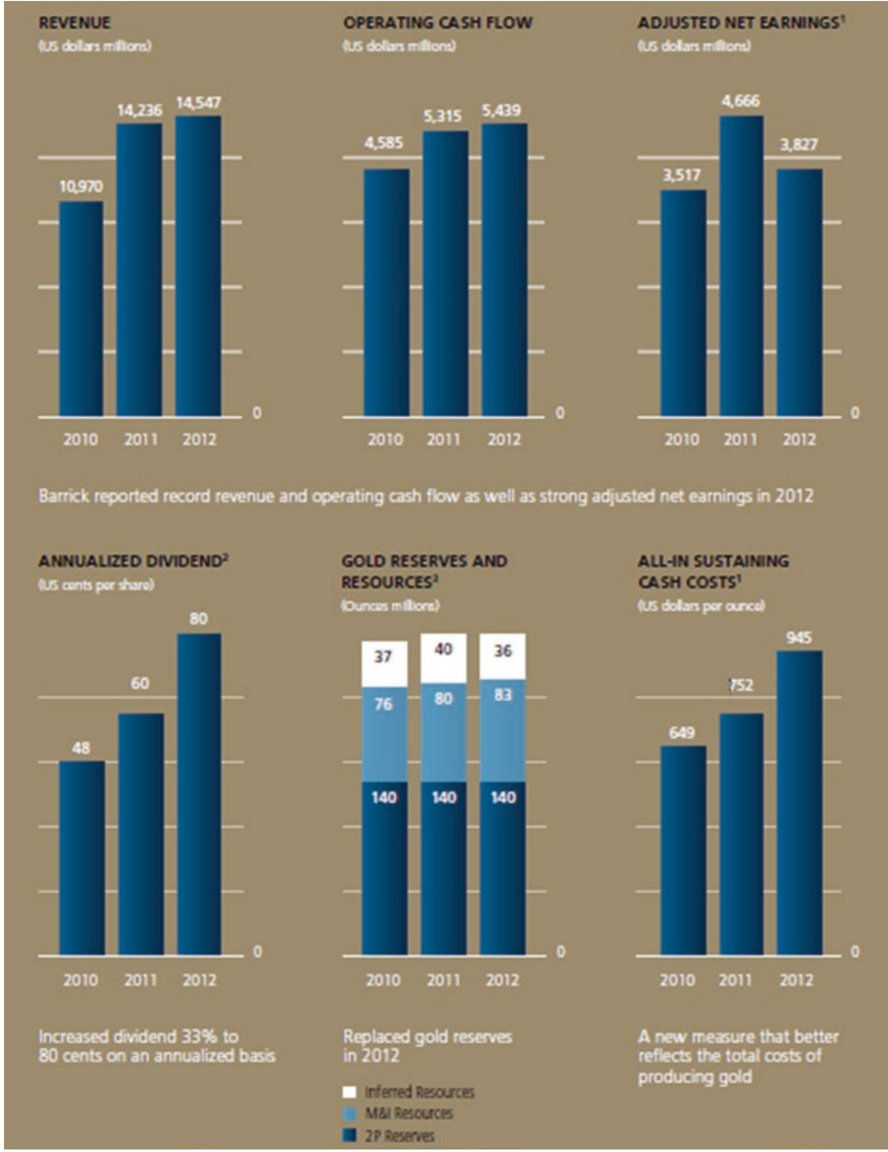

Fig. 12.3 Barrick Gold Corporation 2012 Financial Summary (Source: Barrick 2012 Annual Report)

giving back to the communities where it operated, investing millions in hospitals, medicine, water projects and education in the localities of its mines.

Ranked as one of North America's best companies in terms of corporate responsibility, it was also listed as one of the 'top 100 sustainable companies' by NASDAQ, consistently featured on the Dow Jones Sustainability World Index, and included on

the Corporate Knights Global 100 list of the most sustainable companies. It had set up a Corporate Responsibility Advisory Board and human rights compliance programmes.

Yet Barrick – and Munk himself – had become targets of environmental and social protests, by opponents who called into question the company's motives for social responsibility and the effects of its mines on pristine landscapes and local communities. In its push for expansion, the company had acquired and developed mines in some "challenging environments", where corruption, violence and poverty were endemic, and human rights were often flouted. Barrick claimed to make it a priority to improve the lives of citizens in countries like these – first by stoking the economy and adding employment opportunities, then through community enhancements such as building hospitals and schools. (See Fig. 12.4 for geographic breakdown of Barrick's international gold production.)

In 2011, Barrick came under fire when police security guards at the partly-owned Northern Mara gold mine in a remote area of Tanzania shot at marauding locals looking for remnants of gold rocks on the site. The company was also called to account for rapes allegedly committed by its workers at a mine in Papua New Guinea.[8] A newly-opened mine in the Dominican Republic, which Barrick operated in a joint venture with Goldcorp, faced a setback when the government demanded a larger share of the profits just a few months after the mine began operating in 2013. To cap it all, the company's push to develop Pascua Lama in the Andes had drawn international protest from environmentalists.

But Munk often restated his vow that the company would conduct its mining in a socially responsible fashion:

> "It's not enough to have money. It's not enough to have reserves. It's not enough to have great mining people," he told shareholders in 2012. "Today, the single most critical factor in growing a mining company is a social consensus—a license to mine."

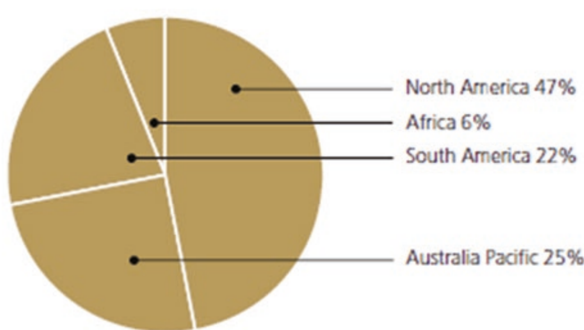

Fig. 12.4 Barrick Gold Corporation's Gold Production by Region (Source: Barrick 2012 Annual Report)

[8] Margaret Wente, "Our World Needs More Peter Munks," Toronto Globe and Mail, June 11, 2011

Pascua Lama

The Pascua Lama mining project posed unprecedented challenges – both political and engineering – as the first gold mine to straddle national borders and at the dizzying altitude of 5000 metres above sea level.

Sitting on one of the world's biggest gold reserves, the open-pit mine was expected to generate an average of 800,000–850,000 oz of gold and 35 million ounces of silver per year in its first 5 years, at very low cost. It had a projected lifespan of 25 years.[9] It was being built on mountain ledges so high that most plants couldn't grow there, and workers had to be checked frequently for altitude sickness. Even in the summer the land was mostly barren. Temperatures ranged from 30 °C to minus 40.[10]

The nearest community on the Chilean side was 45 km westward down the mountain. The nearest Argentine neighbours were 156 km away. Both were keenly interested in the project's potential to impact their water supplies. The mountain peaks, where the project was being built, tower above Chile's Atacama desert region, one of the driest areas on earth. The land there gets almost no rain and depends upon the runoff from snowfall in the Andes Mountains for almost all its water. The Huasco Valley on the Chilean side, with a population of 66,000, is dotted with olive groves and vineyards, where a sweet wine called *pajarete* is produced.

Historically, the populations in the valleys below had had some of Chile and Argentina's highest high poverty and unemployment rates, but the Pascua Lama project promised to increase opportunities. In February 2013, some 12,500 people were working on the construction of the project.[11] According to Barrick, the Pascua Lama promised to generate 1660 direct jobs during the 25 years of its operation. It had received more than 145,000 applications for employment, most from people in the surrounding areas.

Before it could even begin the project, Barrick had to help negotiate a treaty between the governments of Argentina and Chile to allow the gold – 75% of which was expected to come from the Chilean side – to cross the border by truck and conveyor belt to the Argentina side for most of the processing.

Exploration for the project began in 1994, after Barrick acquired the assets of Lac Minerals Corporation. In 2000, Barrick submitted a first environmental impact report (EIR) to the Chilean government, but low gold prices kept the project on hold. A second EIR was submitted in 2004. At that time, the mine was estimated to cost $1.5 billion and go into production in 2009.

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[9] Barrick Pascua Lama project description, http://www.barrick.com/operations/projects/pascua-lama/default.aspx

[10] Descriptions of the mine site summarized from Barrick's Pascua Lama FAQs and Catherine Solyom, "More than just costs are a concern at Barrick Gold's $8.5B Pascua-Lama Megamine," Montreal Gazette, December 14 2012

[11] Barrick Newsletter, Beyond Borders "Training helps fill local skills gap at Pascua-Lama" http://barrickbeyondborders.com/2013/02/training-helps-fill-local-skills-gap-at-pascua-lama/

Fig. 12.5 A Barrick outreach worker goes door-to-door to explain Pascua Lama (Source: Barrick beyond Borders 2009)

Since then, Barrick had spent more than $15 million and 200,000 man hours generating 5336 pages of environmental review documents to obtain the permits for the Chilean side alone.[12] Meanwhile the project had piled up enough delays and cost overruns to make it one of the most expensive mines ever constructed. By the fall of 2013, Pascua's expected total costs by end-of-project had soared to $8.5 billion and production had been pushed back to mid-2016.

Stakeholder Outreach Efforts

As part of the company's commitment "to be a partner in every community where it operates" Barrick had conducted information campaigns and poured resources into the region around Pascua Lama. Starting in 2000, the company held "disclosure meetings", conducted a door-to-door information campaign that reached 40% of the homes in the Huasco region, mounted television, radio and billboard ad campaigns, and set up community information offices in local towns and villages in communities on either side of the border. Barrick held nearly 1000 meetings and dozens of 'open houses' in the region to solicit and respond to community comments.[13](See Fig. 12.5 for photo of outreach efforts.)

In February 2006, the Chilean region's environmental commission set more than 400 conditions the company needed to meet in order to go forward with the project, many of which reflected the comments and concerns expressed by affected residents during the review process. Barrick agreed to changes, including changing the mine pit's boundary to avoid glaciers, increasing the project's environmental monitoring,

[12] Barrick, "Pascua Lama FAQs" http://www.barrick.com/operations/projects/pascua-lama/faq/default.aspx

[13] Barrick's stakeholder outreach activities summarized from Barrick's "Pascua Lama FAQs" and "Barrick Pascua-Lama Shareholder Report" prepared by ERM, November 30, 2006

moving the rock crusher to a below-ground location, road improvements, and the addition of a camp for 750 workers (instead of having them transported to the mine daily). By 2009 it had all the government go-aheads needed for the project.

While conducting the required environmental review, Barrick was spearheading dozens of social projects for local residents. It built a paediatric ward to improve a poorly-equipped hospital in Rodeo, Argentina. It funded school buses to take Chilean children to school in the Huasco Valley area. It built housing for victims of Chile's devastating 2010 earthquake. It partnered with Intel Corporation to bring laptops and teacher training to secondary schools in Chile, and sponsored a dental hygiene program that served 2000 children. It paid to create a book and education programmes on the history of the valley's local Diaguita indigenous tribe, and it teamed up with the Chilean government to create a fund to bring $60 million in water system improvements to local consumers over the lifetime of the mine.[14] In addition, the company ran training programmes to give local residents the skills to work in the mining industry and supplier development programmes to help local merchants gain the expertise to provide supplies to Pascua Lama.

The mine gained fans in the community. In 2007, Barrick published a letter addressed to the regional government from a residents' association representing 6600 families in the Huasco province of Chile supporting the mine's development:

> *For many years we have seen how our families, friends and neighbours have been forced to leave their homes in search of jobs… There are many who fight against our people's progress, to keep them living in inadequate conditions, with no aspirations. But it is time for us to raise our voices demanding the same opportunities that others have had. Our people deserve prosperity.*

But other community members protested that the land was sure to be harmed by the vast amount of rock crushing and chemicals the gold mine operations would bring. Each ounce of pure gold can require removal of as much as 20-tons of rocks, creating rubble heaps the size of a 30-story building.[15] They worried about the effect on the glaciers. They said their sleepy farming community would be turned into a booming mining town that might be abandoned when the mine closed 25 years later.

During the EIR process in 2006, protesters dumped chunks of ice in front of the presidential palace in Santiago, Chile, to symbolize the destruction of glaciers. In the years that followed, protesters marched on the streets of Vallenar, the biggest city in Huasco province, and Greenpeace protesters were arrested for blocking trucks heading to the mine site. An email petition purporting to be written by valley farmers circled the globe, charging that the project would destroy the glaciers,

[14] Benefits to the community summarized from various Barrick Beyond Borders blog posts 2007–2013 http://barrickbeyondborders.com/ and Catherine Solyom "Clean Capitalism Gets Mixed Results in the Andes," Montreal Gazette, December 17, 2012.

[15] Jimmy Langman, "Pollution: Losing Some Luster; With gold prices skyrocketing, environmentalists are taking aim at one of the world's dirtiest industries", Newsweek April 24, 2006.

contaminate rivers, and then "every last gramme of gold will go abroad to the multinational corporation."[16]

While Barrick responded that many of these claims were exaggerated or distorted, the company's outreach efforts seemed to have backfired. Opponents of the project charged that Barrick had simply been buying off community members by paying for costly social benefits. They complained that the Barrick logo had become so prevalent on school buses, new medical clinics and billboards in the Huasco Valley that the area was becoming a company town. They even charged that Barrick had tried to get supporters elected in local mayoral contests.[17]

In particular, opponents pointed to the Pro-Water Fund, created with money from Barrick and the Chilean government, which had committed to spend $60 million on improvements such as sealing irrigation ditches to prevent water waste through evaporation. This resulted in some farmers getting use out of arid lands that couldn't have farmed before. But it also divided the 2000-member irrigation users group from others who didn't enjoy the benefits. Opponents, labelled the fund "hush money", noting that members of the irrigation network had vehemently opposed the Pascua Lama mine until it negotiated the Water Fund with Barrick in 2005.[18]

Some groups said they had been completely disenfranchised. A group representing some of the indigenous Diaguita people living in the Huasco Valley region of Chile, for example, accused government leaders and company officials of ignoring local community concerns in their haste to get money flowing from the gold mine. In two separate lawsuits, they claimed that the project would jeopardize the water and environmental health of the region and impinge upon their ancestral lands. They also claimed that the company had divided their community by creating education programmes that were not faithful to the indigenous traditions of the region, showing a picture of local indigenous people dressed up in "fake" Indian costumes.

In 2010, members of the indigenous community came to Barrick's annual meeting in Toronto to express their opposition to the project:

"Barrick has manipulated and corrupted our culture," said a letter from representatives of the Diaguita Huascoaltinos Indigenous and Agricultural community presented to Barrick shareholders. (See Fig. 12.6 for a full copy of the letter.)

McGill University History Professor Daviken Studnicki-Gizbert, who is also the coordinator of the McGill research group investigating Canadian mining in Latin America, said Barrick's approach to corporate social responsibility was more akin to public relations than genuine community involvement: "It gives an aura of concern and respectability to the industry on social and environmental issues. But the company never sits down and actually says, "Do you want this mine here?" Studnicki-Gizbert, told the *Montreal Gazette*. "It's not consultation. It's a performance."

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[16] See http://www.hoax-slayer.com/pascua-lama-petition.html

[17] Catherine Solyom, "Clean Capitalism Gets Mixed Results in the Andes," Montreal Gazette, December 17, 2012.

[18] Catherine Solyom, "In Arid Chile, Villagers and Farmers Divided over Benefits of Water Fund," Montreal Gazette, December 17, 2012.

Letter Presented at the Barrick Gold 2010 Annual General Meeting by:

Idolia del Carmen Bordones Jorquera, Jaime Nibaldo Ardiles Ardiles, María Inés Bordones Jorquera, Daniela Guzmán González (interpreter and advisor)

We have come from the Huasco Valley in Chile, representing the Diaguita Huascoaltinos Indigenous and Agricultural Community. We are the direct heirs of the Native People of Huasco Alto, and we have inhabited this land since time immemorial. Our Community consists of 250 families of indigenous peasants, farmers and herders; we are the only Diaguita community that remained organized after the Spanish colony in Huasco Valley and we also have title to our lands.

Huasco Valley is the last unpolluted valley of northern Chile. Our lands guard important natural and cultural resources, and they hold the major fresh water reservoirs of this valley. That is why in 2006 we decided to make our Community territory a Natural and Cultural Reserve. This is incompatible with Barrick's Pascua Lama and future Pachuy megaproject.

Barrick Gold, without respect for our traditions, our plans and our right to self-determination, wants to force us to accept the mega mining in our Reserve. In 1998, Barrick Gold seized about 124,000 acres of ancestral lands that belong to our Community. Then, Barrick installed a locked gate that prevents the passage of herders through our own land. This gate is illegal as this road is public, but Barrick continues to refuse public access.

The Pascua Lama project was approved by the State of Chile in 2001 without permission from our community. So we sued the State of Chile in the Inter-American Commission on Human Rigths, and this demand was admitted for processing in February of this year.

Although the project officially began this year, Barrick exploration has led to the degradation of the glaciers near the Pascua Lama project. In 2005, the General Directorate of Water of Chile issued a report that blames the company for the loss of 50-75% of glaciers in the area. Recently, on November 11, 2009, the Chilean Government fined Barrick Gold for, among other things, continuing to damage the glaciers, drawing water from unauthorized sites and breaking occupational health and air quality commitments.

Now, Barrick has illegally extended its work to other sectors of our domain title. In those areas, we can already see the destruction of wetlands and forests, and the extraction of water from unauthorized sites, among other damages. These actions have led us to bring two lawsuits against the company in the courts of Chile which are now being processed.

Also, in seeking to better its image, Barrick Gold, in conjunction with the National Indigenous Development Corporation of Chile, has promoted the creation of Diaguita Communities with no territorial base. With financial support from the company, Barrick has manipulated and corrupted our culture. They have denied that we, Huascoaltinos, are an indigenous people, they have raised false community leaders, and they have brought professionals to teach the Huascoaltinos about our own culture. What right do you have to come to teach us about our own traditions? What right do you have to manipulate our traditions, inventing costumes, dances, forms of weaving and pottery that are not our own? With this, the company has divided and confused the identity of our people, and has caused us great damage.

We have always been aware that in the land of Huascoaltinos there is great mineral wealth, but our real wealth is its landscapes, the pure water rising in the Andes, with its unique animals and plants. It is our responsibility to protect this precious legacy, as a mark of respect to our ancestors, as a gift to our children and grandchildren, and also as a contribution to the care of Mother Earth and the heritage of all mankind. Therefore, as Huascoaltinos, we are going to defend the Valley. We will not allow Barrick to destroy our land and our culture. We will not allow you to appropriate the legacy left by our ancestors. Today, we come here to order the closure of Pascua Lama. Shareholders, if you continue to mine in our lands, you will remain complicit in the pollution and destruction of our culture and you will be enriched in return for the death of our people. We are here to tell you again that we do not need your money to develop and we are not seeking compensation, because there is not fair compensation for the death of our Mother. We just want you to leave our lands and allow us to live in peace.

Fig. 12.6 Letter presented to the Barrick Annual Shareholders meeting in 2010 by members of the Diaguita Huascoaltinos Indigenous and Agricultural community

Yet, in speaking about the Barrick's corporate social responsibility efforts, Peter Munk has said that the company needs to draw a line between genuine stakeholders and those who oppose all industry:

> *"While we love NGOs…We equally have to stand up to those who are, just on principle, against any type of development,"* Munk told shareholders in 2012. *"Instead of working with us to develop better mine operations…they say: whatever you do, go away. We don't want you. What are people going to do, line up for social programmes in the remote hills of Tanzania or Peru? There ain't no social programmes there, so there is no alternative."*

Environmental Concerns

For residents of the valleys down the slopes from Pascua Lama, the biggest worry was that the project would dissipate or contaminate their already-dwindling water supplies. (See Fig. 12.7 for map of the project.) Once in operation, the mine would use up to 38 tons of explosives a day to blast mountain tops into rocks, then up to

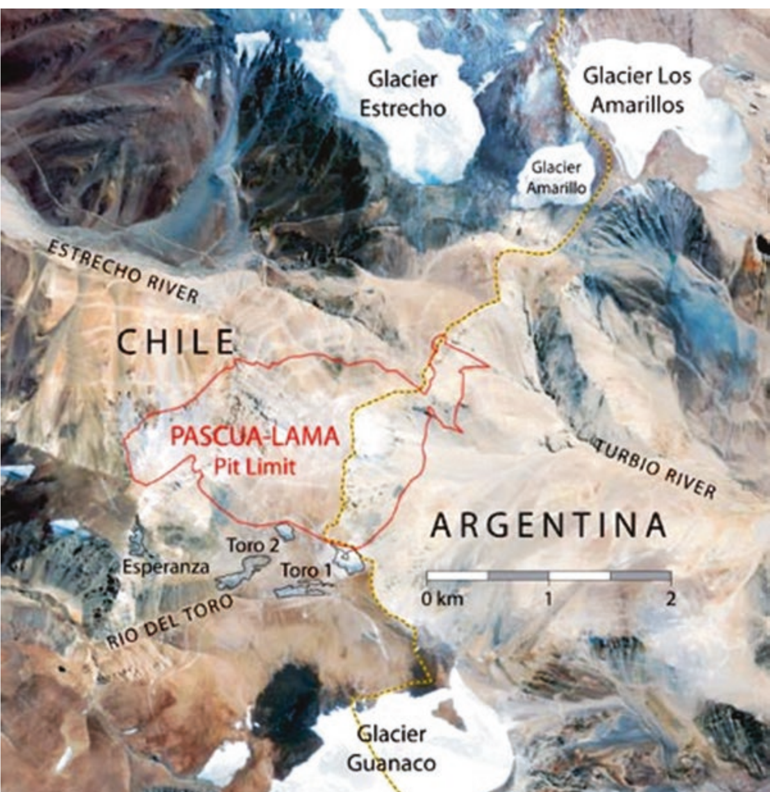


Fig. 12.7 Pascua Lama Plan (Source: Barrick Gold Corporation)

27 tons of cyanide and 33 million litres of water per day to extract the gold.[19] The mine's processing plant would have the capacity to move 45,000 tons of ore per day through a cyanide leaching process. Barrick said that the mine would only draw about 0.3% of the water flowing down the Huasco River into the Chilean valley's main reservoir. The rest would come from the Argentina side, where most of the processing facilities were being constructed.

Seeing as how the Huasco farming region on the Chilean side of the border depended upon runoff which coursed down the slopes from the Pascua Lama area, Barrick planned to prevent contamination that could occur if natural runoff were to pass through the mine site. The company acknowledged that if precipitation, snow melt or runoff passed through the mine, it could produce acidic water potentially harmful to the environment. This toxic runoff, known as acid rock drainage (ARD), is released when sulphides in the rock come into contact with air and water. The disturbance caused by crushing tons of rock in the mining process could worsen the acidification.

Barrick planned to prevent acid drainage from coming into contact with the surrounding landscape by capturing and diverting water that would have naturally flowed through the mine facility. Instead it would be carried around the site in troughs that encircled the mine's perimeter. It would run the water used in the mining process through a treatment plant, then recycle it to be used again in mining. The company promised to monitor the quality of any water leaving the Barrick property going into the Huasco Valley and ensure it met Chilean potable water standards 15 km upstream from the nearest users. Water quality would be monitored at 49 surface and underground points in Chile and 25 points in Argentina.[20]

In practice, regulators started finding fault with the mine's environmental regulation systems long before Pascua Lama was due to open. In January 2013, Barrick said, one of the water diversion channels on the Chilean side collapsed, causing a mudslide that flooded a small area of vegetation. The facility was forced to let natural runoff water flow through the mine construction site – a violation of Barrick's environmental permit.[21]

The violation resulted in Chilean regulators suspending construction on the Chilean side of the project until Barrick could complete millions of dollars in improvements to the water diversion system. The regulator claimed that under its permit, Barrick should have finished the water system before it started the "pre-stripping process" of moving tons of rock mountain tops to reach the gold-containing ore underneath, but didn't.[22] (See Fig. 12.8 for Barrick's explanation of the problem.)

[19] Catherine Solyom, "More than just costs are a concern at Barrick Gold's $8.5B Pascua-Lama Megamine," Montreal Gazette, December 14 2012.

[20] Barrick, "Pascua Lama FAQs" http://www.barrick.com/operations/projects/pascua-lama/faq/default.aspx

[21] Barrick Pascua-Lama Chilean Water Management System Fact Sheet.

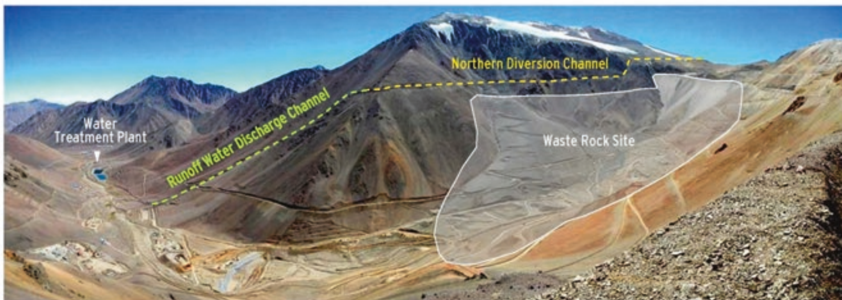
[22] Reuters "Chile environment permit for Barrick mine was flawed –president," June 6, 2013.

Next Steps: Strengthening the Water Management System

Barrick has submitted a plan to the SMA that outlines how the company will complete the water management system, and how it will strengthen key aspects of it to ensure such an incident does not occur again. Subject to permit approvals, Barrick anticipates this work will be completed by the end of 2014, after which the company expects to be in a position to resume construction on the project in Chile. The improvements to strengthen the system target the design of key channels and include enhancements to environmental monitoring at the site.

The North Channel design has been significantly upgraded to handle increased water and sediment flow. Natural and unlined channels will be strengthened with concrete lining and cover slabs will be used in areas where landslides may occur. The enhanced design also features improved sediment controls. The run-off water discharge channel that failed in January will be upgraded to a stepped concrete channel, which will disperse energy from water as it flows down, transporting it safely into the local river system below. This is natural water from snow and glacier melt that does not come into contact with the mine area.

The environmental monitoring system will be enhanced to include additional flowmeter sensors to better measure and control the water flow rate in the system. Enhancements to dust monitoring and mitigation measures include the installation of additional dust monitoring stations, fog cannons and mesh netting around waste rock sites and the open pit area to reduce airborne dust.



Pascua-Lama - Chilean Water Management System Fact Sheet Page 2

Fig. 12.8 Barrick fact sheet explaining water management problems at Pascua Lama (Source: Barrick Gold Corporation)

The Chilean government had already suspended pre-stripping in October 2012, citing concerns that excessive dust from the pre-stripping process could harm workers' health. Also hanging over the project was a law approved by Argentina's congress in 2010 banning any mining on or around glaciers. The measure passed into law, but hadn't been enforced by local authority's overseeing Pascua Lama's development in Argentina's San Juan Province. Environmentalists were pressing for the law to be used to stop the mine, but Barrick denied it was applicable as the ore it was

mining was not under a glacier. Courts had also demanded a stop to the construction on the Chilean side of the project while they considered the validity of the environmental claims by members of the indigenous Diaguita community.

While the locals were most concerned about whether Pascua Lama would harm their water supplies, it was the potential to damage glaciers that worried the international environmental community most. The Glacier Estrecho was a few kilometres to the north of the vast pit Barrick was clearing for the mine. To the south was Glacier Guanaco. Within the boundaries of the mine site were three smaller glaciers, referred to by Barrick as "glacierets" or "ice reserves," known as Toro 1, Toro 2 and Esperanza.

In its 2005 environmental report, Barrick had proposed getting at some of the buried gold deposits by moving some of this ice by bulldozer and attaching it to another glacier a few kilometres away. But Chile had insisted as one of 400 environmental conditions set on the project in the permit process that "the company shall only access the ore in a manner that does not remove, relocate, destroy or physically intervene with the Toro 1, Toro 2, and Esperanza glaciers." The company then redrew the boundaries of the mine pit to avoid the glacial areas, thus agreeing to leave more than one million ounces of gold under the ice. Barrick vowed not to impact the small glaciers, which it said were already melting due to global warming. It planned monitoring programmes to watch for impacts with photographic surveys, meltwater monitoring and baseline statistical comparisons.

But environmental groups claimed damage had already been done in Barrick's initial exploration of the site and in the pre-stripping process. A technical report by the Center for Human Rights and Environment, an NGO in Cordoba, Argentina, claimed glaciers had already been affected by road-building and the dust and disruption caused by explosions used in the process of building Pascua Lama and Veladero, another Barrick mine 10 km away on the Argentina side of the border, which went into operation in 2005. The report claimed that the small glacier Toro 1 had been completely covered in debris and dust from construction, which had the potential to change the glacier's reflectivity and accelerate melting. It said Google satellite images showed that roads were built right through the glaciers during the exploratory process.[23]

Barrick acknowledged that the glaciers had shrunk, but attributed it to the effects of global warming. Barrick Corporation President Jamie Sokalsky told shareholders in April: "it's important to note there have been no adverse impacts on water quality or glaciers."

[23] Jorge Daniel Taillant, "Barrick's Glaciers, Technical Report on the Impact by Barrick Gold on Glaciers and Periglacial Environments at Pascua Lama and Veladero," Center for Human Rights and Environment, 2013.

Industry-Wide Woes

As Munk explained to shareholders at Barrick's 2013 annual meeting, even larger market forces were threatening to capsize the entire gold mining industry. For years, gold prices had been pumped up by the world's economic worries. Between 2007 and 2011 the price of gold tripled from around $680 to an all-time high of $1920 an ounce, sending mining companies scrambling to develop new sources of precious ore. Most of the easily-accessible gold had already been mined, forcing miners to undertake ambitious projects to cull the valuable metal from increasingly lower grades of ore. Like Barrick, many companies had launched expensive mega-mining projects.

Meanwhile, said Munk, the world's citizens were becoming more environmentally-conscious and regulators were becoming tougher on mining projects. Developing countries were showing increasing signs of 'resource nationalism' and demanding greater royalties from projects. All this pushed costs up at the worst time.

The price of gold began falling in late 2011. By June of 2013 it had taken its biggest plunge since 1980 to $1233 an ounce and in October it still hovered at around only $1300 an ounce, a level that threatened to make much of the ongoing production unprofitable.[24] "Everybody was enjoying the high tide, and now that the tide is coming down you're seeing who's swimming naked. And the thing is, everybody's swimming naked." Veritas Investment Research analyst Pawel Rajszel told Reuters.

For Barrick, pressure to take new action on Pascua Lama was coming from all sides. Shareholders were demanding immediate profitability and were even calling for Munk's resignation as part of a push for new management direction. Environmentalists and some locals wanted the project to be scrapped altogether. And regulators were looking for quick action on the environmental problems at the site. Meanwhile, the costs the project were rising by the minute, as falling gold prices made the prospect of profitability ever more distant. As the end of 2013 neared, the question of what Barrick would do with its most ambitious project loomed large. Should the company push past the opposition to forge ahead with a project that promised to provide rich gold sources for years to come? Or should it turn back on the nearly $5 billion it had already invested?

Munk made it clear to investors that, under existing conditions, there was no easy course for gold mining interests:

> *"Gold itself is under attack," he told shareholders in April. "There are traders and analysts who have pointed out that trees don't grow to the sky and there's a limit to this bonanza that, for the last 10 or 12 years, covered up all kinds of mistakes and flaws and all these missteps, purely by having a higher gold price."*

[24] Allison Martell and Euan Rocha "Gold miners face new challenge in plummeting gold price," Reuters, April 15, 2013.

Walmart: Love, Earth (A)

13

N. Craig Smith and Robert J. Crawford

In late 2004, Assheton Carter was contemplating what projects he should take on. Carter was an activist at Conservation International (CI) in mining safety, working conditions, the environment, and the rights of community and indigenous peoples. From his CI unit, the Center for Environmental Leadership in Business (CELB), he was seeking to find a high-profile, high impact project that would both accomplish something concrete and set a precedent – of transparency in extractive industries, of activist methods, and of cooperative interaction between non-governmental organizations (NGOs) and multi-national corporations (MNCs). His desk was littered with documents from current projects, including the overall strategy for CI as well as engagements with Disney and the oil and natural gas industries.

One of his potential projects included Walmart's jewellery business. Walmart, he knew, was the world's largest jewellery retailer, with annual sales of $US2.75 billion, which represented nearly 2% of total world sales. Change Walmart's approach to sustainability, he reasoned, and MNCs throughout the world would take notice. However, after nearly 2 years of attempting to engage with the company, he had recognized that Walmart personnel changed so fast that he seemed to have to re-educate a new set of managers in the same issues every few months. Not only did that add up to a major commitment of his time, but he felt increasingly frustrated with the lack of momentum.

Then his phone rang. Dee Breazeale, Vice President for jewellery at the Walmart affiliate Sam's Club, was on the line. "Can you fill me in", she asked, "on sources of rubies and the challenges with buying rubies from Burma?" He had met Breazeale earlier that year at Walmart headquarters in Bentonville, Arkansas, in a CI delegation that was negotiating the modalities of an advisory arrangement with the company. Her honesty and willingness to learn had deeply impressed him, though little

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G. G. Lenssen, N. C. Smith (eds.), *Managing Sustainable Business*,
https://doi.org/10.1007/978-94-024-1144-7_13

had happened in the months that followed. Nonetheless, he knew that, once convinced, she had the power to act – immediately.

Within a week, she decided to purchase all of her unit's rubies from suppliers in Brazil rather than Burma; this represented a major shift in the jewellery market, with global implications. It was at that moment that Carter decided to work more intensively with the company. "Dee was not what I was used to when dealing with corporate execs," he recalled. "No pretence, no 'silver tongue', just 'I've got an issue, I don't like being associated with dirty business, and I want your help to put it right.' To me, that was wonderful. I could work with that."

Carter had many ideas on how he might proceed. Executives like Breazeale in Walmart, he observed, were beginning to take a straightforward approach to issues of corporate responsibility and sustainability: "Figure out what the problem is; find people who want to help solve it." Those who preferred to denounce Walmart from the sidelines, it was clear, would not be invited. This was, he believed, an opportunity to impact not just the jewellery market, but to establish a new approach to sustainability for global businesses. While the "conflict diamonds" campaign earlier in the decade had been relatively successful, he wanted to do something different by creating a project that would largely rely on MNCs to change and monitor their behaviour – in a way that made *business sense* to them – rather than depend on enforcement by governments and international organizations in accordance with international treaties.

One of the most promising ideas might be the creation of a "green" line of jewellery – free of "dirty gold" and "conflict diamonds", with sustainable operations and careful attention paid to working conditions along the entire supply chain. Once they established the proper standards for mining companies, and indeed the entire supply chain, the system would have to be transparent and verifiable. No one had ever done this for the mining industry. So it was with these ideas in mind that a few days later Carter picked up the phone to call some NGO colleagues.

Background

Sam Walton founded Walmart in 1962, to bring big-city discounting to his corner of the rural American South. His idea was to offer the same range of merchandise found in nearby stores, but at about 20% lower prices every day rather than by short-term sales promotions. While this would lower his profit margins, he calculated that Walmart could triple gross sales. Furthermore, as the company grew Walton instilled a relentless drive in managers to lower costs by going directly to manufacturers, as well as by constantly increasing worker productivity.[1] As computer technologies became available, Walmart also developed a distribution network of state-of-the-art

[1] See Robert Slater, The Walmart Triumph: Inside the World's #1 Company, Portfolio, 2003, p. 30–34.

precision, enabling the company to predict consumer tastes but also to deliver goods where and when they were desired.[2]

Walton's formula was a phenomenal success. By 2004, Walmart had become the world's largest corporation and non-governmental employer. Net sales in fiscal 2009 exceeded $US400 billion, serving 200 million customers each week in over 8400 stores worldwide; operating income reached $24 billion.[3] Walmart accounted for approximately 10% of all retail sales in the U.S.[4]

Combined with its sheer size, Walmart's technological capabilities enabled the company to exert an unprecedented degree of control over not only its employees, but also its business partners (independent manufacturers, suppliers, and distributors).[5] A centralized management style placed high expectations on local managers, who routinely worked 60-h weeks. While managers faced brutally demanding targets for cost containment and profitability, they were given an extraordinarily free hand with which to achieve them, the so-called "tight/loose" management practice. As long as they acted within their mandate and with support from their superiors, this freedom empowered Walmart managers to pursue their own ideas with energy and creativity so long as they respected certain limits. Walmart's centralization represented a fundamental shift of market power to the retailer and away from manufacturers, in effect creating a near-monopsony – it could impose its will on partners to set prices, to package goods to fit Walmart requirements, and even to adopt management and accounting practices in accordance with Walmart requirements.[6]

The Critics

Walmart's power and behaviour galvanized an army of critics and activists, who condemned its practices and began to mount grassroots protest campaigns, boycotts and media attacks in an effort to tarnish the brand.[7] First, critics argued, Walmart had to somehow ameliorate its impact on the communities that it entered. Not only did they believe that Walmart destroyed local "mom and pop" stores that could not compete on price, but it also generated the second-hand effects of increased traffic, reduced demand for other local businesses, such as competing shops and

[2] See James Hoopes, "Growth Through Knowledge" in Lichtenstein, op. cit., p. 91, and Misha Petrovic and Gary G. Hamilton, "Making Global Markets," in Lichtenstein, ibid., p. 133.

[3] Walmart Annual Report 2010, http://walmartstores.com/sites/annualreport/2010/financial_highlights.aspx.

[4] Charles Fishman, The Walmart Effect: How the World's Most Powerful Company Really Works – and How It's Transforming the American Economy, Penguin Press, 2006, p. 103.

[5] See Nelson Lichtenstein, Walmart: The Face of Twentieth Century Capitalism, Nelson Lichtenstein (ed.), p. 11.

[6] Petrovic and Hamilton, op. cit., p. 130.

[7] See Maria Halkias, "Walmart's Urban Push," The Dallas Morning News, 1 November, 2005.

newspapers that lost ad revenues, and imposed additional infrastructure costs that generated new tax burdens.[8]

Second, Walmart's labour practices, they demanded, had to improve. Employees must be allowed to unionize, earn better wages, obtain affordable health insurance benefits, and enjoy more humane treatment.[9] As it stood, many critics charged, the tight/loose management style forced managers to resort to degrading and even illegal practices in the relentless pursuit of "improvements" in employee performance, allegedly in the form of unpaid over-time, the effective elimination of rest or meal breaks, and the exploitation of overseas sweatshop labour.[10]

Third, they charged, Walmart had to provide a more equitable and environmentally friendly management of its supply chain, from the treatment of "sweatshop workers" in China by supply partners to its means of transportation. To meet these goals, many observers believed, Walmart would have to change its business model: the company would have to pay more for the goods and services it bought, which would diminish its razor-thin profit margins and necessitate higher prices. This would violate the principle behind Walmart's "everyday low prices" formula.[11]

Walmart Responds

For its first few decades of explosive growth, Walmart had ignored the critics as a matter of company policy. The company had virtually no lobbying presence in Washington, DC, and devoted little attention to its image.[12] That changed in 2004. Faced with mounting criticism and a momentarily declining stock price, then-Chief Executive Lee Scott decided that Walmart should become a more responsible company, to jump ahead of the curve in a move assailed by some as a blatant public relations counter-offensive.[13]

The first big success of Scott's new strategy was the company's relief efforts in 2005 on behalf of the victims of Hurricane Katrina, in Louisiana and Mississippi.

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[8] See Bill Quinn, How Walmart is Destroying America (and the World) and What You Can Do About It, Ten Speed Press, 2005, pp. 1–26.

[9] According to Fishman, op. cit., pp. 240–1, in Tennessee 10,261 children of Walmart employees were enrolled in state health care for the poor; in Georgia, 9,617 Walmart associates were provided healthcare by state-aided programmes for the poor. Wake-Up Walmart claimed that one in seven U.S. Walmart employees had no healthcare coverage and that a substantial number earned below the poverty line. See: http://www.wakeupwalmart.com/facts/#healthcare

[10] Ellen Israel Rosen, "How to Squeeze More Out of a Penny," in Lichtenstein, op. cit., pp. 245–246.

[11] See Liza Featherstone, "Walmart's P.R. War," Salon.com, 2 August 2005.

[12] Bethany Moreton, To Serve God and Walmart: The Making of Christian Free Enterprize, Harvard University Press, 2009, pp. 1–5.

[13] Michael Barbaro, "A New Weapon for Walmart: A War Room," The New York Times, 1 November, 2005. From 2000 to 2005, Walmart's share price dropped approximately 20 %; at that time, Walmart appeared to have reached the saturation point of its rural expansion strategy, necessitating a move into urban markets, where it faced a more effective political opposition.

Scott, who claimed that the Katrina episode led to a personal "epiphany", promised that this was only the beginning of the company's transformation.[14] Articulating a vision in cooperation with Conservation International and other external groups, Scott promised that the company would become a leader in sustainability, reducing greenhouse gases produced by Walmart stores by 20% over the next seven years, enhancing the efficiency of its truck fleet, which was the largest in the U.S., and innumerable similar measures. Moreover, Scott emphasized, Walmart was taking steps to improve the treatment of its workers: health care coverage would be provided to Walmart associates for as low as $25 per month. To further publicize these efforts, Scott even called on the US Congress to raise the minimum wage.[15]

Walmart began to take concrete steps to implement Scott's vision, which he disseminated within the company in a series of "aspirational goals" that were realistic and transmitted a message of change – both internally and externally. With the help of consultants, Scott encouraged Walmart employees to undertake "Personal Sustainability Projects", which were designed to educate them through voluntary activities, hopefully inspiring them to pursue their own sustainability initiatives. Later, employees elected "sustainability captains" to communicate their goals and explain their activities to others in the company, eventually growing to include just under one third of all Walmart employees. In addition, Walmart began a number of initiatives to increase the transparency of the company's practices, including:

- A company-wide effort to identify and openly acknowledge "environmental blind spots";
- A series of reports on its progress toward the aspirational goals;
- The opening of the company to constructive outside stakeholders.

Such transparency would, Scott stated, encourage employees to think in new ways, spark an influx of new ideas for improvement, and finally, uncover business opportunities that Walmart had not considered. It was not, in his view, merely greenwashing, as critics continued to charge.[16]

By early 2006, with the aid of CI under a consultancy arrangement, a group of Walmart executives were designating "actionable priorities" they could pursue. Combining Walmart's sales data with environmental impact factors as articulated by the Union of Concerned Scientists, a science-based nonprofit advocacy group, they focused in on 14 areas, which were called "Sustainable Value Networks". (See Exhibit 13.1.) In each of the 14 areas, Walmart assigned an Executive Vice President as sponsor along with a "network captain", who was usually a Senior Vice President. Dee Breazeale was designated a network captain for jewellery. Like the others, she was mandated to contact academics, NGOs, suppliers and other stakeholders to join

[14] See Robert Berner, "Can Walmart Wear a White Hat?" BusinessWeek, 3 October, 2005.

[15] As cited in Pia Sarkar, "Walmart's World View: Giant Retailer Says It's Ready to Tackle Hot-Button Issues," San Francisco Chronicle, 26 October, 2005.

[16] Adam Werback, Strategy for Sustainability: A Business Manifesto, Harvard Business Press, 2009, pp. 35–36; 92–118; 132–135; 157–158.

discussions on sustainability measures that Walmart might undertake.[17] At this early stage, their actions were voluntary, according to Carter: "Dee was acting on her own sense of responsibility, there was no obligation" for her or any other participants.

A native of Arkansas, Dee Breazeale went to a local university. At one time, she had worked as a backup singer to a Country Western band. She had been at Walmart for nearly two decades. After graduating with an MBA, she took an entry level job as a merchandise assistant at Walmart on an hourly wage. Quickly recognizing her commitment to the company and high potential, her bosses recommended Breazeale for the management fast-track programme. She rotated through every area in the company, from real-estate, human resources and marketing to information systems and operations. Later, Breazeale ran a district of stores in northern California, served three years in Germany with the international division, and returned to Arkansas as Vice President in the jewellery division. At Walmart, she recalled, "I was allowed great autonomy to pursue my vision… You set a goal, get the signoff, and then you have the freedom to do it just about any way you want… If it didn't work, they [upper-level managers] let you try something different but just don't make the same mistake twice!"

During the internal discussions on sustainability in 2005, which led to the creation of Walmart's Sustainable Value Networks, Breazeale had become interested in contributing to the effort and participating in the jewellery SVN. "I loved to take on more," she explained. With the support of her boss, she also committed herself to interface with and represent the LGBT (Lesbian, Gay, Bisexual and Transgender) community in Walmart, which began to attract some critical attention in the local "family" press. "The typical role of the retailer was to buy product from the suppliers at the best price," she recalled. "I found the concept of digging into every aspect of getting jewellery to market – transparently – a daunting task, but a very positive goal."

The success of a Sustainable Value Network depended in large measure on the energy that their captains devoted to them. Nonetheless, the Walmart employees involved in them still had to accomplish their full-time jobs. Some critics worried that network captains and participating employees lacked the time either to devote themselves to these tasks or indeed to engage their minds in areas they had never had time to contemplate. With few exceptions, there were no new full-time staff hired to run the networks. Some of them, such as the packaging network, had 500 members or more; others, such as Breazeale's jewellery SVN, consisted of only 15 or so. Often, even Walmart's determined outside critics were invited to participate.[18]

Earthworks and the NGOs

When Stephen D'Esposito joined the NGO Earthworks in 1997, the "extractive sector" – the mining of gold, diamonds, and other minerals – was viewed by activists as fragmented and unfocused, in spite of documented environmental degradation,

[17] See Erica L. Plambeck, "The Greening of Walmart's Supply Chain", Supply Chain Management Review, 1 July, 2007.

[18] Ylan Q. Mui, "At Walmart, 'Green' Has Various Shades", Washington Post, November 16, 2007.

ongoing health issues in mining communities, and innumerable instances where corporations had failed to correct or even examine their conduct. “The premise,” he recalled, “was that, due to the remoteness of mining sites, our leverage was severely limited.” As VP for Policy and later President and CEO, D’Esposito believed that a new approach, based on the entire life cycle of the products involved, would create opportunities to promote Earthworks’ agenda in clean water, community health, and corporate social accountability. “I wanted to work on the mining companies,” he explained, “but also involve the refineries, the jewellers, and even the retailers at the end of the life-cycle chain.”

As a visible industry that was deeply concerned with branding, he believed that the jewellery sector offered the best opportunity to create influence throughout the overall sector. Indeed, gold mining was one of the dirtiest industries in existence. Not only was it getting more difficult to extract as deposits dwindled – to produce the gold for a single finger ring generated approximately 20 tons of waste, much of it toxic, including cyanide – and its slag was responsible for the pollution of waterways, vast areas were deforested, and it often displaced communities nearby.[19]

Over the previous decade, D’Esposito had helped to transform Greenpeace from a collection of local activist groups carrying out their own initiatives into an integrated, global advocacy and campaign organization. Through its provocative actions, Greenpeace could draw attention to the conduct of corporations or governments that it deemed harmful to the environment. It was the quintessential “protest NGO” that ran campaigns of opposition. Nonetheless, D’Esposito felt that a positive message – some species to protect, some specific environment to preserve – was key to his fundraising efforts. “We preferred to build campaigns around saving an animal or a beautiful place, not just attack companies,” he explained. “It is an oversimplification to say that NGOs must appear in opposition to MNCs to raise money,” he argued. “That is repeated way too often.”

For Earthworks, D’Esposito resolved to combine protest actions with a more constructive engagement. The times, he observed, were changing: not only were efforts from within the extractive sector underway to create formal deliberative structures regarding sustainability, but in January, 2000 a major mining accident in Baia Mare, Romania, had captured world media attention and led to demands for action.[20] There was also the example of “conflict diamonds”. In the late 1990s a grassroots campaign sought to restrict the exportation of diamonds as a means to finance civil wars in several countries, such as Sierra Leone and the Democratic Republic of Congo. In a few years, the conflict diamonds campaign led directly to the establishment of the Kimberly Process Certification Scheme, whereby the governments of diamond producing and importing countries would exchange only sealed packages of diamonds; traffickers in conflict diamonds would face criminal prosecution; and exporting countries violating its terms could be expelled from the scheme, in effect blocking their trade revenues. Backed by public opinion, the

[19] See Earthworks, “Tarnished Gold? Assessing the jewelry industry’s progress on ethical sourcing of metals,” March 2010.

[20] See UNEP/OCHA Report on the Cyanide Spill at Baia Mare, Romania.

Kimberly Process was the result of a collaboration between the United Nations, governments, NGOs, and diamond producers. Not only did it succeed in curtailing trade in conflict diamonds, but it aided in the stabilization and development of fragile countries.[21]

Some MNCs in the extractive sector, D'Esposito was coming to believe, appeared ready to act as more responsible corporate citizens and even to take concrete steps. "I found some companies were doing their own analyses," he said. "They had seen the writing on the wall" about sustainability and increasing consumer involvement, particularly in the luxury industry. For example, the mining company Rio Tinto was spearheading the Global Mining Initiative, which initiated a dialogue with stakeholders. To D'Esposito, this suggested that a more inclusive approach was becoming possible, relying on a network of groups – local activists, governments at various levels, and media, but also for-profit corporations – to pursue Earthworks' goals in negotiations with MNCs. "We would start with pressure," he said, "but then try to collaborate if the [target] corporation should demonstrate some willingness to work with us." It was a stick and carrot approach.

One key collaborator was Keith Slack, a campaign activist with Oxfam America. According to D'Esposito, "He had the best early ideas. Earthworks needed him because we had weaknesses, we were small with limited reach… and lacked a well-known brand" among NGOs. As such, Earthworks was able to combine its substantive expertise in the industry with Oxfam's ability to mobilize international protests against specific corporations or sectors via its regional and global activist networks. Raising awareness about the mining accident in Baia Mare, Romania, had been one of their early successes.

D'Esposito and Slack began to work with civil society leaders worldwide to establish a set of "Golden Rules" for responsible mining that would form the basis of both a public advocacy campaign and segue into an engagement with mining companies and others in the supply chain. This included an in-depth analysis of best practices – a "Framework for Responsible Mining" – that was co-sponsored by Tiffany & Co. By 2002, in addition to other initiatives, the efforts of D'Esposito, Slack and other NGOs culminated in the No Dirty Gold campaign, which employed protest action as a means to leverage the industry to open negotiations.

By early 2004, No Dirty Gold had introduced the Golden Rules pledge (see Exhibit 13.2), to which signatories would commit themselves on a voluntary basis, in effect refusing to buy gold from suppliers that failed to respect human rights and its environmental criteria for mining. By signing, retailers acknowledged that they felt "morally obligated" to address these issues. It was an unmistakable acknowledgment that gold suppliers were susceptible to pressure from consumer groups, setting a precedent for that sector of the mining industry.[22] The eventual goal was to create a multi-stakeholder system (of retailers, mining companies, manufacturers,

[21] See blooddiamonds.org/the-kimberly-process/.

[22] See John Tepper Marlin, "The 'No Dirty Gold' campaign: what economists can learn from and contribute to corporate campaigns," The Economics of Peace and Security Journal, Vol. 1, No. 2 (2006), pp. 57–60.

and NGOs), similar to those that existed for wood products and diamonds, to independently verify compliance with the Golden Rules.[23] No Dirty Gold, they believed, would open the way to further dialogue with leaders from civil society organizations and industrial groups.

By late 2005, 17 of the world's most important retailers had signed on – most on the luxury end, including Tiffany & Co. and Cartier. But Walmart, Sears and Target had not. "That was when we initiated our 'leaders and laggards' strategy," D'Esposito said, according to which additional public pressure would be brought to bear. Walmart, he knew, might be attempting to change, but its managers so far had failed to respond to letters from the campaign.

In February, 2006 Earthworks and Oxfam named Walmart a No Dirty Gold "laggard" in a full page ad in the New York Times. After extensive discussions with Assheton Carter, Dee Breazeale extended an invitation on his recommendation to D'Esposito, Slack and a few others to meet.

The Vancouver Dialogue

Conservation International (CI) was a NGO with a history of dialogue and negotiation with MNCs as a stakeholder; CI did not engage in protest campaigns against corporations from the outside but chose instead to work with them closely and discreetly. CI's association with Walmart had begun in 2002, when biologist Peter Seligman, co-founder and CEO of CI, began to cultivate a friendship with Sam Walton's eldest son, Robert Walton, a member of the company's board. In 2004, this led to a consulting arrangement with CI, which was engaged to investigate opportunities and make recommendations for sustainability initiatives at the company.[24]

Assheton Carter had been attempting unsuccessfully to engage Walmart since 2003. He was tired of the lack of response and had felt tempted to move on to other projects. Nonetheless, he hoped, the consulting arrangement might open up the company. The moment, in his view, was unusually propitious. "There was a shift in the concept of CSR [corporate social responsibility]," he said. It was moving, he believed, from a kind of elitist concern – "of carping NGOs" – to a more democratic movement involving direct pressure from consumer activists in new areas, such as conflict diamonds, rare hardwoods, and sea resources. One method, he continued, was to attack the brand of large MNCs in an effort to get them to direct their managers and business partners to act in a more ethical manner. Then his CI unit, the Center for Environmental Leadership in Business (CELB), could bring innovative approaches for sustainability to corporations. According to Carter, CI was not directly paid for its advice, but instead received donations in a general conservation fund. "Campaign NGOs play a vital role," he explained, "but are only part of a bigger process."

Even more important, according to Carter, was a shift in focus: "We are not just looking at environmental impacts like the 'carbon footprint'," he said, "but also at

[23] See http://www.nodirtygold.org/fact_sheet.cfm

[24] Marc Gunther, "The Green Machine," Fortune, July 31, 2006.

the core business itself. That is the way to establish *strategic* sustainability." In other words, he saw it as his mission to move CSR into the heart of a company's business model from the peripheral, somewhat esoteric concerns that NGOs had long pursued. "If you don't understand the business model," he explained, "you are not going to get anywhere. It's the starting point for real dialogue." Otherwise, he cautioned, public relations concerns tended to dominate the results for MNCs, with simple actions tacked on after the business decisions had already been made. "We want to open their eyes to sustainability. CELB's goal is transformational," that is, to embed CSR and sustainability into everyday decision-making as a matter of course. This could only occur, he argued, when it was a component of the business model and hence part of the company's incentive systems that rewarded managers for performance. To do so, Carter explained, "We would offer advice that was relevant to their business concerns, but that also fit our mandate regarding sustainability… We were business consultants, but with our own agenda."

From the first months of 2004, Carter had patiently attempted to establish a professional relationship with Breazeale. "I began to educate Dee on the issues," he recalled. "It was very hard. She rarely had any time – every time we talked she was multi-tasking on something else. I wanted to know that she was taking what I had to say seriously, that she was committed. Sometimes weeks or months would go by with no response, but she always came back to me." Carter was attempting to engage her in a number of processes:

- To gain her trust as an advisor.
- To provide basic information and context on the issues, in particular those beyond the normal purview of her job.
- To explain what she could expect from the various NGOs.
- To bring Walmart into formal, constructive dialogues with other stakeholders.
- To gain access to other sustainability leaders within Walmart.
- To keep concrete goals and missions at the forefront of the company's concerns.
- To formulate and help to implement company strategies.

In spite of the frustration, Carter had persisted. Eventually, this resulted in Breazeale's decisive action on his advice about rubies from Burma. Carter concluded: "Dee wanted to engage with NGOs who were challenging Walmart…I facilitated conversations and kept things going." They discussed many issues, including the idea of creating a line of jewellery that had traceable source materials.

In June, 2006 Carter organized a meeting in Vancouver, Canada, which included mining companies, Tiffany & Co., Walmart, various NGOs, and many others. It was the culmination of a long effort to bring the stakeholders together. At the meeting, he introduced D'Esposito and Slack to Breazeale and her team. It was, he explained, a mixture of information and putting the companies on notice that there was a concerned activist community ready to take action. The suggestions from NGOs included signing onto the "Golden Rules" standards for responsible mining and

better controlling the use of recycled gold. They were suggesting putting the buying power of Walmart behind direct sourcing from specific mines as a way to create a dedicated chain-of-custody, that is, establish tighter control over the behaviour and policies of all segments in the supply chain.

For their part, most of the mining companies wanted to get the NGOs off their backs and saw that a line of traceable products might go some way to accomplish that. In addition, because Walmart and Tiffany & Co. – the end-users of mining products – were pushing the mining companies to work with NGOs, some recognized the advantages in doing so. Interestingly, according to Carter, the retailers learned that the mining companies Rio Tinto and Newmont were far more vertically integrated than they had thought.

D'Esposito and Slack took on the development of mining standards through IRMA, the Initiative for Responsible Mining Assurance, a multi-stakeholder effort that included mining companies, trade organizations, NGOs, retailers, and individual consultants. Walmart indicated that, should IRMA come up with "good standards", it would incorporate them into its sustainability requirements. Nonetheless, it would be an extremely ambitious multi-stakeholder effort.

The Vancouver meeting was exciting for Breazeale. "I wasn't plugged in at all to the NGOs and activist groups surrounding mining. I needed to educate myself to tear apart every step of the process and determine what path to take," Breazeale recalled, "so we [within Walmart] began to put our heads together and engage leading mines and manufacturers to work together for a common goal." Her chief collaborator was Assheton Carter, who had become intimately involved with all aspects in the formulation of her sustainability initiatives at Walmart, including not just the provision of information, but also writing, editing, and commenting on documents for both public and confidential, in-company purposes, and sometimes even the implementation of its sustainability strategy. But Walmart did not pay him. While CI received funds from Walmart, as Oxfam and other NGOs did from many corporations, Carter emphasized, his unit did not. "My job never depended directly on Walmart funding," he said.

Working Together

After the Vancouver meeting, Breazeale and Carter invited D'Esposito and Keith Slack of Oxfam to the Bentonville, Arkansas headquarters to continue the dialogue. They began to brainstorm about what might be done concretely, perhaps even in the creation of sustainable product lines. "It was the most intense half-day meeting – really good," D'Esposito recalled, "because it was all operational people leading it… We told them what we are doing, they asked me what they should do, where they might get traction."

However, the IRMA effort turned into a time-consuming and frustrating episode that advanced at a glacial pace. A big issue was that Breazeale – and the Walmart colleagues to whom she was delegating tasks – sometimes lacked the mental space to come up with ideas in new areas beyond their regular jobs. Unlike some other SVNs,

they were not given any additional resources to fulfil their sustainability mission. For their part, the NGOs found the commitment onerous as well. According to Keith Slack, "It required a real investment of time. NGOs don't have the bandwidth or resources to do this… We had to educate them and continually follow up on things, like reviewing the countless draft documents for the standards that we were trying to negotiate."

Slack was disappointed in the mining standards that were emerging from Walmart. He also felt increasingly worried that the involvement of Oxfam might somehow co-opt the organization. "We did not," he emphasized, "wish to see Oxfam's participation as an endorsement of the results. We wanted to talk and contribute, but that was as far as it went." He did not want to be paid as a consultant, in his view, "because that would have led to a loss of independence." CI, he believed, "could no longer publicly be critical when it is necessary." Regarding the results, like many participants and observers, Slack was disappointed that representatives of the local communities were not sufficiently consulted as they went forward. "Even though we had a constructive dialogue that allowed expert input, it wasn't inclusive enough," he explained. "No one could speak on behalf of the miners or the people living nearby." Furthermore, Slack was concerned about the disposal of waste generated in the mining process (or "tailings") as well as the regulation of mining in environmentally protected areas. Beyond that, he remained suspicious about Walmart's motives. "The most important issue," he concluded, "was the treatment of Walmart labourers [employees]. I began to wonder if the whole sustainability effort was a way to deflect attention from that."

According to Carter, "Keith was unwilling to compromise on these issues, even when we [at CI] felt that we were making significant progress." In Carter's opinion, the outcome had much more positive potential. "We spent a lot of time trying to push the players to think," he recalled. "We didn't want them to take something off the shelf. We wanted to create something together, to be part of a process. Walmart saw itself as only a retailer, but we were arguing that there were immense scale-up possibilities, that the company could have a major impact by changing the way that it did things. They were listening." For many months, Carter was also striving to convince mining companies – which were reluctant to deal with retailers because they were unaccustomed to collaborating with that segment of the supply chain – into a traceable jewellery deal. Nonetheless, he was confident that Breazeale could make things happen with Walmart's market clout.

By the end of the summer, Breazeale and Carter were championing the creation of a line of jewellery, later named "Love, Earth", all inputs of which would be able to be traced to sustainable sources and practices. Carter took on the role of doing much of the legwork for the project; beyond sustainability issues, this included input into the formulation of the business case, its sales goals, and the documents to present their ideas within the company. In particular, with a long-term commitment by vertically integrated suppliers, Carter and Breazeale advanced the arguments that a traceable line would carry a number of business advantages: (1) the creation of an exclusive jewellery line differentiated by its pioneering sustainability and unique design; (2) a less complex (or "truncated") supply line, based on closer relations with suppliers, that

should reduce prices of input materials, as well as (3) assure a more secure supply line, and (4) provide a guarantee of product quality for the duration of the arrangement.

In October 2006, the initiative suffered a number of serious setbacks. The IRMA negotiations on standards for an industry-wide certification system had apparently stalled. Carter reluctantly concluded that voluntary criteria only for Walmart, such as those in No Dirty Gold, would have to do for the time being. This would generate controversy among NGOs, some of which wanted to continue to push for a comprehensive voluntary agreement rather than a one-off commitment from Walmart. For other NGOs, not even a comprehensive voluntary agreement would be enough: they wanted governments to impose stricter regulations on the mining companies. Soon thereafter, Keith Slack exited the process, convinced that he could accomplish more from the outside. Perhaps worst of all, Dee Breazeale left Walmart to open her own consulting business, which threatened to derail the entire process. If her attention had appeared sporadic, at least she had known how to get things done from within the Walmart culture.

Love, Earth

After some initial scepticism, Breazeale's successor, Pam Mortensen, became interested in the traceable jewellery project, though she needed to get up to speed on the issues. In Carter's view, they were starting over once again "from square 1". It was, he reasoned, just part of the cost of doing business with Walmart. As soon became evident, Mortensen brought her own inspiration and energy to the process. In Carter's opinion, Walmart was prepared to invest in a real business initiative with sustainability at the heart of its business model. On Mortensen's recommendation, Walmart finally signed the Golden Rules pledge in early 2007, and was taken off the Earthworks/Oxfam "laggard" list.

By April, 2007, a concrete business plan emerged for a line of traceable jewellery, from mining to delivery for sale. The jewellery line would be designed and manufactured for Walmart, carrying an exclusive brand name. It would meet Walmart's sustainability goals, yet would not charge consumers any kind of green premium. Instead, the jewellery line would be affordable in accordance with Walmart's "everyday low prices", ranging approximately from less than $US 40 to no more than $150, which was not appreciably different from the other jewellery lines that Walmart currently sold. Finally, as a measure of success, traceable jewellery should account for 10% of all Walmart sales in both gold and diamond jewellery by 2010, which based on public figures would add up to approximately $US 60 million and $US 50 million respectively. "Pam was a brilliant champion for the idea," Carter said. The plan was finalized and approved in early 2008, though some pieces still had yet to fall into place, not least of which was assuring traceability.

For his part, Carter continued in his role as an advisor, coaching Mortensen on how to interact with NGOs, but also helping her to implement the project. "We continued to run it together," Carter explained, in a relationship based on trust and mutual respect rather than obligation. Soon, Carter was writing documents on behalf of Mortensen and Walmart, from internal memos to press releases and web materials.

Carter also maintained relations with NGOs and the mining companies. Regarding Slack's departure, he understood that Oxfam as an organization no longer felt the outcomes likely to emerge from the traceable jewellery line would be sufficient to warrant its continued participation. In other words, Oxfam found that too many compromises had been made. According to Carter, "Campaign NGOs face a real dilemma. Their opposition to MNC practices is their legitimate strategy to raise awareness about irresponsible business and is how they build their support base. They are comfortable and effective being unequivocal opponents, but they aren't sure how to constructively engage corporations and, at the same time, satisfy their supporters."

Moreover, in his view, Slack and many other NGOs lacked the technical expertise in the extractive sectors that CI and Earthworks had developed. CI, for example, specifically sought to engage scientists and academics in their work. In Great Britain, Carter had earned a PhD in business strategy and sustainability in the international mining sector; he was able to write a business plan that would be profitable and do the right thing in accordance with his vision.

Without agreed-upon voluntary standards, Carter decided that separately negotiated criteria, a "mini-certification scheme", was a viable option that also had the potential to revitalize other efforts. (See Exhibit 13.3 for Walmart Mining Criteria.) Carter based them largely on the Golden Rules pledge. To verify compliance, third-party inspectors were supposed to be allowed into the supply chain. Unfortunately, no matter what commitments they established, Carter acknowledged that some critics would denounce these as greenwashing from both Walmart and the mining companies.

There were also technical challenges to overcome. The principal problem with traceability was the complexity of inputs: any product could have hundreds of entry points along the supply chain. When it came to gold, the challenge was to differentiate sources when the refining process typically destroyed the possibility of tracing its origins: the output from multiple mines and even recycled gold were melted and mixed together into an indistinguishable molten mass. Furthermore, the labour practices of subcontractors in both processing and manufacturing jewellery would come under scrutiny and hence had to be controlled. Finally, Walmart's implementation and oversight would also receive vigorous attention from activists. Would it be acceptable if any of these inputs were "ethically tainted", that is, came from questionable sources that employed unsustainable mining practices, paid the miners too little, or even used methods of transportation damaging to the environment? It appeared that there were few straightforward answers to these challenges. Any claim that Walmart made was guaranteed to receive minute critical scrutiny.

The mining companies Rio Tinto and Newmont agreed to join the effort as long-term partners. Newmont was highly vertically integrated: it had its own mines and refineries. This meant that Newmont could arrange to refine all the gold that it mined, making virtually all inputs traceable, from mining to manufacturing. Rio Tinto, it turned out, could accomplish a similar arrangement for both gold and diamonds. Both companies would use only their own mines (gold from the US, diamonds from Australia), which guaranteed their responsibility and control over all raw material inputs. To offer transparency to consumers – the opportunity to follow

the overall process for sustainability – Carter found a software engineer, Tim Wilson, who had created a wiki for collaborative input at each stage in the supply process. Carter introduced Wilson to Mortensen, who was leading the effort within Walmart for Love, Earth. With her support, Walmart signed them on to the project immediately. Finally, the jewellery manufacturer Aurafin, which was owned by the philanthropist Warren Buffett, was brought on board.

Though Mortensen soon moved on to another job, her successor Gail Campbell oversaw the final stages of development of the Love, Earth line of jewellery. By going online, a consumer could input the batch number of their purchase and instantly learn where and how it was mined, where it was refined, and who manufactured it, including details of the conditions they worked in. (See Exhibit 13.4, Love, Earth Press Release; Exhibit 13.5, Process Comparison; Exhibit 13.6, Online Trace It; Exhibit 13.7 Example of Walmart Love, Earth products and Trace It Batch Query Box.) Launched in July 2008, the process and product line were touted as a precedent-setting breakthrough, receiving wide coverage in the popular press.

Exhibit 13.1 Sustainable Value Network Goals

Background. The Sustainable Value Networks were launched during the Business Sustainability milestone meeting on November 9th, 2005. Since that time, most of the Sustainable Value Networks have had a Network kickoff meeting with suppliers, supplier's suppliers, non-governmental organizations (NGOs), government organizations, academics and other external thought-leaders.

Network Deliverables. All Networks have completed the following deliverables:

- Identified six quick wins
- Identified at least one innovation project
- Developed an understanding of the systemic barriers to achieving "big game change" (reaching full sustainability) and identified the critical success factors for overcoming those barriers
- Developed a draft product scorecard or metrics

Progress. In general, momentum and excitement continues to build and most networks have framed exciting projects that deliver business value and environmental performance. In addition to material economic and environmental benefits, common business benefits include:

- Expanding the internal network of working relationships – Associates are working across organizations and functions to solve issues;
- Developing an external network of stakeholders, relationships and capabilities related to listening, internalizing and acting on new information and perspectives; and,
- Increased employee engagement and job satisfaction.

Opportunities. The common challenges that many networks are experiencing are:

- Resource issues – time commitments associated with learning our way into a new way of working;
- Ability to maintain ongoing productive relationships with external stakeholders outside of Network meetings;
- Getting suppliers out of an incremental mindset and truly innovating; and
- Gap between current global procurement function and a strategic, global sourcing function, designed to address sustainability issues and build capabilities in the extended supply chain.

In addition, we see opportunities to accelerate progress and results through competency building on key skills, including systems thinking, strategic planning and fact-based decision making.

For details on each network's deliverables, go to the intranet site, www.walmart-plus.com and select the network you want in the upper right corner of the page. At the bottom of each network page is a downloadable .pdf file with the detailed report for that network.

Walmart Sustainable Value Networks
Greenhouse Gas
Sustainable Building
Alternative Fuels
Logistics
Waste
Packaging
Wood and Paper
Agriculture and Seafood
Textiles
Jewellery
Electronics
Chemical Intensive Products

Source: CELB walmartstores.com/sustainability/7672.aspx

Exhibit 13.2 Golden Rules Pledge

The Golden Rules

The Golden Rules are a set of criteria for more responsible mining. These criteria are based on broadly accepted international human rights laws and basic principles of sustainable development.

The No Dirty Gold campaign developed the Golden Rules based on extensive reviews of documents and research prepared by the mining industry, civil society organizations, scientific researchers and technical experts, international bodies such

as the UN, the World Bank's Extractive Industries Review, and other multi-stakeholder processes.

The No Dirty Gold campaign calls on mining companies to meet the following basic standards in their operations:

- Respect basic human rights as outlined in international conventions and laws.
- Obtain the free, prior, and informed consent (FPIC) of affected communities.
- Respect workers' rights and labor standards, including safe working conditions.
- Ensure that operations are not located in areas of armed or militarized conflict.
- Ensure that projects do not force communities off their lands.
- Refrain from dumping mine waste into oceans, rivers, lakes, or streams.
- Ensure that projects are not located in protected areas, fragile ecosystems, or other areas of high conservation or ecological value.
- Ensure that projects do not contaminate water, soil, or air with sulfuric acid drainage or other toxic chemicals.
- Cover all costs of closing down and cleaning up mine sites.
- Fully disclose information about social and environmental effects of projects.
- Allow independent verification of the above.

Source: Earthworks and Oxfam, No Dirty Gold Brochure; http://www.nodirtygold.org/goldenrules.cfm

Exhibit 13.3 The Walmart Voluntary Criteria

Walmart's Initial Environmental and Social Sourcing Criteria for Mining and Metals in Jewellery

The vision of the JSVN is to provide Walmart and Sam's Club customers with affordable, quality products that aim to have a net positive effect on the environment and human health. We plan to achieve this vision by striving to ensure the application of the following principles in our supply chain throughout the life-cycle of our products:

1. Incorporation of lifecycle analysis into business decisions planning and management plans and to recover material value wherever possible
2. Continual improvement of health and safety performance
3. Efficient production and minimization of waste and pollution
4. Safe disposal and management of waste and hazardous materials
5. Protection of ecological functioning, ecosystem services and important biodiversity and respect legally designated protected areas
6. Respect for the rights of individuals, indigenous peoples and communities
7. Respect for employee rights regarding safe working conditions and terms of employment
8. Contribution to the sustainable development of communities affected by operations
9. Transparency of sources and assurance of sustainability performance

10. Compliance with applicable laws, regulations and treaties at international, national, state and local level

Long Term Goal: 100% of gold, silver and diamonds used in the jewellery sold in Walmart will be sourced from mines and produced by manufacturers that meet Walmart's sustainability standards and criteria. We also want to incorporate recycled materials used in the jewellery by working with mines, refineries and manufacturers.

Target: By 2010 achieve 10% traceability of all diamonds, gold and silver in jewellery sold in Walmart from mines, refineries and manufacturers meeting Walmart's sustainability standards and criteria.

Long Term Goal – Packaging: All jewellery poly-bags to be bio-degradable and convert all pallets and all boxes to recyclable materials.

How the Walmart Sustainability Criteria Are Developed

To help us develop the Walmart criteria for responsible mining we reviewed many existing commitments and continuing initiatives on sustainable mining, including the International Council of Mining and Metal's (ICMM) Sustainable Development Framework, the Initiative for Responsible Mining Assurance's (IRMA) emerging standards for mine site assurance, the ten Gold Rules put forward by the No Dirty Gold Campaign, the standards championed in the Framework for Responsible Mining, and the International Financial Organization's (IFC) environmental and social performance standards. While we have made all final decisions as to these criteria, over many months, we engaged and sought input from a wide spectrum of experts, some of which included Rio Tinto Ltd., Newmont Mining Corporation, Conservation International, Earthworks, World Wildlife Fund, and Oxfam America. We sought input from these organizations because of their perspective and energy they bring to advancing the sustainable development agenda. In line with their institutional policies, we understand that the valuable participation of these organizations does not imply their endorsement of the Love, Earth product line or sourcing criteria.

Walmart's Initial Environmental and Social Sourcing Criteria for Mining and Metals in Jewellery

Company Criteria: Mines supplying precious metals and gemstones for jewellery sold in Walmart and Sam's Club stores are operated by companies that:

1. Are committed to incorporate the principles of sustainable development and the respect for human rights into policies and operating practices pursuant to the International Council on Mining and Metals Sustainable Development Framework or an equivalent standard;
2. Are signatories to and in compliance with the Voluntary Principles on Security and Human Rights;
3. Are signatory to the Global Compact;
4. Are committed to supporting the Extractive Industries Transparency Initiative practices;

5. Are signatory to the World Economic Forum's Partnering Against Corruption Initiative;
6. Seek to reduce Greenhouse Gas Emissions and report their emissions annually using a credible reporting protocol (for example The World Resources Institute and World Business Council on Sustainable Development Greenhouse Gas Protocol or the Carbon Disclosure Project);
7. Annually publish an externally assured environmental and social performance report using the Global Reporting Initiative guidelines and sector supplement, and AA1000 Assurance Framework, or equivalent process.
8. Adhere to Kimberley Process certification scheme and the World Diamond Council system of warranties where appropriate;

Mine Criteria: Mines supplying precious metals and gemstones for jewellery sold in Walmart and Sam's Club stores will:

9. Have in place policies and practices that uphold fundamental human rights and respect cultures, customs and values in dealings with employees including[25]:
   1. Elimination of forced, compulsory or child labor;
   2. Fair remuneration of employees that is in compliance with the local and national laws and consistent with the prevailing local standards in the countries of operation;
   3. Policies and practices designed to eliminate harassment and unfair discrimination;
   4. The freedom of association and the effective recognition of the right to collective bargaining;
   5. Maintain reasonable employee work hours in compliance with local standards and applicable laws;
   6. Provision of appropriate cultural and human rights training and guidance for all relevant staff, including security personnel;
10. When operating in zones of armed conflict, through initial due diligence and, thereafter, by careful monitoring of risk and in consultation with local communities and other stakeholders as appropriate, should seek to ensure that, through their actions or inaction, they are not benefiting from, supporting, contributing

[25] Criteria 8 and 9 have been in part guided by Walmart's Stores Inc., Standards for Suppliers, The International Finance Corporation (IFC), Performance Standard 2: Labor and Working Conditions; the International Council of Mining and Metals, Sustainable Development Principle 3; the UN Global Compact; and, a number of international conventions negotiated through the International Labour Organization (ILO) and the United Nations (UN) including:

ILO Convention 87 on Freedom of Association and Protection of the Right to Organize
ILO Convention 98 on the Right to Organize and Collective Bargaining
ILO Convention 29 on Forced Labor
ILO Convention 105 on the Abolition of Forced Labor
ILO Convention 138 on Minimum Age (of Employment)
ILO Convention 182 on the Worst Forms of Child Labor
ILO Convention 100 on Equal Remuneration
ILO Convention 111 on Discrimination (Employment and Occupation)

to, nor tacitly permitting human rights abuses or atrocities, either directly or indirectly.

11. Conduct public consultation and disclosure to achieve the widest possible acceptance and support of communities directly affected by project activities throughout the project's lifecycle from earliest exploration activities, prior to commencement of mining, during mine operations and through to closure;
12. Engage with communities directly affected by the project on an ongoing basis and in an inclusive and culturally appropriate manner, ensuring that their rights are respected and their interests and development aspirations are considered in major mining decisions and community-related programs; and implement and utilize compensation and a grievance and mediation mechanism where and when appropriate;
13. Seek to avoid or at least minimize involuntary resettlement of communities for new operations and expansion of existing operations and where this is unavoidable compensate fully, appropriately and fairly for adverse effects on individuals and communities with the objective of improving or at least to restore the livelihoods, standards of living, and living conditions of displaced people;
14. Complete an environmental and social impact assessment, including an analysis of mine closure, that follows credible and recognized guidelines for impact assessment (for example the US National Environmental Policy Act (NEPA) and International Association for Impact Assessment (IAIA));
15. Utilize a recognized environmental management system that explicitly states the company's environmental policy and objectives and includes management plans, as is appropriate, for acid rock drainage, water, cyanide, mercury, waste management, overburden, tailings, and releases (for example, the International Standards Organization 14001 standard);
16. Prepare an appropriate closure and reclamation plan for the operation that includes a financial guarantee, sureties or provisions, to meet costs of closure and reclamation;
17. Certification under the International Cyanide Management Code (ICMI) Verification Protocol, where cyanide is used;
18. Implementation of emerging MACT (Maximum Achievable Control Technology) where by-product mercury is produced, pursuant to the Nevada Administrative Code, for point source air emissions;
19. Adopt tailings management practices that maintain terrestrial, marine and river ecosystem functioning and services at the landscape scale;
20. Not operate in World Heritage Sites and sites of critically important biodiversity,[26] including Alliance for Zero Extinction sites and protected areas

[26] Sites with habitat required for the survival of critically endangered or endangered species; four areas having special significance for endemic or restricted-range species; sites that are critical for the survival of migratory species; areas supporting globally significant concentrations or numbers of individuals of congregatory species; areas with unique assemblages of species or which are associated with key evolutionary processes or provide key ecosystem services; and areas having biodiversity of significant social, economic or cultural importance to local communities.

categorized as 1 and 3 under The World Conservation Union (IUCN) system of Protected Area Management Categories[27];

21. Adopt practices that contribute to the long-term conservation of species and the integrity of biotic communities, ecosystem processes and services;
22. Compensate within a landscape context for any significant residual adverse impacts on biodiversity, and the direct users of biodiversity, after appropriate avoidance, minimization and reclamation (rehabilitation) measures have been taken;
23. Develop and maintain an Emergency Response Plan, in collaboration with local communities and relevant agencies, pursuant to guidance provided by Awareness and Preparedness for Emergencies at the Local Level (APELL);
24. Comply with, at a minimum, applicable host country laws and regulations.

Source: CELB

Exhibit 13.4 Love, Earth Press Release

Walmart Adds a New Facet to Its Fine Jewellery Lines: Traceability

Retailer Partners with Conservation International to Launch Love, Earth Jewellery and New Sustainable Criteria

Bentonville, Ark. and Arlington, Va. – July 15, 2008 – Walmart Stores, Inc. (NYSE: WMT) today launched Love, Earth® jewellery, its first completely traceable fine jewellery line available exclusively at Walmart stores, Sam's Club locations and on Walmart.com and Samsclub.com.

Marking a shift in how affordably-priced fine jewellery is produced and sold, the new line is the result of collaboration between Walmart, Conservation International (CI) and Walmart's supply chain partners. It will give customers the ability to trace the path of their Love, Earth jewellery from mine to store by simply going online.

Love, Earth is the retailer's first step toward having all of the gold, silver and diamonds used in the jewellery sold in its Walmart stores and Sam's Club locations come from mines and manufacturers that meet Walmart's sustainability standards and criteria. The criteria address both environmental, human rights and community issues. By 2010, the retailer aims for at least 10 % of its jewellery offerings to achieve these standards.

"Walmart recognizes that our customers care about the quality of their jewellery and its potential impact on the world," said Pam Mortensen, vice president and divisional merchandise manager for Walmart. "With Love, Earth, customers are getting an affordable and beautiful piece of jewellery that also helps sustain resources and strengthen communities."

[27] There may be unique situations where the development of a mine can benefit or enhance the conservation and protection of valuable ecosystems. If it can be demonstrated that material benefit from mining will occur – a 'net-positive' outcome – development in these areas may be considered.

Consumers can visit www.loveearthinfo.com to see where their Love, Earth jewellery was mined and manufactured, and learn about suppliers' environmental and social programs. The site also offers information about the standards used to select suppliers and ensure the entire process is more sustainable.

"With its considerable influence, market reach and commitment to sustainability, Walmart has brought together like-minded suppliers, mining companies and conservation partners to work together to build a traceable jewellery supply chain at an impressive scale," said Dr. Assheton Stewart Carter, Senior Director of Business Policies and Practices at Conservation International.

"We hope others in the jewellery industry will follow this leadership example and thus enable consumers to make simple choices that benefit the environment and mining communities when shopping for jewellery."

To create Love, Earth, Walmart selected partners in the mining and jewellery manufacturing industries that already demonstrated environmental and social leadership, including Rio Tinto, an Anglo-Australian mining company; Newmont Mining Corporation, a global gold producer headquartered in Denver, Colorado; and Aurafin, a Florida-based jewellery manufacturer. During the next phase of the partnership, the retailer plans to expand the number of approved mining and manufacturing suppliers and introduce diamonds in the Love, Earth line.

The Walmart Love, Earth collection is made from 10 karat gold and sterling silver; the Sam's Club collection from 14 karat gold and sterling silver. Each collection includes fashion pendants, hoop earrings, bangles and fashion beads. Created with gold and silver, the Love,

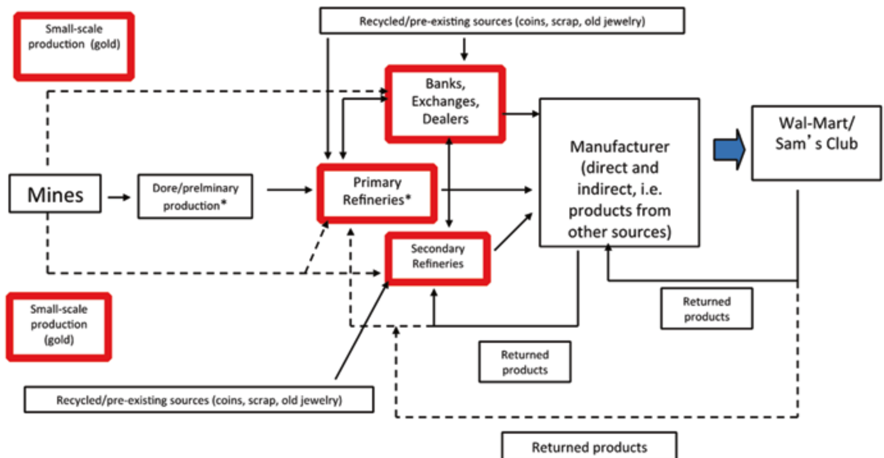
Earth collection is designed to symbolize the Earth's elements and based on the precepts of recycle, reduce, and respect.

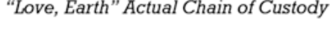
Want to Trace a Piece of Love, Earth Jewellery from Mine to Market?

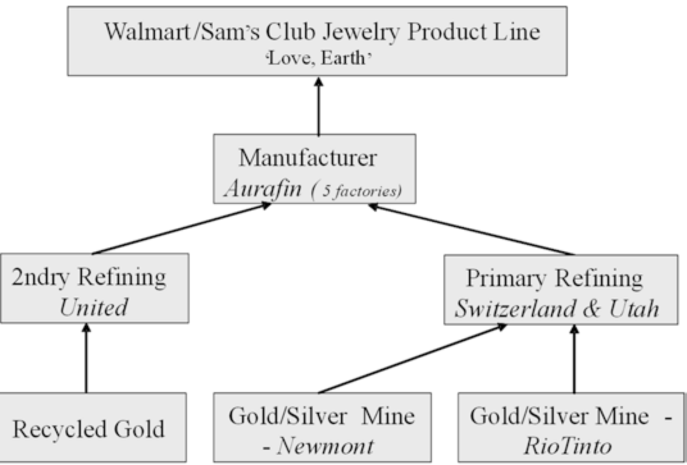
Go to http://www.loveearthinfo.com/, find the "Trace it from Mine to Market" box and enter: SMPM88.

Source: Walmart and CI

Exhibit 13.5 Process Comparison







Source: CELB

Exhibit 13.6 Online Trace It

Product History

Walmart Stores Inc. Retailer – USA Love Earth Jewellery (147713)
Aurafin Jewellery Design and Manufacture – USA Tagged Love, Earth Item (147698)
Exportadores Bolivianos S.R.L Jewellery Manufacturer – Bolivia 06 Castings (4 batches)
Arin Jewellery Manufacturer – Peru 05 Rope (2 batches)
Aurafin Jewellery Design and Manufacture – USA Gold bars (144775)
Kennecott Utah Copper Mining and Refining – Gold bars (144667)
Exportadores Bolivianos S.R.L Jewellery Manufacturer – Bolivia 07 Rope (146493)
Aurafin Jewellery Design and Manufacture – USA Gold bars (2 batches)
Kennecott Utah Copper Mining and Refining - -- Gold bars (2 batches)
Aurafin Jewellery Design and Manufacture – USA Silver bars (2 batches) Gold bars (140543)
Kennecott Utah Copper Mining and Refining – Silver bars (2 batches) Gold bars (139353)

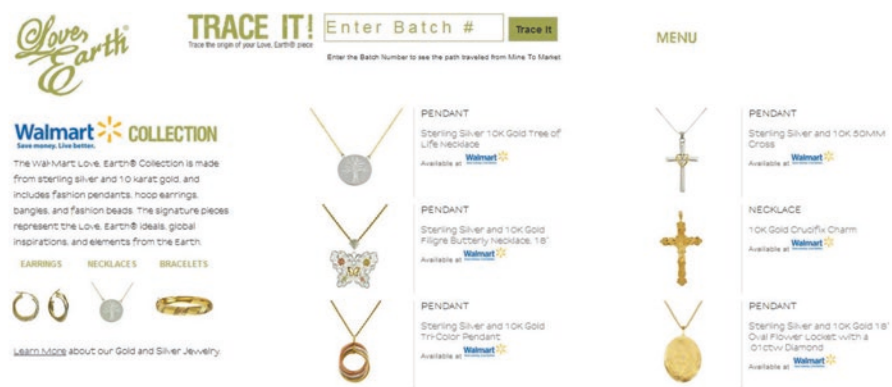
Spiral Heart Pendant

The Love, Earth sterling silver and 10K spiral heart pendant. This pendant represents the spiral of positive effect that each of us has on the Earth.

Each piece in the Love, Earth family is created with materials from responsible sources and can be traced to its origin.

Source: http://www.loveearthinfo.com/

Exhibit 13.7 Love, Earth®: Walmart Collection



Shell Nigeria: Changing the Community Engagement Model

14

Onajomo Akemu, Alexandra Mes, and Lauren Comiteau

Introduction

Since the 1950s, Shell's subsidiary in Nigeria, the Shell Petroleum Development Company (SPDC),[1,2] has invested in the communities that host its oil and gas operations. SPDC has built schools, roads, boreholes, community centres and other infrastructure. In 2005, SPDC management decided to implement a new community development strategy that would flip the old model on its head by making the local communities the drivers of development projects with Shell providing technical and financial support. Gloria Udoh, now Social Investment and Local Content Advisor at Shell The Hague—or as she describes it, a "change management professional"—was tasked with implementing the new model. At the time, Udoh was a community development officer at SPDC. She recalls that "interestingly, most of the resistance didn't come from within Shell, where senior management supported the change. It was local leaders and communities," says Udoh, who objected. "Sometimes when you hear 'legacy,' most people hear about it from a positive context. But in our own case, we learned to use legacy negatively. We went in there with a huge pile of unfulfilled projects. So at first, they [the communities] did not even want to talk to us."

[1] The focal company in the case is SPDC. SPDC is a wholly-owned subsidiary of Royal Dutch Shell. SPDC focuses on onshore and shallow water oil and gas production in the Niger Delta. Royal Dutch Shell and the companies in which it owns investments are distinct entities. For convenience, we use the word "Shell" to refer to these companies.

[2] In addition to SPDC, Royal Dutch Shell has interests in three other companies operating in Nigeria. They are (a) Shell Nigeria Exploration and Production (SNEPCo)—holds interests in four deep water oil and gas blocks; (b) The Nigeria Liquefied Gas Company—produces liquefied natural gas (LNG) and natural gas liquids for export. Royal Dutch Shell owns 25.6% equity stake; and (c) Shell Nigeria Gas Limited (SNG)—distributes gas domestically in Nigeria.

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© Springer Science+Business Media B.V. 2019

G. G. Lenssen, N. C. Smith (eds.), *Managing Sustainable Business*,
https://doi.org/10.1007/978-94-024-1144-7_14

After years of broken promises, environmental mishaps and conflict in the Niger Delta region, local communities had little trust in Shell. The company had suffered an image problem not only in Nigeria but worldwide, especially after the 1995 execution of Ogoni environmental activist Ken Saro-Wiwa and eight other Ogoni leaders. In the wake of the Saro-Wiwa execution, SPDC increased its engagement with local communities. However, by the early 2000s, SPDC's engagement model was becoming unsustainable. The company needed to figure out a more effective way of meeting the needs of local communities without compromising its long term position in the region. Udoh was part of a team recruited by former USAID [United States Agency for International Development] advisor Deirdre LaPin, then working as a consultant for Shell. Under LaPin's leadership, the team decided to adopt a bottom-up approach to development, what LaPin calls the "leveraged buy-in."

How does one gain the trust of communities who have been at the short end of broken promises for decades? How does one convince local communities that sustainable models of development would benefit them more in the long run than paternalistic handouts? And how does one make the case to SPDC managers that 50 years of corporate social responsibility practices need to be overhauled? These were the questions that Udoh and her team grappled with as they proposed and implemented what they conceived as a more sustainable model of engagement between Shell and its host communities in the Niger Delta.

Shell in Nigeria: A Brief History

A Huge Footprint in Nigeria

Shell has been active in Nigeria since 1936. Begun as Shell D'Arcy, the company was licensed to explore for oil 2 years later. The company discovered oil in 1956 at Oloibiri in the Niger Delta. In 1958, Shell exported Nigeria's first barrels of oil to international markets. Today, the footprint of this oil and gas corporation in Nigeria is vast. SPDC's operations in the Niger Delta are spread over 20,000 km^2. According to Shell, they include "a network of more than 6,000 km of flowlines and pipelines, 60 oil fields, 700 producing wells, 60 flowstations, seven gas plants and two major oil export terminals at Bonny and Forcados." SPDC's operations cover a region comprising about seven million people (Shell Nigeria 2014a, b, c, d). Figure 14.1 shows a map of Nigeria and the extent of Shell's operations in the Niger Delta.

Shell has a huge economic impact in Nigeria. SPDC, for instance, as the largest acreage of any oil company in the country. The company produces about 40% of Nigeria's crude oil output—the source of 95% of the country's export earnings and 45% of the country's gross domestic product (Central Intelligence Agency 2014). Between 2008 and 2012, SPDC paid about $42 billion in taxes and royalties to the Nigerian government (Shell Nigeria 2014). In Nigeria as a whole and the Niger Delta in particular, Shell is a fact of life.

However, the story of Shell and the oil industry in Nigeria has not always been a positive one. Despite its oil wealth, Nigeria remains a poor and highly unequal

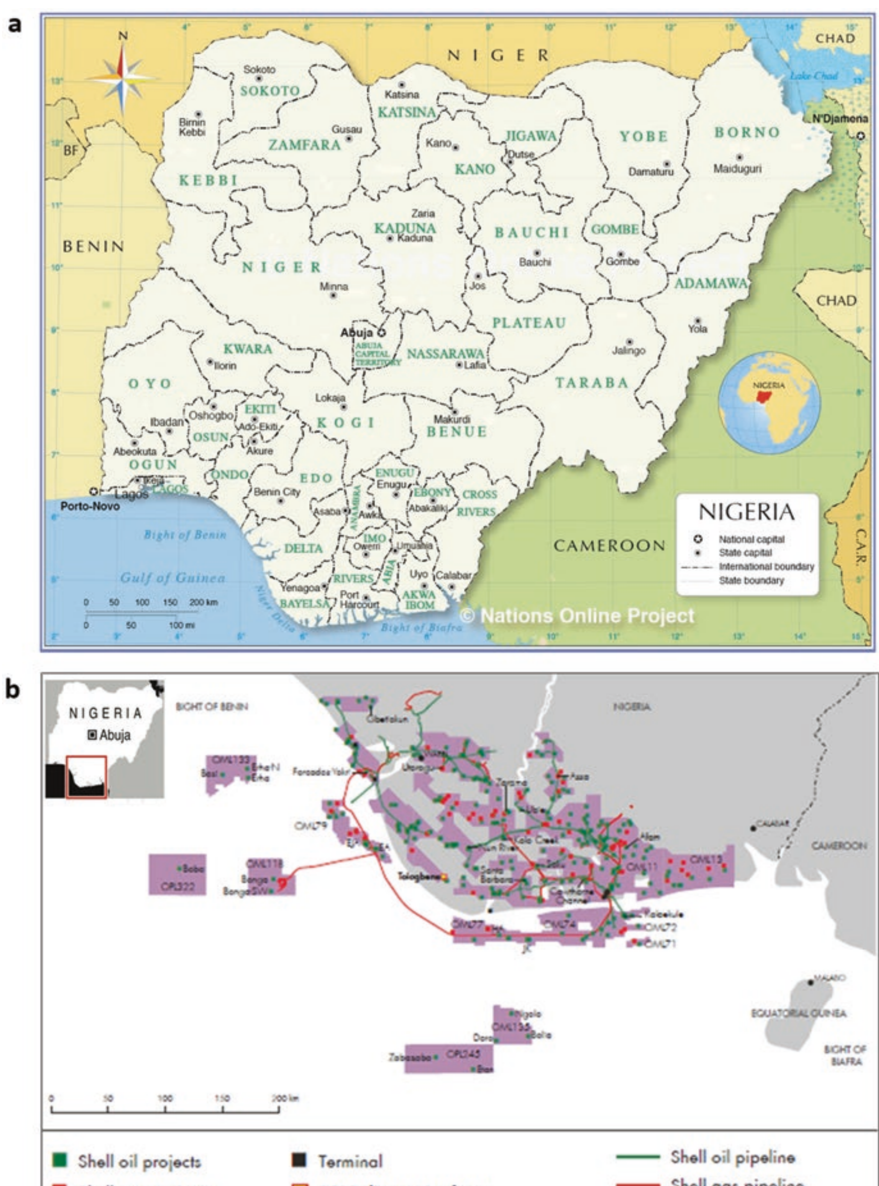

Fig. 14.1 (**a**) Map of Nigeria (*top*) showing location in Africa, (Source: United Nations 2014) (**b**) Map of the Niger Delta showing extent of Shell Petroleum Development Company (SPDC) operations (Source: Shell http://reports.shell.com/investors-handbook/2011/upstream/africa/nigeria.html)

country. In last six decades, oil companies (Shell included) and the Nigerian government have generated billions of dollars in oil revenue. Yet the majority of the population has benefited little from oil wealth. According to the World Bank, 84% of Nigeria's population lives on less than $2 a day. Only 40% of the adult female population is literate and 54% of the country's wealth accrues to the top quintile of the country's income distribution (World Bank 2014).

In addition to poverty and inequality, the Niger Delta, the region from which oil is extracted, has suffered severe environmental damage. Available records indicate that about 6900 oil spills occurred between 1976 and 2001 resulting to a loss of about three million barrels of oil (United Nations Development Programme 2006). In 2011, the UNEP [United Nations Environment Program] conducted an in-depth assessment of pollution in Ogoniland, a region of the Delta in which SPDC had operations. The report found that pollution from over 50 years of oil operations "has penetrated further and deeper than many may have supposed" (United Nations Environment Programme 2011a, b, p. 6). The report called for a clean-up that could take 25–30 years. In the preamble to the report, the UNEP stated:

> *The environmental restoration of Ogoniland could prove to be the world's most wide-ranging and long term oil clean-up exercise ever undertaken if contaminated drinking water, land, creeks and important ecosystems such as mangroves are to be brought back to full, productive health* (United Nations Environment Programme 2011a, b).

While Shell maintains that is addressing the UNEP reports recommendations on Ogoniland (Shell Nigeria 2014), the company denies culpability for most spills in the Niger Delta. According to SPDC, 70% of oil spills between 2005 and 2011 were due to sabotage or "bunkering"—the practice by which locals steal crude oil from the company's pipelines. Nevertheless, Shell has faced multiple lawsuits pertaining to polluted farmland and rivers. In 2013, the district court in The Hague (Netherlands) ruled that SPDC was liable for pollution in a village in the eastern Niger Delta in 2006–2007 because the company had failed to take sufficient measures to prevent sabotage of its pipelines (Sekularic and Deutsch 2013; Bekker and Prelogar 2013).

SPDC and the Nigerian Government

SPDC is the operator of a joint venture partnership called a joint operating agreement (JOA) involving the following partners (participatory interests are in brackets): the Nigerian government-owned National Petroleum Corporation (NNPC, 55%), Shell (30%), Total E&P Nigeria Ltd., a subsidiary of France's Total (10%), and Italian oil company ENI subsidiary, Nigerian Agip Oil Company Limited (5%) (Shell Nigeria 2014). The JOA covers over 30 oil mining licenses (OMLs) in the onshore and shallow water (swamp) zones in the Niger Delta.

How the Partnership Works

The JOA governs the relationship between the joint venture partners, budget approval and funding of participations by the partners. All partners share the cost of operation based on their participatory interest. Thus, SPDC bears 30% of the operating cost of the joint venture while the NNPC bears the lion share of those costs (55%).

In addition to the JOA, a Memorandum of Understanding (MOU) governs the fiscal incentives of the partners such as revenue allocation, payment of taxes and royalties and partner margins (Ameh 2005). Under the MOU, partner companies (SPDC included) received a fixed margin within an oil price range $15–19 per barrel. The "split of the barrel"[3] (Shell Petroleum Development Company of Nigeria 2004, p. 7), i.e. how much each partner receives as a function of oil prices in the MOU in the years 2000–2004 is shown in Fig. 14.2.

For instance, at an oil price of $19 per barrel, the Nigerian government (represented by the NNPC) receives $13.78 per barrel in taxes, royalties and equity share. Of the remaining $5.22, operating cost and capital expenditure account for about $4 per barrel and a margin of $1.22 per barrel is shared among the other participants (Shell, Total and Agip). At $30 per barrel, the Nigerian government receives $24.13 per barrel, while the margin shared by the Shell, Total and Agip increases to $1.87 and remains at this level beyond $30 per barrel oil price.

Under the JOA, the operator prepares annual work programmes and budgets (Nigeria National Petroleum Corporation 2015). SPDC, as operator, is responsible

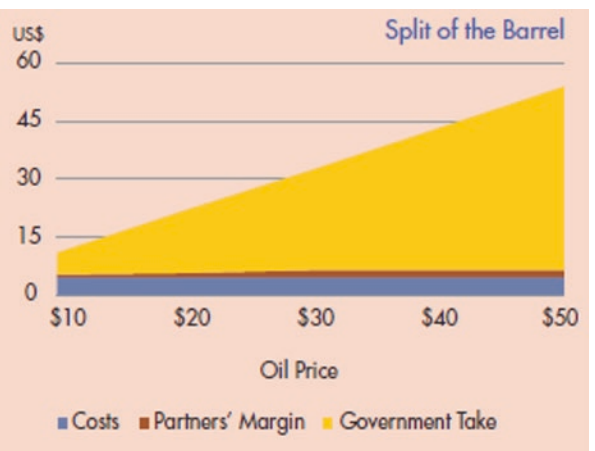

Fig. 14.2 "Split of the barrel" between venture partners and Nigerian government in the years 2000–2004. The Nigerian government receives an increasing share of revenues from oil production as the oil price increased above $10 per barrel (Shell Petroleum Development Company of Nigeria 2004, p. 7)

[3] According to correspondence with knowledgeable industry insiders in 2015, the "split of the barrel" in the JOAs has changed since 2005. Though the NNPC and its JOA partners do not release publicly their production costs, a combination of high oil prices in the years 2007–2014 and the tense security situation in the Niger Delta have led to increased production cost. For the purpose of the case, however, Fig. 14.2 will suffice as an indication of how revenues from the JVs were split between the partners in the years 2000–2005, the time in which the case is set.

for the day-to-day running of the agreement and has the most direct contact with local communities covered by the OMLs in the agreement.

SPDC as Operator of Joint Venture Partnership

In Nigeria, an oil-dependent and highly unequal country, SPDC's host communities have looked to the company to provide infrastructure such as water, electricity and roads that the country's government had failed to provide, creating a situation in which local communities depended on Shell for basic amenities. In some respects, said LaPin, where Shell ended and the government began was hard to tell. "The Shell style was a colonial style. They inherited it," she said of the company's way of dealing with local communities. "A colonial officer and a Shell manager was not an easy distinction to make for those living in the community."

Furthermore, due to Shell's relationship with the Nigerian government—through its partnership within the JOA—Shell has also often been seen as colluding with the often-repressive Nigerian government. Things came to a head in the early 1990s. Led by writer and environmental activist Ken Saro-Wiwa, the Ogonis, one of the many ethnic groups in the Niger Delta, began a high-profile campaign to protest their exclusion from the benefits of oil production and the contamination of their land. In 1995, Saro-Wiwa and eight Ogoni leaders were captured, tried by a secret military tribunal and executed by the government of dictator, General Sani Abacha (British Broadcasting Corporation 1995; CNN 1995).

In 1996, families of the executed Ogoni leaders filed a lawsuit against Shell. The plaintiffs claimed that Shell had been complicit in human rights abuses including torture and killing. Shell, however, denied the charges. After a protracted legal battle lasting 13 years, Shell settled the case out-of-court with a payment of $15.5 million to the plaintiffs in 2009 (Mouawad 2009; British Broadcasting Corporation 2009; CNN 2009).

Given this history, by the late 1990s, Shell managers knew that the company had to change its model of community engagement for "its reputation and to preserve its business," said LaPin.

SPDC and Its Host Communities in the Niger Delta

Community Assistance

When SPDC started operating in the Niger Delta in 1958, the rules for community assistance were simple. "We would just say, 'OK, this community probably will need water and we'll do the water for them,'" says Trevor Akpomughe, a Social Performance Specialist at SPDC, of the corporation's top-down approach to social responsibility. But, by the late 1990s, that method, carried out for decades, was proving unsustainable. Udoh adds:

We were making the decisions for them [the local communities]…and also constructing the projects, so to a very large degree, their participation was not there in terms of [them saying], 'this is what our needs are and this is how we prioritise them in terms of making a development journey from where we are today to where we want to be tomorrow.

In addition to the lack of community ownership, the thinking at Shell appears to have shifted. Udoh, a native of the Niger Delta, felt that the issue of change was "very close" to her heart. By the late 1990s, according to Udoh, "[Shell managers started asking,] 'are we really relating with the communities the way we ought to? Are we involving them in the decisions we make?'"

Also, operational problems within Shell were tasking the paternalistic approach to community assistance. The corporation was providing assistance to some 1000 communities in a piecemeal fashion. For every road or water project in a community, there were several project management committees, which often meant several committees in one community. Akpomughe:

The committees wanted to put as many people to manage things as possible, and nobody was looking at it holistically. That was stretching our resources, because we're not resourced to do development…So that piecemeal approach was not giving us the best benefits, and our dollar spent was not giving the community a holistic view of how development ought to be managed. Everybody just implements and nobody manages.

According to a 2006 internal report, SPDC had committed to over 400 community development projects and had an outstanding 371 legacy projects to complete.

Often, there was little coordination of the commitments that the company had made to communities. Communities' resistance to Shell was often legitimate. Not only had Shell made past promises it could not keep, but the company had made some it did not even remember. Udoh says that with so many Shell people interacted with the communities. A courtesy call made by a Shell manager to a community before the implementation of the GMOU could result in a promise for a classroom or some other project. "Sometimes when we were saying that, nobody from the Shell side took an inventory [of the promises] and followed through," says Udoh of the lack of central coordination and integration. "But the community keeps its own record. So we also had incidences [sic] like that where multiple interfaces, multiple projects, we did not even have a record of them and we said to the community, 'No we didn't promise that.'"

But communities usually kept records of promises and demanded that Shell fulfil them. Kudaisi, then a community manager with SPDC, explained the situation:

Some of those [promises] were in the sixties …Community members would say to me, 'so why are you not coming back after to come and do work with us on the road or do some stuff? You promised us…' *And they bring out the letter [from Shell]. And I say, 'I don't know about that, I'm new [to Shell]…But the communities kept saying, 'you know what; you guys owe us this.*

Thus, poor coordination within the company led to broken promises and ill-feeling among many host communities.

Furthermore, when projects were finished, there was no mechanism in place to keep them running. SPDC had to maintain the projects after completion. Udoh: "[When we build a classroom], it is seen as a Shell classroom. And if a light bulb goes off, you get a phone call [from the community], 'please come and fix your classroom'." From boreholes that needed refurbishing to town hall tiles that needed replacing. The manpower and financial expenditure of the community assistance model proved to be costly for the company.

By 2004, SPDC was under pressure to reduce expenditures and streamline operations. This made it more difficult for the company to fulfil its community assistance obligations. Akpomughe speaking of the lack of community involvement in projects and the corporation's financial commitments said:

> *These two things walked together. The communities needed to pick up the slack, as it were. And it was good that they picked up the slack because otherwise we would still be in the mode where we do things for them and the [community] capacity is not built…. Development should not be handed to them from either a company or from a government without their participation… They need to lead their own development.*

But SPDC was spending considerable sums of money in its community assistance programmes. In 1997, according to LaPin, Shell spent $32million on community assistance. This was a huge commitment, but it was coming from an oil company that was not staffed with development professionals—and all that money was yielding little results. LaPin said of 11 community projects she saw in the Niger Delta, she considered only one a success. She wanted to replace the company's "colonial" approach with a community-based approach to development. "My aim was to change that, to set up an egalitarian, partnership-style relationship between Shell and the community where both sides would be on equal footing."

In 2005, opposition to the oil industry took a violent turn in the Niger Delta, threating oil revenues, the economic lifeline of the Nigerian government. Against the backdrop of national political crises under President Olusegun Obasanjo, oil supply disruptions and increasing militancy in the Niger Delta, an insurgency group, the Movement for the Emancipation of the Niger Delta (MEND) emerged in the Delta. Well-armed and politically-connected to local elites, MEND demanded equitable distribution of oil rents by sabotaging oil pipelines, kidnapped oil company workers and killed Nigerian Army personnel (Obi 2010). It is estimated that MEND's attacks led to deferment of 700,000 barrels of oil per day, roughly a third of Nigeria's daily production output (Watts 2007).

It was in this environment that SPDC senior management realised that the company had to move even quicker to change its engagement model with host communities. "Shell's community development programme was an attempt to counter that force, the freedom fighters demanding control of oil resources," said LaPin. Shell moved quickly to implement the new model. "They managed to get $60million up and running in less than a year. I had a staff of 180 including Gloria Udoh, one of the 'best and brightest' Nigerian development experts recruited to make the changes."

A New Approach to Community Engagement

What exactly should replace SPDC's ad-hoc often paternalistic approach to community assistance? In 2005, Gloria Udoh led a team to propose a new approach to community engagement. The team consulted various departments within the company and studied the community engagement efforts of other oil companies in the Niger Delta, other multinational companies (MNCs) operating in Nigeria and state governments. They found a variety of approaches to community development among these actors. For instance, some companies like telecommunications giant MTN had a non-profit philanthropic foundation funded by the MNC to offer grants to social, educational and developmental ends in Nigeria. One state government had pioneered community development projects in partnership with civil society organisations and local communities to identify "self-help" projects. Udoh and her team also found that Chevron Nigeria, a subsidiary of U.S. multinational oil company Chevron, operating in the Niger Delta, had introduced a model, called the Global Memorandum of Understanding (GMoU) model in the wake of crises that had disrupted its operations in 2003.

In Chevron's model, development programmes were open not only to its host communities, but spread across communities associated with a "cluster". Furthermore, Chevron's model involved inclusion of development stakeholders such as civil society groups, local governments and development agencies (Consensus Building Institute 2008). After the study period—which involved rounds of consultation with Chevron—Udoh's team recommended to SPDC leadership team the 'Global Memoranda of Understanding' (GMoU) approach to community engagement.

GMoUs are written statements of understanding between SPDC and clusters of local communities. Under GMoUs, SPDC agrees to provide funding and access to development experts while the communities set their own development priorities, plan and implement development projects. See Fig. 14.3 for a comparison of the GMoU model and the community assistance model of engagement.

In the community assistance model, Shell signed multiple bilateral agreements with its numerous host communities and the company was held responsible for community development. In the GMoU model, Shell's 'interfaces' with the communities would be reduced. The number of development projects made more manageable. Shell would provide funding and technical assistance for projects proposed by communities comprising the clusters and would do so for a fixed term (5 years) after which the GMoU would be renewed.

Importantly, in the GMoU model, a wider selection of stakeholders would be involved in development. For instance, the local government would be involved in the cluster development activities. Udoh and her team expected that the government would mediate conflict between the communities. Civil society organisations [non-governmental organisations] would also play a role, helping the communities articulate better their development needs. In the GMoU approach, Shell in partnership with state, local government and NGOs signed memoranda of understanding (MoU) with clusters of communities forming a cluster development board (CDB).

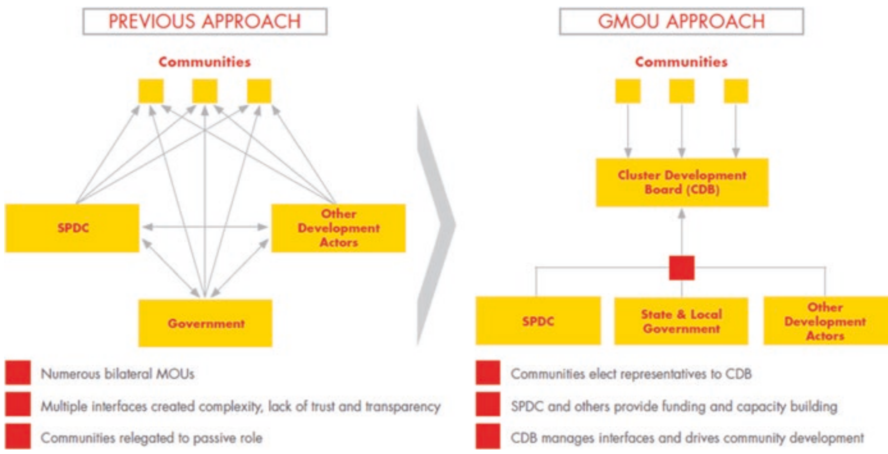

Fig. 14.3 Two approaches to community engagement, comparing the community assistance mode of engagement with GMoU approach (Shell Nigeria 2013)

Udoh presented her proposal to SPDC's leadership team in mid-2006. Mutiu Sunmonu, SPDC's Managing Director at the time of writing this case, was then Executive Director for Production. He recognised the benefits of Udoh's proposition. Udoh recalled:

> *Getting conviction internally was easier than the implementation... Because when we did the study, we said, 'Fine. From the study we've done, we want to go very slowly.' I said,* 'we want to do six, maybe twelve [GMoUs]. And learn from that before we replicate everywhere.' *The first reaction I had [from SPDC leadership team] was excitement, interestingly. And they said look,* 'if you say this is going to work, do it everywhere.' *And that is also what caused a problem, to some degree, the challenge to some degree [was implementation]…So that was why, after that presentation, they [SPDC top leadership team] said fine, you said this would work, you are very convinced, I said, 'yes'. They said,* 'OK fine, you go lead the first implementation team.'

Udoh and her team needed a pilot location. "We started looking for other things that would enable the community to take some responsibility off our shoulders," remembers Udoh. "The turning point was late 2005 with the Gbaran-Ubie project."

Implementation of the GMoU Model

Pilot Phase Gbaran-Ubie Project

The Gbaran-Ubie Integrated Oil and Gas Project (GUIOGP) covers an area of approximately 650 km^2 in Bayelsa State in the Niger Delta (See Fig. 14.1). It is one of Shell's largest integrated oil and gas plants. It began production in June 2010. By 2011, it was supplying about a quarter of the gas produced for export and producing

more than 50,000 barrels of oil a day. The project is particularly important because it produces gas to The Nigerian Liquefied Natural Gas Company, a joint venture between Shell, the Nigerian government, France's Total and Italy's ENI, which liquefies the gas and exports to customers in Europe, Asia and the United States. An aerial view of the central processing facilities of the Gbaran-Ubie Project is shown in Figs. 14.3 and 14.4.

The Gbaran-Ubie project impacts 44 distinct host communities within the project area. After lengthy consultations with the communities, SPDC grouped the communities into four clusters (number of communities in brackets): Gbaran/Ekpetiama (18), Epie/Atissa (14), Okordia/Zarama (8) and Kolo Creek (4). SPDC signed a GMoU with each cluster in 2006–2007 in line with the GMoU approach. Figure 14.5 shows an extract of a generic GMoU.

Convincing local communities to sign up to the GMoU model was a difficult task. Udoh and her team had to negotiate a very complex, often emotionally-charged, implementation phase that coincided with the rise of a violent insurrection in the Delta led by militant groups like MEND. Deploying Shell staff and contractor staff to work on the project was difficult due to the threat of violence in the Delta. "Don't forget, Gbaran-Ubie would be a project that was executed at the peak of the insecurity in the Niger Delta," adds Kudaisi. "Nobody wanted to be there. It was the biggest project in the worst of times." Some of the challenges in the implementation are discussed.

Fig. 14.4 Aerial view of the Gbaran-Ubie integrated oil and gas project central processing facilities (CPF). Arrow shows the direction north (Source: Shell http://www.shell.com.ng/aboutshell/media-centre/news-and-media-releases/2011/gbaran-ubie.html)

GLOBAL MEMORANDUM OF UNDERSTANDING

This Global Memorandum of Understanding (herein after referred to as GMoU) is entered into this ..... day of 2010

BETWEEN

The accredited representatives of the communities whose names are as stated on the signature page acting on behalf of themselves and the entire Xxxxxx) cluster and its satellite communities, all in Xxxxxx) Local Government Area of Xxxxxx State of Nigeria (hereinafter referred to as 'Xxxxxx) cluster which expression shall, whenever the context so admits, include the entire people of the various communities including their Traditional and Institutional Leaders, their successors-in-office, assigns, and agents) of the one part

AND

THE SHELL PETROLEUM DEVELOPMENT COMPANY OF NIGERIA LIMITED, a Company incorporated in Nigeria and having its registered office address at Shell Industrial Area, Rumuobiakani, Port Harcourt, Rivers State, Nigeria (hereinafter referred to as '**SPDC**', which expression shall where the context so admits, include its successors-in-title, assigns and agents) in its capacity as operator of the NNPC/Shell/Elf/AGIP Joint Venture of the other part.

1. PREAMBLE

PURPOSE

1.1 This Global Memorandum of Understanding (GMoU) is made in good faith and without prejudice to any pending land title or ownership disputes in any of the below listed communities, with a view to creating understanding and consolidating the existing cordial and mutually beneficial relationship between **Xxxxxx** Cluster and SPDC.

1.2 The parties to the GMoU hereby jointly and severally declare, recognise and accept the obligations stated herein on the part of each to be performed and observed as their contribution towards the development and economic empowerment of **Xxxxxx** Cluster on the one hand and the smooth execution of SPDC operations/activities within the Cluster on the other hand. The parties also acknowledge that these objectives can only be pursued and realised in an atmosphere of mutual support, openness and understanding between the parties.

2. DEFINITIONS

Expressions and their meanings

Under this GMoU, the following expressions shall have the meaning assigned to them here under:

Capacity Building: refers to all activities aimed at institutional formation and enhancement of the capabilities of CTs and CDBs to perform their responsibilities as outlined in this GMoU.

Cluster: the collection or aggregation of communities on clan (historical/affinity) or local government basis as defined by the relevant State government or agreed by the people of the communities that constitute the Cluster themselves.

Cluster Development Board ("CDB"): a grassroots institution with responsibility for coordinating implementation of the development programmes and projects outlined in this GMoU and for managing issues arising between SPDC and communities within the cluster as well as amongst the communities. The membership, functions and committees of the CDB are provided for in clause 5.1, 5.2 and 5.3 of this GMOU.

Committees: the functional organs of the CDBs set up to play specific roles either on an ongoing basis or on an ad hoc basis.

Community: a group of people sharing common ancestry, culture and values, residing within the same geographical location and possessing government statutory recognition.

Community Trust (CT): a community-based institution to be established pursuant to this GMoU in each community with responsibility for design and implementation of community development plans in/for that community. Specific provisions relating to the CT are contained in clause 5.4 of this GMOU.

Global Memorandum of Understanding (GMoU): a comprehensive agreement that guides relationship between the communities within a Cluster and SPDC over an initial period of 5 years.

Qualified Contractor: means a contractor that has met the qualifying criteria of SPDC as prescribed by the Vendor Services Department of SPDC

Generic MOU For illustration purposes only

Fig. 14.5 Extracts from a GMoU agreement (Source: Shell)

8.2 SPDC OBLIGATIONS

SPDC agrees to use its best endeavours to

a. Ensure that its Contractors award appropriate subcontracts to community contractors commensurate with their capabilities and in line with SPDC Contracting procedures and Nigerian/Local Content Development goals. All parties recognise that the provisions in the contracts between SPDC and contractors, subject only to the Laws of Nigeria, exclusively govern the relationship between SPDC and the contractors, including community-nominated contractors.

b. Fund SCD projects/programmes under the GMoU on a timely and annual basis.

c. Utilise the governance structures of the GMoU for overall business and community interface management especially with regards to community projects, spills management, pipelines surveillance, and first level dispute resolution.

d. Honour the provisions of the GMoU in its dealings with the Cluster.

e. Without prejudice to sustainable community development projects/programmes implemented under the provisions of the GMoU, wherever possible bring other **Xxxxxx** Cluster development needs to the attention of the Niger Delta Development Commission (NDDC) or similar body as may be set up from time to time by the Federal Government, donor agencies and other multilateral agencies.

f. Without prejudice to sustainable community development projects/programmes implemented under the provisions of the GMoU, carry out other regional projects/programmes that may impact on the Cluster as part of its corporate social responsibility.

8.3 Now in consideration of the foregoing, the parties hereby freely agree to and accept the following commitment:

SPDC COMMITMENTS	Xxxxxx CLUSTER COMMUNITIES COMMITMENTS
• Proactively engage **Xxxxxx** Cluster to pursue a mutually beneficial and sustainable relationship at all times. • SPDC is committed to an amicable, cordial, constructive relationship free from violence, acts of criminality and destruction. • SPDC and her Contractors shall keep **Xxxxxx** Cluster aware of all employment opportunities in the Company by making available all relevant information on vacancies to the accredited Community representatives through the XxxxxxState Government. • SPDC shall ensure that its contractors are formally introduced to **Xxxxxx** Cluster with the support of government. • SPDC shall endeavour to resolve any disagreements between **Xxxxxx** Cluster and Contractors that affect the commencement and/or continuation of an activity/project with the support of the State Government. • SPDC and her contractors shall comply with the terms set out in this GMoU. • To support the police and other law enforcement agencies in the handling of breaches and other illegal activities. • No ghost worker will be allowed. • No work no pay for site/facility shutdowns by communities. • Any worker that misbehaves or	• Resolve to actively work and cooperate towards ensuring a peaceful environment and a conducive atmosphere for SPDC's operations and the execution of **Xxxxxx** Cluster Projects. • **Xxxxxx** Cluster is committed to an amicable, cordial, constructive relationship free from violence, destruction or acts that may disrupt peace and SPDC operations. • Ensure that the elected representatives of **Xxxxxx** Cluster take full responsibility to discharge their duty to safeguard this GMoU entered into with SPDC and its contractors. • Take all lawful steps and diligent actions to forestall any activities in **Xxxxxx** Cluster that may be detrimental to the safety of lives and property and to bring person(s) to book irrespective of whether they are members of **Xxxxxx** Cluster or SPDC and its agents. • Ensure that where names of **Xxxxxx** Cluster members/representatives, etc. are required in the course of interaction with SPDC, that such names are well authenticated and confirmed to be genuine from **Xxxxxx** Cluster. • Forward only names of qualified and competent personnel for jobs/positions offered to **Xxxxxx** Cluster under this GMoU and other interactions with SPDC. • Affirm SPDC's right (and that of its contractors) to reject any personnel found not to be qualified and/or suitable for a position. • Ensure that **Xxxxxx** Cluster personnel offered jobs/positions are subject in entirety to the terms and conditions of employment of their employer. • Agree to observe and execute the terms of this GMoU in its entirety notwithstanding any change in the name, constitution, and community executive, communal authority or in the name or constitution of **Xxxxxx** Cluster. • We the **Xxxxxx** Cluster: • Shall provide an enabling environment and freedom to operate for the smooth, peaceful and orderly execution of all SPDC projects and operations in the Cluster. • Agree to actively assist the police and other law enforcement agencies in handling and prosecuting matters that may cause public disturbance or impede SPDC's ability to operate • Agree that no other benefits will be requested or demanded from SPDC or any of SPDC contractors.

Generic GMoU. For illustration purposes only

Fig. 14.5 (continued)

Trust between SPDC and the Communities Kudaisi who worked for Udoh negotiating the GMoUs with the communities in the Gbaran-Ubie project recalled:

> *It was never done before, so you really, really needed to win the trust and confidence of the community, to do what you say you are going to do," he says. "Grandparents talked about Shell.., I said [to local community leaders]* 'This is the new face of Shell. We all have history.' *You have to win their confidence. We had to address the issue of 50 years of legacy.*

Kudaisi remembers setting a deadline for community members to check the archives and cull their grandparents' memories for Shell's promises past. In the end, SPDC made trade-offs for promises they could no longer keep. For instance, SPDC had promised a new electricity supply scheme in one of the communities. However, the company did not need to make good on the promise because electricity had already been provided by the Nigerian government. Instead, the company agreed to fund another development project in the community. As part of the budgeting process, the company set aside funds to address all legacy issues in the communities.

Clustering Communities based on Clan Affiliation For some clusters, this process was largely uncontroversial. According to Akpomughe:

> *Communities largely are built of clans, so one of the things we needed to decide was, 'how do we cluster communities?' It would be easier to cluster by local governments, because that means the units would be fewer. So we found that even within local governments, you have various clans and tribes, and they were not historically friendly. We had also put it to the [Bayelsa state] government who then helped with that. The communities don't mind having a cluster with their own clan, so we then largely went on clan basis*

In other areas, however, the process was more difficult. As one interviewee recalled, "Some communities [in the Epie/Atissa cluster] had issues. One of the communities was protesting that they were being attached to a larger community… that had so many facilities [on their land], that they thought they were going to be oppressed. But then, because of the GMoU structure, which was based on what your community is needing and also based on even development, we were able to work together."

Aligning SPDC and Community Goals Communities often preferred visible, tangible projects that had no apparent development impact. Akpomughe:

> *One of the challenges we found all over [in Gbaran-Ubie] was that everybody wants a prestige project like a town hall. But in truth, many of the communities can't sustain a town hall; they don't have enough activities to use the town hall, for example. So the town hall is locked [for most of the year]…and it's really monies that are not properly utilised, it's for prestige value.*

SPDC's goal was to have the clusters embark on self-sustaining projects to generate their own income. "We thought to build human development kind of things, but the people want 'hardware'", said Akpomughe.

> *They would want to build a road, a concrete road between the communities; nothing wrong with that in itself! But if you look at the level of development in the community, one of the*

things we [SPDC] looked at was that if people increase their capacity or generate income for themselves, it's a much better way to spend development funding because then if they generate income, likely their children will go to school. Their parents would be able to afford books, could afford school uniforms, and things of that nature. We thought to build human development kind of things like a skills acquisition program, but the people wanted 'hardware'.

He added reflectively, "But it's a delicate, ongoing process. How do you convince local communities to develop sustainable projects without appearing to impose your ideas from above?"

Equitable Distribution of GMoU funds How would a cluster of communities allocate funds that the cluster had received from Shell? This was a particular thorny aspect of implementing the GMoU in Gbaran-Ubie. It was not clear how to determine the degree of impact on Shell's operations on different communities. Number of wells? Size of infrastructure? Or length of pipelines? Some communities claimed that they were more impacted than others because their land hosted more pipelines than their neighbours. Other communities challenged such claims with counter claims that their land hosted oil wells, which were more important than pipelines. Yet other communities that did not host large infrastructure feared that they would not get any funding from the GMoU.

Furthermore, after the clusters were formed, community representatives had to be elected:

The first challenge was getting the governance structure in place. At the time, different people thought that the community members of the governance structure of the GMoU were either going to be paid by Shell or going to get some political appointment or [enjoy] some form of patronage. It took time to explain and to educate them to know that it's just a service to your society, something you do in the interest of the society. And then of course we needed to validate, check the integrity of some of the nominees. We had to check that through the relevant government authorities and through the traditional institutions, through the governments, and all this. At the end of the day, the nominees were confirmed and certified.

Conflicting Interests within Communities Communities are not homogenous. The interests of the traditional rulers was often at odds with those women and youth within the communities. In some instances, traditional rulers extorted money from contractors who built the infrastructure. One NGO worker said:

Most of the projects we [the local NGO] were supervising then were infrastructural projects and a lot of money was involved. The kings captured the contractors, the community contractors that were handling the projects. Why the king was able to do [such a] thing? Because the king is the signatory to the work completion certificate. You understand that? So then they were in a position to put pressure on the community contractors to say, 'If you don't give me a certain amount of money, I won't sign your work completion certificate.'

Udoh and her team, working with local NGOs, often challenged the community chiefs in order to increase the inclusiveness of engagement processes.

Sometimes people want projects that just benefit a tiny portion of the community. So a chief probably wants a road to go to his house. Now, the NGO will challenge that and say: 'How

Fig. 14.6 (**a**) 4 km road built between Shell's facilities and Gbaran host communities (Gbaran/Ekpetiama cluster). (**b**) Water tower for the Gbarantoru community (Gbaran/Ekpetiama cluster). (**c**) Power station for Obunagha and Gbarantoru communities (Gbaran/Ekpetiama cluster). (**d**) 18–classroom block in Onopa community (Epie/Atissa cluster) (Source: Shell)

c

d

Fig. 14.6 (continued)

> *does this benefit the women that need to go to the market, or that need to get water? Why is that a priority project and why is this not a priority project? (Akpomughe).*

Working with a New Development Actor—The State Government As shown in Fig. 14.5, the GMoU governance structure included community representatives, SPDC, state and local government, and other development actors (such as NGOs). Unlike the NNPC that is a partner in the JOAs, the Bayelsa state government had never been involved in SPDC's community engagement efforts. Getting the buy-in of the state government for the GMoU tasked the negotiation. As one interviewee put it:

> *SPDC had to build trust with the state government and convince them that the GMoU approach was going to work. "The relationship with them [the Bayelsa state government] started off rather... best way to say it is, we had to work slowly to develop and establish credibility and trust. I mean, when we started off, they weren't antagonistic, but they started off remaining to be convinced that we weren't able to deliver this.*

Results of Pilot Phase Implementation

The Gbaran-Ubie pilot GMoU officially ended in December 2011. Through the GMoU, Shell claims to have funded 151 projects of which over 100 were completed. In addition, the company reports that over 80 university scholarships were awarded as a result of the GMoU (Shell Nigeria 2011). In Fig. 14.6, a cross section of projects completed under the Gbaran-Ubie GMoU (as at December 2012). They include a road, water project, an electrification project, and an 18-classroom block.

Importantly for Shell's operations, the company did not suffer significant disruption or deferment from local communities in Gbaran-Ubie despite the insurgency in other parts of the Niger Delta.

Implementing the GMoU Beyond the Pilot Phase

SPDC's leadership team was supportive. After presenting her findings on the Gbaran-Ubie pilot to Shell's leadership team, she was met with excitement by senior leadership team. They pressured Udoh and her team to move quickly, remembers Udoh, who wanted to slowly roll out the new model. She proposed to implement the GMoU with 12 communities. "They said OK, fine, if you think this will work, you have our blessing. But don't do just 12. Do it everywhere! So we were now put again under pressure, not having enough resources, even in terms of people on the inside that could run with this."

With lessons from the Gbaran-Ubie pilot, Udoh and her team began implementing GMoUs with communities in the Delta. Some of the challenges they faced are discussed in detail below.

Winners and Losers On the ground, change was resisted by those who stood to lose the most. "Any change means there are winners and losers," recalled LaPin. In

the old top-down system, she explained, there were Community Liaison Officers (CLOs) who Shell sent out to explain its plans and manage the land all of which technically belongs to the government. Shell paid local royalties for its use and the CLOs negotiated the terms with local leaders. LaPin:

> *We introduced parallel officers, Community Development Officers (CDOs), who were representatives of the communities and who listened and asked what they wanted." The CDO's job was to help communities act and plan together and to guide them through the process. And importantly, they controlled the funds. The losers were the community liaison officers, who were the primary contacts with local leaders and some of whom were not entirely honest. When we introduced the CDOs, it was a check on their activities and they were advocating for the community. That was a new concept.*

The other losers were community leaders, who made the deals with the CLOs, but were increasingly resented by the area's youth. "This was a more democratic process, so the 'big men' were not benefiting much. It shifted the balance of power," said LaPin. "But the big men had enough good sense to not resist the program, which was beneficial to their community and ultimately to them. But they tried to manipulate it to their advantage," she reflected with a laugh.

Clustering Communities As was the case in Gbaran-Ubie, forming the clusters also proved a challenge. What was the best way to cluster communities? Geographical contiguity? Clan affiliation? What role should political boundaries play? For instance, if a community straddled state boundaries as was often the case in the Niger Delta, should the community be split into separate clusters in each state? "We had instances where communities had been at war, for like 20, 30, 40 years and they had never sat together," says Udoh of a particularly testy negotiation in Rivers State. "And we wanted to put those communities in one cluster." Speaking of the difficulty of clustering communities, an interviewee said to the case writers:

> *Many of these communities, they speak different languages. There is no common history. Nigeria is a country that is an artificial creation, we are not like Holland in that even if they break down your [Holland] boundaries today, you would still come back together to one another because you all are the same and you have the allegiance to one king. Sorry, in Nigeria, there is no one king that anyone has allegiance to. It's a country that was created and if we were given the choice, most of us would not be together. So that's the reality of the Delta. And it's worse in the Delta than in other parts…So you have people speaking different languages from one village to the next. Some of them have had a history of conflict.*

Role of Civil Society Organisations SPDC considers this a "weak area" of the GMoU model. Civil society groups like NGOs [non-governmental organisations] working as part of the GMoU model are ostensibly independent of Shell. In principle, they are charged with pursuing the best interests of the communities. During the Gbaran-Ubie project, according to Kudaisi, NGOs attended cluster meetings to facilitate planning. At the implementation stage, their role was to make sure the projects hit their targets. In practice, however, under the GMoU model, the NGOs are paid by Shell. Critics say there is a lack of long-term planning by NGOs, who still operate in project development mode. A 2010 report commissioned by the

Ecumenical Council for Corporate Responsibility (ECCR) included this analysis from Tracey Draper, of NGO Pro-Natura International Nigeria:

> *Weak local NGO capacity has led to NGO staff invariably following instructions from SPDC implementation staff. The NGOs are often unable to achieve an equal dialogue with SPDC and as a result essentially become contractor agents, doing what they are told. The oil industry in general, SPDC included, lacks mechanisms to partner with NGOs effectively. It categorises NGOs as contractors, hired for services delivered in the same way that contractors may be hired to lay a pipe or construct a bridge*. (Ecumenical Council for Corporate Responsibility 2010)

There is also the rush to get a piece of the "development pie". Draper continued, "PNI's view is that SPDC evaluates NGO performance on how quickly project implementation is completed and exploits NGO fears of losing contracts. In response, NGOs ignore participatory principles and bypass most of the steps to complete projects" (Ecumenical Council for Corporate Responsibility 2010).

Yet NGOs may be playing a role that local state actors have neglected to play. Kudaisi:

> *Just like it's done everywhere else, each community is supposed to have a plan. That's why you have what you call [it a] "local" government, but local government in Nigeria doesn't really exist. …. That's why there is a role, that's the gap that is now filled by the NGOs. Actually, the best would have been to get a local government functionary to get the engineers, work with the communities and come and plan it, get Shell and other oil companies to kind of put money in the pot and get it done with contribution from [local] government.*

Nembe: An Exemplar Case

Sometimes getting local communities to the negotiating table was near impossible. One such case was with the Nembe, a group of SPDC's host communities in the Niger Delta. Udoh says she remembers the Nembe negotiations as if they happened yesterday. "I still remember the first meeting. The chief said to me, 'Please leave. We are not willing to discuss with you if you are not going to address the outstanding electricity project.' It was rough". Udoh appeared to face a particular disadvantage: she was a woman acting on behalf of a mistrusted corporation within in a conservative patriarchal community. The negotiations for the GMoU between Shell and the Nembe lasted for a year.

Despite the acrimony that attended negotiating the Nembe GMoU, Udoh holds it up as "one of the most successful we have." According to Udoh, SPDC has since begun work on the electricity project that the Nembe chief referred to during her first meeting with the community. Also, "SPDC and Niger Delta Development Commission have also partnered to complete a road linking Nembe to other parts of state." (See map in Fig. 14.1.) The cluster development board (CDB) (see Fig. 14.3) consisting ten communities signed the GMoU in 2008.

Some of the Nembe GMoU projects, notes Udoh, were self-sustaining. "They [the Nembe communities] became smart," she said. "For instance, they have a

transport business, they have a printing and publishing business, they have a guest house. So the various things they have done have helped them to generate income to add to what they receive. And they also have started engaging other donors to see if they can get funding…the local government at some point also contributed funds. So that's why I say it is the most successful [GMoU]."

In 2010, the Nembe CDB became a licensed NGO: Nembe City Development Foundation (NCDF). A report by Shell Nigeria singled out the NCDF for praise:

> *Nembe City Development Foundation (NCDF) in Bayelsa State [a state in the Niger Delta] received a total of $90,000 as counterpart funding from a partnership between PACT Nigeria, the United States Agency for International Development (USAID) and Foundation for Partnership Initiative in the Niger Delta (PIND) under the Advocacy, Awareness and Civic Empowerment (ADVANCE) programme. The funding received was used for a capacity building programme … for all GMoU Clusters in Bayelsa State*. (Shell Nigeria 2013)

Has GMoU Model Been Successful?

By the end of 2012, SPDC had implemented GMoU agreements with 33 clusters covering over 349 communities in the Niger Delta. The company also claims that it committed $117 million to these clusters and that nine of the 33 cluster development boards (CDBs) are registered foundations (Shell Nigeria 2013). But has the GMoU been successful in achieving the goal of community self-reliance? "In a sense it was successful," said LaPin. "There are better relations with the oil-producing communities, better development in the communities and they are more empowered to plan their projects." It is unclear whether there is systematic evidence to support LaPin's claims.

What appears certain, however, is that some GMoUs have been more successful than others. Udoh says of the GMoUs that they've "had some brilliant results, some mixed results, and the weak ones are in the minority." Udoh continued: "So if you were to put it on a 80/20 kind of thing, the weak ones would be 20." In a presentation to the SPDC leadership, Udoh stated that some GMoUs were not successful due to "to lack of community organisational capacity, poor utilisation of funds and exclusion of some community members." Furthermore, while the local governments play a mediating role, they have not yet committed funds into the GMoU clusters. There is also a lack of trust in the government on the part of the local communities and the NGOs are sometimes seen as doing Shell's bidding.

How does one convince local communities that are mistrustful of Shell to change from a mind-set of dependency to one of self-sufficiency? How does a manager win the trust and convince communities to work together in a complex situation like the Niger Delta's? How does a manager align interests of corporate and community actors in a situation where mediating institutions such as local and state governments are ineffective? These are the challenges that Gloria Udoh and her team wrestled with as they implemented the GMoU model.

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15 Economy of Mutuality: Equipping the Executive Mindset for Sustainable Business

Kevin T. Jackson

Introduction

Market economy (Gregory and Stuart 2004, pp. 25–27) is the orthodox frame of reference for many businesses, dictating how business has traditionally been, and still is, taught in executive business education. A market economy frame of reference drives mainstream corporate strategy. It sets the stage for how business activity is understood and valued by executives, managers, and numerous other stakeholders in private and public institutions alike.

Social economy, by contrast, encompasses cooperatives, mutual societies, nonprofit organizations and foundations. The social economy frame of reference recognizes economic sectors based upon charities and collective not-for-profit initiatives (Mook et al. 2007, p. 17).

Yet the moral crisis underneath global economic collapse, heightened mistrust of market capitalism, patterns of unsustainability, excessive consumerism, inequality and social unrest occurring alongside of a rising interest in social enterprise, solidarity, and global justice suggest it is time to rethink the conventional market economy/social economy divide.

Numerous businesses traditionally following a short-term shareholder wealth maximization approach are rethinking the relationship between financial performance, sustainability, and social responsibility. Today, companies stand in need of embracing shifting social expectations about the purpose of business, and some leaders are reconsidering the implications of these shifts for corporate strategy. More and more, leaders and managers are cultivating new skillsets together with a deepened understanding of social needs and an enhanced appreciation of the ultimate nature and purpose of business and the real foundations of economic value.

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G. G. Lenssen, N. C. Smith (eds.), *Managing Sustainable Business*,
https://doi.org/10.1007/978-94-024-1144-7_15

As well, firms are being challenged to cultivate new ways of collaborating across the profit-nonprofit divide as traditional boundaries become blurred by new forms of enterprise exemplifying features from both market economy and social economy (Dees 1998; Boyd et al. 2009; Billis 2010). Behind this hybridization of business enterprises is a blending of a commercial exchange logic, characteristic of the for-profit sector, with a gift logic typified by the nonprofit sector. Whereas the logic of commercial exchange is conventionally driven by principles of profit maximization, mutual gains, and the pursuit of financial sustainability, the logic of gift is conventionally driven by principles of charity, solidarity, and the pursuit of social sustainability. Accordingly, this chapter presents *economy of mutuality,*[1] as a conceptual blueprint for business leadership oriented to merging financial and social sustainability.

The chapter is structured as follows. First the idea of economy of mutuality is introduced. Second a schema categorizes business enterprises under the umbrellas of for-profit enterprise, social enterprise, and nonprofit enterprise (see Diagram 15.1). Then, three levels of business ends are distinguished: (1) the proximate end; (2) a higher pro-social end; (3) the highest end-state. Fourth, an ends-oriented analysis of the archetypes is given. The proximate end, considered in the context of an archetype-specific inquiry, reveals the respective aims of separate genres of business enterprises: for-profit enterprises, social enterprises, and non-profit enterprises. The pro-social end aims higher, considering the nature and purpose of business not just from an economic standpoint but from a social point of view. At this level principles of mutual benefit, shared value and gratuitousness are identified as embedded across archetypes in varying degrees. Finally, the question of what the highest end-state of business is, or ought to be, is explored through a discussion of five key ideas: social solidarity and interdependence, cultural capital, *homo reciprocans,* common good, and virtue. This analysis supports the proposition that the ultimate end-state of business is to advance reciprocity and integral human development.

Economy of Mutuality

Economy of mutuality envisions a new understanding of business enterprise, challenging the assumption that the chief purpose of business is to maximize profit (Duska 1997; Handy 2002, p. 51).

Not only does this unproven assumption hoodwink countless economists, business leaders, and laypeople, it stifles deeper discussion about the authentic purpose

[1] The concept should not to be confused with the John Kay's notion of "economics of mutuality" (Kay 1991). Some ideas in this chapter originated in a paper delivered at a workshop entitled "Teleology and Reason in Economic and Social Affairs," conducted at Blackfriars Hall, University of Oxford in 2014. Parts of the argument are developed further in my article "Economy of Mutuality: Merging Financial and Social Sustainability," 133(3) *Journal of Business Ethics,* 499–517 (2016).

of business. On the contrary, economy of mutuality, while ceding the significance of profit as a success indicator, posits that from the standpoint of global sustainability, the pursuit of profit is at the service of a higher purpose.

Broadly speaking, economy of mutuality fits within streams of research comprehending economic life as multilayered and occurring in various structures – social, legal, political, cultural – that together form a more complex whole (Kropotkin 1902/2009; Polanyi 1944/2001; Hirst 1994; Nee and Swedberg 2005; Buğra and Arğatan 2007; Heinberg 2011). Economy of mutuality draws upon virtue ethics, linking it to classical and neoclassical economic writings, and extending it to contemporary trends in global business (such as microfinance and social enterprises) springing from a sustainability paradigm (Daly and Cobb 1990; Wals 2007) and seeking to merge financial and social imperatives of business (Paine 2003). Economy of mutuality sees businesses as contributors to integral human development, mutuality, and reciprocity.

Market transactions are based on an exchange of equivalents, whether in the form of barter or money. Yet business is not reducible to a system of market exchanges, but flourishes in a wider social context. So economy of mutuality provides breathing space within and alongside the market for economic activity conducted by participants freely choosing to act from motivations other than pure profit-taking, still creating economic value in the process.

Markets have the important task of enabling persons to deploy contracts in regulating their relations as they exchange goods and service of equivalent value between them. This is clearly a vital step towards satisfying many needs and desires of market participants. But markets as such are often disengaged from society. Market-based decisions are not motivated or constrained directly by social custom and legal strictures, not to say ethical norms, and even less, virtue and the common good.

Therefore, economy of mutuality sets forth rudiments for a new way of understanding business: rethinking not only the higher purpose of enterprise, but also reflecting upon how business contributes to (or takes away from) the common good of the society in which it is engaged.

A possible objection might question the need for such an approach, asserting a stakeholder approach (Phillips 1997; Freeman et al. 2010) will bring about the right balance between business and society. But stakeholder thinking is flawed in accepting at face value the interests and claims of various stakeholder groups independently—in isolation from one another—without considering their deeper connections as part of the larger human community. So unless situated in a comprehensive view of humanity, stakeholder thinking runs the risk of neglecting to regard each stakeholder as a person that has, not simply external material and instinctive dimensions, but interior and spiritual dimensions as well. (Goodpaster 2011, p. 13).

Reconsidering the End State of Business

Consistent with the spirit of Aristotle's inquiry (Aristotle 1941) about the ultimate purpose of human life, we may ask: What is the end-state of business activity? (Abela 2001; Solomon 2004). Is there some characteristic end or purpose or *raison d'être* of conducting business? What, in general, does business do that is the most valuable?

First we need to be clear about what we understand business to be. To gain clarity, we can look at fundamental archtypes of business along with proximate ends associated with them. In penetrating further to specify their respective higher ends, we will continue to heed the conventional categories established by the archetypes (i.e. for-profit vs. non-profit; financial value vs. social value). But later, in directing attention toward discernment of the ultimate end, or *telos*, we will, consistent with a holistic approach, witness an erosion of traditional categorizations to some extent.

Business Archetypes

Consider a triad of business archetypes in which alternative emphasis goes to elements of profitability and financial independence (market economy) on one hand, and poverty alleviation and solidarity (social economy) on the other.

Archetype 1. Business enterprises are run mainly as for-profit institutions to the end of being financially sustainable in the long term. Financial self-reliance is a precondition of a firm's survival and for remaining capable of continuously expanding its products or services to new clientele. Important as a company's social mission may be, it is sublimated to profit-making capabilities to ensure the firm serves the interests of its shareholders.

Archetype 2. The social and financial missions of business enterprises are merged; a coordination of social and financial functions is at the heart of the "promise" of the company as a sustainable enterprise. To be sure, a business firm has a fundamentally economic character. Accordingly, reasonable efficiency in its management is expected: covering operational costs and realizing some form of added value, surplus or profit. On the other hand the sustainability paradigm for business emerging over the past several decades presupposes that companies are expected to uphold and even champion social policies. Nevertheless, while the pursuit sustainability presents special challenges for businesses, there is no necessary or incompatibility between the joint pursuit of social and financial objectives.

Archetype 3. Businesses (such as some microfinance institutions and the Economy of Communion project) are run with principal allegiance to social missions – such as outreach to the poor, environmental production and promoting other facets of sustainability. The moral justification for business requires staunch commitment to doing good. Profit is necessary and explicitly intended as a condition to keep doing good. The social outreach objective ought not to be imperiled by the sort of corruptive tendencies that sometimes attend market-driven business activities, as seen for instance, in instances of mission drift, exorbitant interest rates, and group

lending abuses that involve microfinance institutions exploiting indigent people to increase profitability.[2]

The above archetypes express divergent ways of understanding alternative generic strategic directions for individual business enterprises. For instance, Archetype 1 represents the strategic orientation of a traditional profit-maximizing corporation such as GE or IBM in the 1970s. Archetype 2, by contrast, expresses the current strategic direction of a sustainability oriented firm such as Google.org or Timberland. Archetype 3 captures the strategic direction of enterprises such as Grameen Bank and *Focolare*-inspired organizations.

The first of these archetypes is sometimes been held up as the model or ideal for the nature and purpose of business as such. However, today even some profit-maximizing multinational firms are seeking to demonstrate that they can spread value and profits more broadly across their stakeholders and supply chain. More importantly, holding up only one of these archetypes – the for-profit model – as an embodiment of the exclusive or dominant end-point of business is a conceptual error. The mistake consists of falsely attributing goals or ends of specific kinds of business enterprises to the goal or end of business life in general. It is more perspicacious to launch one's inquiry with the full spectrum of business enterprises at one's disposal – across for-profit, social enterprise, and non-profit varieties – and then inquire as to how best to account for their shared nature and purpose. It is beneficial for us to question and debate what business really is, and ought to be, about. Proceeding from such a broadened outlook, economy of mutuality is posited as a moral-economic conception of preconditions of sustainable and inclusive business (Diagram 15.1).

End-Point Examination of Business Archetypes

For purposes of this chapter, a distinction is made between the proximate end, higher end, and ultimate end-state of business enterprise. By proximate end is meant an immediate purpose of conducting business, as understood within the particular archetype at hand. Here, identifying the immediate purpose of business helps to characterize the archetype, and is taken in a more specific and concrete sense than the purpose revealed in the higher end. But this higher end remains subordinate to yet another end, which is the absolute last end, one "for the sake of which all other

[2] *Mission drift.* Commercially-oriented microfinance institutions (MFIs) are sometimes identified as drifting away from an original mission of serving low-income clients, instead serving better-off clients to improve the financial bottom line (Armendariz and Szafarz 2011). An ethical issue arises insofar as such MFIs are found to be using poor clients mainly as a means to attaining profitability (Sandberg 2012). *Excessively high interest rates.* Interest rates charged by some MFIs can range between 20% and 70% per annum, making them higher than rates commanded by commercial banks (Rosenberg et al. 2009; Sandberg 2012). *Group lending abuses.* Violent collection practices and oppressive forms of group pressure are sometimes used by MFIs for obtaining repayment of group loans (Montgomery 1996; Ghate 2007).

Diagram 15.1 Enterprise analysis and design

Social economy			Market economy				
Charities/ non-profit enterprises	Hybrid social enterprises						Traditional for-profit enterprises
Pure not-for-profit goal	Non-profit with trading/ business activity as part of delivery model	Organization working toward financial sustainability (some grants)	Breakeven—all revenues from trading activities	Profits made, but not distributed back into mission	Profits made and (some) distributed to investors; profits likely to be lower due to social mission	Commercial, competitive, and profit maximizing; social value proposition built into business model	Profit- making goal for end of financial sustainability
Full subsidy	Partial subsidy		Trade-offs			Profit-maximizing	

things are desired, and which is not itself desired for the sake of anything else." (Aquinas 1273/1972, 1–2, q. 2, a. 8, c).

In terms of how the triad of archetypes has already been specified, it is seen that the proximate end of archetype 1 is profitmaking with an eye toward financial sustainability. The proximate end of archetype 2 is hybrid development pursued through a merging of financial and social objectives. The proximate end of archtype 3 is alleviation of poverty through social outreach. It is possible, as will be shown, to discern for each archetype a higher end.

For-Profits

Concerning for-profit, market-based enterprise, reflective economists provide a range of interpretations. For example, Friedman (1962, p. 13) states that "the technique of the market place" is "voluntary cooperation of individuals." Similarly, Buchanan and Tullock (1962, p. 103) assert that "[t]he raison d'être of market exchange is the expectation of mutual gains." What can be discerned in these accounts, along with those of countless other economists, is the notion that markets and the enterprises operating within them have some general point or purpose, and it is the end of mutual benefit from commercial exchange.

To be sure, other economists have stressed how the market creates wealth by exploiting comparative advantage (Ricardo 1817), the division of knowledge (Hayek 1948), and increasing returns to scale (Marshall 1920). Yet all such wealth-producing mechanisms function through mutual benefits arising from activities of trade.

A critic might say that the higher end of market-based, for-profit enterprise is attaining economic freedom. After all, a coupling of the market economy and freedom is a recurring theme in economics literature. Its advocates include Mill (1852), Hayek (1948), and Friedman (1962). But this criticism is misleading. It mistakenly takes economic freedom as the liberty of everyone to get at all of what they want, period. But economic freedom is better understood as the freedom to use one's own possessions and talents as one sees fit, remaining free to trade – under conditions of reciprocity – with those willing to trade in return.

The common core of these understandings is captured by the logic of commercial exchange. For-profit business in a market economy is aimed at the efficient facilitation of mutually beneficial voluntary transactions. Market economy commercial transactions are seen as valuable because individuals want to make them. Business transactions satisfy individuals' preferences not only because such transaction are wealth-creating, but also because the opportunity to make commercial transactions is a form of freedom. So beyond the proximate end of profitability for financial sustainability, we see the higher end of archetype 1 enterprise to be the principle of mutual benefit.

An illustration of how an archetype 1 business might go about incorporating the concept of mutuality concretely, even without having a formal mutuality configuration, is provided by the food and beverage company Mars. In the process of tracing

the origins of its supply chain back to 150,000 impoverished cocoa farmers, Mars determined that it had a responsibility to share the fruits of its worldwide financial success with all those involved in its business. Accordingly, the company invested in new technology for cocoa growers that transfigured their way of life. The average cocoa yield tripled, along with associated average incomes. Consequently Mars gained access to more cocoa. Mars launched another mutuality project in Kenya, investigating how people from the poorest communities in Nairobi might be included in the company's distribution and supply chain. A key objective is for Kenyans to access employment and gain entrepreneurial skills. Kenyan youth, it is projected, will benefit as they are able to make income as a local distributor. Mars will benefit, in turn, because their products are marketed and distributed to new communities. Such mutuality initiatives comprise part of a joint research project between Mars and the Said Business School of Oxford University. By thus pairing up with Mars, academics at Said are exploring ways that a for-profit business can in effect be a mutual organization, yet without directly sharing ownership (Fearn 2014).

Hybrid Enterprises

While hybrids ordinarily work within a market economy by operating a business, their ends are not exclusively financial. Their principal duty extends beyond advancing shareholder interests. Their end is both to succeed (financial sustainability) and to do good for the community (social sustainability). Accordingly, the hybrid enterprise represents a helpful structure with which to meet the needs of business organizations with wider pro-social purposes (Sertial 2012, p. 271.)

Although the exact structure varies among firms, the hybrid archetype ordinarily links the goals of a for-profit corporation and a nonprofit charity. One illustration of a well-known social enterprise is Google.org, a for-profit company also dedicated to social benefit. Google.com funded Google.org with a grant of three million shares, pledging to contribute 1% of its annual profits to Google.org. A notable feature of Google.org is that, in addition to funding grants to support social causes, it makes for-profit investments, encouraging employees to participate directly in furthering changes in company policy. While elements of Google.org's structure may vary from those of other hybrids, it stands as a noteworthy example of a for-profit enterprise that assumes an explicit pro-social posture.

Further inquiry into the higher end of archetype 2 enterprises may be undertaken by reference to emerging models such as Mohammad Yunus' social enterprise (Yunus 2007, 2011) and Michael Porter and Mark Kramer's shared value (Porter and Kramer 2011).

Social Enterprise

According to Yunus, a social business is "a non-loss, nondividend enterprise, created with the intention to do good to people, to bring positive changes to the world, without any short-term expectation of making money out of it" (Yunus 2007, pp. 265–266). The social enterprise is a hybrid in the sense that it grows and develops as a commercial enterprise. While not intended to make profits for investors, it needs to generate enough income to cover its expenses, which includes providing adequate compensation for managers and employees. Yunus provides a description of the higher end of the social business:

> In its organizational structure, this new business is basically the same as the existing PMB [profit-maximizing business]. But it differs in its objectives. Like other businesses, it employs workers, creates goods or services, and provides these to customers for a price consistent with its objective. But its underlying objective—and the criterion by which it should be evaluated – is to create social benefits for those whose lives it touches (Yunus 2007, pp. 21–22).

Profits, understood as a surplus of revenues over expenses, are anticipated, yet not returned to investors in the form of dividends. As Yunus puts it:

> The company itself may earn a profit, but the investors who support it do not take any profits out of the company, except recouping an amount equivalent to their original investment, over a period of time. A social business is a company that is cause-driven rather than profit-driven, with the potential to act as a change agent for the world (2007, pp. 22).

Yunus advocates a "total delinking from the old framework" of profit-maximization. (Yunus 2010, p. 14). What Yunus offers potential investors, who recoup funds invested while relinquishing a return on investment, is the chance to partake in the logic of gift.

Here the principle of gratuitiousness is at work: personal acts of donation creating relationships in which further exchanges of various sorts become possible (Faldetta 2011). Besides the Grameen Bank, Yunus and his associates have diversified into other social enterprises, partnering with companies like Groupe Danone, to market a yogurt product that aims to ameliorate nutritional deficiencies of poor children at an affordable price.

Yunus (2011, pp. 33–56) used the Grameen Bank's expertise in social networking among rural poor to develop Grameen-Danone, an independent social business. Operating with a social enterprise archetype, Yunus shows how it is possible to go beyond conventional thinking about philanthropy and corporate social responsibility (CSR). Groupe Danone is not a donor, and is Grameen-Danone is not merely a CSR feature of the Groupe. The new company is independent and autonomous, yet with substantial investment and expertise put up by Groupe Danone. The partnership materialized thanks in large part to Yunus' ability to persuade Group Danone's management that they could not participate in solving social problems effectively within the framework of a traditional profit-maximizing enterprise.

Yunus believes that people who might be donors to various charities or supporters of CSR policies are drawn to investing in social businesses, provided they are well designed and managed to produce and distribute social benefits more efficiently than conventional alternatives.

Shared Value

Porter and Kramer urge bringing business and social good together to create shared value. Stressing that business, operating within the traditional capitalist paradigm, has forfeited social legitimacy, they propose reorienting capitalism to be aimed not exclusively toward corporate profits with bolted-on CSR, but instead at shared value between corporations and community. Currently business is mired in an outmoded approach that thinks of

> value creation narrowly, optimizing short-term financial performance in a bubble while missing the most important customer needs and ignoring the broader influences that determine their longer-term success. How else could companies overlook the well-being of their customers, the depletion of natural resources vital to their businesses, the viability of key suppliers, or the economic distress of the communities in which they produce and sell? (Porter and Kramer 2011, p. 4).

The conclusion is that a radical alteration of perspective is needed to restore business legitimacy. Under the old model, business distinguished between profit and social responsibility. Shared value, by comparison, is about "creating economic value in a way that also creates value for society by addressing its needs and challenges" (Id. p. 64). The authors assert that, unlike corporate philanthropic efforts, this alternative approach "is not on the margin of what companies do, but at the center" (Id. p. 64). In contradistinction from CSR, shared value mandates that all of an enterprise's budget be dedicated to shared value. For it is within shared value that business converges with social needs. Since it brings about a positive impact on a community, shared value turns out to be good for the company as well.

Certainly significant changes need to come about to pave the way for shared value. Company leaders need to be capable of identifying social needs, and be equipped to work collaboratively with members of society toward ends within the scope of their shared interest. Enterprises with a commitment to shared value need to channel efforts at building economic value by creating social value. Some areas where shared value can be generated include: healthcare, adequate housing, better nutrition, assistance for aging populations, enhanced financial security, and environmental preservation (Id. p. 67).

Insofar as enterprises embarked upon creating shared value need to pinpoint social needs, benefits and harms relevant to their respective products, Porter and Kramer endorse creating clusters, "geographic concentrations of firms, related businesses, suppliers, services, providers and logistical infrastructure in a particular field such as IT in Silicon Valley, cut flowers in Kenya, and diamond cutting in Surat, India" (Id. p. 72). Cluster building improves company productivity,

competitiveness, and innovation while enhancing the local community (Id. p. 72). As an illustration, Yara, a mineral fertilizer manufacturer, recognized that a dearth of infrastructure in many parts of Africa was an obstacle to farmers obtaining fertilizers and other farm products they need, as well as an impediment to getting crops to market. To address this need, they invested sixty million dollars to build agricultural growth corridors in Mozambique and Tanzania (Id. p. 74).

One way shared value operates is provided by the case of m-pesa, a mobile banking system Safaricom introduced into Kenya. M-pesa enabled Kenyans to transact financial services via cell phones. The phones reduced risks of carrying and storing cash, which customers turned into e-money. Spouses working at a distance could transmit money home over the phones, reducing transportation expenses. With the arrival of m-pesa in Kenya, saving patterns ascended, and employment was invigorated when m-pesa agents were hired. Before m-pesa, large traditional banks neglected the poorer population, deeming it too risky and insufficiently profitable. The World Bank lauded m-pesa and Safaricom for investing in the indigent. A study reported that, as a result of the service, rural income rose 30% (Mbarathi 2011). The M-pesa initiatives exemplify the hydbrid economic logic behind shared value. Safaricom identified a niche within which to address social needs of the poor, resulting in amelioration of their lives, while simultaneously creating profit for the company.

In conclusion, in light of the predominance of hybrid economic logic in social businesses, the higher end of archetype 2 enterprise may be specified in terms of both the principle of shared value and the principle of gratuitousness.

Nonprofits

Let us turn to identifying the higher end of archetype 3 enterprise, the nonprofit charity. It may be noted that throughout Western civilization's history, one finds business ventures embodying humanitarian endeavors. Monasteries in the Middle Ages were incipient economic institutions. As far back as the fifteenth century, the Franciscans provided philanthropic impetus in the form of the *Monte di Pietà*, a precursor of the modern bank, which grew up not seeking profit, but bringing reform to usurious lending practices and providing charity to the impoverished (Menning 1993, p. 37). The public office extended moderate-rate loans to needy people. An underlying rationale was to benefit borrowers instead of providing profits for lenders, representing a lesser evil attached to traditional money lending. The *Monte di Pietà* was dependent upon funds collected from voluntary donations by the financially privileged having no intent to recoup their monetary contributions. Those in need came to the *Monte di Pietà*, contributing some item of value in exchange for the financial loan. The term of the loan extended for 1 year, representing approximately two-thirds of the borrower's item value. A pre-set interest rate applied to the loan. Any profits realized were applied to offset operating expenses.

As well, the nineteenth century provided for a merging of economic and humanitarian objectives as the bulk of European welfare establishments and hospitals emerged out of spiritual associations.

More recently, the Economy of Communion (EoC) project merits discussion as an enterprise launched in the spirit of this tradition of outreach to the poor. In addition to uniting people to advance social good and fostering a "culture of giving," the Economy of Communion (EoC) project has a peculiar approach to distributing profits Uelmen and Bruni (2006, pp. 647–648). Profits from an EoC enterprise are divided into three parts, within the discretion of the business. The first portion goes to the materially poor, often directly linked to *Focolare* networks. The second portion is kept in the firm for reinvestment. The third portion is used to sustain elements of infrastructure that promote and preserve a "culture of giving," which includes programs for education and formation to help people live according to its values. After the owner determines how much to reinvest in the company, the remainder of the profits can be equally divided between assisting those in need, and shaping activities for a culture of giving. To make sure that the needs of the materially poor in *Focolare* communities are met, profits from EoC enterprises have been supplemented by individual donations from *Focolare* members. This division of profits can be viewed as a useful archetype for businesses with a charitable purpose.

Notably, participation in the EoC and sharing profits is totally voluntary among shareholders and business owners. Neither group is legally bound to give a portion of their profits to the EoC. Instead, a decision to share profits comes from people internal to the business itself. Such a structure provides the for-profit with the freedom to participate in the EoC to whatever extent it wishes, without needing to conform to rigid guidelines. While this freedom provides for widespread ownership, extending an opportunity to join to many people, it could have a negative impact on shareholders by generating smaller dividends. Consequently, a majority of the shareholders must agree with the ideals of the *Focolare* and be willing to forgo these returns. Potentially this could mean that EoC and other hybrid enterprises following the model would experience difficulty operating as a publicly traded company, or operating in situations where management is separate from ownership. On the other hand, the growth of ethical investment funds within the stock market could provide a means of raising business capital in an EoC model. Alternatively, EoC enterprises could advocate for shareholders to relinquish dividends altogether, donating them to the EoC (Gold 2010, p. 40).

The EoC departs from standard business archetypes in four ways. First, pay structure is organized differently in the EoC model. Under the EoC, employers increase wages to reward employees for extra effort extended for the company, and to maximize efficiency of the enterprise. Second, the EoC involves special policies for recruitment. EoC companies, for instance, have as one goal the hiring of more employees and giving employees making mistakes a second chance. The EoC business reintegrates those facing difficulties into the work environment, yet balances this principle with maximizing efficiency maximization. Third, EoC companies use

participative management, encouraging workers to participate in decision-making within the business. This might entail organizing councils, meetings, and other formal structures to stimulate communication between different levels of authority. Lasty, EoC enterprises are proactive in cultivating a spirit of solidarity within the enterprise, such as hosting events to increase social interaction among employees including their children as well (Gold 2010 p. 40).

In consideration of the major driving force of the logic of gift at play in charitable enterprise, the higher end of archetype 3 may be specified as the principle of gratuitousness.

To summarize, although on its face Archetype 1 is often taken to presuppose that business is all about maximizing profits for shareholders, we see that its higher end, in light of the logic of commercial exchange, is the principle of mutual benefit. Under Archetype 2, the higher end, in light of a hybrid economic logic, is the principle of creating shared value for a broader range of stakeholders, complemented by the principle of gratuitousness. For Archetype 3, the higher end relates to the logic of gift, taking business to be a moral calling whereby the main objective is doing good. Here the higher end is identified as the principle of gratuitousness. It is important to keep in mind that, in moving to consideration of the higher end, and beyond to ultimate end-state, conventional borders between archetypes (profit, nonprofit; financial, social) tend to become more fluid. At the same time, the influence of broader principles (common good, gratuitousness, solidarity, interdependence, reciprocity) tends to appear across diverse models.

Architecture of Economy of Mutuality

We can develop the idea of economy of mutuality further with the help of five key background concepts. Taken together, these key concepts point to the ultimate end-state of business across archetypes – reciprocity and integral human development (See Diagram 15.2 below).

Diagram 15.2 Conceptual architecture of economy of mutuality

Transcendent *telos* (across archetypes)	Reciprocity; integral human development		
Philosophical anchors	Social solidarity & interdependence, cultural capital, *homo reciprocans,* common good, virtue		
Pro-social end	Mutual benefit; shared value; gratuitousness		
Proximate end	Assistance, welfare	Development	Profitability
Modus operandi	Logic of gift	Hybrid economic logic	Logic of exchange
Sector	Social economy	Crossbreed economy	Market economy
Business Enterprise archetype	Charitable/nonprofit Enterprises (archetype 3)	Social Enterprises (hybrids of archetypes 1 & 2; 2 & 3)	For-Profit Enterprises (archetype 1)

The five key concepts are as follows:

1. Solidarity
2. Cultural capital
3. *Homo reciprocans*
4. Common good
5. Virtue

Solidarity

Some may be surprised to learn that many classical social and economic theorists espoused a robust spirit of social solidarity for business. For Émile Durkheim, social solidarity correlates with various types of society. Durkheim distinguished "mechanical" from "organic" solidarity in his theory of the division of labor (Durkheim 1893). In the case of mechanical solidarity, a society's cohesion stems from homogeneity. People are linked through similar work, educational backgrounds, religious training, and lifestyles.

Mechanical solidarity typically is found in "traditional" and small-scale societies, such as tribes, where kinship bonds of familial networks occur. On the other hand, organic solidarity arises out of interdependence from specialization of work and complementarities between people. This is a development occurring in "modern" and "industrial" societies. Organic solidarity is social cohesion grounded in a dependence individuals have upon one other in more advanced societies.

For J.S. Mill and others, mutual assistance in business was the norm. Cooperation in the context of particular businesses was in elemental form a more generalized style of cooperation forming the heart of the division of labor, and hence, of the market (Mill 1848, at IV.7.21). Unlike Marxist accounts, Mill interpreted collaboration, not class conflict, as essential to market operation.

Mill favored economic democracy rather than capitalism as such. In advocating worker cooperatives over capitalist enterprise he states:

> The form of association, however, which if mankind continue to improve, must be expected in the end to predominate, is not that which can exist between a capitalist as chief, and work-people without a voice in the management, but the association of the labourers themselves on terms of equality, collectively owning the capital with which they carry on their operations, and working under managers elected and removable by themselves (Id. at IV.1.7).

From the standpoint of today's competitive global economy, Mill's observation is incisive: "there is no more certain incident of the progressive change taking place in society, than the continual growth of principle and practice of cooperation" (Ibid.).

Although individuals may perform different tasks and possess different values and interests, the order and solidarity of society depends on their mutual reliance to carry out their respective tasks. As such, social solidarity is maintained in more

complex societies through interdependence. Such solidarity is seen in contemporary business relationships such as supply chains.

With globalization questions arise about what it spells in terms of solidarity. Robert Keohane and Joseph Nye characterize globalization as an increase in networks of interdependence obtaining between people across multi-continental divides (Keohane and Nye 2000, p. 105). Their characterization emphasizes that globalization, far from being a one-dimensional type of connectedness, is taking place within intricate interdependent webs. Globalization occurs on multiple tiers: technological, environmental, economic (encompassing consumption, finance, investments, production, trade), cultural, social, legal, and political. Given so many patterns of interdependence, the challenge is to infuse these patterns with solidarity. One way this can come about is through growth of cultural capital.

Cultural Capital

The concept of cultural capital (Bourdieu 1986) refers to the reservoir of lively interrelations among people, along with mutual concern, shared understandings, common moral values, and trust. This intangible social asset solidifies affiliates of human communities and associations. It enables cooperative pursuits to materialize. Cultural capital lifts organizations and business communities up, making them more than a haphazard group of people each bent on advancing their respective private projects. The idea signifies the wherewithal required in running everyday dealings in public life. Those resources comprise beliefs, customs, habits, and morals. Such multifarious traditions, what Rousseau characterized as *moeurs* (Trachtenberg 1993, p. 231) we learn from our parents, and they make us suitable participants in the social and economic order.

The way we interpret the mutual influences exerted between our common culture, the regulatory authority of government, and the businesses that operate in the economy shapes the way we comprehend the virtuous businessperson and the virtuous company.

Granted that businesses may have the ability to generate wealth, a question lingers: for what purpose? Considering, in light of financial engineering advancements, the momentous technical progress that can be achieved in constructing wealth, what remains unanswered is whether we are left any better than before. Of course, empirical data culled from balance sheets and revenue statements can indicate that a firm has generated greater wealth than the previous quarter. And technological innovation might raise its levels of productivity. But KPIs (key performance indicators) will not provide any indication of whether our character is improved, or whether we are in a state of overall well-being. The intricate issue of to what extent our creative drive guides us toward authentic human betterment cannot be completely comprehended from the perspective of a market devoid of moral-cultural capital. On its own, such a market gives no signals as to whether we are approaching greater alignment with our human nature. Considered apart from cultural capital, the economic system itself does not provide criteria for making judgments

distinguishing between higher modes of human satisfaction, based on authentic needs, and lower modes that chase after fake needs and cripple our opportunities for genuine human fulfillment.

Economy of mutuality presupposes devotion to moral virtues developed within a culture having the ability to ripen the excellence of the whole person. Considered by themselves, neither market nor government can accomplish this. Economy of mutuality reminds us that technical business competence and informed government policies, while imperative, cannot of themselves assemble a good company or a good businessperson.

Culture inculcates a way of viewing the world, of perceiving what is real, of bringing sense to reality. Culture illuminates what we hold sacred, guiding us to apprehend the deepest meaning extending back to our origins and ahead to the future.

Human society is built upon a bedrck of cultural institutions. Family and education are two of the foremost institutions vital for economic society. Family comprises the primary component of human culture; it is the basic unit of society. Education cultivates an awareness of and sensitivity toward the world, inspiring a sense of wonder, firing the imagination, and granting moral vision necessary to enlighten scientific, technical and commercial undertakings.

Philosophy, along with religion, the arts, music, literature and other humanities are at the center of culture. These endeavors are concerned with what is most precious and noble in our lives. These wellsprings of higher culture prompt us to engage the deeper significance of our world, pointing beyond drab concerns of everyday things to what is enduring, directing us toward ultimate questions concerning our nature, our purpose and our destiny.

The reason for this stems from a dynamic understood from antiquity: by drawing us back to our purpose, to our authentic nature, to our destiny, higher forms of culture equip us to perceive the whole, not simply the fragments. Culture equips us to assimilate the totality of the cosmos and guides us to comprehend how we fit into it. We grasp the wholeness by being united with elemental cycles of our existence such as living, growing, dying, loving, and working so as to relate them in an organic unity instead of in a subdivided way. Hidden at the center of all cultures deserving of the name is a yen to reunite what is detached.

The gulf separating work and virtue engenders a kind of nihilism throughout much of today's business world – crossing all peoples and cultures.

Perhaps what is needed is a way of connecting one's vocation in business to an ethical outlook on commercial life. This would involve linking:

- Business life to communities of virtue;
- Generation of goods and services to the end of human flourishing;
- Commercial enterprise to the common good;
- Employment to the cultivation of excellence and pursuit of well-being in employees.

Straightforward talk about the ways cultural capital inspires and develops virtuous businesspeople can stimulate meaningful discourse across cultures. This may engender some harmony among them. A heightened rapprochement between morality and business may promote more profound interactions among cultures, equipping them to negotiate thorny ideological divergences. Yet it is not plausible to believe that we impart moral wisdom to one another if we simply follow government laws and regulations or mimic technical financial methodologies. In truth, the profit-driven mindset, collective laws and conventional practices, and the econometric worldview are too constraining for the art of business to flourish.

The notion of cultural capital provides a means of explanation for why the profit motive is best interpreted as something broader than a relentless quest for profit maximization. Most of what is needed to create profit is attainable only through the cultivation and deployment of cultural capital. And although this type of intangible capital is not amenable to being reduced to a specific item on the balance sheet, nevertheless it contains value as a path to enhancing the bottom line.

Therefore, the idea of cultural capital should be brought within the orbit of economic thinking. As with financial capital, a business can build up reserves of cultural capital. It can accumulate this asset by helping to establish relationships of accountability, commitment, fair-dealing, goodwill, mutual respect, and trust, and in the process, helping people to direct their respective talents toward a shared venture. It is a facilitator of human and social capital (Harrison 2013, p. 2). Likewise, a business can draw upon cultural capital just as it can draw upon these other forms. Yet accomplishing this may require adopting non-traditional styles of leadership and management aimed at a sapiential harnessing of intrinsically valuable human goods.

People are most apt to flourish in the sort of surroundings in which overall social progress and cultural advancement are taking place. Economic growth comes about as a cooperative—not simply an individual—enterprise. The ability of sizeable groups to operate in conjunction with one another generates social trust, one of the essential components of market activity. Francis Fukuyama states that "[t]rust is the expectation that arises within a community of regular, honest, and cooperative behavior, based on commonly shared norms …" (Fukuyama 1995, p. 26). "These norms," he notes, "can be about deep 'value' questions like the nature of God or justice, but they also encompass secular norms like professional standards and codes of behavior" (Ibid.).

Homo Reciprocans

One finds in a variety of economic theories the ideological construct *homo economicus*. Here the human person is reduced to an egoistic actor seeking to satisfy his or her subjective ends. Making rational assessments, *homo economicus* sets foot in the market to maximize utility *qua* consumer and economic profit *qua* producer.

Hence *homo economicus*, emblematic of market economy, starkly contrasts with the notion of *homo reciprocans* that portrays the human person embedded in social economy, having behavioral inclinations for reciprocity and cooperation with others (Dohmen et al. 2009). Real people do not necessarily pursue only exchanges of equivalent value; their actions sometimes spring from gratuitousness; their exchanges can be prolonged over time (Grassl 2011, p. 114; Becchetti et al. 2008).

The conceptual model relied upon to portray market economy, embraced by much of the business world, largely overlooks the fundamental complexity of human nature at the core of economics and business (Freeman and Newkirk 2008, pp. 139–143). In fact, reciprocal human behavior is harmonious with markets. Historical evidence shows that reciprocity promotes markets and is conversely buttressed by market economies (Grassl 2011, p. 114).

Common Good

Economy of mutuality stresses the purposive nature of business enterprise. As such it is in line with both the methodological approach taken by Aristotle – inquiring into the purposive character of all human enterprises (Solomon 2004, p. 1023) – as well as with approaches examining the broader purpose of business (Calvez and Naughton 2002; Sison and Fontrodona 2011).

> The notion of "common good" is especially germane, denoting something more than the competing interests of selfish individuals and beyond composite interests of special groups. It is the good we all have in common – communal conditions necessary for virtuous pursuit of human fulfillment, flourishing, and perfection by all in society. The common good is an aggregation of collaborative initiatives and shared restraints by which society helps everyone achieve what in the end only each individual can accomplish for herself: shaping a good will and constituting an authentically human self by freely choosing good every time one is given the chance and responsibility to do so.
>
> Thus understood, the common good looks in two directions: to the good of society and to the good of the individuals, since social conditions supply part of the means for human fulfillment. Yet ultimately the two directions are not at odds with one another. Instead they are correlational since "any good of an individual that is a real good is rooted in the good of the community, and, conversely, any common good that is a real good is at the same time the good of all individuals who share in that community" (O'Brien 2009, p. 29).

At its best, business builds up the common good of society (Solomon 2004; Melé 2009; O'Brien 2009; Sison and Fontrodona 2011). Moreover, the institution of business can be depicted from the standpoint of its own peculiar common good (Sison 2007; Melé 2009). Taken together these propositions mean that business advances the common good of society when it sets about fulfilling the common good of its own (Sison and Fontrodona 2011).

To this point, in the eyes of many classical economists, instead of contravening civil society, the market embodies it. Proper functioning of the market depends on contracts, cooperation, institutions and trust. These elements promote reciprocity. Throughout the classical Latin tradition, economic activity provides a setting where humans manifest their social being, revealing a thirst for camaraderie in relationships of equality and dignity.

For those who see the market as a den of vicious selfish competition, characterized by excessive gain-seeking behavior of business firms, such characterizations appear strange. But a crucial insight that economy of mutuality offers is this: the market reveals itself as a manifestation of social life the moment we discern beneath it a shared sense of common good. This is something logically prior to bargaining.

By building good and just institutions, by forming agreements grounded in authentic trust rather than on the basis of deceptive and disingenuous corporate images, market interactions will take on a wider and more virtuous role. From this vantage point, the economy of mutuality acquires nourishment from a tradition of thought common in ancient economies.

Virtue

There is a moral disconnectedness both within business and within wider culture. This decoupling arises from a self-understanding of business that has unwittingly abandoned the moral virtues in relation to economic life, together with their broader cultural underpinnings. Consequently, it is urgent to consider what is meant by being “good” and “successful” in business, and to clarify the virtues required for being a good businessperson.

Our inquiry is aided by reflecting on cultural capital – the intangible moral resource needed to develop the virtues for achieving excellence in business, whatever one’s station. The virtuous businessperson is not only a self-project of individual motivation and effort. Cultivating virtue ultimately depends upon culture – its institutions of family, education, and the arts – to provide formation that fosters excellence.

The Place for Profitability

Considering business as a human enterprise (Freeman and Newkirk 2008), one finds that deep down, people work to gain a better, fulfilled life for themselves, for loved ones, for the community in which they live. For this betterment to happen, it is vital that individuals working in a free market economy have opportunities to willingly invest whatever talent, vigor, and know-how they possess.

From this dynamic of freely investing themselves, a free people is guided, in Adam Smith's imagery, by an invisible hand toward prosperity and well-being. In this way, we expect that wealth will be created, not just in the short term but in a sustainable fashion. Adam Smith's invisible hand need not be taken to convey anything mysterious. Common sense suggests that by letting people go after their self-interest, unintended yet favorable social outcomes will ensue. In the course of seeking profit, people unwittingly contribute beneficial effects: increasing the overall wealth of society, facilitating technological innovation, fostering peace and civility, enabling workers to get more and improved jobs, bringing people of different lands together to know and respect one another.

Of course, not all motivations underpinning markets are purely self-interested. Nor is the invisible hand a completely reliable check on individual rapacity. Beyond pointing out the importance of pursuing self-interest, Adam Smith stresses the virtues of benevolence and sympathy. (Smith 1759/1976). For Smith, self-interest expressed within the rules of a commercial society is not opposed to virtue. Indeed, character traits associated with the pursuit of long-term self-interest – prudence, temperance, and self-command – are key business virtues (Hirschman 1997, pp. 18–19).

Contemporary market economy represents one component of ideal commercial society. Additional elements are private property, free exchange, democracy and rule of law. Taken together, these components help fuel individual initiative, engaging creative capacities across the population to give those potentials a chance to ignite, express themselves, and lead to contentment and well-being.

Yet the profit motive is seen in wider culture as the end-all-and-be-all of business. Relentless pursuit of profit is praised: "the honor is in the dollar." But the concept of "profit motive" is distorted by narrow economic models. The mindset that sees markets as fueled entirely by self-interest, taking self-interest as the single-minded hunt for profit, misunderstands both "self-interest" and "profit maximization."

Self-Interest in Proper Proportion

Tocqueville observed, in the American context, an attitude of rational self-interest properly understood: each person identifies their own self-interest with that of all in the society.

When rightly understood, self-interest elevates people above narrow selfish preoccupations. Although self-interest might not instantaneously manufacture virtue, it wields a discipline that "shapes a lot of orderly, temperate, moderate, careful, and self-controlled citizens" (Tocqueville 1863/1994, p. 527). From Tocqueville's vantage point, a person's rational concern for self gets joined to a broader sense of esteem for various cultural, moral, and legal establishments enabling the wider population to follow their freely selected ambitions, principally through business enterprise.

A virtuous company is a far cry from a mere "profit machine." Writing about visionary companies, Collins and Porras state that

> Profitability is a necessary condition for existence and a means to more important ends, but it is not the end in itself for many of the visionary companies. Profit is like oxygen, food, water, and blood for the body; they are not the *point* of life, but without them, there is no life (Collins and Porras 1994, p. 55).

Such companies embrace a "core ideology," or "vital shaping force" which might stem from its origins, as in the case of Sony; or, as with Merck, from a successive generation; or even remain quiescent to be revivified at some subsequent point, as occurred with Ford (Id. p. 54). A virtuous firm might have as its principal motivations professionalism, civic responsibility and customer service, like Housing Development Finance Corporation.[3] Its driving force could be "bedrock values" of personal accountability, respect for the individual, truth, and fair dealing, like Sealed Air Corporation.[4] It may be spurred on by a commitment to integrity, fairness, fun, and social responsibility, as AES Corporation is.[5]

As with a human being, the organization must have an authentic commitment to its objectives, in a way that is true to its own character and internal nature as a moral agent that is free to choose. It cannot simply mimic the values of other firms, conform to external diktats, or smartly calculate which roster of values will prove to be the most lucrative, trendy or well-liked (Collins and Porras 1994, p. 75).

No matter how a company articulates its mission, profit maximization normally is not listed as its objectives. Instead, profit is a predictable and reliable side-effect arising in an indirect fashion from the company seeking other aspirations. To situate this thought within the real world of business, we can turn to the results of Collins and Porras' extensive study of companies noted for attaining exceptional long-term performance. Among their findings, the authors note a shattering of the myth that the companies achieving the highest degree of success owe their existence principally to the quest for profit maximization:

> Contrary to business school doctrine, "maximizing shareholder wealth" or "profit maximization" has not been the dominant driving force or primary objective through the history of the visionary companies. Visionary companies pursue a cluster of objectives, of which making money is only one – and not necessarily the primary one. Yes, they seek profits, but they're equally guided by a core ideology – core values and sense of purpose beyond just making money. Yet, paradoxically, the visionary companies make more money than the more purely profit-driven comparison companies" (Collins and Porras 1994, p. 8).

Narrowing in on profit alone makes an enterprise lose sight of its authentic mission. Conversely, if a firm remains guided by its true objective, profit is produced in due course.

[3] HDFC (A) Harvard Business School Case No. 9-301-093 (2000).

[4] Sealed Air Corporation: Globalization and Corporate Culture (A), (B), Harvard Business School Case Nos. 9-398-096, 9-398-097 (1998).

[5] AES Honeycomb (A), Harvard Business School Case No. 9-395-132 (1994).

Collins and Porras demonstrate how companies that elevate profit to the apex of their business plan, considering everything else as subordinate to it and deeming this to be the principal means by which to beat the competition, forfeit the competitive advantage they were pursuing. Rather than "beating the competition," visionary companies,

> focus primarily on beating themselves. Success and beating competitors comes to the visionary companies not so much as the end goal, but as a residual *result* of relentlessly asking the question "How can we improve ourselves to do better tomorrow than we did today?" And they have asked this question day in and day out – as a disciplined way of life – in some cases for over 150 years. No matter how much they achieve – no matter how far in front of their competitors they pull – they never think they've done "good enough" (Collins and Porras 1994, p. 10).

The upshot is that the invisible hand is more flexible, having a wider range of motion than normally thought. The invisible hand guides in not one but two directions: social good gets generated as a consequence of businesses' quest for profit; as well, businesses' quest for social good generates profit. Economic and moral values, along with financial and social values, are not necessarily at odds with one another but instead complementary, in the way oppositions of "yin" and "yang" function as harmonizing forces of holistic Eastern philosophy (Jackson 2004, p. 46).

Conclusion

This chapter shows how economy of mutuality can help us comprehend the blurring of boundaries sometimes seen between "normal" businesses (market economy) and non-for profit or social businesses.

The proximate ends of for-profit, hybrid, and nonprofit businesses respectively was identified at the level of business and economic theories.

Higher ends of these various archetypes were then spotlighted, and an account of an ultimate end-state across archetypes was articulated at a deep and broad level. With the help of five concepts – social solidarity and interdependence, cultural capital, *homo reciprocans,* common good, and virtue – it was explained why the ultimate end-state is reciprocity and integral human development.

Among the implications raised by economy of mutuality are a reappraisal of boundaries between sectors, along with an appropriate endorsement of new forms of business enterprises. According to this interpretive framework there is no reason to privilege either for-profit enterprise or non-profit enterprise, by crediting either of them with carrying out a more important task or imparting higher moral value. The shift is toward the objective of infusing all archetypes of business enterprise with "pro-social" attitudes.

Another implication of economy of mutuality is a call to update outmoded approaches to executive leadership entrenched in narrow mindsets threatening to decouple business from its nobler purposes.

Overall, the chapter shows how the mode of organization represented by various archetypes of business enterprise is secondary to the higher purpose of a business. The analysis advocates comprehensive moral thinking, inviting business leaders to look at their roles not solely in insular economic terms, but in pro-social terms. From the standpoint of economy of mutuality, while it is acknowledged that for-profit business enterprises have shareholder and stakeholders, they have as well vocations to engage in realistic ways with other institutions in building a better, more sustainable world by fostering reciprocity and authentic human development.

Part IV

Introduction: Strategic Differentiation – Creating Competitive Advantage

Gilbert G. Lenssen

According to Michael Porter and Mark Kramer, there are three pathways to creating shared value; i.e., developing sustainable value propositions to stakeholders for the purpose of gaining competitive advantage:

1. Reconceiving products and services to better meet social and environmental needs in a profitable way;
2. Redefining productivity in the value chain to generate more efficient and more sustainable use of human and material resources, both in the supply and distribution chain;
3. Local cluster development among producers and suppliers and also between profit and non-profit sectors, including NGOs, who can become partners in the business model instead of adversaries.

This reflects the core idea of Porter and Kramer's Creating Shared Value (CSV): that business can create economic value AND value for society in mutually beneficial ways. This can create competitive advantage for the business and, as a result, the value for stakeholders and society is more sustainable because it is underpinned by economic incentives. A growing number of companies (Nestle, Coca-Cola, Johnson & Johnson, Umicore, Illy Café, General Electric, Unilever, GSK and others) have already embraced the shared value concept.

However, while stakeholder pressure can force companies to become more sustainable, it does not necessarily follow that competitors in the sector will follow. An example is Hydro Polymers Limited, a division of Norsk Hydro ASA (Hydro Polymers later became INEOS ChlorVinyls), which dramatically changed its strategy to become a more sustainable producer of PVC. Some investments in sustainability paid back handsomely, but overall the European PVC producers were was left at a considerable cost disadvantage relative to cheap Chinese imports, in part due to the costs associated with sustainability improvements.

A deliberate strategy ahead of NGO pressures has to consider first mover disadvantages and make sure that upfront investments can be remunerated over the

medium term. There are no guarantees, especially when sustainability driven strategies can be subject to uncertain regulatory conditions.

Key Questions to Ask (Applicable to All Part IV Cases)

How can a sustainability-related value proposition enhance strategic advantage?

How is this achieved: by new innovative products and services, redefining productivity in the value chain, partnerships and clusters?

How can business models lower disadvantaged exposure to macro trends?

How can differentiation be achieved? Can it be sustained?

How is this strategy informed by first mover advantage/ disadvantage analysis?

Is the strategy backed up with critical resources such as preferential external relationships with stakeholders, internal organisational capabilities, knowledge management processes and systems?

Are these resources unique or difficult to imitate by competitors?

Which normative framework needs to support the sustainability business proposition?

Chapter 16: Creating Shared Value by Michael E. Porter and Mark R. Kramer

We include this popular article from the *Harvard Business Review* on the concept of "shared value". The concept is not new, but the article is crafted with the language of industry competitiveness for which Porter gained fame. Porter differentiates his concept clearly from philanthropy, which he earlier theorised and advocated as a way for business to discharge social responsibilities (as a way of "giving back" to enhance legitimacy) during the second (E)ABIS colloquium in 2003 in Copenhagen. The response from the audience was so unfavourable that perhaps it contributed to his later writing where he articulates a much deeper sense of social responsibility. In 2006, he published with Mark Kramer "Strategy and Society: The Links Between Competitive Advantage and Corporate Social Responsibility" in the *Harvard Business Review* in which he distances himself from the views expressed in his 2003 lecture. But he also distances himself from CSR in the later paper which we publish here and claims that his concept of shared value is about a new capitalist way of creating sustainable value in a strategic way, whilst CSR is more about tactical responses to pressures for social responsibility from NGO activists.

Chapter 17: Response to Porter: Responsibility for Realising the Promise of Shared Value by Gastón de los Reyes, Jr. and Markus Scholz

Porter may have been applauded by the corporate world for his pro-market, pro-business stance, his emphasis on the role of business in creating value, and for coining the term shared value, which speaks clearly to managers. However, in academic circles, he was heavily criticised. His apparent departure from a normative ethical stance at the outset created much antagonism. To an outsider to the community of CSR scholars, this critique might at first have appeared to be driven by envy of

Porter's success, but it became well substantiated as further research emerged. Indeed, a purely instrumental strategy of shared value might backfire with stakeholders viewing it as insincere or even cynical. As is demonstrated in Chap. 22, a laudable CSV inspired business initiative like micro finance needs a normative framework for managers to keep the business model credible and sustainable. Moreover, there are sometimes negative impacts of business that can only be remediated at the cost of business since there is no shared value to be gained (though action can potentially protect against loss of value from issues driven campaigns and subsequent loss of legitimacy and trust). Often, this can only be achieved by industry sector wide action, inspired by normative concerns.

Chapter 18: Illycafè: Value Creation Through Sustainable Supplier Relationships by Francesco Perrini and Angeloantonio Russo

This case is an excellent example of creating shared value through redefining productivity in the value chain, while also including due attention to the normative ethical motivations of Illy's management. The *Fair Trade* initiative asks consumers to pay a fair price for coffee to remunerate the work of the farmers in a decent way. Porter portrays this as a CSR initiative which is not at the heart of the business model of the coffee industry and therefore likely to remain an ethical niche trade. Illy started from a different motivation. The company succeeded in securing quality of coffee in the face of a crisis in the global coffee market by creating direct partnerships with coffee farmers, training and supporting them, and paying a higher price for higher quality. The shared value between the company and the farmers is embedded in the transformed business model and is more stable and sustainable. Andrea Illy, the family firm's CEO, believes passionately in caring for "his" farmers as part of a successful business and, to this day, Illy does not seek publicity for "doing good". It just claims to make the best coffee in the world.

Chapter 19: Microfinance as a Shakespearean Tragedy: The Creation of Shared Value, While Acting Responsibly by Harry Hummels

Microfinance—providing financial products to poor entrepreneurs—was hailed as the panacea for unlocking business potential at the "bottom of the pyramid" in emerging and developing societies for potentially more than 100 million entrepreneurs. Microfinance is a classic illustration of creating shared value: by attracting capital from around the world (not in the least from big institutional investors) with above average returns and risks spread widely over many lenders, and providing much-needed finance to poor entrepreneurs with great potential to their enhance business opportunities, business acumen and business skills. Microfinance promised to make dreams come true the world over, but it became a victim of its own success. By attracting massive capital inflows, the unethical practices of loan officers and debt collectors proved to be fatal to the business. Sudden external changes in the social environment did the rest. The case focuses on the microfinance business of Actiam, a Dutch asset manager and how it sailed through the ensuing crisis.

The article shows that managers need to incorporate normative ethical elements in their CSV framework as well as be “streetwise” in an ever-changing environment. Gaston de los Reyes and Markus Scholz were proven right, at least with this story, that realising the promise of CSV requires a normative framework of responsibility and ethical conduct which Porter and Kramer (at least in Chapter 17) choose to ignore.

Chapter 20: “Ecomagination” at Work: GE’s Sustainability Initiative by S. George and S. Regani

This case is a good example of a company creating shared value by improving energy efficiency in its own operations and by reconceiving products and services to better meet social and environmental needs in a profitable way. Lately GE has also been creating partnerships for sustainable development solutions. Ecomagination was conceived as a business strategy for GE’s B2B customers to use innovative and intelligent resource efficiency solutions to help them grow and compete in a sustainable way. Innovation, partnerships, new business models and engaging stakeholders all form part of the strategy. In 2015, GE formed the *Ecomagination 2020 Partnerships for Sustainability and Innovation*, with large companies like Walmart, Total, Intel, Statoil, Masdar, MWH Global and Goldman Sachs, to address global resource challenges. Collaborative partnerships have been created in energy efficiency, water reuse, energy neutral wastewater, and new hybrid renewable solutions. ‘Current, Powered by GE’ is a new start-up which focuses on combining innovative technology solutions for sustainability with digital and financial capabilities. In 2015 alone, GE invested $2.3 billion in clean technology R&D and generated $36 billion in revenues from its Ecomagination business.

Chapter 21: Sustainability as Opportunity: Unilever’s Sustainable Living Plan by Joanne Lawrence, Andreas Rasche and Kevina Kenny

Shareholder value has been the prevailing orthodoxy in business since the eighties. The focus on delivering short-term shareholder value has led, says Paul Polman, CEO of Unilever in an interview in *Management Today* in 2011, “to widespread addiction to quick artificial highs – rather like a junkie hooked on heroin or a financial trader on cocaine”. The ultimate cost of short-termism, he says, was the financial crisis of 2008–2009. He elaborates: “Too many investors have become short-term gamblers: the more fluctuations in share price they can engineer, the better it is for them. It is not good for the companies or for society, nor for long term shareholders, but it is influencing the way firms are being run, all the same. To drag the world back to sanity, we need to know why we are here. The answer is: for consumers, not short term investors. If we are in synch with consumer needs and the environment in which we operate, and take responsibility for society as well as for our employees, then the shareholder will also be rewarded.” Clearly the CEO of Unilever is a man with a mission and a strong belief in shared value. When Polman announced his Sustainable Living Plan (SLP) strategy in 2010 and his intention to abandon quarterly earnings forecasts, Unilever’s shares dropped 10 % at a stroke. At Davos in 2011, he announced that he would no longer make financial presentations

to hedge fund managers. "I do not wish to be political, but my decisions are made in the long-term interests of the company," he said. It seems he was rather happy that the hedge fund investors left.

The essence of the SLP strategy is to decouple growth from environmental impact in the areas of greenhouse gases, water use, waste and packaging, and sustainable sourcing. Unilever wants to double its sales by 2020, but halve its effects on the environment. Meanwhile, social objectives have been added to the plan in the areas of health, well being and nutrition, and in relation to fairness in the workplace, opportunities for women, and "inclusive business". All areas have detailed performance targets. Regular reporting on these targets is provided in the Annual Report (e.g., 2015 report) as well as in the online Sustainable Living Report (e.g. May 2016 report). These reports are verified by independent external auditors.

Creating Shared Value

16

How to Reinvent Capitalism—And Unleash a Wave of Innovation and Growth

Michael E. Porter and Mark R. Kramer

THE CAPITALIST SYSTEM is under siege. In recent years business increasingly has been viewed as a major cause of social, environmental, and economic problems. Companies are widely perceived to be prospering at the expense of the broader community.

Even worse, the more business has begun to embrace corporate responsibility, the more it has been blamed for society's failures. The legitimacy of business has fallen to levels not seen in recent history. This diminished trust in business leads political leaders to set policies that undermine competitiveness and sap economic growth. Business is caught in a vicious circle.

A big part of the problem lies with companies themselves, which remain trapped in an outdated approach to value creation that has emerged over the past few decades. They continue to view value creation narrowly, optimizing short-term financial performance in a bubble while missing the most important customer needs

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Capitalism is under siege....Diminished to set policies that sap economic growth…. The purpose of the corporation must be trust in business is causing political leaders Business is caught in a vicious circle.... redefined around

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© Springer Science+Business Media B.V. 2019
G. G. Lenssen, N. C. Smith (eds.), *Managing Sustainable Business*,
https://doi.org/10.1007/978-94-024-1144-7_16

and ignoring the broader influences that determine their longer-term success. How else could companies overlook the well being of their customers, the depletion of natural resources vital to their businesses, the viability of key suppliers, or the economic distress of the communities in which they produce and sell? How else could companies think that simply shifting activities to locations with ever lower wages was a sustainable "solution" to competitive challenges? Government and civil society have often exacerbated the problem by attempting to address social weaknesses at the expense of business. The presumed trade-offs between economic efficiency and social progress have been institutionalized in decades of policy choices.

Companies must take the lead in bringing business and society back together. The recognition is there among sophisticated business and thought leaders, and promising elements of a new model are emerging. Yet we still lack an overall framework for guiding these efforts, and most companies remain stuck in a "social responsibility" mind-set in which societal issues are at the periphery, not the core.

The solution lies in the principle of shared value, which involves creating economic value in a way that *also* creates value for society by addressing its needs and challenges. Businesses must reconnect company success with social progress. Shared value is not social responsibility, philanthropy, or even sustainability, but a new way to achieve economic success. It is not on the margin of what companies do but at the center. We believe that it can give rise to the next major transformation of business thinking.

A growing number of companies known for their hard-nosed approach to business—such as GE, Google, IBM, Intel, Johnson & Johnson, Nestlé, Unilever, and Wal-Mart—have already embarked on important efforts to create shared value by reconceiving the intersection between society and corporate performance. Yet our recognition of the transformative power of shared value is still in its genesis. Realizing it will require leaders and managers to develop new skills and knowledge—such as a far deeper appreciation of societal needs, a greater understanding of the true bases of company productivity, and the ability to collaborate across profit/nonprofit boundaries. And government must learn how to regulate in ways that enable shared value rather than work against it.

Capitalism is an unparalleled vehicle for meeting human needs, improving efficiency, creating jobs, and building wealth. But a narrow conception of capitalism has prevented business from harnessing its full potential to meet society's broader challenges. The opportunities have been there all along but have been overlooked. Businesses acting as businesses, not as charitable donors, are the most powerful force for addressing the pressing issues we face. The moment for a new conception of capitalism is now; society's needs are large and growing, while customers, employees, and a new generation of young people are asking business to step up.

The purpose of the corporation must be redefined as creating shared value, not just profit per se. This will drive the next wave of innovation and productivity growth in the global economy. It will also reshape capitalism and its relationship to society. Perhaps most important of all, learning how to create shared value is our best chance to legitimize business again.

Moving Beyond Trade-Offs

Business and society have been pitted against each other for too long. That is in part because economists have legitimized the idea that to provide societal benefits, companies must temper their economic success. In neoclassical thinking, a requirement for social improvement—such as safety or hiring the disabled—imposes a constraint on the corporation. Adding a constraint to a firm that is already maximizing profits, says the theory, will inevitably raise costs and reduce those profits.

Idea in Brief

The concept of shared value—which focuses on the connections between societal and economic progress—has the power to unleash the next wave of global growth.

An increasing number of companies known for their hard-nosed approach to business—such as Google, IBM, Intel, Johnson & Johnson, Nestlé, Unilever, and Wal-Mart—have begun to embark on important shared value initiatives. But our understanding of the potential of shared value is just beginning

There are three key ways that companies can create shared value opportunities:

- By reconceiving products and markets
- By redefining productivity in the value chain
- By enabling local cluster development

Every firm should look at decisions and opportunities through the lens of shared value. This will lead to new approaches that generate greater innovation and growth for companies—and also greater benefits for society.

Societal needs, not just conventional economic needs, define markets, and social harms can create internal costs for firms.

A related concept, with the same conclusion, is the notion of externalities. Externalities arise when firms create social costs that they do not have to bear, such as pollution. Thus, society must impose taxes, regulations, and penalties so that firms "internalize" these externalities—a belief influencing many government policy decisions.

This perspective has also shaped the strategies of firms themselves, which have largely excluded social and environmental considerations from their economic thinking. Firms have taken the broader context in which they do business as a given and resisted regulatory standards as invariably contrary to their interests. Solving social problems has been ceded to governments and to NGOs. Corporate responsibility programs—a reaction to external pressure—have emerged largely to improve firms' reputations and are treated as a necessary expense. Anything more is seen by

many as an irresponsible use of shareholders' money. Governments, for their part, have often regulated in a way that makes shared value more difficult to achieve. Implicitly, each side has assumed that the other is an obstacle to pursuing its goals and acted accordingly.

The concept of shared value, in contrast, recognizes that societal needs, not just conventional economic needs, define markets. It also recognizes that social harms or weaknesses frequently create *internal* costs for firms—such as wasted energy or raw materials, costly accidents, and the need for remedial training to compensate for inadequacies in education. And addressing societal harms and constraints does not necessarily raise costs for firms, because they can innovate through using new technologies, operating methods, and management approaches—and as a result, increase their productivity and expand their markets.

Shared value, then, is not about personal values. Nor is it about "sharing" the value already created by firms—a redistribution approach. Instead, it is about expanding the total pool of economic and social value. A good example of this difference in perspective is the fair trade movement in purchasing. Fair trade aims to increase the proportion of revenue that goes to poor farmers by paying them higher prices for the same crops. Though this may be a noble sentiment, fair trade is mostly about redistribution rather than expanding the overall amount of value created. A shared value perspective, instead, focuses on improving growing techniques and strengthening the local cluster of supporting suppliers and other institutions in order to increase farmers' efficiency, yields, product quality, and sustainability. This leads to a bigger pie of revenue and profits that benefits both farmers and the companies that buy from them. Early studies of cocoa farmers in the Côte d'Ivoire, for instance, suggest that while fair trade can increase farmers' incomes by 10–20%, shared value investments can raise their incomes by more than 300%. Initial investment and time may be required to implement new procurement practices and develop the supporting cluster, but the return will be greater economic value and broader strategic benefits for all participants.

The Roots of Shared Value

At a very basic level, the competitiveness of a company and the health of the communities around it are closely intertwined. A business needs a successful community, not only to create demand for its products but also to provide critical public assets and a supportive environment. A community needs successful businesses to provide jobs and wealth creation opportunities for its citizens. This interdependence means that public policies that undermine the productivity and competitiveness of businesses are self-defeating, especially in a global economy where facilities and jobs can easily move elsewhere. NGOs and governments have not always appreciated this connection.

In the old, narrow view of capitalism, business contributes to society by making a profit, which supports employment, wages, purchases, investments, and taxes. Conducting business as usual is sufficient social benefit. A firm is largely a self-contained entity, and social or community issues fall outside its proper scope. (This

is the argument advanced persuasively by Milton Friedman in his critique of the whole notion of corporate social responsibility.)

What Is "Shared Value"?

The concept of shared value can be defined as policies and operating practices that enhance the competitiveness of a company while simultaneously advancing the economic and social conditions in the communities in which it operates. Shared value creation focuses on identifying and expanding the connections between societal and economic progress.

The concept rests on the premise that both economic and social progress must be addressed using value principles. Value is defined as benefits relative to costs, not just benefits alone. Value creation is an idea that has long been recognized in business, where profit is revenues earned from customers minus the costs incurred. However, businesses have rarely approached societal issues from a value perspective but have treated them as peripheral matters. This has obscured the connections between economic and social concerns.

In the social sector, thinking in value terms is even less common. Social organizations and government entities often see success solely in terms of the benefits achieved or the money expended. As governments and NGOs begin to think more in value terms, their interest in collaborating with business will inevitably grow.

This perspective has permeated management thinking for the past two decades. Firms focused on enticing consumers to buy more and more of their products. Facing growing competition and shorter- term performance pressures from shareholders, managers resorted to waves of restructuring, personnel reductions, and relocation to lower-cost regions, while leveraging balance sheets to return capital to investors. The results were often commoditization, price competition, little true innovation, slow organic growth, and no clear competitive advantage.

In this kind of competition, the communities in which companies operate perceive little benefit even as profits rise. Instead, they perceive that profits come at their expense, an impression that has become even stronger in the current economic recovery, in which rising earnings have done little to offset high unemployment, local business distress, and severe pressures on community services.

It was not always this way. The best companies once took on a broad range of roles in meeting the needs of workers, communities, and supporting businesses. As other social institutions appeared on the scene, however, these roles fell away or were delegated. Shortening investor time horizons began to narrow thinking about appropriate investments. As the vertically integrated firm gave way to greater reliance on outside vendors, outsourcing and offshoring weakened the connection between firms and their communities. As firms moved disparate activities to more and more locations, they often lost touch with any location. Indeed, many companies no longer recognize a home—but see themselves as "global" companies.

These transformations drove major progress in economic efficiency. However, something profoundly important was lost in the process, as more fundamental

opportunities for value creation were missed. The scope of strategic thinking contracted.

Strategy theory holds that to be successful, a company must create a distinctive value proposition that meets the needs of a chosen set of customers. The firm gains competitive advantage from how it configures the value chain, or the set of activities involved in creating, producing, selling, delivering, and supporting its products or services. For decades businesspeople have studied positioning and the best ways to design activities and integrate them. However, companies have overlooked opportunities to meet fundamental societal needs and misunderstood how societal harms and weaknesses affect value chains. Our field of vision has simply been too narrow.

In understanding the business environment, managers have focused most of their attention on the industry, or the particular business in which the firm competes. This is because industry structure has a decisive impact on a firm's profitability. What has been missed, however, is the profound effect that location can have on productivity and innovation. Companies have failed to grasp the importance of the broader business environment surrounding their major operations.

How Shared Value Is Created

Companies can create economic value by creating societal value. There are three distinct ways to do this: by reconceiving products and markets, redefining productivity in the value chain, and building supportive industry clusters at the company's locations. Each of these is part of the virtuous circle of shared value; improving value in one area gives rise to opportunities in the others.

The concept of shared value resets the boundaries of capitalism. By better connecting companies' success with societal improvement, it opens up many ways to serve new needs, gain efficiency, create differentiation, and expand markets.

The ability to create shared value applies equally to advanced economies and developing countries, though the specific opportunities will differ. The opportunities will also differ markedly across industries and companies—but every company has them. And their range and scope is far broader than has been recognized. *[The idea of shared value was initially explored in a December 2006 HBR article by Michael E. Porter and Mark R. Kramer, "Strategy and Society: The Link Between Competitive Advantage and Corporate Social Responsibility."]*

Reconceiving Products and Markets

Society's needs are huge—health, better housing, improved nutrition, help for the aging, greater financial security, less environmental damage. Arguably, they are the greatest unmet needs in the global economy. In business we have spent decades learning how to parse and manufacture demand while missing the most important demand of all. Too many companies have lost sight of that most basic of questions: Is our product good for our customers? Or for our customers' customers?

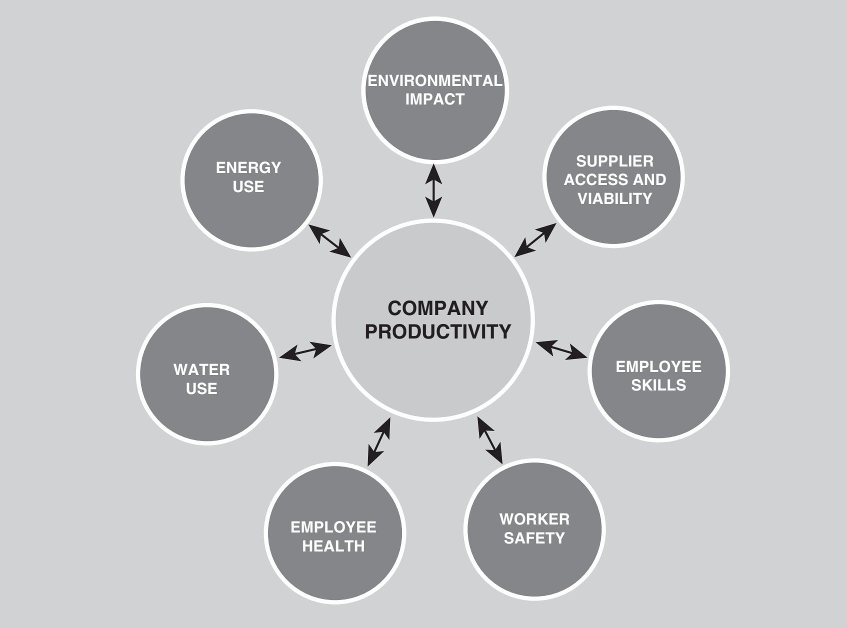
In advanced economies, demand for products and services that meet societal needs is rapidly growing. Food companies that traditionally concentrated on taste and quantity to drive more and more consumption are refocusing on the fundamental need for better nutrition. Intel and IBM are both devising ways to help utilities harness digital intelligence in order to economize on power usage. Wells Fargo has developed a line of products and tools that help customers budget, manage credit, and pay down debt. Sales of GE's Ecomagination products reached $18 billion in 2009—the size of a *Fortune* 150 company. GE now predicts that revenues of Ecomagination products will grow at twice the rate of total company revenues over the next five years.

In these and many other ways, whole new avenues for innovation open up, and shared value is created. Society's gains are even greater, because businesses will often be far more effective than governments and nonprofits are at marketing that motivates customers to embrace products and services that create societal benefits, like healthier food or environmentally friendly products.

Blurring the Profit/Nonprofit Boundary

The concept of shared value blurs the line between for-profit and nonprofit organizations. New kinds of hybrid enterprises are rapidly appearing. For example, WaterHealth International, a fast-growing for profit, uses innovative water purification techniques to distribute clean water at minimal cost to more than one million people in rural India, Ghana, and the Philippines. Its investors include not only the socially focused acumen Fund and the international Finance corporation of the World Bank but also Dow chemical's venture fund. Revolution Foods, a four-year-old venture-capital-backed U.S. start-up, provides 60,000 fresh, healthful, and nutritious meals to students daily—and does so at a higher gross margin than traditional

The Connection Between Competitive Advantage and Social Issues
There are numerous ways in which addressing societal concerns can yield productivity benefits to a firm. Consider, for example, what happens when a firm invests in a wellness program. Society benefits because employees and their families become healthier, and the firm minimizes employee absences and lost productivity. The graphic below depicts some areas where the connections are strongest.



competitors. Waste concern, a hybrid profit/nonprofit enterprise started in Bangladesh 15 years ago, has built the capacity to convert 700 tons of trash, collected daily from neighborhood slums, into organic fertilizer, thereby increasing crop yields and reducing CO_2 emissions. Seeded with capital from the lions club and the United Nations Development programme, the company improves health conditions while earning a substantial gross margin through fertilizer sales and carbon credits.

The blurring of the boundary between successful for-profits and non-profits is one of the strong signs that creating shared value is possible.

Equal or greater opportunities arise from serving disadvantaged communities and developing countries. Though societal needs are even more pressing there, these communities have not been recognized as viable markets. Today attention is riveted on India, China, and increasingly, Brazil, which offer firms the prospect of reaching billions of new customers at the bottom of the pyramid—a notion persuasively articulated by C.K. Prahalad. Yet these countries have always had huge needs, as do many developing countries.

Similar opportunities await in nontraditional communities in advanced countries. We have learned, for example, that poor urban areas are America's most underserved market; their substantial concentrated purchasing power has often been overlooked. (See the research of the Initiative for a Competitive Inner City, at icic.org.)

The societal benefits of providing appropriate products to lower-income and disadvantaged consumers can be profound, while the profits for companies can be substantial. For example, low-priced cell phones that provide mobile banking services, are helping the poor save money securely and transforming the ability of small farmers to produce and market their crops. In Kenya, Vodafone's M-PESA mobile banking service signed up 10 million customers in three years; the funds it handles now represent 11% of that country's GDP. In India, Thomson Reuters has developed a promising monthly service for farmers who earn an average of $2,000 a year. For a fee of $5 a quarter, it provides weather and crop pricing information and agricultural advice. The service reaches an estimated 2 million farmers, and early research indicates that it has helped increase the incomes of more than 60% of them—in some cases even tripling incomes. As capitalism begins to work in poorer communities, new opportunities for economic development and social progress increase exponentially.

For a company, the starting point for creating this kind of shared value is to identify all the societal needs, benefits, and harms that are or could be embodied in the firm's products. The opportunities are not static; they change constantly as technology evolves, economies develop, and societal priorities shift. An ongoing exploration of societal needs will lead companies to discover new opportunities for differentiation and repositioning in traditional markets, and to recognize the potential of new markets they previously overlooked.

Meeting needs in underserved markets often requires redesigned products or different distribution methods. These requirements can trigger fundamental innovations that also have application in traditional markets. Microfinance, for example, was invented to serve unmet financing needs in developing countries. Now it is growing rapidly in the United States, where it is filling an important gap that was unrecognized.

Redefining Productivity in the Value Chain

A company's value chain inevitably affects—and is affected by—numerous societal issues, such as natural resource and water use, health and safety, working conditions, and equal treatment in the workplace. Opportunities to create shared value arise because societal problems can create economic costs in the firm's value chain. Many so-called externalities actually inflict internal costs on the firm, even in the absence of regulation or resource taxes. Excess packaging of products and greenhouse gases are not just costly to the environment but costly to the business. Wal-Mart, for example, was able to address both issues by reducing its packaging and rerouting its trucks to cut 100 million miles from its delivery routes in 2009, saving $200 million even as it shipped more products. Innovation in disposing of plastic used in stores has saved millions in lower disposal costs to landfills.

> By reducing its packaging and cutting 100 million miles from the delivery routes of its trucks, Wal-Mart lowered carbon emissions and saved $200 million in costs.

The new thinking reveals that the congruence between societal progress and productivity in the value chain is far greater than traditionally believed (see the exhibit "The Connection Between Competitive Advantage and Social Issues"). The synergy increases when firms approach societal issues from a shared value perspective and invent new ways of operating to address them. So far, however, few companies have reaped the full productivity benefits in areas such as health, safety, environmental performance, and employee retention and capability.

But there are unmistakable signs of change. Efforts to minimize pollution were once thought to inevitably increase business costs—and to occur only because of regulation and taxes. Today there is a growing consensus that major improvements in environmental performance can often be achieved with better technology at nominal incremental cost and can even yield net cost savings through enhanced resource utilization, process efficiency, and quality.

In each of the areas in the exhibit, a deeper understanding of productivity and a growing awareness of the fallacy of short-term cost reductions (which often actually lower productivity or make it unsustainable) are giving rise to new approaches. The following are some of the most important ways in which shared value thinking is transforming the value chain, which are not independent but often mutually reinforcing. Efforts in these and other areas are still works in process, whose implications will be felt for years to come.

Energy Use and Logistics The use of energy throughout the value chain is being reexamined, whether it be in processes, transportation, buildings, supply chains, distribution channels, or support services. Triggered by energy price spikes and a new awareness of opportunities for energy efficiency, this reexamination was under way even before carbon emissions became a global focus. The result has been striking improvements in energy utilization through better technology, recycling, cogeneration, and numerous other practices—all of which create shared value.

We are learning that shipping is expensive, not just because of energy costs and emissions but because it adds time, complexity, inventory costs, and management costs. Logistical systems are beginning to be redesigned to reduce shipping distances, streamline handling, improve vehicle routing, and the like. All of these steps create shared value. The British retailer Marks & Spencer's ambitious overhaul of its supply chain, for example, which involves steps as simple as stopping the purchase of supplies from one hemisphere to ship to another, is expected to save the retailer £175 million annually by fiscal 2016, while hugely reducing carbon emissions. In the process of reexamining logistics, thinking about outsourcing and location will also be revised (as we will discuss below).

Resource Use Heightened environmental awareness and advances in technology are catalyzing new approaches in areas such as utilization of water, raw materials, and packaging, as well as expanding recycling and reuse. The opportunities apply to all resources, not just those that have been identified by environmentalists. Better resource utilization—enabled by improving technology—will permeate all parts of the value chain and will spread to suppliers and channels. Landfills will fill more slowly.

For example, Coca-Cola has already reduced its worldwide water consumption by 9% from a 2004 baseline—nearly halfway to its goal of a 20% reduction by 2012. Dow Chemical managed to reduce consumption of fresh water at its largest production site by one billion gallons—enough water to supply nearly 40,000 people in the U.S. for a year—resulting in savings of $4 million. The demand for water-saving technology has allowed India's Jain Irrigation, a leading global manufacturer of complete drip irrigation systems for water conservation, to achieve a 41% compound annual growth rate in revenue over the past five years.

Procurement The traditional playbook calls for companies to commoditize and exert maximum bargaining power on suppliers to drive down prices— even when purchasing from small businesses or subsistence-level farmers. More recently, firms have been rapidly outsourcing to suppliers in lower-wage locations.

Today some companies are beginning to understand that marginalized suppliers cannot remain productive or sustain, much less improve, their quality. By increasing access to inputs, sharing technology, and providing financing, companies can improve supplier quality and productivity while ensuring access to growing volume. Improving productivity will often trump lower prices. As suppliers get stronger, their environmental impact often falls dramatically, which further improves their efficiency. Shared value is created.

A good example of such new procurement thinking can be found at Nespresso, one of Nestlé's fastest- growing divisions, which has enjoyed annual growth of 30% since 2000. Nespresso combines a sophisticated espresso machine with single-cup aluminum capsules containing ground coffees from around the world. Offering quality and convenience, Nespresso has expanded the market for premium coffee.

The Role of Social Entrepreneurs

Businesses are not the only players in finding profitable solutions to social problems. A whole generation of social entrepreneurs is pioneering new product concepts that meet social needs using viable business models. Because they are not locked into narrow traditional business thinking, social entrepreneurs are often well ahead of established corporations in discovering these opportunities. Social enterprises that create shared value can scale up far more rapidly than purely social programs, which often suffer from an inability to grow and become self-sustaining.

Real social entrepreneurship should be measured by its ability to create shared value, not just social benefit.

Obtaining a reliable supply of specialized coffees is extremely challenging, however. Most coffees are grown by small farmers in impoverished rural areas of Africa and Latin America, who are trapped in a cycle of low productivity, poor quality, and environmental degradation that limits production volume. To address these issues, Nestlé redesigned procurement. It worked intensively with its growers, providing advice on farming practices, guaranteeing bank loans, and helping secure inputs such as plant stock, pesticides, and fertilizers. Nestlé established local facilities to measure the quality of the coffee at the point of purchase, which allowed it to pay a premium for better beans directly to the growers and thus improve their incentives. Greater yield per hectare and higher production quality increased growers' incomes, and the environmental impact of farms shrank. Meanwhile, Nestlé's reliable supply of good coffee grew significantly. Shared value was created.

Embedded in the Nestlé example is a far broader insight, which is the advantage of buying from capable local suppliers. Outsourcing to other locations and countries creates transaction costs and inefficiencies that can offset lower wage and input costs. Capable local suppliers help firms avoid these costs and can reduce cycle time, increase flexibility, foster faster learning, and enable innovation. Buying local includes not only local companies but also local units of national or international companies. When firms buy locally, their suppliers can get stronger, increase their profits, hire more people, and pay better wages—all of which will benefit other businesses in the community. Shared value is created.

Distribution Companies are beginning to re-examine distribution practices from a shared value perspective. As iTunes, Kindle, and Google Scholar (which offers texts of scholarly literature online) demonstrate, profitable new distribution models can also dramatically reduce paper and plastic usage. Similarly, microfinance has created a cost-efficient new model of distributing financial services to small businesses.

Opportunities for new distribution models can be even greater in nontraditional markets. For example, Hindustan Unilever is creating a new direct- to-home distribution system, run by underprivileged female entrepreneurs, in Indian villages of fewer than 2,000 people. Unilever provides micro- credit and training and now has more than 45,000 entrepreneurs covering some 100,000 villages across 15 Indian states. Project Shakti, as this distribution system is called, benefits communities not only by

giving women skills that often double their household income but also by reducing the spread of communicable diseases through increased access to hygiene products. This is a good example of how the unique ability of business to market to hard- to-reach consumers can benefit society by getting life-altering products into the hands of people that need them. Project Shakti now accounts for 5% of Unilever's total revenues in India and has extended the company's reach into rural areas and built its brand in media-dark regions, creating major economic value for the company.

> By investing in employee wellness programs, Johnson & Johnson has saved $250 million on health care costs.

Employee Productivity The focus on holding down wage levels, reducing benefits, and offshoring is beginning to give way to an awareness of the positive effects that a living wage, safety, wellness, training, and opportunities for advancement for employees have on productivity. Many companies, for example, traditionally sought to minimize the cost of "expensive" employee health care coverage or even eliminate health coverage altogether. Today leading companies have learned that because of lost workdays and diminished employee productivity, poor health costs them more than health benefits do. Take Johnson & Johnson. By helping employees stop smoking (a two-thirds reduction in the past 15 years) and implementing numerous other wellness programs, the company has saved $250 million on health care costs, a return of $2.71 for every dollar spent on wellness from 2002 to 2008. Moreover, Johnson & Johnson has benefited from a more present and productive workforce. If labor unions focused more on shared value, too, these kinds of employee approaches would spread even faster.

Location Business thinking has embraced the myth that location no longer matters, because logistics are inexpensive, information flows rapidly, and markets are global. The cheaper the location, then, the better. Concern about the local communities in which a company operates has faded.

That oversimplified thinking is now being challenged, partly by the rising costs of energy and carbon emissions but also by a greater recognition of the productivity cost of highly dispersed production systems and the hidden costs of distant procurement discussed earlier. Wal-Mart, for example, is increasingly sourcing produce for its food sections from local farms near its warehouses. It has discovered that the savings on transportation costs and the ability to restock in smaller quantities more than offset the lower prices of industrial farms farther away. Nestlé is establishing smaller plants closer to its markets and stepping up efforts to maximize the use of locally available materials.

The calculus of locating activities in developing countries is also changing. Olam International, a leading cashew producer, traditionally shipped its nuts from Africa to Asia for processing at facilities staffed by productive Asian workers. But by opening local processing plants and training workers in Tanzania, Mozambique, Nigeria, and Côte d'Ivoire, Olam has cut processing and shipping costs by as much as

25%—not to mention, greatly reduced carbon emissions. In making this move, Olam also built preferred relationships with local farmers. And it has provided direct employment to 17,000 people—95% of whom are women—and indirect employment to an equal number of people, in rural areas where jobs otherwise were not available.

These trends may well lead companies to remake their value chains by moving some activities closer to home and having fewer major production locations. Until now, many companies have thought that being global meant moving production to locations with the lowest labor costs and designing their supply chains to achieve the most immediate impact on expenses. In reality, the strongest international competitors will often be those that can establish deeper roots in important communities. Companies that can embrace this new locational thinking will create shared value.

AS THESE examples illustrate, reimagining value chains from the perspective of shared value will offer significant new ways to innovate and unlock new economic value that most businesses have missed.

Enabling Local Cluster Development

No company is self-contained. The success of every company is affected by the supporting companies and infrastructure around it. Productivity and innovation are strongly influenced by "clusters," or geographic concentrations of firms, related businesses, suppliers, service providers, and logistical infrastructure in a particular field—such as IT in Silicon Valley, cut flowers in Kenya, and diamond cutting in Surat, India.

Clusters include not only businesses but institutions such as academic programs, trade associations, and standards organizations. They also draw on the broader public assets in the surrounding community, such as schools and universities, clean water, fair- competition laws, quality standards, and market transparency.

Clusters are prominent in all successful and growing regional economies and play a crucial role in driving productivity, innovation, and competitiveness. Capable local suppliers foster greater logistical efficiency and ease of collaboration, as we have discussed. Stronger local capabilities in such areas as training, transportation services, and related industries also boost productivity. Without a supporting cluster, conversely, productivity suffers.

Deficiencies in the framework conditions surrounding the cluster also create internal costs for firms. Poor public education imposes productivity and remedial-training costs. Poor transportation infrastructure drives up the costs of logistics. Gender or racial discrimination reduces the pool of capable employees. Poverty limits the demand for products and leads to environmental degradation, unhealthy workers, and high security costs. As companies have increasingly become disconnected from their communities, however, their influence in solving these problems has waned even as their costs have grown.

Firms create shared value by building clusters to improve company productivity while addressing gaps or failures in the framework conditions surrounding the cluster. Efforts to develop or attract capable suppliers, for example, enable the procurement benefits we discussed earlier. A focus on clusters and location has been all but absent in management thinking. Cluster thinking has also been missing in many economic development initiatives, which have failed because they involved isolated interventions and overlooked critical complementary investments.

A key aspect of cluster building in developing and developed countries alike is the formation of open and transparent markets. In inefficient or monopolized markets where workers are exploited, where suppliers do not receive fair prices, and where price transparency is lacking, productivity suffers. Enabling fair and open markets, which is often best done in conjunction with partners, can allow a company to secure reliable supplies and give suppliers better incentives for quality and efficiency while also substantially improving the incomes and purchasing power of local citizens. A positive cycle of economic and social development results.

When a firm builds clusters in its key locations, it also amplifies the connection between its success and its communities' success. A firm's growth has multiplier effects, as jobs are created in supporting industries, new companies are seeded, and demand for ancillary services rises. A company's efforts to improve framework

conditions for the cluster spill over to other participants and the local economy. Workforce development initiatives, for example, increase the supply of skilled employees for many other firms as well.

At Nespresso, Nestlé also worked to build clusters, which made its new procurement practices far more effective. It set out to build agricultural, technical, financial, and logistical firms and capabilities in each coffee region, to further support efficiency and high-quality local production. Nestlé led efforts to increase access to

Creating Shared Value: Implications for Government and Civil Society

While our focus here is primarily on companies, the principles of shared value apply equally to governments and nonprofit organizations.

Governments and NGOs will be most effective if they think in value terms— considering benefits relative to costs—and focus on the results achieved rather than the funds and effort expended. Activists have tended to approach social improvement from an ideological or absolutist perspective, as if social benefits should be pursued at any cost. Governments and NGOs often assume that trade-offs between economic and social benefits are inevitable, exacerbating these trade-offs through their approaches. For example, much environmental regulation still takes the form of command-and-control mandates and enforcement actions designed to embarrass and punish companies.

Regulators would accomplish much more by focusing on measuring environmental performance and introducing standards, phase-in periods, and support for technology that would promote innovation, improve the environment, and increase competitiveness simultaneously.

The principle of shared value creation cuts across the traditional divide between the responsibilities of business and those of government or civil society. From society's perspective, it does not matter what types of organizations created the value. What matters is that benefits are delivered by those organizations—or combinations of organizations—that are best positioned to achieve the most impact for the least cost. Finding ways to boost productivity is equally valuable whether in the service of commercial or societal objectives. In short, the principle of value creation should guide the use of resources across all areas of societal concern.

Fortunately, a new type of NGO has emerged that understands the importance of productivity and value creation. Such organizations have often had a remarkable impact. One example is TechnoServe, which has partnered with both regional and global corporations to promote the development of competitive agricultural clusters in more than 30 countries. Root capital accomplishes a similar objective by providing financing to farmers and businesses that are too large for micro- finance but too small for normal bank financing. Since 2000, Root capital has lent more than $200 million to 282 businesses through which it has reached 400,000 farmers and artisans. It has financed the cultivation of 1.4 million acres of organic agriculture in Latin America and

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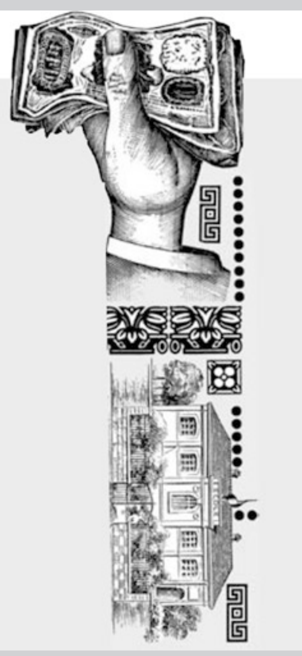
Africa. Root capital regularly works with corporations, utilizing future purchase orders as collateral for its loans to farmers and helping to strengthen corporate supply chains and improve the quality of purchased inputs.

Some private foundations have begun to see the power of working with businesses to create shared value. The Bill & Melinda Gates Foundation, for example, has formed partnerships with leading global corporations to foster agricultural clusters in developing countries. The foundation carefully focuses on commodities where climate and soil conditions give a particular region a true competitive advantage. The partnerships bring in NGOs like TechnoServe and Root capital, as well as government officials, to work on precompetitive issues that improve the cluster and upgrade the value chain for all participants. This approach recognizes that helping small farmers increase their yields will not create any lasting benefits unless there are ready buyers for their crops, other enterprises that can process the crops once they are harvested, and a local cluster that includes efficient logistical infrastructure, input availability, and the like. The active engagement of corporations is essential to mobilizing these elements.

Forward-thinking foundations can also serve as honest brokers and allay fears by mitigating power imbalances between small local enterprises, NGOs, governments, and companies. Such efforts will require a new assumption that shared value can come only as a result of effective collaboration among all parties.



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Government Regulation and Shared Value

The right kind of government regulation can encourage companies to pursue shared value; the wrong kind works against it and even makes trade-offs between economic and social goals inevitable.

Regulation is necessary for well-functioning markets, something that became abundantly clear during the became abundantly clear during the recent financial crisis. However, the ways in which regulations are designed and implemented determine whether they benefit society or work against it.

Regulations that enhance shared value set goals and stimulate innovation. They highlight a societal objective and create societal objective and create a level playing field to encourage companies to invest in shared value rather than maximize short-term profit. Such regulations have a number of characteristics:

First, they set clear and measurable social goals, whether they involve energy use, health matters, or safety. Where appropriate, they set prices for resources (such as water) that reflect true costs. Second, they set performance standards but do not prescribe the methods to achieve them—those are left to companies. Third, they define phase-in periods for meeting standards, which reflect the investment or new-product cycle in the industry. Phase-in periods give companies time to develop and introduce new products and processes in a way consistent with the economics of their business. Fourth, they put in place universal measurement and performance reporting systems, with government investing in infrastructure for collecting reliable benchmarking data (such as nutritional deficiencies in each community). This motivates and enables continual improvement beyond current targets. Finally, appropriate regulations require efficient and timely reporting of results, which can then be audited by the government as necessary, rather than impose detailed and expensive compliance processes on everyone.

Regulation that discourages shared value looks very different. It forces compliance with particular practices, rather than focusing on measurable social improvement. It mandates a particular approach to meeting a standard—blocking innovation and almost always inflicting cost on companies. When governments fall into the trap of this sort of regulation, they undermine the very progress that they seek while triggering fierce resistance from business that slows progress further and blocks shared value that would improve competitiveness.

To be sure, companies locked into the old mind-set will resist even well-constructed regulation. As shared value principles become more widely accepted, however, business and government will become more aligned on regulation in many areas. Companies will come to understand that the right kind of regulation can actually foster economic value creation.

Finally, regulation will be needed to limit the pursuit of exploitative, unfair, or deceptive practices in which companies deceptive practices in which

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companies antitrust policy, for example, is essential to ensure that the benefits of company success flow to customers, suppliers, and workers.

essential agricultural inputs such as plant stock, fertilizers, and irrigation equipment; strengthen regional farmer co-ops by helping them finance shared wet-milling facilities for producing higher-quality beans; and support an extension program to advise all farmers on growing techniques. It also worked in partnership with the Rainforest Alliance, a leading international NGO, to teach farmers more-sustainable practices that make production volumes more reliable.

In the process, Nestlé's productivity improved.

A good example of a company working to improve framework conditions in its cluster is Yara, the world's largest mineral fertilizer company. Yara realized that the lack of logistical infrastructure in many parts of Africa was preventing farmers from gaining efficient access to fertilizers and other essential agricultural inputs, and from transporting their crops efficiently to market. Yara is tackling this problem through a $60 million investment in a program to improve ports and roads, which is designed to create agricultural growth corridors in Mozambique and Tanzania. The company is working on this initiative with local governments and support from the Norwegian government. In Mozambique alone, the corridor is expected to benefit

more than 200,000 small farmers and create 350,000 new jobs. The improvements will help Yara grow its business but will support the whole agricultural cluster, creating huge multiplier effects.

The benefits of cluster building apply not only in emerging economies but also in advanced countries. North Carolina's Research Triangle is a notable example of public and private collaboration that has created shared value by developing clusters in such areas as information technology and life sciences. That region, which has benefited from continued investment from both the private sector and local government, has experienced huge growth in employment, incomes, and company performance, and has fared better than most during the downturn.

To support cluster development in the communities in which they operate, companies need to identify gaps and deficiencies in areas such as logistics, suppliers, distribution channels, training, market organization, and educational institutions. Then the task is to focus on the weaknesses that represent the greatest constraints to the company's own productivity and growth, and distinguish those areas that the company is best equipped to influence directly from those in which collaboration is more cost effective. Here is where the shared value opportunities will be greatest. Initiatives that address cluster weaknesses that constrain companies will be much more effective than community-focused corporate social responsibility programs, which often have ternal influences on corporate success. It highlights the immense human needs to be met, the large new markets to serve, and the internal costs of social and community deficits—as well as the competitive advantages available from addressing them. Until recently, companies have simply not approached their businesses this way.

Creating shared value will be more effective and far more sustainable than the majority of today's corporate efforts in the social arena. Companies will make real strides on the environment, for example, when they treat it as a productivity driver rather than a feel-good response to external pressure. Or consider limited impact because they take on too many areas without focusing on value.

But efforts to enhance infrastructure and institutions in a region often require collective action, as the Nestlé, Yara, and Research Triangle examples show. Companies should try to enlist partners to share the cost, win support, and assemble the right skills. The most successful cluster development programs are ones that involve collaboration within the private sector, as well as trade associations, government agencies, and NGOs.

> Not all profit is equal. Profits involving a social purpose represent a higher form of capitalism, one that creates a positive cycle of company and community prosperity.

Creating Shared Value in Practice

Not all profit is equal—an idea that has been lost in the narrow, short-term focus of financial markets and in much management thinking. Profits involving a social purpose represent a higher form of capitalism—one that will enable society to advance

more rapidly while allowing companies to grow even more. The result is a positive cycle of company and community prosperity, which leads to profits that endure.

Creating shared value presumes compliance with the law and ethical standards, as well as mitigating any harm caused by the business, but goes far beyond that. The opportunity to create economic value through creating societal value will be one of the most powerful forces driving growth in the global economy. This thinking represents a new way of understanding customers, productivity, and the ex-access to housing. A shared value approach would have led financial services companies to create innovative products that prudently increased access to home ownership. This was recognized by the Mexican construction company Urbi, which pioneered a mortgage-financing "rent-to-own" plan. Major U.S. banks, in contrast, promoted unsustainable financing vehicles that turned out to be socially and economically devastating, while claiming they were socially responsible because they had charitable contribution programs.

Inevitably, the most fertile opportunities for creating shared value will be closely related to a company's particular business, and in areas most important to the business. Here a company can benefit the most economically and hence sustain its commitment over time. Here is also where a company brings the most resources to bear, and where its scale and market presence equip it to have a meaningful impact on a societal problem.

Ironically, many of the shared value pioneers have been those with more-limited resources—social entrepreneurs and companies in developing countries. These outsiders have been able to see the opportunities more clearly. In the process, the distinction between for-profits and nonprofits is blurring.

How Shared Value Differs from Corporate Social Responsibility

Creating shared value (csv) should supersede corporate social responsibility (CSR) in guiding the investments of companies in their communities. CSR programs focus mostly on reputation and have only a limited connection to the business, making them hard to justify and maintain over the long run. In contrast, CSV is integral to a company's profitability and competitive position. It leverages the unique resources and expertise of the company to create economic value by creating social value.

CSR	CSV
> values: Doing good	> value: Economic and societal benefits relative to cost
Citizenship, philanthropy, sustainability	> joint company and community value creation
> discretionary or in response to external pressure	> integral to competing
> separate from profit maximization	> integral to profit maximization

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CSR	CSV
> agenda is determined by external reporting and personal preferences	> agenda is company specific and internally generated
> impact limited by corporate footprint and CSR budget	> realigns the entire company budget
Example: Fair trade purchasing	Example: Transforming procurement to increase quality and yield

In both cases, compliance with laws and ethical standards and reducing harm from corporate activities are assumed

Shared value is defining a whole new set of best practices that all companies must embrace. It will also become an integral part of strategy. The essence of strategy is choosing a unique positioning and a distinctive value chain to deliver on it. Shared value opens up many new needs to meet, new products to offer, new customers to serve, and new ways to configure the value chain. And the competitive advantages that arise from creating shared value will often be more sustainable than conventional cost and quality improvements. The cycle of imitation and zero-sum competition can be broken.

The opportunities to create shared value are widespread and growing. Not every company will have them in every area, but our experience has been that companies discover more and more opportunities over time as their line operating units grasp this concept. It has taken a decade, but GE's Ecomagination initiative, for example, is now producing a stream of fast-growing products and services across the company.

A shared value lens can be applied to every major company decision. Could our product design incorporate greater social benefits? Are we serving all the communities that would benefit from our products? Do our processes and logistical approaches maximize efficiencies in energy and water use? Could our new plant be constructed in a way that achieves greater community impact? How are gaps in our cluster holding back our efficiency and speed of innovation? How could we enhance our community as a business location? If sites are comparable economically, at which one will the local community benefit the most? If a company can improve societal conditions, it will often improve business conditions and thereby trigger positive feedback loops

The three avenues for creating shared value are mutually reinforcing. Enhancing the cluster, for example, will enable more local procurement and less dispersed supply chains. New products and services that meet social needs or serve overlooked markets will require new value chain choices in areas such as production, marketing, and distribution. And new value chain configurations will create demand for equipment and technology that save energy, conserve resources, and support employees.

Creating shared value will require concrete and tailored metrics for each business unit in each of the three areas. While some companies have begun to track

various social impacts, few have yet tied them to their economic interests at the business level.

Shared value creation will involve new and heightened forms of collaboration. While some shared value opportunities are possible for a company to seize on its own, others will benefit from insights, skills, and resources that cut across profit/nonprofit and private/public boundaries. Here, companies will be less successful if they attempt to tackle societal problems on their own, especially those involving cluster development. Major competitors may also need to work together on precompetitive framework conditions, something that has not been common in reputation-driven CSR initiatives. Successful collaboration will be data driven, clearly linked to defined outcomes, well connected to the goals of all stakeholders, and tracked with clear metrics.

Governments and NGOs can enable and reinforce shared value or work against it. (For more on this topic, see the sidebar "Government Regulation and Shared Value.")

The Next Evolution in Capitalism

Shared value holds the key to unlocking the next wave of business innovation and growth. It will also reconnect company success and community success in ways that have been lost in an age of narrow management approaches, short-term thinking, and deepening divides among society's institutions.

Shared value focuses companies on the right kind of profits—profits that create societal benefits rather than diminish them. Capital markets will undoubtedly continue to pressure companies to generate short-term profits, and some companies will surely continue to reap profits at the expense of societal needs. But such profits will often prove to be short- lived, and far greater opportunities will be missed.

The moment for an expanded view of value creation has come. A host of factors, such as the growing social awareness of employees and citizens and the increased scarcity of natural resources, will drive unprecedented opportunities to create shared value.

We need a more sophisticated form of capitalism, one imbued with a social purpose. But that purpose should arise not out of charity but out of a deeper understanding of competition and economic value creation. This next evolution in the capitalist model recognizes new and better ways to develop products, serve markets, and build productive enterprises.

Creating shared value represents a broader conception of Adam Smith's invisible hand. It opens the doors of the pin factory to a wider set of influences. It is not philanthropy but self-interested behavior to create economic value by creating societal value. If all companies individually pursued shared value connected to their particular businesses, society's overall interests would be served. And companies would acquire legitimacy in the eyes of the communities in which they operated, which would allow democracy to work as governments set policies that fostered and

supported business. Survival of the fittest would still prevail, but market competition would benefit society in ways we have lost.

Creating shared value represents a new approach to managing that cuts across disciplines. Because of the traditional divide between economic concerns and social ones, people in the public and private sectors have often followed very different educational and career paths. As a result, few managers have the understanding of social and environmental issues required to move beyond today's CSR approaches, and few social sector leaders have the managerial training and entrepreneurial mindset needed to design and implement shared value models. Most business schools still teach the narrow view of capitalism, even though more and more of their graduates hunger for a greater sense of purpose and a growing number are drawn to social entrepreneurship. The results have been missed opportunity and public cynicism.

Business school curricula will need to broaden in a number of areas. For example, the efficient use and stewardship of all forms of resources will define the next-generation thinking on value chains. Customer behavior and marketing courses will have to move beyond persuasion and demand creation to the study of deeper human needs and how to serve nontraditional customer groups. Clusters, and the broader locational influences on company productivity and innovation, will form a new core discipline in business schools; economic development will no longer be left only to public policy and economics departments. Business and government courses will examine the economic impact of societal factors on enterprises, moving beyond the effects of regulation and macroeconomics. And finance will need to rethink how capital markets can actually support true value creation in companies—their fundamental purpose—not just benefit financial market participants.

There is nothing soft about the concept of shared value. These proposed changes in business school curricula are not qualitative and do not depart from economic value creation. Instead, they represent the next stage in our understanding of markets, competition, and business management.

NOT ALL societal problems can be solved through shared value solutions. But shared value offers corporations the opportunity to utilize their skills, resources, and management capability to lead social progress in ways that even the best-intentioned governmental and social sector organizations can rarely match. In the process, businesses can earn the respect of society again.

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17 Response to Porter: Responsibility for Realising the Promise of Shared Value

Gastón de los Reyes Jr. and Markus Scholz

CSV for the Legitimacy of Capitalism

"The capitalist system is under siege" (Porter and Kramer 2011: 64), but companies, Michael E. Porter and Mark R. Kramer tell us in their latest Harvard Business Review article, can push back and triumph with the guidance provided by a managerial framework they call "Creating Shared Value" (CSV). The siege is at the hands of civil society and governments, and the target is the legitimacy of modern day global business, now "fallen to levels not seen in recent history" (Porter and Kramer 2011: 64). The syndrome, the authors tell us, is a vicious cycle born from the proposition that business and society are separate from each other.

The business strategies that follow from the idea that business and society are separate have flooded society with a barrage of externalities—environmental, political, moral, social and otherwise. Governments often respond by imposing (whether or not successfully) regulations that would internalize these costs through strict constraints (hard laws). Such regulations, in Porter and Kramer's view, sap the vibrancy of capitalism. Nevertheless, civil society clamors for companies to go even further than the hard law of existing regulations with voluntary corporate social responsibility (CSR) initiatives. According to Porter and Kramer, CSR pressures also tamper with the virtue of capitalism. Both regulation and CSR are to be avoided, and that means managers must proactively turn this bad news around. The way to do so, Porter and Kramer say, is through their creating shared value (CSV) framework, starting from the idea that "what's good for society is good for business" (Porter and Ignatius 2011a: 4:31). Business strategists just need to find those opportunities to respond to social needs that enhance the competitive advantage of their firms.

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© Springer Science+Business Media B.V. 2019

G. G. Lenssen, N. C. Smith (eds.), *Managing Sustainable Business*,
https://doi.org/10.1007/978-94-024-1144-7_17

The thesis of Porter and Kramer's CSV paper is that creating shared value can redeem global capitalism's flagging legitimacy. Porter and Kramer defend CSV's plausibility with an extensive set of examples that leaves little doubt that many of the praiseworthy achievements of global capitalism in the recent decade owe to a business formula that, in fact, creates shared value—benefit to society that enriches business too. This is especially apparent in environmental responsibility initiatives that dramatically improve operational efficiency. These highly impactful transformations in a firm's activity system (Porter 1996) run the gamut from mundane improvements such as reducing packaging and shipping weight to the bold such as the redefinition by Nissan and Toyota of their market segment (see Levitt 1960) as low-emissions mobility (Pfitzer et al. 2013: 4).

Our thesis is that, despite appearances to the contrary in Porter and Kramer's compelling paper, CSV cannot redeem the legitimacy of global business as a standalone managerial framework. The way Porter and Kramer construct the CSV framework imposes predictable limitations upon the vision of managers, leaving them flat-footed around societal problems whenever competitive advantage appears unable to motivate engagement.

The missing piece is a framework to manage the extra-legal normative environment, including soft laws developed by non-state actors to fill regulatory voids with tailor-made community standards, such as those generated by the Forest Stewardship Council (Scherer and Palazzo 2007). It is certainly true that in replying to the recent critique of CSV provided by a team of leading business ethicists (Crane et al. 2014), Porter and Kramer clarify that they do endorse a "a narrow sense of social responsibility" (2014: 150) and they (2011) have also assumed that managers comply with "ethical standards." However, the category of non-legal norms—for which Porter and Kramer assume compliance—remains opaque in their account of CSV. Their CSV framework does not provide managers a way to make sense of which norms of conduct fit within a "narrow" sense of CSR and which do not. This becomes especially problematic in a fast-changing, globally interconnected business environment (Palazzo and Scherer 2008) where the normal is for norms to evolve and clash (Scherer et al. 2013).

In the vacuum left by CSV's silence around soft law, Porter and Kramer do not point to any other framework for identifying or evaluating non-legal social norms that matter to business. We will propose that what CSV requires is a responsibility framework that gives guidance to managers for identifying legitimate norms. This framework could take different forms; we will illustrate our proposal with the framework carved out by the integrative social contracts theory (ISCT) developed by Donaldson and Dunfee (1999). We will also briefly discuss the importance of expanding this framework to manage cases where there is a regulatory void and another conception of responsibility is required (Scherer and Palazzo 2007, 2011; Bower et al. 2011; Donaldson and Schoemaker 2013).

Why Status Quo Business Has Failed Society

To appreciate the idea behind CSV, it helps to understand the failings Porter and Kramer find in status quo managerial practice. It is these failings that Porter and Kramer fault for the present-day crisis in the legitimacy of business.

Porter and Kramer formulate their attack around two ideas in management, which we discuss in turn. The first is what business ethicists call the "separation thesis" (Harris and Freeman 2008), the idea that business and society represent separate spheres of human activity. The second is what is widely known as corporate social responsibility (CSR).

Rejecting the Separation Thesis Michael Porter has never celebrated *share* value as the end of business activity (Argyres and McGahan 2002). Yet business (if not also society) has done so for decades (Friedman 1970; Jensen 2002), supporting a financial conception of management that fixates on share price (often short term) as the measure of success and failure (Dobbin and Jung 2010). This financial view of the firm throws society out of view in managers' evaluation of business opportunity (Friedman 1962, 1970). Porter and Kramer put the burden of responsibility for this mistaken view of business on the "economists [who] have legitimized the idea that to provide societal benefits, companies must temper their economic success" (Porter and Kramer 2011: 64). The costs, however, are not merely academic. According to Porter and Kramer, the influence of the separation thesis on managers has contributed to the size of the legitimacy deficit prevailing in business today.

The intuition behind Porter and Kramer's judgment that the economist's separation thesis has been destructive of the legitimacy of business is readily seen with examples. A classic case results when a company can choose to raise production costs by investing in the reduction of destructive emissions for which no binding regulation exists (Friedman 1970). According to a narrow, society-ignoring view, the manager has no basis to even think of investing in emissions reductions. This suggests one way to interpret the managerial factors behind environmental accidents like the BP Deepwater Horizon oil spill. Why would you ever go beyond a strict reading of the regulations?

Consider the different case of consumers whose health suffers on account of a product expressly marketed to them. This externality has a ripple effect for the public fisc that has to tend to these consumers' health. Now suppose society-ignoring managers at global food companies. Their imperative is to design products likely to increase revenue, by increasing units sold and/or raising price, and decreasing cost. One strategy pursued by the global brands is to engineer the food product to trigger repetitive consumption (Moss 2013). Now suppose that the success of this strategy leads to abnormally high health expenses for a non-trivial set of its consumers, such as the 8.3% of the United States population who have diabetes. This would not be too surprising if the health of the food company's consumers did not directly figure into these companies' managers' decision frameworks.

CSV is Porter and Kramer's way of correcting the economists' mistaken separation thesis and the destructive conduct it condones. Society *does not* fall out of view in CSV as under the separation thesis. To the contrary, CSV brings to the manager's attention the potential to find competitive advantage in serving society's needs.

Rejecting CSR The separation thesis yields externalities (wherever governments have not directly blocked the way), and these externalities yield social movements for CSR—Porter and Kramer's (2011) second target. Responding to the toll of the

separation thesis in management, civil society—in some cases with the backing of academic research—has stepped up calls for companies to moderate their economic activity with social responsibility. This critical movement has demanded that companies treat the social and ecological externalities that result from their activities as falling within the business's mandate. With the advent of social media, the need of companies to respond to petition campaigns—one way or another—has only further become a fact of corporate life.

Any reasonable definition of CSR comprehends the variety of ways—from philanthropy to compliance with non-legal norms to norm-making activity (Scherer and Palazzo 2007)—in which companies respond to social demands without the force of law (Schwartz and Carroll 2003). CSR troubles Porter and Kramer in the way they understand it has been pursued. Their concern is easily stated. They see CSR as occupying a managerial space that is "separate from profit maximization" (p. 76) and instills an agenda that "is determined by external reporting and personal preferences," (p. 76) rather than independently by the firm pursuant to the aspiration to maximize profit.

CSV, in contrast, is defined by Porter and Kramer to avoid CSR's limitations by occupying a managerial space the entirety of which is "integral to profit maximization" (p. 76). And Porter and Kramer indicate that rather than taking direction from external norms like CSR, CSV "is company specific and internally generated." Interestingly, in an earlier paper (2006), Porter and Kramer describe their theory *within* the CSR construct rather than *outside* it, summarizing their view as follows:

> The essential test that should guide CSR is not whether a cause is worthy but whether it presents an opportunity to create shared value – that is, a meaningful benefit for society that is also valuable to the business (p. 84).

Note that even when they espoused the CSR label for CSV, the fundamental idea was exactly the same: managers should not be making profitability trade-offs for the sake of CSR. The difference now is that Porter and Kramer (2011) call for managers to discard the CSR construct altogether and instead adopt CSV.

Note that Porter and Kramer nevertheless endorse compliance with ethical standards (2011) and have recently indicated that they are in favor of a "narrow sense of social responsibility" (2014). But how is a manager to sort out from the sea of information in the business environment the purported norms Porter and Kramer assume they should follow (as ethical standards or as narrow social responsibility imperatives)? Notice that norms that promise competitive advantage as the reward of compliance fall out from this analysis. Managers should follow those norms from first principles (profitability). But what about the set of ethical standards and social responsibility imperatives that do *not* promise enhanced profitability as a reward? How can managers separate the wheat from the chaff, the legitimate norms that command the manager's respect from other social demands (like the CSR that Porter and Kramer discredit) that should be regarded as threats to profitability and avoided?

What makes CSV so special, as we will discuss next, is that by definition the CSV framework is built for no trade-offs. The manager never has to choose between profitability and social benefit within the CSV framework.

The Virtue of CSV in A-Cases

Status quo managerial practice is, in Porter and Kramer's account, like *Dr. Jekyll* or *Frankenstein*: either the misguided, short-term obsession with *share* value (Dr. Jekyll), or the abomination of free enterprise represented by CSR (Frankenstein). The alternative to this schizophrenia put forth by Porter and Kramer requires companies to trade up from *share* value to *shared* value as their end, and from CSR to CSV as their social strategy. "The purpose of the corporation must be redefined as creating shared value, not just profit per se" (p. 64). As expressed by Mark Pfitzer, a managing director of FSG, a CSV-specialized consultancy formed by Porter and Kramer: "Leaders of companies that are making significant progress in building large-scale social enterprises consider solving major social problems in profitable ways to be a, if not the, *raison d'être*. […] Creating shared value entails embedding a social mission in the corporate culture and channeling resources to the development of innovations that can help solve social problems. In some cases, this is a matter of reemphasizing a firm's founding social mission (Pfitzer et al. 2013: 4).

By implementing such a corporate purpose, managers' strategic imagination is drawn by the CSV framework to search for business opportunity *within* societal challenges. That part is clear and developed further in this section. Whether CSV can also, as Porter and Kramer claim, provide "an overall, strategic view of how to think about the role of the corporation in society" (Porter and Kramer 2014: 149), is the question taken up in the next section. The task now is to understand the virtue of CSV.

By deemphasizing quarterly numbers in the way CSV demands, managers gain the space to focus on profitability built upon durable competitive advantage. Porter and Kramer's contribution with CSV is to inspire managers to reach for imaginative ways to provide society value and their firm profitability. Porter is convinced that the sustainably profitable business strategies of the future will achieve competitive advantage by creating *shared* value, not by profiting at society's expense (Porter and Ignatius 2011b).

As a construct that defines a framework for strategic decision making, shared value stands for business strategies that strike two targets at once: *profitability and societal value*. It is this duality in shared value that grounds Porter and Kramer's claim that CSV can realign society and business to revitalize capitalism with legitimacy. According to Porter and Kramer, the world is full of societal needs that are not yet, but could be, fulfilled by companies, and forward-looking shared value strategies promise the potential for a healing of society that deservedly gives credit to business. For this reason, Porter and Kramer contend that shared value holds the key to unlocking the next wave of business innovation and growth. It will, they believe, also reconnect company success and community success after the age of the separation thesis, short-term thinking, and deepening divides among society's institutions (p. 77).

CSV has met with favor in the corporate world, partly due to FSG's growing track record. Nestle is one high profile early adopter among many, including Mattell, Hewlett-Packard, Houghton Mifflin Harcourt, Shell Oil and Swiss Re. The framework's practical success surely has to do, not only with Porter's fame and track record (Barney 2002), but with the dozens of concrete examples Porter and Kramer

provide to stimulate managerial creativity and point the way forward to successful social engagement (for a review of recent examples, see Pfitzer et al. 2013 and fsg.org). All of these examples, as will become apparent, have in common that they represent cases where the new policy or strategy both improves profitability and provides social reward, as compared with the status quo (Crane et al. 2014: 136). These are win-win for business (at least the focal business) *and* society, and we will call these A-cases (de los Reyes et al. 2017).

One can say that in an A-case what is good for the goose (the company's profitability) is good for the gander (society at large). Here are a few representative examples noted by Porter and Kramer.

> Intel and IBM are both devising ways to help utilities harness digital intelligence in order to economize on power usage (p. 67).
>
> Wells Fargo has developed a line of products and tools that help customers budget, manage credit, and pay down debt (p. 67).
>
> Sales of GE's Ecomagination products reached $18 billion in 2009—the size of a Fortune 150 company (p. 67).
>
> Dow Chemical managed to reduce consumption of fresh water at its largest production site by one billion gallons—enough water to supply nearly 40,000 people in the U.S. for a year—resulting in savings of $4 million. The demand for watersaving technology has allowed India's Jain Irrigation, a leading global manufacturer of complete drip irrigation systems for water conservation, to achieve a 41% compound annual growth rate in revenue over the past 5 years (p. 69–70).

The favorable alignment attained by managers in these cases is hardly to be diminished. The virtue of CSV is the achievement of praiseworthy imagination and inventiveness attuned to the possibilities presented by societal need. We stand wholeheartedly behind the push for creativity to find win-win opportunities.

The logic behind this virtue is elucidated in an earlier article—Porter's breakthrough social issues piece—dealing with environmental strategy and regulation. Arguing for the same formula of win-win strategies, Porter with van der Linde analogizes to the quality revolution of the 1980s. "Today we have little trouble grasping the idea that innovation can improve quality while actually lowering cost. But as recently as 15 years ago, managers believed there was a fixed 'trade off'" (Porter and van der Linde 1995: 122). CSV directs managers to pursue environmentally sound strategies, not only if managers personally want to avoid degradation of the planet, but rather to achieve the advantage of cost savings, improved quality or efficiency and/or higher prices. Managers, in other words, can and should act in socially attractive ways, finding profitable ways to do so. With CSV, it is not from the environmentalism of managers that we expect green and social strategies, but from their regard to their firm's shared value.

The social virtue of imaginative CSV strategies, we believe, is beyond doubt and amply borne out by Porter and Kramer's many examples. For this reason, we agree that Porter and Kramer have framed CSV as an essential component of a twenty-first century managerial framework. We will now proceed to lay the foundation for

our contention that being necessary does not make CSV sufficient. Contrary to Porter and Kramer, we argue that CSV, on its own, does not provide "an overall, strategic view of how to think about the role of the corporation in society" (Porter and Kramer 2014: 149). Certainly, Porter and Kramer would grant that CSV must fit alongside the normativity of law; fortunately, managers do not need a managerial framework to help them identify binding law (lawyers can manage that). Porter and Kramer also endorse compliance with ethical standards and a narrow sense of social responsibility. This category of norms is not self-legitimating in the way the law can be (Hart 1961). Managers have to make judgments about the legitimacy of those norms that call for compliance, and the limitation with CSV, as we shall see, is that it does not have a way to specify how and when non-legal norms acquire legitimacy in managerial decision making.

CSV Beyond the A-Case

In this section, we motivate our contention that CSV does not provide a comprehensive managerial framework, one that can plausibly promise to restore business legitimacy as Porter and Kramer project. The guidance of CSV around A-cases has virtue. CSV directs the manager to search for A-cases by exploring society's needs. Unfortunately, as Porter and Kramer acknowledge, "NOT ALL societal problems can be solved through shared value solutions" (emphasis in the original) (Porter and Kramer 2011: 77). And those societal problems that fall within CSV's blind spot are not necessarily exceptional or immaterial, but rather many are predictable and often serious. What falls into this blind spot are all those cases that are not *win-win* for business and society and, therefore, do not represent A-cases. These B-cases are either *win-lose* (like increasing the amount of destructive but unregulated and cost-saving emissions) or *lose-win* (like CSR initiatives that demand profitability trade-offs) (de los Reyes et al. 2017).

What defines a B-case context is that managers have not yet identified a win-win strategy at the margin. To the contrary, profitability and social advantage appear at odds, as, for example, in the case of improving labor standards in Bangladeshi textile manufacture: the obvious way to interpret the implications of investment in safety improvements by the global brands is as a reduction, rather than as an increase, in profit margins. As presented by Porter and Kramer, there is no obvious shared value in voluntarily reducing margins to raise labor conditions (value is not "shared" unless the firm gains profitability). CSV's potential for disregarding the labor conditions of supply chain workers abroad is reinforced by Porter and Kramer's criticism of the fair trade movement.

Fair trade aims to increase the proportion of revenue that goes to poor farmers by paying them higher prices for the same crops. Though this may be a noble sentiment, fair trade is mostly about redistribution rather than expanding the overall amount of value created.

Framed in this manner, CSV would also seem to disfavor (or at least not encourage) investing in labor standards: it is not obviously the case that by investing profits

in labor standards the global clothing brands would increase "the overall amount of value created."

In addition to those emerging from working conditions, supply chain management can run up against a number of other B-case issues, including potential reliance upon child or forced labor and the violation (or complicity in the violation) of human rights. B-case issues also often result when marketing abroad in different normative regimes. Yahoo entered the Chinese market to offer search and other web-based services to the world's most populous country in the late 1990s (Dann and Haddow 2008). Yahoo later found itself under orders from the Chinese government to turn over the email addresses of two Chinese journalists. Should it comply or not? Complying would have a negative impact on the journalists and would chill anything approach freedom of the press in China. This is a difficult question, and CSV does not help with an answer.

Similarly, the decision to act affirmatively about improving labor conditions abroad must seemingly come from a different normative principle than CSV. Porter and Kramer recognize ethical standards and a narrow sense of social responsibility, and this realm is implicated by B-cases. Porter and Kramer have not specified how managers are to assess the legitimacy of these norms, and CSV does not provide any guidance either. Are the global brands morally responsible, in Porter and Kramer's view, for harms to Bangladeshi textile workers who died in the Rana Plaza building crash (caused by corruption and recklessness that led to over 1000 worker deaths)? Was there a reprehensible managerial failing that gave rise to a global brand's labor strategy? Would voluntarily reducing the profit margin to improve the working conditions in textile factories fall within the narrow sense of social responsibility Porter and Kramer endorse? These are challenging questions, and the CSV framework, as Porter and Kramer present it, has no comment.

The last question asked in the previous paragraph raises an additional difficulty with Porter and Kramer's account and its handling of B-cases. The difficulty was suggested by the discussion of fair trade above: Porter and Kramer dismiss the legitimacy of economic redistribution. Shared value, they emphasize, is *not* "about 'sharing' the value already created by firms—a redistribution approach" (p. 65). To return to the case of Bangladeshi textiles, it is difficult to see the absence of redistribution when global brands assume and pay for voluntary compliance with norms that reduce profit margins so as to improve labor conditions. Does that, in Porter and Kramer's view, disqualify the norm of investing in supply chain labor conditions to a certain standard from achieving legitimacy as an ethical standard or within a narrow sense of social responsibility?

In sum, for several related reasons, Porter and Kramer's account of CSV would leave global brands managers flat-footed about B-cases like where there is no economic reason to invest to improve labor conditions in the supply chain. The limitation with Porter and Kramer's account of CSV, we have argued, is that B-cases are typical enough to cast doubt on the potential of this framework to single-handedly restore the legitimacy of capitalism. The societal downside of B-cases where business is pursuing opportunities to society's detriment (like polluting)—or is failing to

pursue social enterprise for want of competitive advantage (like healthier food that not enough consumers will pay more for)—stands in the way of the legitimacy of business, as conceptualized by Porter and Kramer and, with greater complexity, in the management literature (Suchman 1995; Scherer et al. 2013).

A team of leading business ethicists, in their recent review of CSV, go even further and suggest that with its emphasis on A-cases CSV not only obscures harms that result from business activity but could also induce companies to celebrate A-cases (or apparent A-cases) for marketing purposes.

> Operating with a CSV mindset, corporations might tend to invest more resources in promoting the impression that complex problems have been transformed in to win-win situations for all affected parties, while in reality problems of systemic injustice have not been solved and the poverty of marginalized stakeholders might even have increased because of the engagement of the corporation … [I]nstead of promoting the common good, CSV might promote more sophisticated strategies of greenwashing (Crane et al. 2014: 137).

Moreover, these business ethicists correctly, we think, point out that CSV's methodology for identifying A-cases ignores the question whether the underlying product offers genuine social good. A tobacco company, for example, might reduce the water used in production, and that measure, seen as a discrete strategy, is socially positive. No matter how much water is saved making cigarettes, this A-case cannot change the fact that tobacco causes serious health risks.

Supplementing CSV with a Responsibility Framework

In this section, we address the challenge of supplementing CSV with a responsibility framework, of one kind or another. What we are interested in showing is how two managerial frameworks—CSV and a responsibility framework—may be combined to provide a more comprehensive framework, one that fills the B-case gap in CSV with a norm-identifying apparatus.

A prominent candidate in business ethics to address these issues is Integrative Social Contracts Theory (ISCT), an approach that has been widely embraced in business ethics and serves as an exemplar of social contracts theory in management (e.g., Van Oosterhout et al. 2006; Gilbert and Benham 2009). Social contract theory originated in political philosophy over 300 years ago when philosophers such as Hobbes, Locke and Rousseau sought to justify the existence of the state and to better understand the reciprocal obligations of the state and citizen. Applied to business and society, the idea of the social contract as a theory of moral philosophy attempts to understand the terms under which the members of society consent to the legitimacy of a business system involving markets, organizations and other economic communities (Dunfee et al. 1999).

Developed by Thomas Donaldson and Thomas Dunfee, ISCT transforms the idea of social contracts (e.g., Rousseau 1762; Rawls 1971) into a concrete managerial framework. The framework posits two layers of norms, beyond which managers enjoy "moral free space." The top layer consists of "hypernorms," norms with

universal reach that are deeply embedded in human society transculturally, identifiable by their common embrace around the world in the leading religious, political and philosophical traditions (1999: 49–81). Other more local norms emerge from the microsocial contracts that result from joint participation in business activity by members of a given economic community, such as employees in a corporation or traders in a given marketplace (1999: 83–116). These microsocial norms are binding under ISCT so long as four conditions are met. The first is that the norms be (1) well established, meaning they are dominant in a community that gives members a meaningful (2) right of exit, i.e., that they are in a meaningful way voluntary with respect to the bound party, and (3) right of voice to weigh in on and influence the community's norms. These conditions ensure that microsocial norms only bind when it can be said that the actor in question chose to be subject to the norms. Finally, microsocial norms do not bind—even if the first three conditions are met—if they are not consistent with hypernorms, like human rights.

The theory of ISCT generates a framework by prompting thought experiments to help identify applicable hypernorms and microsocial contracts (e.g., 1999: 63–73; 102–112). The resulting norms identified by a manager are deemed legitimately binding under the theory (e.g., Donaldson 1996; Donaldson and Dunfee 1999, 2002; Dunfee et al. 1999; Dunfee 2006). In realms where managers cannot identify binding norms through the ISCT framework, Donaldson and Dunfee think they enjoy "moral free space" meaning they "have substantial discretion in deciding how to respond to stakeholder claims and interests" (1999: 253).

How could CSV and ISCT fit together? Where the manager identifies moral free space, CSV's imperatives can operate without restriction, meaning that managers can focus on creating shared value. Outside moral free space, managers and their companies are subject any hypernorms and microsocial norms identified by applying the framework, meaning that they can pursue the creation of shared value *subject to binding norms*. The conjunction of ISCT with CSV means that managers have a decision apparatus for identifying when a norm binds them in a way that overrides CSV. In this way, ISCT provides a plausible managerial framework to fill the gap in CSV with clear rules of engagement: in moral free space, CSV reigns untrammeled, whereas hypernorms and microsocial contracts, where applicable, trump CSV. As Donaldson recently noted in a review of CSV:

> A company should tell the truth to investors, refuse to discriminate on the basis of race or gender and refrain from dumping cancer-causing chemicals in public waters, even when doing so fails to enhance its competitive posture. It should do so even when the regulatory apparatus in a developing country is inadequate to regulate pollution; and it should do so even in a developed country when industry insider knowledge exceeds regulatory reach, as when bankers know their complex toxic mortgage derivatives are opaque to regulators. The logic of the language of morals is often not about optimisation, but commitment (Donaldson 2014).

The manager who follows a managerial framework consisting of CSV plus ISCT, therefore, finds guidance around B-cases, rather than the silence of CSV.

Consider the case of forestry, and the many issues it raises. Does it matter whether harvested forests are depleted? Do managers need to worry about other environmental impacts? What about the status of indigenous peoples who spend their lives in forests that could be legally harvested? What norms should a manager committed to a narrow sense of social responsibility follow? According to ISCT, managers should scan the environment for applicable microsocial norms and hypernorms. There are potential human rights concerns in loss of habitat of indigenous peoples, and there are likely other relevant hypernorms as well. One of the virtues of microsocial norms is often to bring concrete content to deep-tissue moral principles like human rights. In the forestry space, this advantage has been realized, however imperfectly, through a series of voluntary certification schemes, of which the Forestry Stewardship Council (FSC), founded in 1993, was first and remains the standard bearer. FSC resulted from a multi-stakeholder initiative—forestry companies, environmental NGOs and forest certification organizations (as discussed in the following section, a prototypical case of norm-making). FSC has established and maintained up to date a set of ten principles and detailed criteria for the industry to follow. The twist is that FSC does not enforce these principles as if they were law. FSC provides a certification that can be enjoyed by forest owners that act according to the FSC Principles—ensuring the right of exit ISCT demands. Today, the question for companies in the industry is whether to comply with the FSC's (or another norm-making organization's) certification standards (a matter of norm-taking).

The following commitments, adopted by FSC members, address the questions raised above:

To maintain or restore the ecosystem, its biodiversity, resources, landscapes;

To identify and uphold indigenous peoples' rights of ownership and use of land and resources.

In this case, there is not at all a blank slate for managers of the forestry company to do what appears to be in the best interest of the company, without considering societal needs and impacts. There are carefully developed and well-established FSC norms that speak to the precise issues that face forestry companies. According to ISCT, these norms are legitimate and binding since they result from voluntary participation that allows for voice and exit. The nature of the FSC process makes for a compelling case that the legitimacy of a forestry company calls for its managers to meet or beat FSC certification standards.

Coupling CSV with ISCT, as the norm-taking framework in CSV+ requires the two frameworks to integrate, and they do so in the following, straightforward way: Where the manager is in moral free space, i.e., there are no well-established microsocial norms or hypernorms to bind, CSV's own imperatives would operate without impediment. Outside moral free space, managers and their companies are subject to any hypernorms and legitimate microsocial norms identified by applying the framework. By coupling ISCT, managers can go after CSV and yet be oriented to heed legitimate norms on the way there. In this manner, ISCT provides a managerial framework designed to help fill the gap in CSV and make good on Porter and

Kramer's injunction to comply with ethical norms. The decision tree is clear: in moral free space, CSV reigns untrammeled, whereas legitimate norms, where applicable and well established, delimit the pursuit of CSV.

We close this section by noting the importance of a responsibility framework geared to deal with cases where the existing normative landscape is not reasonably up to the demands of business practice and its societal impacts. In these cases, where prevailing norms appear to be absent, too general, obsolete or otherwise maladapted to the matter at hand (Scherer and Palazzo 2011; Bower et al. 2011; Donaldson and Schoemaker 2013), a framework like ISCT loses plausibility (Scherer and Palazzo 2007: 1101–1102). Donaldson has recently supplemented ISCT with a framework designed to address cases like these with a managerial imperative to engage in norm-marking industry initiatives (Donaldson and Schoemaker 2013). Specifically, Donaldson and Schoemaker argue that the responsibilities of a captain of industry activate a legitimate norm that binds these executives as custodians of an industry's good health and survival, safeguarding for society the welfare the industry should provide. Scherer and Palazzo, in part based on their critique of ISCT's limitations, also call for executives to engage in norm-making deliberation, calling this activity "political CSR." Writing from a tradition closer in lineage to Porter, Bower, Paine and Leonard of the Harvard Business School (2011: 154) frame the imperative to engage in norm-making discourse as *institutional activism*: "success in addressing the challenges we have identified [as facing capitalism] will also require innovation in *institutional arrangements* in the external environment within which firms operate" (emphasis in the original).

A framework for norm-making along the lines suggested by these three different approaches picks up where a norm-identifying and prescribing framework like ISCT leaves off. Re-consider the example of the Bangladesh apparel industry. In the aftermath of the April 2013 Rana Plaza disaster, leaders in the global apparel industry faced a major threat to the industry's moral legitimacy. The trail led to the global brands' supply chain practices and their failure to monitor their suppliers and promote safety for workers (Quelch and Rodriguez 2013). The global brands had failed to engage in norm-making in time to prevent the Rana Plaza tragedy. Nevertheless, immediately following the tragedy, numerous brands responded to the crisis with collaborative norm-making processes.

Two different approaches emerged, one organized by European companies, the Accord on Fire and Building Safety in Bangladesh (the Accord) (Accord 2015); the other by US firms (notably, Walmart and The Gap), the Alliance for Bangladesh Worker Safety (the Alliance) (Alliance 2015). Both issued norms applicable to their members that address labor conditions, concerning safety especially. The norms that emerged from these two microsocial communities are not, however, identical. A noteworthy difference is that joining the Alliance is not supposed to subject the member to legal risk, whereas under the Accord the member may be exposed to certain obligations that create the potential for legal liability. Which set of norms will work better to protect worker safety is an evolving question of fact.

We recognize the importance of saying much more about the interface between a norm-taking framework and a norm-making framework than we can here. In this

section, our limited aim has been to ground the plausibility of layering CSV with a compound responsibility framework of the sort we sketched (ISCT plus a call to norm-making where existing norms fall short). The purpose of such an elaboration of Porter and Kramer's CSV framework has been to support our view that CSV's limitations do not provide a reason to reject the framework, but rather provide a reason to supplement the framework in the manner suggested in this section.

Conclusion

In this chapter, we have sought to develop the intuition behind Porter and Kramer's powerful CSV framework, demonstrating how it answers the limitations with a society-ignoring obsession with share value. The virtue of CSV is bringing societal needs into the heart of strategy, as the primary ground for developing sustainable competitive advantage. In light of this virtue, Porter and Kramer conclude that "learning how to create shared value is our best chance to legitimize business again" (64). We have argued that as a freestanding managerial framework CSV is not a plausible antidote to business's legitimacy crisis. In our view, Porter and Kramer's claim requires at least one more word: learning how to create shared value *responsibly* is our best chance to legitimize business again.

What CSV therefore needs, in our view, is a managerial framework to operationalize the meaning of responsibility. While Porter and Kramer endorse the general legitimacy of ethical standards and a narrow sense of social responsibility, they do not articulate a responsibility framework to assist the manager in separating the wheat (legitimate and binding norms) from the chaff (norms that do not legitimately bind managers). To show how to supplement CSV with a responsibility framework, we drew upon ISCT. The plausibility of ISCT for our purposes owes to the way it yields a managerial framework geared to facilitate the identification of the legitimate non-legal norms that bind managers. Even ISCT, we have suggested, has its limitations whenever business activity has outstripped normative development in civil society, and we highlight the importance of norm-making as a feature of a comprehensive responsibility framework.

The corporate managers who we think can do the most to help restore the legitimacy of capitalism will have to be devoted to CSV, turning over every stone of societal need to find opportunities to extend their firm's competitive advantage. They will also, we add, listen very carefully, not only to the hard law of legislators and regulators, but also to wide range of players in civil society who have a voice in the articulation of norms, from soft law to best practices. These norms—contested though they may be—arise to channel business activity with the grain of societal interest, and the twenty-first century manager cannot disregard the guidance these norms may legitimately provide. What managers need is a framework, such as ISCT models, that can help them figure out when norms bind and also when norms are lacking, requiring managers to become public deliberators engaged in norm-making processes. Only managers so equipped with a compound framework—CSV *plus* an

adequate responsibility framework—can hold the promise for a renewal of capitalism in the century ahead.

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The Roots of Corporate Sustainability: the Art of Managing Innovation and Relationships by illycaffè

18

Francesco Perrini and Angeloantonio Russo

Francesco Perrini and Angeloantonio Russo prepared this case study, as a basis for class discussion rather than to illustrate either effective or ineffective handling of a business situation.

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About the Project

This case was written as part of a project on "*Curriculum Development for Mainstreaming Corporate Responsibility*," coordinated by INSEAD and London Business School and supported by the European Academy of Business in Society (EABIS). The project aims to develop degree and executive programme designs and teaching materials that will assist the process of mainstreaming the area of corporate responsibility into core disciplines in management education and increasing its inter-disciplinarity. Within this context, EABIS members from across Europe have been invited through an open call to submit case proposals with the intention of developing a range of cases across a number of subject areas for use by mainstream faculty. The open call for case studies generated over 25 submissions from around Europe, from which a shortlist was selected, including this case study, on the grounds of their business relevance, academic rigour and potential for mainstreaming.

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© Springer Science+Business Media B.V. 2019
G. G. Lenssen, N. C. Smith (eds.), *Managing Sustainable Business*,
https://doi.org/10.1007/978-94-024-1144-7_18

Introduction

The crisis that hit the coffee market after the International Coffee Organization (ICO) agreement collapsed in 1989 led Italian company illycaffè to look beyond the typical business model that had characterized the coffee industry to date. illycaffè decided to embrace a new strategic challenge and focus on a direct-purchasing model. They would bypass the intermediaries and reward their chosen growers by paying them a premium over the market price.

In the early 1990s, Brazil was the world's largest producer of coffee, but had a reputation for low-quality products and poorly paid producers. But illycaffè prided itself on the high-quality coffee it offered consumers, and so the company had to find a way to overcome the quality problems associated with Brazilian coffee. They had to identify Brazilian coffee producers who were able to supply the high-quality beans the company required. Innovation translated into quality and networking translated into knowledge transfer thus became the drivers behind illycaffè's strategy, looking for and demanding quality, and teaching producers how to deliver that quality. Ultimately, the company had to build a new kind of relationship with relevant stakeholders along the supply chain, starting from the cultivation of coffee, continuing through the purchase, and culminating in the roasting, packaging, and selling of high-quality coffee blends.

Innovation translated into quality and networking translated into knowledge transfer became, in fact, the main drivers of sustainability, enabling illycaffè to incorporate environmental and social concerns within a strategy of corporate sustainability (CS). This strategy produced interesting results in Brazil in terms of company growth, but now management had to assess illycaffè's sustainable strategy against the impact of several factors, including the CS strategies of competitors and market reaction in the long-term. They also had to determine whether their own strategy was robust. Was illycaffè's CS strategy really a key differentiator in the coffee industry supply chain?

The Coffee Industry

Since the nineteenth century, the coffee industry has suffered from long periods of oversupply and low prices followed by relatively brief periods of short supply and high prices. The 1990s saw a surge in production that substantially altered the global supply structure, causing the worst coffee crisis ever in terms of growers' incomes. A number of factors drove this crisis, including the collapse of the International Coffee Organization (ICO) Agreement in 1989 (see Exhibit 18.1), which led to oversupply; the emergence of cost-efficient new entrants such as Vietnam; productivity innovations in Brazil; a lack of technical and financial support for farmers; and tariff and non-tariff barriers imposed by the European Union (EU) trade regime.[1]

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[1] Golding, K. and K. Peattie: 2005, 'In Search of a Golden Blend: Perspectives on the Marketing of Fair Trade Coffee,' Sustainable Development 13(3), 154–165.

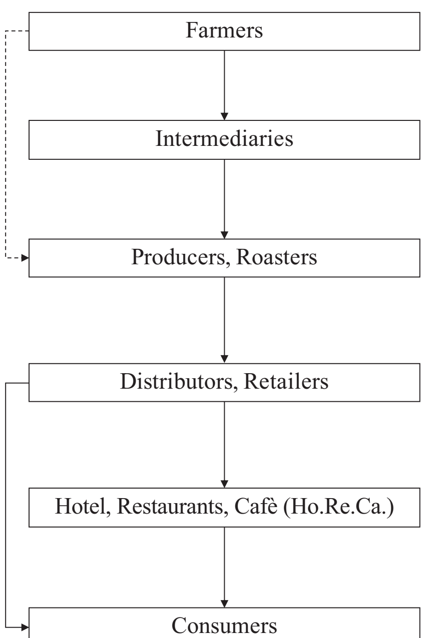


Fig. 18.1 The coffee industry supply chain

The poorly paid coffee farmers at the start of the coffee supply chain (see Fig. 18.1) showed enormous resilience, and one way or another most managed to survive and continue to produce, but this did not make for sustainable development of the coffee industry.

Fluctuations in production and market prices for coffee are shown in Exhibit 18.2. Between 1980 and 1990, the average production of the main exporting countries was 90 million bags (each weighing 60 kg), increasing to 112 million bags in the 2000–2005 period. In 2006, world-wide production of coffee was 124 million bags against a global consumption estimated at 116 million bags in the same year, compared to 115 million bags in 2005. In general, total coffee production exceeded demand for most of the period from 1997 to 2003 (see Exhibit 18.3). Consumption showed an increase in some coffee-importing countries during 2002–2005, with per capita consumption rising. In 2005, per capita consumption in the EU was 4.71 kg, and 4.18 kg in the USA.

Coffee-growing countries exported on average about 75% of their total production during the period 1980–2005. Domestic consumption in exporting countries in 2006 was estimated at 31 million bags (30 million bags in 2005), against a consumption of around 85 million bags in importing countries in 2006, basically unchanged compared to 85.5 million bags in 2005.

Meanwhile, market prices were falling. From 1980 to 1990, prices averaged US$1.20 per pound, but fell to an average price of US$0.60s per pound, at a CAGR of −22%, for the period between 2000 and 2005.

Brazil unquestionably produced more coffee than any other country. Having contributed more than 42 million 60 kg bags of coffee in the 2006 harvest, Brazil had a market share of 35%, more than one-third of the world's coffee (see Exhibit 18.4).

The breakdown in the ICO Agreement in 1989 and the economic damage that resulted led to substantial pressure on coffee importers to use their market leverage to alleviate the economic hardships faced by coffee growers and their employees. Leading companies in the coffee industry responded with CS initiatives. At the same time, several organizations were formed to address particular aspects of the situation. The Brazil Speciality Coffee Association (BCSA) dedicated itself to improving the reputation and quality of Brazilian coffee, the Rainforest Alliance focused on sustainable livelihoods, and Utz Kapeh was founded to certify the social and environmental quality of coffee production, identifying responsible coffee producers (for more information on these organizations, see Exhibit 18.5).

Commenting on the relationship between the coffee industry and sustainable corporate practices, Dr. Decio Zylbersztajn, Professor of Economics of Organization at the University of São Paolo and Coordinator of the PENSA, Agribusiness Intelligence Centre (PENSA, Centro de Conhecimento em Agronegòcios), stated:

> Looking at the coffee industry, I have to say that CS is ignored in general. To the supply process side of the coffee industry in Brazil, CS is not an issue; most of the companies might not even know what we are talking about. They get their supplies to the market in formalized transactions that can be accomplished through intermediaries. If you have brands, like illycaffè, you might not have to consider CS as a cost, but as a cost-and-benefit issue, as illycaffè does. You have a market that values CS. CS of course can be an expensive strategy, but also, reading the literature, I feel that final consumers recognize the high value of those brands that behave responsibly.

Coffee and Fair Trade

Coffee was the first product to carry the Fair Trade label promoted by the group Fair Trade Labelling Organizations International (FLO). The idea was born when Frans van der Hof, a Dutch missionary living in Mexico, noticed that coffee growers in Oaxaca were selling their coffee to intermediaries at extremely low prices. A plan was developed with Dutch NGO Solidaridad to help the farmers sell their coffee direct to the market.

The Fair Trade movement is described by Wikipedia as a 'market-based approach to alleviating global poverty and promoting sustainability'. Fairtrade coffee sales benefit producers both directly and indirectly. In contrast to Codes of Conduct and other social labels, the Fairtrade Standards are not simply a set of minimum standards for socially sustainable production and trade. The Fairtrade Standards go farther: they guarantee a minimum price considered as fair to producers. They provide a Fairtrade Premium that the producer must invest in projects that enhance social, economic, and environmental development. They strive for mutually beneficial long-term trading relationships. They set clear minimum and developmental criteria and objectives for social, economic, and environmental sustainability. Fairtrade

Standards must be met by producers, their organizations, and the traders who deal with Fairtrade products (see Exhibit 18.6 for more information).

Sales of Fairtrade coffee rose by 40% from 2004 to 2005. As of 2007, FLO was working with 248 coffee producers in Africa, Asia and Latin America.

> ...Worldwide, sales of Fairtrade-certified coffee have increased from $22.5m per year to $87m per year since 1998. This is still only a tiny fraction of the overall world coffee trade, worth $10 billion annually. But there are plenty of other niche markets for high-quality coffee. Some small producers can charge more by marketing their coffee as organic—a switch which takes five years or so—or 'bird-friendly' because, unlike large, mechanised plantations, they have retained shade trees.

Fair enough. Taking the quality route to survival. *The Economist* 30 March 2006

> The well-known growth of the Fair Trade movement is only the first step toward sustainability, since the fair trade will continue no matter what the quality of its product. My triple concern is, first, that higher prices do not always mean higher value and quality; second, that producers looking for ad hoc certifications have to manage higher costs that spread throughout the supply chain; third, that sustainability does not always last, so that, in the long run, if the fair trade requirements are not met, the market (i.e., producers) might go back to the previous business model very quickly.
>
> Andrea Illy, Chairman and CEO, illycaffè

The illycaffè Group

illycaffè S.p.A. was founded by Francesco Illy in 1933, and was dedicated to providing quality coffee. Francesco was succeeded by his son, Ernesto, soon after World War II, and in 1994, Andrea Illy became Chairman and CEO.

By 2007, illycaffè's distinctive blend of 100% Arabica coffee[2] was available in approximately 130 countries worldwide, and was served in over 50,000 public outlets, including 50 espressamente illy coffee bars in Italy and 100 worldwide. The company's headquarters, including its only roasting, processing, and packaging facility, were located in Trieste, Italy, where shipments of green coffee beans arrived. The illycaffè group controlled ten companies worldwide dedicated to international distribution, and maintained relationships within a wider network of companies globally (see Fig. 18.2). illycaffè employed over 700 people in 2007, 400 of whom worked in Trieste.

[2] Coffee has its peculiarities, and the kind of bean grown and its location determines the flavour of the coffee. Various labels help traders identify the beans used in the coffee, thus assisting them in pricing it. There are, about 60 kinds of coffee plant, and each kind comes in several varieties. Of these varieties, only 10 are mass-produced throughout the world, the most popular being Arabica (*Coffea Arabica*) and the well-known Robusta coffee (*Coffea Canephora*). Arabica and Robusta coffees are classified, respectively, as the highest quality and most expensive and the lowest quality and least expensive coffees sold in the international market. The taste of an Arabica bean from Brazil will differ from that of an Arabica bean from Kenya.

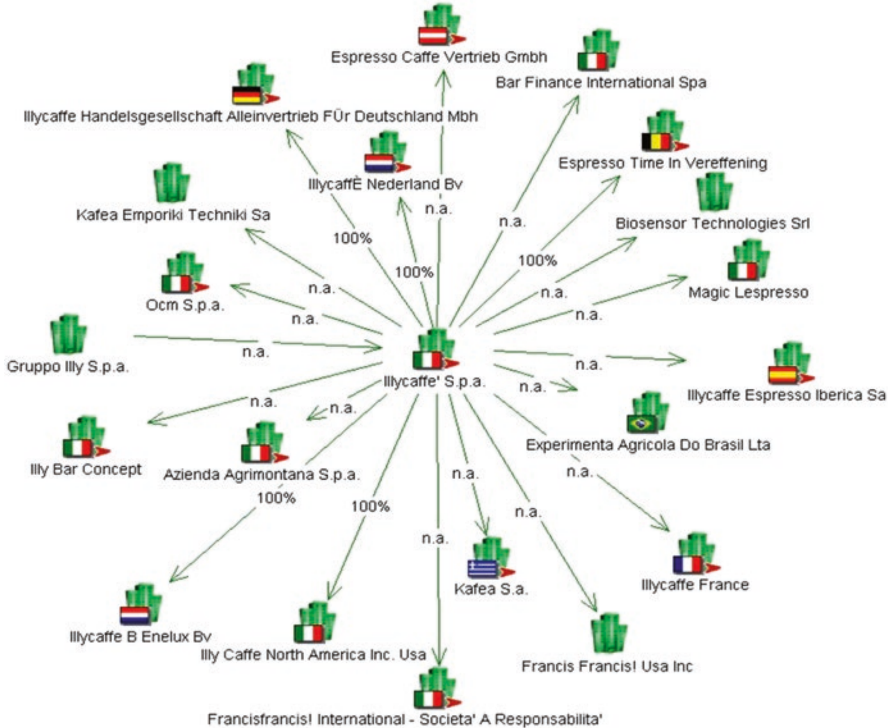


Fig. 18.2 The illycaffè group worldwide network (2007) (Source: Amadeus Database)

illycaffè ranks among the top performers in the European coffee industry. Among companies in the Processing of Tea and Coffee industry (NACE Rev. 1.1, code 1586), illycaffè had a market share of 2.27% in 2005, ranking it the sixth largest company in terms of turnover in Europe, following larger companies such as Unilever N.V., Sara Lee International B.V., Kraft Foods France, Luigi Lavazza S.p.a., and Kraft Foods Schweiz Ag (see Exhibit 18.7). Turnover for illycaffè increased from €130 million in 1998 to €228 million in 2005, representing a CAGR of 7% over the 8 years (see Exhibits 18.8 and 18.9 for illycaffè's financial results and relevant ratios). illycaffè diversified through acquisitions that built the coffee portfolio and took the company into the tea and chocolate businesses. The company accredits its results to unique managerial practices that mirror its organizational identity. Innovation and quality are critical elements of that organizational identity.

A History of Innovation

illycaffè's dedication to innovation stems from 1935, when Francesco Illy invented the 'illetta', a revolutionary espresso machine that substituted the traditional steam method with compressed air and a system of pressurization to better preserve the flavour of his coffee blend.

Soon after he took control of the company, Ernesto Illy started a research laboratory that rapidly began to produce a range of products and inventions related to coffee roasting, brewing and drinking. Fourteen new patents were awarded to illycaffè between 1981 and 2006.

Throughout the years, the concept of innovation at illycaffè has been expanded to include a range of projects embracing many different faces of the coffee world. 'illy art collections', 'illywords', 'In Principio', and 'illystories' are examples of the linkages that illycaffè has built between its network of suppliers, consumers, collaborators and young artists, writers and photographers.

'Excellence and Ethics'

When Andrea Illy took over in the 1990s, he refocused illycaffè's goals towards making it a sustainable company, building on existing company values. As he pointed out:

> illycaffè is a stakeholder company, not a shareholder company. We have always paid primary attention to several stakeholders – specifically clients, partners, collaborators, suppliers, local communities, and then shareholders. We manage our relationship with these stakeholders by activating our two main values, excellence and ethics, which drive the company, while striving for perfection in all that we do. Of course illycaffè is a private company that has to manage its cash flows; but cash flows together with environmental and social concerns comprise our approach to sustainability, through which we respond to our stakeholders' needs.

The place to start was with quality, a concept basic to illycaffè's business model and the fundamental value that grounded the company's strategies and production processes. illycaffè believed that it could reach its objectives with greater efficacy by means of a business philosophy based on CS, and developed guiding principles founded on quality and encompassing partnerships and social commitment (see Exhibit 18.10).

illycaffè was the first coffee company in Europe to obtain Quality System ISO 9001 certification from Det Norske Veritas, Italy (DNV). Further certification included ISO 9001:2000, UNI EN ISO 14001 and the environmental ISO 14001 in 2003. In 2004, illycaffè registered with the Eco-Management and Audit Scheme (EMAS), and published its first Environmental Declaration.

Making high-quality coffee meant starting at the beginning of the supply chain, and illycaffè recognised that long-term investments were needed to ensure that the company had a sustainable supply of the best Arabica coffee beans for its blends. As Alessio Colussi, Head of the Green Coffee Department at illycaffè, said:

> At illycaffè, we know that value is created on the tree. As you move along the supply chain, starting with the harvest, you lose value and quality. The key skill, therefore, is to capture and preserve the quality you have on the tree. To make this possible, illycaffè has always valued its relationship with farmers. We buy green coffee directly from those growers who produce the highest-quality Arabica coffee beans, rather than purchasing it on the market. The farmers have to work hard to produce the highest-quality coffee, and this involves personal, economic, as well as managerial efforts. But illycaffè remunerates these efforts, we pay about 30–35% more than the market price.

illycaffè established a strong collaborative relationship with its suppliers, starting by selecting the best local growers around the world, mainly in Brazil but also in Central America, India and Africa. illycaffè also began looking for optimum coffee growing conditions in areas not yet planted with coffee trees. According to Marino Petracco, Research and Technical Development Department at illycaffè (and Chair of the Food Products 'Coffee' Technical Committee at ISO), they were also looking for something else:

> … among the others, factors are climate, environment, and techniques, but also love and passion for what you do. If you cannot transfer love and passion in your day-to-day work, you cannot have the highest-quality coffee.

Successful collaboration only works if a long-term, mutually beneficial relationship is established. For illycaffè, this meant finding growers willing to join them in a virtuous cycle of sustainability (see Exhibit 18.11). Alessandro Bucci, Buyer of the Green Coffee Department at illycaffè, described how their grower partnerships were based on trust

> Throughout the years, illycaffè has worked on building a strong relationship with local growers that is essentially based on trust. If I have to use a Brazilian Portuguese word to describe this situation, I would say 'parceria,' which means a partnership between illycaffè and our suppliers, in which both parties gain excellent results. We get the highest-quality Arabica coffee beans we are looking for, they receive knowledge, competences, support, and margins of course. Our suppliers often do not bargain over the price, actually, because they know that we are offering the best price they can get. illycaffè pays more than a fair price; illycaffè pays for the effort to produce quality.

When it arrived in Brazil in 1990, illycaffè was almost unknown among Brazilian coffee producers. The company developed specific initiatives to raise awareness and help it to implement its sustainable strategy. The first major project was the launch of the illycaffè Brazil Quality Espresso Coffee Award in 1991, the second significant launch was the illycaffè University of Coffee, established in 2000.

illycaffè Brazil Quality Espresso Coffee Award

Brazil's reputation for low-quality coffee presented a challenge, since quality was integral to illycaffè's business model. In order to find the best growers, and therefore to guarantee procurement of high-quality raw material, illycaffè began a competition. The growers would present samples of their coffee, these samples would be analysed by illycaffè, and, if approved, purchased. The illycaffè Brazil Quality Espresso Coffee Award (Prêmio Brasil de Qualidade do Café para Espresso) was created to provide incentives and to recognize growers' efforts to produce high-quality coffee. The best coffee of the year was rewarded through a monetary prize, and purchase of a significant amount of the coffee at prices higher than the market value. The number of participants grew from one year to the next, along with the quality of their coffee.

Evidence that the Espresso Coffee Award improved Brazilian coffee can be seen in the fact that some regions previously thought unfit for coffee cultivation have been discovered and their coffee-growing potential exploited. Such was the case for the Cerrado region, an area that is now producing high-quality coffee. After the first competition, it was discovered that this region had produced some interesting samples. Eventually, a number of growers from the state of Paranà, which had been repeatedly hit by frost, decided to relocate to Cerrado. Other coffee producing areas, such as Sul de Minas and Alta Mogiana, both in the state of São Paulo, subsequently joined the competition seeking to improve the quality of their crops.

In 1999, the success of the illycaffè Brazil Quality Espresso Coffee Award competition led to the creation of Clube illy do Café, a programme through which the best coffee producers reinforced their relationship with illycaffè. The Clube illy do Cafè was the first example in Brazil of an organization devoted to strengthening relationships between producers and suppliers. Admission to the Clube illy do Cafè was free, but only to growers who had sold their coffee to illycaffè at least once. New members automatically received the Cartão Clube illy Vermelho, but their position in the club could be reinforced and additional benefits gained if they managed to be suppliers of illycaffè for more than 1 year (see Exhibit 18.12 for Clube illy do Cafè benefits). Of course, high quality had to be maintained – producers could lose their status within the Clube if they did not maintain a long-term supplying relationship with illycaffè. As Giacomo Celi, Agronomist and Buyer of the Green Coffee Department at illycaffè, highlighted:

> Out of the approximately 450,000 growers in Brazil, illycaffè only buys Arabica coffee beans from about 72 suppliers regularly. Moreover, we only buy 10 to 15 percent of their production on average, as this is the amount of coffee that meets our requirements. Nevertheless, commitment by coffee producers is very high.

The illycaffè Brazil Quality Espresso Coffee Award and the Clube illy do Café built up a mechanism through which Brazilian coffee producers were able to learn and become capable of producing high-quality coffee.

The illycaffè University of Coffee

In 2000, the first academic institution dedicated to coffee producers, the illycaffè University of Coffee (Universidade illy do Cafè), was established in Brazil in collaboration with the University of São Paolo. The goal was to transfer illycaffè knowledge to current growers, operators, and technicians in the coffee supply chain, as well as to future generations, in order to enrich and improve their productivity and managerial skills. Brazil was chosen because it was the largest producer of green coffee in the world, therefore an excellent place from which to harvest the growth that originated the best blends.

The illycaffè University of Coffee was built as a network within which different actors performed specific activities. The network facilitated information exchange

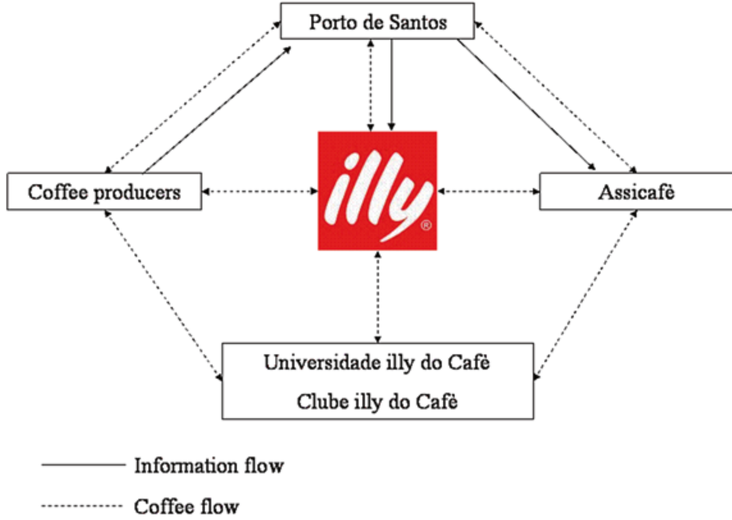


Fig. 18.3 The illycaffè University of Coffee network (Source: Adaptation from University of Coffee Web site 2007)

between illycaffè, coffee producers, Porto de Santos (illycaffè's official distributor in Brazil), Assicafè (the organization in charge of certifying the quality of coffee for illycaffè) and of course the illycaffè University of Coffee and the Clube illy do Cafè (see Fig. 18.3). People who attended the university could improve their skills, and thus their ability to produce high-quality coffee. Everything around the network of the university was based on specific prerequisites, such as passion and competent human resources, that were a cornerstone of the illycaffè University of Coffee values.

The illycaffè University of Coffee helped producers to became entrepreneurs working toward high quality, and facilitated the creation of a useful, direct relationship between coffee growers and illycaffè. The Economist[3] reported in 2006 that more than 1,000 growers a year attended a one-day course at the illycaffè University of Coffee in São Paolo, and that a team of nine agronomists had been travelling the world providing training. Dr. Samuel Ribeiro Giordano, Professor of Agribusiness and Environmental Management, Vice Coordinator of the illycaffè University of Coffee and Coordinator of Education of the PENSA, Agribusiness Intelligence Centre, also suggested that:

> The main objective of the illycaffè University of Coffee is to transfer competences to, and build new professionals among farmers. The logic that we apply throughout our courses at the university is strictly related to what theorists call stakeholder theory. Growers are not just suppliers, but stakeholders of the firm. Therefore, following a sustainable approach we have to transfer knowledge and techniques to growers wherever they are, even if they do not supply illycaffè.

[3] The Economist, 'Face Value. Head Barista,' Business, September 30th, 2006.

Voices from the Supply Chain

Josè Carlos Grossi, President of Alto Cafezal, has cultivated 1,200 ha of coffee plants distributed in 11 '*fazenda*' (farms) in the Cerrado region since 1972, employing between 800 and 1,500 employees depending on the season. His company has obtained several certifications, including BSCA, Utz Kapeh, and Rainforest Alliance. He has very clear ideas about how CS must be part of the corporate strategy:

> Since 1990, we have changed the way we produce coffee. Comparing coffee with cars, until that time we didn't know we could produce a Ferrari; we thought that we probably could produce a Fiat. illycaffè told us that our coffee was very good, something we hadn't known. Today, we are very proud to know that we produce the best coffee in the world. We learned a lot from illycaffè about the best way to produce high-quality coffee and obtain certifications, indicating compliance with social and environmental issues; nevertheless, if certifications do not bring in income, they do not produce miracles and are not real. The main issue is that we work to make a profit and we have to care about cash flows.

Ednilson Alves Dutra and Walter César Dutra have owned Fazenda Dutra since 1950. The company has three *fazenda* of about 500 ha in the Manhuaçu region employing between 200 and 600 people according to season and producing 1,500 bags of coffee. Fazenda Dutra is Utz Kapeh and BSCA certified. The Dutras emphasized the benefits of learning how to make high-quality Arabica coffee:

> We learned a lot from the course with illycaffè, and we were able to improve the quality of our coffee. In 1999, we sold our coffee to illycaffè for the first time, the next year, in 2000, we were fourth at the illycaffè Brazil Quality Espresso Coffee Awards. Becoming a supplier of illycaffè helped eliminate the prejudices against our region and local community, which learned to value the quality of our coffee. It was a long process, but now we can sell our coffee, and thanks to illycaffè, which we really think of as our family.

Josè Aparecido Naimeg cultivates 560 ha of coffee in four *fazenda* in the Cerrado region, produces 2,000 bags of coffee a year and has been supplying illycaffè since 1992. He had direct experience of the change in the supply-chain structure:

> Becoming an illycaffè supplier was an opportunity more than a decision. We began in 1992, when we also won first prize at the illycaffè Brazil Quality Espresso Coffee Award competition. The award was satisfying to us of course, but the important thing was joining the illycaffè network. We do not have relationships with intermediaries, we just trust illycaffè, as illycaffè trusts us. It is actually a cooperative relationship. The University is also a network. You can learn, of course, but can also participate in a dynamic exchange of ideas and knowledge, not just between illycaffè and its suppliers, but, most important, between producers.

Francisco Sergio de Assis, who has supplied illycaffè since 1992 from his 5 *fazenda*, has 50 permanent employees and 250 seasonal employees during the harvest. He suggested how CS and specific corporate strategies might be related:

> Even small producers can benefit from the corporate strategies that illycaffè brought to Brazil. The first was innovation in our cultivation techniques and technologies, which we learned at the illycaffè University of Coffee. Second, illycaffè changed the history of coffee

> production in Brazil since they took the responsibility of rewarding our efforts to achieve the quality they required; now they still pay a fair premium that rewards the quality and innovation we have applied to improving our production processes.

Coffee producers clearly understood that recognised certification could become a managerial tool with which to manage their relationships with stakeholders, but there were also broader impacts on sustainability in the supply chain. Public authorities as well as the financial system, for example, have been increasingly influencing the operations of coffee producers. Ednilson Alves Dutra again:

> Banks no longer just ask for our financial status. They now require social and environmental responsibility before funding our firms, and the same pressure comes from the Secretary of the Environment and the Ministry of Labour. We joined the certification program because we aspired to a level of competence that would help us increase our volumes of high-quality coffee and to better structure managerial practices in our firm. That is why we focused our attention on labour conditions, the environment, and health and safety as well, even though keeping up the standards of these certifications is expensive.

Joao Carlos de Souza Meirelles, the Secretary of Agriculture, sees illycaffè's contribution as significant: 'The Illys were pioneers. They helped us learn to produce high-quality coffee, first for them and then for everybody else. Today, we don't think anymore in terms of quantity of production. We think in terms of quality of production.' And this was echoed in a Fortune report in 2002,[4]

> ... the indirect benefits illycaffè has brought to Brazil may be even more valuable than the millions of dollars a year the company puts in the pockets of the country's coffee farmers. illycaffè taught Brazilian growers how to produce high-quality coffee, in the process helping Brazil shake its bad reputation among the gourmet coffee crowd. As a result, the Brazilian growers who supply illycaffè – and those who don't – get more for their coffee today, relative to the market price, than a decade ago.

Other Approaches to CS in the Coffee Supply Chain

Larger players in the global coffee industry have different business models. In 2002, Nestlé stated that only 13% of the estimated 13 million bags of coffee it bought each year came directly from the farm. Sara Lee claimed 10%, and Procter & Gamble (P&G) and Kraft didn't buy directly at all. But regardless of their individual commitments, none of the so called 'Big Four' believed direct purchasing was a long-term solution for ailing growers. 'For us it would be impractical and less financially feasible to manage commercial relationships and bean quality at the farm level,' said P&G spokeswoman Tonia Hyatt. 'We would have to work with one million growers to buy directly'.[5] In order to somehow respond to this situation, P&G

[4] Stein, N., 'Crisis in a Coffee Cup The price of beans has crashed. Growers around the world are starving. And the quality of your morning cup is getting worse. So why is everyone blaming Vietnam?', Fortune, December 9, 2002.

[5] See note 4.

announced in September 2003 that it would sell FT coffee through its Millstone label. Sara Lee also later began to sell FT coffee, but this represented slightly less than 1% of total American coffee consumption.[6]

Projects comparable to illycaffè's sustainable strategy included the ¡Tierra! Project of Luigi Lavazza S.p.a., the Nespresso AAA SUSTAINABLE QUALITY™ Program of Nestlé, and C.A.F.E Practices by Starbucks (see below). The contrast between the Starbucks approach and that of illycaffè were highlighted by Wendy Liebmann, President of market researcher WSL Strategic Retail, who stated that 'Starbucks is less about coffee and more about community. illycaffè is about the elegance of coffee... It is elitist.'[7]

Luigi Lavazza S.p.a.: ¡Tierra! (Source: Lavazza Web Site 2007)

Luigi Lavazza S.p.a., established in 1894, had a turnover of over €850 million in 2005 and was the leading Italian coffee producer. The company had seven foreign subsidiaries and a wide-reaching international distribution network. In 2007, more than 16 million families in Italy claimed to buy Lavazza coffee, and the company challenge was to become a worldwide leader in the coffee industry.

Lavazza has always been committed to developing sustainable activities to improve social welfare. For three generations, the Lavazza family worked to reach this goal alongside other partners. The company focused its attention on sustainability projects in coffee-producing countries, aware that it was well capable of managing its own agenda in the coffee industry. Lavazza engaged in activities to improve living conditions and social and production structures in countries such as Africa and Central and South America, where coffee production played a crucial role in the national economy.

[6] Vogel, D. 2005. The Market for Virtue: The Potential and Limits of Corporate Social Responsibility. Washington, D.C.: Brookings Institution Press.

[7] Business Week, 'Basta With The Venti Frappuccinos. illycaffè is the anti-Starbucks, and it's out to spread the espresso gospel to java heathens', Global Business, August 7, 2006.

In 2004, the ¡Tierra! project was conceived, organized, and implemented based on the triple-bottom-line approach, which means taking into account the social, economic, and environmental impacts of coffee production. As declared by Lavazza: ‘The objective of ¡Tierra! is to enable its beneficiaries – communities of small-scale coffee producers who currently live in extremely disadvantaged situations – to improve their living conditions and the quality of their products, to acquire new tools in order to trade under more favourable conditions and, finally, to be truly more competitive and autonomous in their choices and in the economic management of their production.’

Implementation was supported by Volcafè, one of the world’s leading coffee-exporting groups, and guidelines were drawn up with the help of the Rainforest Alliance. ¡Tierra! aimed at building differentiated operations that involved not just the coffee-production process, but also education, health, and homes. The project was rolled out in communities in three different coffee-producing countries, Honduras, Colombia, and Peru, and participants were directly involved in the project, bringing in both their direct experience and their needs.

The communities involved aimed to meet the social and environmental requirements for Rainforest Alliance Certification. In its final stage, the communities directly involved in ¡Tierra! were producing 100% Arabica coffee, and the result was a coffee blend of extraordinary quality but at no extra cost to the final consumer, because the costs of the entire project were part of Lavazza’s commitment to CS.

Nestlé: Nespresso AAA Sustainable Quality™ (Source: Nespresso Web Site 2007)

As of 2007, Nestlé, with its headquarters in Vevey, Switzerland, was the world’s biggest food and beverage company. Sales for 2006 were CHF 98.5 billion, with a net profit of CHF nine billion. Nestlé employed approximately 260,000 people and had factories or operations in almost every country in the world.

Based on its Shared Value approach, Nestlé has always demonstrated CS in the coffee industry, where it operated through several brands: Nescafé, Taster’s Choice, Ricoré, Ricoffy, Nespresso, Bonka, Zoégas, and Loumidis. While searching for high-quality coffee, Nestlé realized that only a small percentage of the world’s coffee harvest, around 2%, matched the standards required for the Nespresso Grands Crus. Therefore, Nestlé focused on lasting and mutually beneficial relationships with the farmers who produce that coffee.

The Nespresso AAA SUSTAINABLE QUALITY™ Program was launched in 2003. It was based on an extensive collaboration with farmers across the coffee-producing world, as well as on collaborative partnerships with the Rainforest Alliance. 'The AAA SUSTAINABLE QUALITY™ Program is a set of practices that together enable farmers to benefit directly from the cultivation of the highest-quality coffees. It is not a solution to all of the problems affecting coffee producers around the world, but it is our clear commitment to the farmers who produce Nespresso AAA coffees that they benefit from their relationship with us.' Farmers were introduced to the principles of AAA through the Tool for Assessment of Sustainable Quality (TASQ™). In collaboration with the Rainforest Alliance, Nespresso' agronomists set up workshops for farmers and trained them in AAA farm practices. Then the farms were assessed by agronomists, and later on Rainforest Alliance independently verified if an individual farm management plan conformed to AAA practices.

The program was based on a few simple principles established at Nestlé: 'First, we pay a premium price for the AAA coffees we buy. Second, we invest in the whole farm assessment and verification process and do not pass this cost on to the farmer. Third, we analyse the data from the TASQ™ assessments and work with the farmers to suggest and make improvements at the farm and regional level. Fourth, we set up technical training and assistance workshops for farmers. Finally, we invest in specific projects in the communities.'

The Nespresso AAA SUSTAINABLE QUALITY™ Program has produced interesting results. In 2005, Volluto, one of the most popular brands, became Grands Crus, the first 100% AAA SUSTAINABLE QUALITY™ coffee in the Nespresso range, as independently verified by the Rainforest Alliance. The next year, in 2006, Caffè Forte for the B2B market was added to the range of Nespresso Grand Crus sourced 100% from the AAA SUSTAINABLE QUALITY™ Program. In 2007, the 30% of the total green coffee beans bought by Nespresso came from the AAA program, and the objective was to reach 50% by 2010.

Starbucks: C.A.F.E Practices (Source: Starbucks Web Site 2007, and Starbucks 'Beyond the Cup. Highlights of Starbucks Corporate Social Responsibility,' 2006)

Starbucks Coffee Company is the leading retailer, roaster, and brand of specialty coffee in the world, with more than 6,000 retail locations in North America, Latin America, Europe, the Middle East, and the Pacific Rim. Born in 1970 in Seattle, Starbucks is committed to offering its customers the world's best coffee and the finest coffee experience, while also conducting its business in ways that produce social, environmental, and economic benefits for the communities in which it does business.

CS at Starbucks runs deeply throughout the company. Starting from its mission statement, several actions are implemented every day for relevant stakeholders: commitment to origins™, environment, communities, and partners. Within this mission, the C.A.F.E. (Coffee And Farmer Equity) Practices were developed and launched in 2001. C.A.F.E. Practices evaluated, recognized, and rewarded producers of high-quality, sustainably grown coffee. Guidelines were developed in collaboration with Scientific Certification Systems (SCS), a third-party evaluation and certification firm. C.A.F.E. Practices sought to ensure that Starbucks sourced sustainably grown and processed coffee by evaluating the economic, social, and environmental aspects of coffee production against a defined set of criteria.

Starbucks buys high-quality Arabica coffee. According to its commitment to origins™, Starbucks pays premium prices that result in a profit for the farmers and their families. In 2005, Starbucks paid on average $1.28 per pound for high-quality coffee beans. This was 23% higher than the average New York 'C' market price (NYC).

In 2000, Starbucks agreed to sell Fair Trade Certified™ coffee in its retail outlets (Table 18.1). Starbucks purchased 11.5 million pounds of Fair Trade Certified™ coffee in 2005, paying a minimum of $1.26 per pound for nonorganic green Arabica coffee and $1.41 per pound for organic green Arabica coffee. Of all the Fair Trade Certified™ coffee imported into the U.S. in 2005, Starbucks purchased 21%, becoming the largest purchaser of Fair Trade Certified™ coffee in North America. Considering the rest of the coffee purchased by Starbucks, Mary Williams, a Starbucks senior vice president, said 'We would love to know where all our coffee comes from, but it is very difficult to purchase directly from such small farmers' (Stein 2002).

Table 18.1 Starbucks's purchases of coffee from C.A.F.E. and fair trade systems

	2004		2005	
	Coffee purchased (lb Mln)	% of total coffee purchases	Coffee purchased (lb Mln)	% of total coffee purchases
C.A.F.E. practices	43.5	14.5	76.8	24.6
Fair trade certified™ coffee	4.8	1.6	11.5	3.7

The Business Dilemma

> If we consider the international coffee industry, we are happy to see that today CS-related actions are gaining momentum among several organizations, but we believe that more can be done. We believe CS is not just a matter of social and environmental issues, but strictly refers to companies' responsibility. That is why we manufacture coffee focusing on innovation, that is the quality, and the networking, that is the knowledge transfer, as drivers of sustainability (Andrea Illy)

Managers now need to determine whether the illycaffè CS concept is different, what impact its initiatives have had on sustainability in the supply chain, and whether this approach really is a source of competitive advantage over rivals – is illycaffè's sustainable strategy sufficiently differentiated from other business models that it offers the potential for value creation within the company?

Several other issues must also be explored. What are the future challenges for illycaffè? Are competitors imitating illycaffè's CS strategy, and if so, how long does it take them to catch up? Is the illycaffè model viable on a larger scale? Is the illycaffè CS concept the most efficient initiative for emerging markets? Where should illycaffè position itself in the market? Do its sourcing and delivering strategies support the brand? Is illycaffè's business model applicable to other industries?

illycaffè Social Value Improvements (2007–2014)

During the last years, illycaffè strengthened its commitment towards corporate sustainability. A clear example is the value of "Ethics", evidently stated by the company. Actually, illycaffè kept on reinforcing its aim of creating value for all the stakeholders, merging high-quality products with sustainability, transparency and personal growth.

illycaffè is a fundamental part of Gruppo Illy S.p.A., a holding company including different high-quality food and drinks firms. The whole group encompasses all companies that consider sustainability as a key business driver. Moreover, to underline the commitment towards corporate sustainability, illycaffè research and innovation is intended to develop new environmental friendly industrial activities (especially concerning with recycle materials), partnering with Universities of Padova and Trieste, together with the Agricultural Institute of Slovenia.

One of the main achievements accomplished in the last years concerned the *Sustainable Value Report*, which clearly and transparently stated all the declared goals, actions and projects carried out by illycaffè to implement corporate sustainability in three different forms: economic, social, and environmental.

The report has been prepared following the GRI-G3.1 sustainability reporting guidelines and audited by an independent third-party. It depicted how performance is linked to responsible management.

Actually, the report explained the main actions implemented by illycaffè during the period up to 2013, highlighting the company desire to create an environment that brings sustainability at the core of all the business activities. For example, the

company governance structure has been composed by a Sustainability Committee, whose role and responsibilities enclosed the engagement towards responsible management, the accountability of the Value Report, the environmental critical considerations, and other activities performed to support corporate sustainability.

As a result of the corporate sustainability strategy implemented by illycaffè, one of the most important achievements was the *Responsible Supply Chain Process Certification* obtained in 2011, which awarded the sustainable green coffee supply chain process and the ability of creating value for all the stakeholders following the principles of traceability, reciprocity and quality. An independent third-party principally certified that all the coffee has been purchased without intermediaries (directly from coffee growers) and coffee growers have been paid a higher price with respect to market average. To give some interesting data of the collaboration born with suppliers: from 2010 to 2013 more than 5,000 coffee growers attended courses and meetings to improve and to share know-how, in order to achieve always better product quality, following an ethical approach common to all the supply chain.

Furthermore, the company reinforced its sustainable programs by adhering in 2012 to the Global Compact and drafting a *Sustainability Manifesto* that, together with the Code of Ethics, represented a fundamental step in order to share the strategy of sustainable and ethical business with all the stakeholders. Regarding the Global Compact, it is a United Nations initiative to encourage sustainable global economy with the adhesion to ten principles concerning human rights, environment, labour and corruption. illycaffè, in compliance with Global Compact, committed to follow those ten principles in pursuing its business activities. The Sustainability Manifesto was a clear example of the company commitment, because it stated the ethical principles applied inside the organization. Moreover, illycaffè adhered to the *International Labour Organization (ILO)* principles, purchasing coffee by suppliers that do not employ children younger than 14 years old.

Besides certification and adhesion to important initiatives, illycaffè strengthened its contributions to the territories and communities where it was and is still operating. As far as suppliers are concerned, the company supported projects to develop infrastructures in order to enhance the living conditions of coffee growing communities and committed to apply, as a general rule, the employment of local resources. In addition, the company also kept on monitoring all the suppliers, with who illycaffè continued to apply the strategy of building increasingly strong and long-lasting relationships.

Other contributions to local communities and territories have been made possible by *Ernesto Illy Foundation*, a non-profit organization aimed at increasing ethics and sustainability through initiatives with producing countries and other territories where business is carried out. To give an example, among the Foundation activities, there was the *Master degree in coffee economics and science* to enhance quality and corporate sustainability strategies.

A closer eye on environmental activities cannot be avoided. On the one hand, there was a commitment to reduce illycaffè direct environmental impact and on the other hand, this commitment tended to be spread to collaborators in order to efficiently and effectively implement the *Comprehensive Environmental Management*

System. The latter was developed to minimize the direct environmental impact, reducing waste and pollution. To stress its commitment illycaffè signed an agreement with the Ministry of the Environment regarding the analysis of the impact of climate on coffee sector. Moreover, in 2012, the company implemented the LCA – Life Cycle Assessment – using software to reduce the environmental impact during the business processes. In addition, illycaffè promoted in the areas where coffee was produced agricultural activities with responsible water consumption, low waste and little employment of chemical fertilizers.

Also concerning with the environment, illycaffè managed to win "The Impresa Ambiente Pirze", one of the most prestigious Italian award.

Two final important recognitions underlined how corporate sustainability was appreciated particularly externally. As a matter of fact, illycaffè was an official partner of EXPO 2015 and the Ethisphere Institute recognized the company as one of the World's Most Ethical Companies for 2014, thanks to its achievements in corporate governance, its code of ethics, its CSR strategies and investments to innovate its processes in a sustainable manner. This award was of particular interest in light of the fact that illycaffè was the only one Italian company included by Ethisphere Institute in its list.

To sum up, illycaffè improved its strategy based on corporate sustainability, especially by setting a reporting activity and transparently committing to sustainable present and future projects. To make some example, among future goals written in the Sustainable Value Report, there were, first of all, the ability of increasing the number of coffee producers with Supply Chain certification, the implementation of a Sustainability Road Map to develop initiatives in line with Global Compact principles and the improvement of stakeholders' engagement.

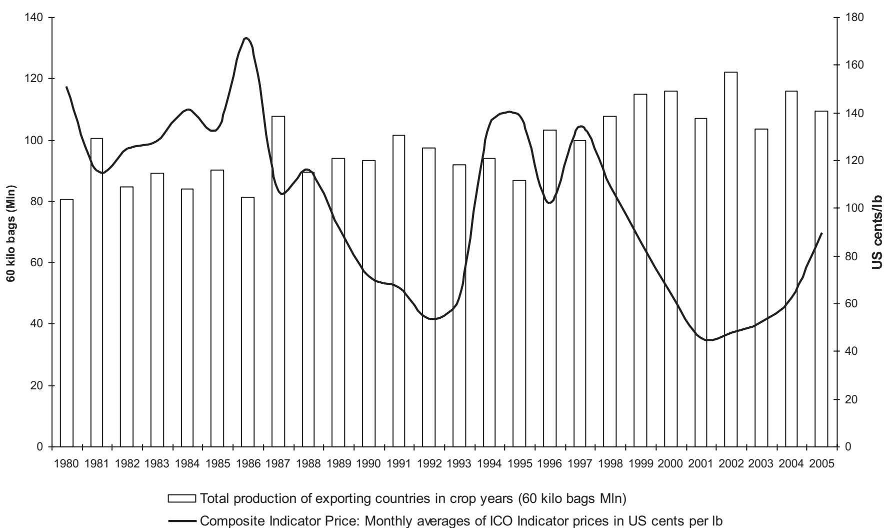
Exhibit 18.1: The International Coffee Organization

The International Coffee Organization (ICO) is the main intergovernmental organization for coffee, bringing together producing and consuming countries. The ICO was established in 1963, a year after the first 5-year International Coffee Agreement came into force in 1962. As of January 2007, ICO members comprise 45 exporting countries and 32 importing countries from all over the world. ICO members have to comply with the International Coffee Agreement. The text of the new International Coffee Agreement was written at a meeting of the 63 Member Governments of the International Coffee Council in London on 27 and 28 September 2000. It was formally adopted by the Council in Resolution 393.

A 6-year collaboration to strengthen international cooperation among producing and consuming countries became provisionally operative on 1 October 2001 and definitively on 17 May 2005. It includes a number of new objectives reflecting the ICO mission, such as encouraging members to develop a sustainable coffee economy, promoting coffee consumption and the quality of coffee, providing a forum for the private sector, promoting training and information programmes designed to assist the transfer of technology relevant to member countries, and analyzing and consulting on suitable projects to benefit the world coffee economy.

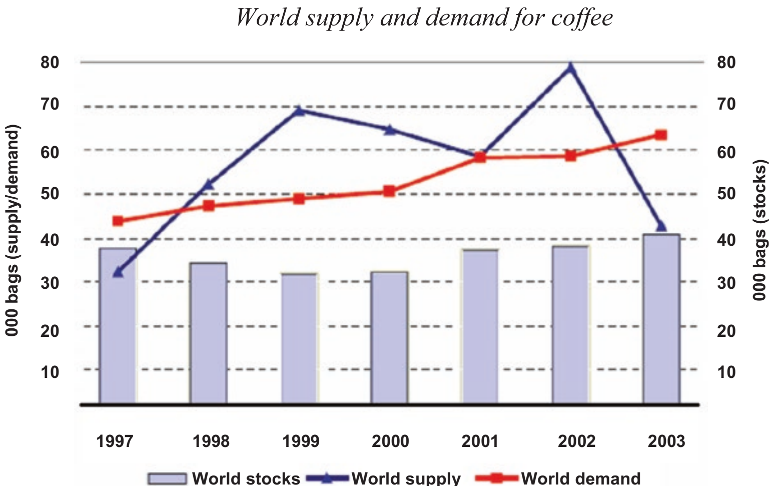
Source: International Coffee Organization Web site 2007

Exhibit 18.2: Production and Market Prices of Coffee, 1980–2005



Source: Elaboration of International Coffee Organization historical statistics

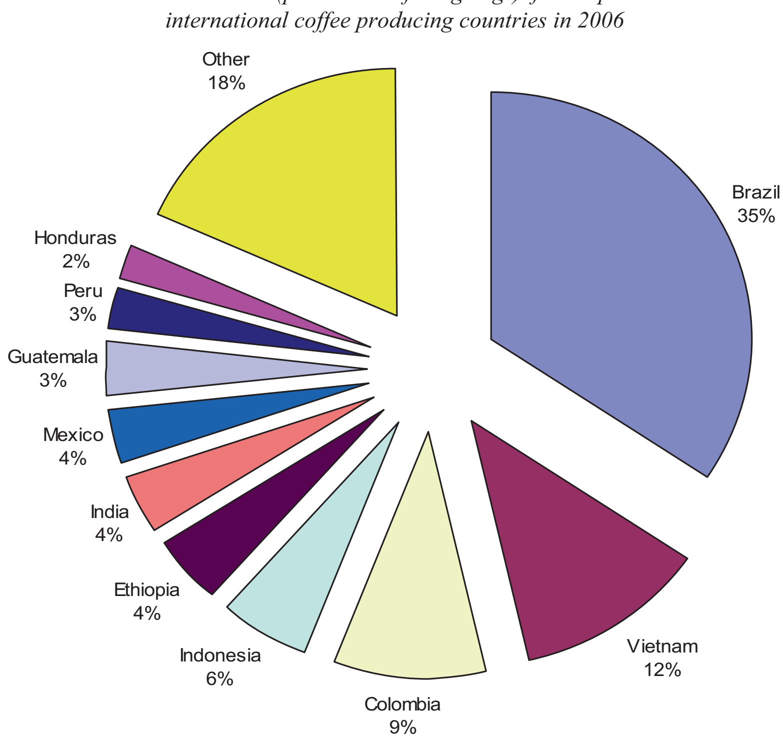
Exhibit 18.3



Source: International Coffee Organizations (ICO), 2004

Exhibit 18.4

Market share (production of 60kg bags)of the top ten international coffee producing countries in 2006



Source: International Coffee Organization historical statistics

Exhibit 18.5: Certifications in the Coffee Industry

The Brazil Specialty Coffee Association

The Brazil Specialty Coffee Association (BSCA) was founded by a group of growers of high-quality coffees to bring to the market their finest specialty products, the very best of Cafés do Brazil. BSCA has members in all areas of Brazil where high-quality Arabica coffees are grown: Sul de Minas, Matas de Minas, Cerrado, Chapadas de Minas, Mogiana, Bahia, and Parana.

BSCA's purpose is to obtain thorough research and quality-control techniques that comply with the standards of excellence of Brazilian coffees offered to the international market. Founded in 1991, it has sent representatives to major international events related to the specialty coffees. Since 1992, BSCA has attended all Conferences and Shows of the Specialty Coffee Association of America (SCAA). It has its own booth that exhibits a large variety of Brazilian gourmet coffees, and it organizes lectures and promotional events.

Since 1993, the entity is also responsible for organizing meetings in Europe, together with gourmet roasting companies. Representing Brazilian coffees, BSCA actively participates in congresses and fairs in Germany, Switzerland, Italy, Austria, the United Kingdom, France, Spain, and Norway. At these events, it distributes relevant information and promotional samples, as well as tests to demonstrate the quality of its member companies' specialty coffees.

Rainforest Alliance

The Rainforest Alliance works to conserve biodiversity and ensure sustainable livelihoods by transforming land-use practices, business practices, and consumer behaviour. Producers who want their farms to be successful, productive, efficient, and sustainable follow the farm-management guidelines continuously developed since 1992 by the Sustainable Agriculture Network, a coalition of independent NGOs. By following the guidelines, farmers can reduce costs, conserve natural resources, control pollution, conserve wildlife habitat, ensure rights and benefits for workers, improve the quality of their harvest, and earn the Rainforest Alliance Certified seal of approval.

Utz Kapeh

The founders created an organization that could stand independently from the producers and the roasters. They chose the name 'Utz Kapeh' which means 'good coffee' in the Mayan language Quichù. An office was opened in Guatemala City in 1999. In 2002, the head office was opened in The Netherlands. In March 2007, Utz Kapeh updated its name to UTZ CERTIFIED, 'Good inside.' This updated name combines confidence in the model and pride in their heritage, with clearer communication for the international market. UTZ CERTIFIED assures the social and environmental quality of coffee production. The idea behind UTZ CERTIFIED is to create recognition for sustainable coffee producers and tools for roasters and brands to respond to a growing demand for assurance of responsibly produced coffee.

Source: BSCA, Rainforest Alliance, and Utz Kapeh Web sites, 2007

Exhibit 18.6: The Fair Trade Movement

Many definitions of 'Fair Trade' have been proposed, but the following issued by the informal umbrella network, FINE,[8] is widely accepted within the movement.

> Fair Trade is a trading partnership, based on dialogue, transparency, and respect, which seeks greater equity in international trade. It contributes to sustainable development by offering better trading conditions to, and securing the rights of, marginalized producers and workers, especially in the south. Fair Trade organizations (backed by consumers) are engaged actively in supporting producers, awareness rising, and in campaigning for changes in the rules and practice of conventional international trade.

FLO Standards

Trader Standards stipulate that traders that buy directly from the Fairtrade producer organizations must:

- Pay a price to producers that at least covers the costs of sustainable production: the Fairtrade Minimum Price.
- Pay a premium that producers can invest in development: the Fairtrade Premium.
- Partially pay in advance, when producers ask for it.
- Sign contracts that allow for long-term planning and sustainable production practices.

Producers and traders of coffee have to comply with specific Product Standards for small farmers' organizations (such as a cooperative or association).

- **Product description**. The Fairtrade Standards cover two varieties of coffee: Arabica coffee (*Coffea Arabica*) and Robusta coffee (*Coffea Canephora*).

[8] FINE is an informal umbrella network established in 1998 within which representatives of the most important worldwide Fair Trade networks meet to share information and coordinate activities. The acronym FINE stands for the first letters of the following four Fair Trade networks: Fairtrade Labelling Organizations (FLO) International, the International Federation for Alternative Trade (IFAT), the Network of European World Shops (NEWS!), and the European Fair Trade Association (EFTA).

- **Procure a Long-Term and Stable Relationship**. Buyers and sellers will strive to establish a long-term and stable relationship in which the rights and interests of both are mutually respected.
- **International Customary Conditions**. All other customary conditions applicable to any international transaction will apply, such as the conditions of the European Contract of Coffee, unless overruled by any of the special FLO conditions.
- **Pricing and Premium.** Buyers shall pay producer organizations at least the Fairtrade minimum price as set by FLO. The Fairtrade minimum prices vary according to the type and origin of the coffee. In addition to the Fairtrade minimum price, the buyers shall pay a Fairtrade Premium as set by FLO at 5 US cents per pound of coffee. For certified organic coffee, an additional premium of 15 US cents per pound of green coffee will be due, in addition to the Fairtrade minimum price or the market reference price, respectively. If the market price is higher than the Fairtrade minimum price, the market price shall apply. At various times between 1997 and 2003, the Fairtrade coffee price was double that of the world market (see Figure, below).
- **Prefinancing/credit.** The buyer shall make available up to 60% of the contract value, according to what the seller stipulates.

Fair trade minimum price and premium information (December 2005)

	Fairtrade minimum price (US cents/lb)				Fairtrade Premium
	Conventional		Organic		Conventional and organic
Type of coffee	Central America, Mexico, Africa, Asia	South America, Caribbean Area	Central America, Mexico, Africa, Asia	South America, Caribbean Area	All regions
Washed[a] Arabica	121	119	136	134	5
Non-washed Arabica	115	115	130	130	5
Washed[a] Robusta	105	105	120	120	5
Non-washed Robusta	101	101	116	116	5

[a]Semiwashed or pulped natural coffees are regarded as washed coffee

The Arabica coffee market 1989-2006: Fairtrade and New York exchange prices

Source: FLO Web site 2007

As of October 2006, FLO was working with 586 Fair Trade Certified Producer Organizations representing over one million farmers and workers from more than 50 countries in Africa, Asia, and Latin America. Including with their dependents, five million people were affected, as well as 469 certified traders (consisting of exporters, importers, processors, and manufacturers). Between 2004 and 2005, Fairtrade labelled sales across the world grew by 32% to more than 168,863 metric tonnes (MT). In 2005, millions of consumers worldwide bought some €1.1 billion of Fairtrade labelled products, 37% more than the year before. All product lines expanded their markets, especially fair trade coffee in the U.S. (+70,9%) and the U.K. (+34%).

Product	2004	2005	Var.
Bananas[a]	80,640	103,877	29%
Beer[b]	62,934	123,758	97%
Cocoa[a]	4201	5657	35%
Coffee[a]	24,222	33,992	40%
Cotton[a]	0	1402	++
Dried fruit[a]	238	306	29%
Flowers[c]	101,610,450	113,535,910	12%
Fresh fruit[a]	5156	8289	61%
Honey[a]	1240	1331	7%
Juices[a]	4543	4856	7%
Others[a]	611	833	36%
Rice[a]	1384	1706	23%
Sportballs[d]	55,219	64,144	16%
Sugar[a]	1960	3613	84%
Tea[a]	1965	2614	33%
Wine[b]	617,744	1,399,129	126%

Source: FLO Annual Report 2005
[a]MT, [b]Litres, [c]Stems, [d]Items

Attracted by Fairtrade's success with consumers, more companies knocked on the door of the labelling organizations. Marks and Spencer, one of the largest food and clothes retailers in the UK, switched its entire range coffee and tea to Fairtrade, totalling 38 lines, in a move which was estimated will increase the value of all Fairtrade instant and ground coffee sold in the UK supermarkets by 18%, and increase the value of Fairtrade tea by approximately 30%.

Exhibit 18.7: European Tea and Coffee Producers, Market Share by Turnover (2005)

Company name[a]	Market share[b] (%)	Country
Kraft Foods France	10.65	France
Luigi Lavazza S.P.A.	8.68	Italy
Kraft Foods Schweiz Ag	2.31	Switzerland
illycaffè S.P.A.	2.27	Italy
Sara Lee Coffee & Tea Belgium	2.25	Belgium
Markus Kaffee Gmbh & Co. Kg	2.24	Germany
Alois Dallmayr Kaffee Ohg	2.15	Germany
Paulig Ab	2.14	Finland
Nestlé Sverige Ab	2.14	Sweden
Drie Mollen International B.V.	2.10	Netherlands
Coop Industria	1.91	Italy
Lipton Limited	1.80	United Kingdom
Oy Gustav Paulig Ab	1.61	Finland
Nevskie Porogi	1.59	Russian Federation
Deutsche Extrakt-Kaffee Gesellschaft Mit Beschränkter Haftung	1.59	Germany
Droga Kolinska, Zivilska Industrija, D.D.	1.59	Slovenia
Nestle Kuban	1.38	Russian Federation
Segafredo-Zanetti S.P.A.	1.30	Italy
Gebr. Westhoff Gmbh & Co. Kg	1.27	Germany
Coffein Compagnie Dr. Erich Scheele Gmbh & Co. Kg	1.24	Germany
Koffie F Rombouts – Cafes F Rombouts	1.16	Belgium
Kraft Foods Cr, S.R.O.	1.14	Czech Republic
Cafè do Brasil S.P.A.	1.11	Italy
Arvid Nordquist Handelsab	1.04	Sweden
Mai	1.01	Russian Federation
Others[c]	42.33	

Source: Amadeus Database
[a]Unilever N.V. and Sara Lee International B.V. are not included, since those are multinational diversified companies for which it was not possible to identify figures related to the coffee industry
[b]Market share is computed on the total number of companies classified in the 'Processing of tea and coffee industry' (NACE Rev. 1.1, code 1586) for which data were available in 2005 (n = 1101)
[c]'Others' are companies with a market share lower than 1% in 2005

Exhibit 18.8: illycaffè Balance Sheet and Profit and Loss Account (€ Th)

Balance sheet	**2005**	**2004**	**2003**	**2002**	**2001**	**2000**	**1999**	**1998**	***Average***	***CAGR***
Fixed assets	66,908	61,416	50,902	44,664	40,646	36,780	29,689	22,997	*44,250*	*14%*
Intangible fixed assets	19,078	16,501	8,022	6774	6364	5990	4696	2682	*8763*	*28%*
Tangible fixed assets	44,437	42,587	37,091	35,337	32,780	28,750	21,245	18,117	*32,543*	*12%*
Other fixed assets	3393	2328	5789	2554	1502	2040	3748	2198	*2944*	*6%*
Current assets	111,928	87,343	74,660	74,880	80,617	90,620	66,834	53,984	*80,108*	*10%*
Stocks	52,320	38,181	30,973	31,664	40,969	46,818	32,247	26,684	*37,482*	*9%*
Debtors	48,323	38,925	36,796	34,604	33,427	32,523	27,622	23,620	*34,480*	*9%*
Other current assets	11,285	10,237	6891	8612	6221	11,279	6965	3680	*8146*	*15%*
Cash & cash equivalent	3577	4346	1077	4516	3091	3868	3856	2455	*3348*	*5%*
Total assets	178,836	148,758	125,562	119,544	121,263	127,400	96,523	76,982	*124,359*	*11%*
Shareholders funds	84,057	75,156	72,523	65,444	57,536	48,721	34,249	24,760	*57,806*	*17%*
Capital	6,300	6,300	6,300	6,300	6,300	5,423	5,423	1,085	*5,429*	*25%*
Other shareholders funds	77,757	68,856	66,223	59,144	51,236	43,298	28,826	23,675	*52,377*	*16%*
Non current liabilities	39,716	32,500	18,395	20,327	46,276	35,072	24,976	21,375	*29,830*	*8%*
Long term debt	0	0	0	0	0	0	0	0	*0*	*n.a.*
Other non-current liab.	39,716	32,500	18,395	20,327	46,276	35,072	24,976	21,375	*29,830*	*8%*
Current liabilities	55,062	41,103	34,645	33,772	17,452	43,656	37,297	30,846	*36,729*	*8%*
Loans	15,094	9357	8480	6328	12,676	18,050	9585	13,505	*11,634*	*1%*
Creditors	25,727	21,653	17,311	19,448	0	17,467	16,578	10,113	*16,037*	*12%*
Other current liabilities	14,241	10,093	8854	7996	4776	8139	11,134	7,228	*9058*	*9%*
Total shareh. funds and liab.	178,836	148,758	125,562	119,544	121,263	127,400	96,523	76,982	*124,359*	*11%*
Working capital	74,916	55,453	50,458	46,820	74,396	61,874	43,291	40,191	*55,925*	*8%*
Net current assets	56,866	46,240	40,015	41,108	63,165	46,964	29,537	23,138	*43,379*	*12%*
Number of employees	647	590	537	731	678	996	417	385	*623*	*7%*

(continued)

Exhibit 18.8: (continued)

Profit and loss account	**2005**	**2004**	**2003**	**2002**	**2001**	**2000**	**1999**	**1998**	***Average***	***CAGR***
Operat. revenue/turnover	228,737	208,188	190,314	193,818	193,845	179,709	154,766	130,596	*184,997*	*7%*
Sales	226,907	204,997	189,930	193,113	190,309	175,913	152,584	131,075	*183,104*	*7%*
Costs of goods sold	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	*n.a.*	*n.a.*
Gross profit	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	*n.a.*	*n.a.*
Other operat. expenses	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	*n.a.*	*n.a.*
Operating P/L	22,856	17,608	20,357	22,555	19,810	21,081	15,972	12,188	*19,053*	*8%*
Financial revenue	1,162	433	1997	1588	2508	2203	1920	2131	*1743*	*−7%*
Financial expenses	3554	1815	3444	3611	4736	5318	2925	5547	*3869*	*−5%*
Financial P/L	−1,377	−2,127	−1,447	−2,023	−2,227	−3,115	−1,005	−3,416	*−2,092*	*−11%*
P/L before tax	21,480	15,480	18,911	20,532	17,583	17,967	14,967	8,772	*16,962*	*12%*
Taxation	9268	7676	8121	8335	7135	7932	6596	4492	*7444*	*9%*
P/L after tax	12,212	7804	10,789	12,197	10,447	10,035	8371	4281	*9517*	*14%*
Extr. and other revenue	879	967	621	385	804	716	819	417	*701*	*10%*
Extr. and other expenses	2487	847	607	1567	1,160	328	285	299	*948*	*30%*
Extr. and other P/L	−1,609	121	13	−1,182	−356	387	535	118	*−247*	*n.a.*
P/L for period	10,603	7925	10,802	11,015	10,091	10,422	8906	4399	*9270*	*12%*
Export turnover	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	*n.a.*	*n.a.*
Material costs	88,820	73,189	66,113	63,612	76,586	76,242	60,654	56,478	*70,212*	*6%*
Costs of employees	39,922	36,734	32,204	30,253	28,067	25,727	23,182	19,671	*29,470*	*9%*
Depreciation	14,213	11,620	9153	8703	8533	8887	6383	4220	*8964*	*16%*
Interest paid	2594	1813	3116	3167	3925	4532	2915	5395	*3432*	*−9%*
Cash flow	24,816	19,545	19,955	19,718	18,624	19,309	15,289	8619	*18,234*	*14%*
Added value	76,600	65,768	63,396	61,473	57,751	57,500	47,982	38,177	*58,581*	*9%*
EBIT	22,856	17,608	20,357	22,555	19,810	21,081	15,972	12,188	*19,053*	*8%*
EBITDA	37,069	29,228	29,510	31,258	28,343	29,968	22,355	16,408	*28,017*	*11%*

Source: Amadeus Database

Exhibit 18.9: illycaffè Ratios

Ratio	2005	2004	2003	2002	2001	2000	1999	1998	Average	CAGR
Current ratio	2.03	2.12	2.16	2.22	4.62	2.08	1.79	1.75	2.35	2%
Liquidity ratio (%)	1.08	1.2	1.26	1.28	2.27	1	0.93	0.89	1.24	2%
Shareholders liquidity ratio (%)	2.12	2.31	3.94	3.22	1.24	1.39	1.37	1.16	2.09	8%
Solvency ratio (%)	47	50.5	57.8	54.7	47.45	38.24	35.48	32.16	45.42	5%
Gearing (%)	65.2	55.7	37.1	40.7	102.5	109	100.9	140.9	81.5	−9%
Share funds per employee (€ Th)	130	127	135	90	85	49	82	64	95	9%
Work. capital per employee(€ Th)	116	94	94	64	110	62	104	104	93	1%
Total assets per employee (€ Th)	276	252	234	164	179	128	231	200	208	4%
Profit margin (%)	9.39	7.44	9.94	10.6	9.07	10	9.67	6.72	9.1	4%
Return on shareholders funds (%)	25.6	20.6	26.1	31.4	30.56	36.88	43.7	35.43	31.27	−4%
Return on capital employed (%)	19.5	16.1	24.2	27.6	20.72	26.85	30.19	30.71	24.48	−6%
Return on total assets (%)	12	10.4	15.1	17.2	14.5	14.1	15.51	11.39	13.77	1%
Interest cover	8.81	9.71	6.53	7.12	5.05	4.65	5.48	2.26	6.2	19%
Stock turnover	4.37	5.45	6.14	6.12	4.73	3.84	4.8	4.89	5.04	−1%
Collection period (days)	76	67	70	64	62	65	64	65	67	2%
Credit period (days)	40	37	33	36	n.a.	35	39	28	35	5%
Net assets turnover	1.85	1.93	2.09	2.26	1.87	2.14	2.61	2.83	2.2	−5%
Costs of employees/oper. rev.(%)	17.5	17.6	16.9	15.6	14.48	14.32	14.98	15.06	15.81	2%
Operat. rev. per employee (€ Th)	354	353	354	265	286	180	371	339	313	1%
Aver. cost of empl./year (€ Th)	62	62	60	41	41	26	56	51	50	2%
Profit per employee (€ Th)	33	26	35	28	26	18	36	23	28	5%
Cash flow/turnover (%)	10.9	9.39	10.5	10.2	9.61	10.74	9.88	6.6	9.72	6%

Source: Amadeus Database

Exhibit 18.10: illycaffè's Guiding Principles Based on Quality

Consumer: the client comes first. The main object of illycaffè's passion for quality is to provide complete satisfaction to clients and consumers. Besides being responsible for the unfinished product that leaves the plant, the company also feels jointly responsible for the finished product – an espresso must always be perfect throughout the world. Toward this goal, illycaffè adheres to and attempts to improve every aspect of the standards of quality, in production, the processes, and in customer services.

Team spirit: care for collaborators. The policy of collaborator growth reaches toward the self-fulfilment and happiness of these people, based on respecting the dignity of others, on professional and personal growth, on their involvement in their work, their sense of responsibility, and a system of rewarding commendable work. Indeed, the company's success depends on the skill and contribution of all the collaborators. illycaffè aims at developing the competencies of the collaborators through technical training in each sector and at providing for the necessary resources and a pleasant, stimulating, and safe working environment.

Partnership with the supplier. In the area of business ethics, the company policy emphasizes mutual benefits with its suppliers by both selecting and leading them with its values. It fosters long-term collaborations convinced that only a relationship based on mutual interest and growth can guarantee quality and, at the same time, improve the value of the product. In particular, illycaffè provides the producers of green coffee with its acquired know-how and expertise in ways to obtain better-quality coffee, for which it offers a sustainable, above-market price.

Social commitment. illycaffè deeply respects the environment and communities where it works. It undertakes not only to comply with the regulations, but also to implement policies of sustainable development for both the environment and society, by contributing to the development of the territory and the community living there.

illycaffè's commitment with financers. illycaffè's commitment to and its passion for quality and the protection of the shareholders' and financiers' legitimate interests, constantly work toward improving economic performance, aimed at self-financing and the growth of the company's value.

Source: illycaffè Web site 2005

Exhibit 18.11: Sustainability in illycaffè

Sustainable development and quality: an inseparable pair. To make the best coffee, you need to use the best coffee beans, i.e., the highest-quality Arabica purchased by illycaffè, mainly in Brazil but also in Central America, India, and Africa. illy quality begins at its origin, with its cooperative relationship with the cultivators, based on principles of mutual respect and listening to each other's requirements and needs. This company philosophy is consistent with its own strategy and has led illycaffè to work on sustainable development since the end of the 1980s.

One hundred percent of illy coffee is purchased directly from the producers. We know each and every one of our suppliers; we educate and train them to produce quality, while protecting the environment; we purchase the high quality our suppliers produce, always paying a price that ensures them a profit: this is at the core of the relationship illy has created and maintained with the growers who supply its raw material. It is a relationship based primarily on trust.

Quality as a tool for enhancing the living conditions of growers over time. The suppliers need to be very carefully selected. This is accomplished through a system of quality-incentive awards established in 1991 in Brazil with the *Prêmio Brasil de Qualidade do Café para Espresso* directed at the best growers in the country. The transfer of know-how begins once the cultivators have been selected. illycaffè agronomists make every effort to transfer knowledge and techniques of cultivation, harvesting, and processing. The growers are thus enabled to meet the high standards of quality required by illycaffè. Each year the company team of agronomists dedicate an average of 300 days of training to the growers. Moreover, illycaffè, in conjunction with the University of São Paolo, has created the University of Coffee in Brazil, which offers both practical and theoretical courses for producers.

Fair price. illycaffè calculates a minimum price, below which it never goes, under any circumstances. This price is based on variables such as the country of origin, the type of market, the quality of the product, and the cost of production. This minimum price is based on the international market quotations (NYC) and on the cost of production to which a fair margin is added: a margin to reward the producer for the greater care he has taken with his crops and to guarantee him a profit. illycaffè's price policy is based on an empirical approach, built partly through the long-term relationships the company maintains with its producers.

Source: illycaffè Web site 2007: In Principio Project

Exhibit 18.12: Clube illy Do Café Benefits

Card	Benefits
Cartão Vermelho	Supplying illycaffè for 1 year allows producers to become members of the Clube illy do Cafè. Members:
	1. Receive the Cartão Vermelho and the membership certificate;
	2. Preferred access to the Clube illy do Cafè Web site;
	3. Special offers among illycaffè's products (e.g. coffee, 'espresso' coffee machine, etc.);
	4. Periodic information about the Clube illy do Café;
	5. Access to the relevant references about coffee;
	6. Copy of the movie 'Como Fazer do Café uma Obra de Arte' (How to make coffee a work of art);
	7. Opportunity to buy products and participate, as a special benefit, in seminars organized by the Clube with other organizations;
	8. Participation in technical workshops with experts identified by illycaffè

(continued)

Exhibit 18.12: (continued)

Card	Benefits
Cartão Prata	Supplying illycaffè for a 3-year period allows members to receive the Cartão Prata, which provides additional benefits:
	1. Status and reward for receiving a higher-level card;
	2. Free participation in courses and workshops at the Universidade illy do Cafè;
	3. Free logo identifying the authorization by illycaffè to analyze the coffee;
	4. Reserved Internet channel to exchange information with Dr. Illy, researchers, and coffee experts;
	5. Annual participation in a holiday in Italy with the full organization
Cartão Ouro	Supplying illycaffè for more than three consecutive years allows members to receive the Cartão Ouro, which provides additional benefits:
	1. High status and rewards for receiving the highest-level card;
	2. Free participation in courses and workshops at the Universidade illy do Cafè;
	3. Free logo identifying the authorization by illycaffè to analyze coffee;
	4. Reserved Internet channel to exchange information with Dr. Illy, researchers, and coffee experts;
	5. Technical support with direct visits by illycaffè experts;
	6. Free copy of the book by Andrea Illy *Espresso Coffee: The Science of Quality*;
	7. Participation as special guest in the illycaffè Brazil Quality Espresso Coffee Award Ceremony;
	8. Annual participation in a holiday in Italy with the full organization
Award 'Supplier of the year'	Each year, members of the Clube illy do Cafè with Cartão Ouro and Cartão Prata can participate in a cultural trip to Italy
	Members of the committee are illycaffè, Assicafè (Organization providing quality certification for illycaffè), Porto de Santos (official retailer for illycaffè), and ADS (Assessoria de Comunicaçoes, official communication agency for illycaffè)
	Requirements to participate in the award are:
	Loyalty in supplying illycaffè;
	Efficiency in production;
	Reliability;
	Outstanding coffee;
	Correspondence of the lot with the original sample;
	Perfect balance sheet;
	Processing of supplied quantity and subsequent high quality;
	Relationships: efficiency and reliability in the bargaining process;
	Participation in the illycaffè Brazil Quality Espresso Coffee Award Ceremony

Source: Clube illy do cafè Web site, 2007

Acknowledgements The development of this case and the overall project has been made possible due to the generous financial support of EABIS' founding corporate partners: IBM, Johnson & Johnson, Microsoft, Shell and Unilever.

19 Microfinance as a Shakespearean Tragedy: The Creation of Shared Value, While Acting Responsibly

Harry Hummels

Introduction

Shakespeare would have been thrilled by all the intrigues in this relatively new and emerging financial theatre. All the elements are there to write yet another masterpiece – this time on the rise of King Microfinance, his conquering the world and the subsequent gradual decay of his empire. This case study will describe the struggle of one of the king's knights – ACTIAM Impact Investing – in enlarging the empire in a way that simultaneously serves the interest of the people and the king's financiers. So what happened?

In 2006 the Nobel Peace Prize was awarded to Grameen Bank and its founder, Mohammad Yunus. In his acceptance speech Yunus described the launch and development of the bank.

> Grameen Bank gives loans to nearly 7.0 million poor people, 97 per cent of whom are women, in 73,000 villages in Bangladesh. (…) We focused on women because we found giving loans to women always brought more benefits to the family. In a cumulative way the bank has given out loans totalling about US $6.0 billion. The repayment rate is 99%. Grameen Bank routinely makes profit. Financially, it is self-reliant and has not taken donor money since 1995. Deposits and own resources of Grameen Bank today amount to 143 per cent of all outstanding loans. According to Grameen Bank's internal survey, 58 percent of our borrowers have crossed the poverty line.[1]

In the decades following the launch of Grameen Bank microfinance spread with viral speed. Across the globe initiatives were taken to improve access to finance for the poor, most notably in South and South East Asia, Central America and the Caribbean, and South America. After the fall of the Berlin Wall, microfinance also

[1] Muhammad Yunus, *Nobel Peace Prize Acceptance Speech*, December 2006

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© Springer Science+Business Media B.V. 2019
G. G. Lenssen, N. C. Smith (eds.), *Managing Sustainable Business*,
https://doi.org/10.1007/978-94-024-1144-7_19

emerged quite rapidly in Eastern Europe and the Caucasus. Assuming that one could do good, while at the same generating high returns microfinance became the ascending star on the financial firmament. The amount of investors rose spectacularly.

Only a few months passed since Yunus' acceptance speech until the first cracks in the pavement became visible. The wealth of investment opportunities in emerging markets attracted a highly diversified audience of investors – ranging from professional investors to adventurers. It resulted in a somewhat wrought-up market that showed characteristics of what Shiller[2] would have called the 'irrational exuberance' of the microfinance market. This development led to excesses, damaging the sustainable development of the microfinance sector. Following the initial public offering (IPO) of the largest Mexican microfinance institution (MFI), Banco Compartamos, Muhammad Yunus himself warned against the inflation of microfinance. Instead of opening up the market to allow for more competition benefiting the poor, the IPO primarily resulted in Banco Compartamos' expansion and its increased domination of the Mexican microfinance market. Among other things, the MFI was criticised for charging its customer excessive interest rates.[3] In 2010 a microfinance crisis emerged in Andhra Pradesh following the suicide of a number of microfinance borrowers. And then there were the discussions on excessive interest rates, client over-indebtedness, tax avoidance and a lack of transparency of MFIs that did not really contribute to raising confidence in the creation of a sustainable microfinance industry.

This case study focuses on ACTIAM, previously known as SNS Asset Management, as a medium-sized Dutch asset manager,[4] that developed microfinance as a successful business activity. ACTIAM Impact Investing took responsibility for building this particular business line. The objective of the asset manager's development investment department was to create shared value (CSV) for both investors and investees and to build a sustainable investment practice. The ACTIAM microfinance proposition already echoed the core idea behind Porter and Kramer's CSV framework – even at a time when that framework was not available yet.

When ACTIAM started its activities in microfinance in 2007, investors were open and sympathetic to the idea of doing good while doing well through their investments. This attitude, however, changed as a result of the financial crisis. Pressured by the European Commission, the European Central Bank, the national central banks, and other supervisory authorities, the appetite for high-risk, long-term, and illiquid investments significantly decreased. Investors changed their policies and introduced tighter risk management procedures. In general, the crisis and all the legislation that resulted from it, such as the Alternative Investment Fund Management Directive (AIFMD), has had a negative effect on the

[2] Shiller, R.J., *Irrational Exuberance*. New York, USA, Crown Business, 2006

[3] Rosenberg, R., 'Muhammad Yunus and Michael Chu debate commercialization', *CGAP Microfinance Blog,* 2008

[4] Just to give an indication, ACTIAM managed some 46bn Euros by the end of 2014

willingness of investors to allocate resources[5] to alternative investments – including microfinance.

During the spring of 2007, when ACTIAM launched the first of two microfinance funds it was to bring to the market in just over a year, the situation was different. ACTIAM attracted investments up to an amount of 320mn Euros from institutional investors, including pension funds and insurance companies. At the core of the investment philosophy was the belief that microfinance could and should be beneficial to the poor. Oddly enough, it was not necessary to prove the social value added of microfinance in those days. Microfinance was seen as a contribution to sustainable development per se, which needed no additional proof of its social value for the microfinance borrowers or the communities they lived in. However, that was going to change rapidly, resulting in the integration of the social rationale of microfinance in the due diligence and the analysis of the underlying investments. The funds aimed at providing capital to microfinance institutions, which enabled these institutions to disperse loans to the poor and low-income people. These loans were intended to bring the microfinance clients in a situation of increased financial control. With blue and white-collar jobs being largely absent, access to finance helped the microfinance entrepreneurs to invest in their own business. Without this key social aspect of microfinance ACTIAM Impact Investing's business proposition would have been void of meaning.[6] However, while disbursing loans to microfinance institutions some unintended side effects of microfinance in a global environment came to the fore, which were potentially harmful to micro-entrepreneurs.

This study starts with a description of microfinance and its development in the new millennium. Having introduced ACTIAM Impact Investing and its institutional microfinance funds I then turn to the potential social risks connected to microfinance. A few of these risks impacted the relationship between ACTIAM Impact Investing and its investors, consisting of some of the largest institutions in the pension sector in the world. One intriguing threat that I want to focus on in this study deals with sudden changes in the external environment as a result of social unrest that ACTIAM itself was not instrumental in, but immediately affected the sustainability of its business model. The events taking place elsewhere in the world were kinds of 'dei ex machina' for the asset manager and its investors. The relevance of this case study is not limited to the financial sector, including the microfinance sector. Other industries, like the apparel industry, the consumer staples industry or the extractives industry, to mention just a few, face similar problems.

[5] The problem is not only the allocation of money but also of additional resources like management attention, portfolio management capacity and reputation management.

[6] Institutional investors face a trade-off between financial only and impact investments. Based on their fiduciary responsibility institutional investors want to be compensated for their potential loss of financial return.

The Case of Microfinance

The Origin and Growth of Microfinance

Microfinance is about providing access to financial services to previously excluded clients. Usually those clients can be found in low-income economies, although microfinance emerges in developed countries as well. It refers to informal and formal arrangements offering financial services to low-income and poor people, thereby focusing on micro-entrepreneurs. Most financial transactions are in the form of microcredit, although (micro) finance institutions increasingly offer savings and insurance products to their clientele. In his book Banker to the Poor, Mohammad Yunus, the founder of Grameen Bank, explains that providing credit to poor entrepreneurs provides them with a way out of poverty.

The concept of microfinance is not new. Savings and credit groups that have operated for centuries include the "susus" of Ghana, "chit funds" in India, "tandas" in Mexico, "arisan" in Indonesia, "cheetu" in Sri Lanka, "tontines" in West Africa, and "pasanaku" in Bolivia. In Europe, microfinance dates back to the sixteenth century when informal and small-scale lending and savings clubs were established. In Ireland, Jonathan Swift initiated a loan fund system early in the eighteenth century, using peer monitoring to enforce weekly repayments. In Germany, after the hunger year of 1846/47, Raiffeisen created rural savings and credit cooperatives, originally called credit associations, and currently known as Raiffeisenbanken. The concept of microfinance as it is known today, received wide attention and recognition since the establishment of Grameen Bank in Bangladesh in 1976.

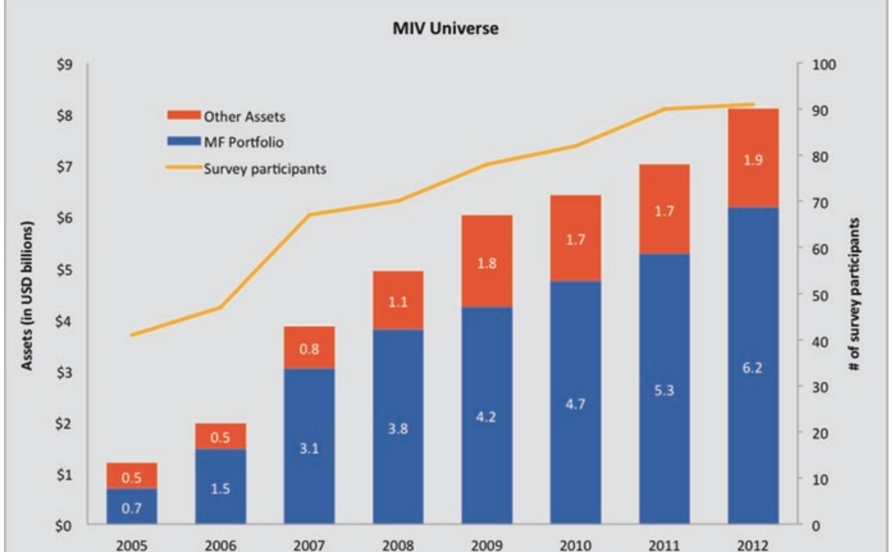
Over the years the microfinance industry has shown significant development and change. In the eighties and nineties of the last century the market was dominated by NGOs and development aid organizations. Since 2004, the industry started growing at an unprecedented rate. Both donors and investors began channelling large amounts of funding to microfinance institutions (MFIs) across the globe – mostly via microfinance investment vehicles (MIVs). Table 19.1 offers an overview of the rapidly expanding supply side of the market but, at the same time, can be seen as a clear indication of the growing demand for microfinance capital. The financial crisis caused a minor slowdown of the rapid increase of investments in microfinance, although the sector still shows impressive growth figures. MicroRate's 2013 report showed a growth of 18% of the MIV microfinance portfolio in 2012.

Despite the growth this portfolio there has been a discrepancy between the offering of microfinance services and the alleged need or desire for financial services coming from the underserved communities. At yearend 2012, more than 204 million microfinance clients, of whom 82% are female, made use of microfinance in more than 85 countries. The annual growth rate of clients amounted in the first decade of the millennium to approximately 20%.[7]

The microfinance landscape has been divided into three tiers. Tier 1 consists of mature, financially sustainable, large and highly transparent MFIs. Tier 2 is made up of small or medium sized, slightly less mature MFIs that are, or are approaching

[7] See Microcredit Summit bi-annual report: http://stateofthecampaign.org/read-the-full-report/

Table 19.1 Market development of microfinance assets by MIVs (MicroRate, 2013)



profitability, while tier 3 comprises immature and unsustainable start-up MFIs or small NGOs. A recent survey of the microfinance market showed that nearly 1200 MFIs – approximately 70% of all MFIs worldwide – fell into the tier 3 category.[8] Only 108 MFIs – representing 7% of the market – were considered tier 1 institutions. Table 19.2 provides an overview of the demarcation of the three types of MFIs.

Microfinance Investors

Investors in microfinance are divided into three groups: (a) governments and development finance institutions (DFIs), (b) institutional investors, and c) NGOs and other retail investors. Governments and DFIs are public investors; the others are private. Together these investors have allocated an amount of microfinance that topped US$ 25bn in 2011.[9] Of this funding 60% came from local actors, while 40% was cross-border.[10] DFIs and multilateral organizations, like the World Bank, IFC and EBRD, provided more than half of all foreign investments whereas institutional

[8] See MIX Market (www.mixmarket.org)

[9] CGAP, Cross-boarder survey on microfinance, 2012

[10] A distinction is made between NGOs and Non-Banking Financial Institutions (NBFIs) on one side and banks on the other. The latter received substantially more foreign investments. There were also regional differences. Latin America and the Caucasus attracted most foreign investments, while South Asia, Africa and Middle East and North Africa (MENA) were clearly lagging.

Table 19.2 Classifications of MFIs (Microrate 2013)

	Tier 1	Tier 2	Tier 3
Description	*Mature, financially sustainable, and large MFIs that are highly transparent*	*Small or Medium sized, slightly less mature MFIs that are, or are approaching profitability*	*Start-up MFIs or small NGOs that are immature and unsustainable*
Sustainability	(i) Positive RoA for at least 2 of the last 3 years AND	(i) Positive RoA for at least 1 of the last 3 years and other years >−5% OR	The rest
	(ii) No RoA <-5% in the last 3 years	(ii) Positive trend in RoA in last 2 years and >−5%	
Size	>$50 million	$5–$50 million	<$5 million
Transparency	(i) Regulated financial institution OR	Audited financial statements for at least the last 3 years	The rest
	(ii) Rated at least once in the last 2 years		

http://www.microrate.com/media/downloads/2013/04/MicroRate-White-paper-Microfinance-Institution-Tier-Definitions.pdf 'Size' in this table refers to the Gross Loan Portfolio (GLP). Although loan sizes differ from one microfinance borrower to another there is no data available on the Average Loan Size (ALS) per category. Even within these tiers major differences occur. So take a Tanzanian 'tier 1' microfinance provider that categorizes all loans below 25,000 USD as microfinance. With such a wide range of loans no overall ALS is published. The bank uses an ALS for 70% of its portfolio – referring to the lower end of the market – which is 1400 USD.

investors contributed significantly to the growth of microfinance in the last few years – particularly in the area of private equity investments. This group of institutional investors included international banks, pension funds, and insurance companies. The impressive growth figures have sometimes been interpreted as a sign of a maturing microfinance. In addition, it has been used as an argument for demonstrating the attractiveness of microfinance for institutional and other 'finance first' investors – at a time the jury was still out. Microfinance has gone through a "process of transformation from a sector dominated by a mission-driven ethos to one responding to the needs and interests of private capital".[11] Somewhere during the middle of the first decade of the new millennium the impression started to take root that microfinance was socially and financially attractive. Microfinance was believed to have the potential of adding value to institutional investors in terms of attractive risk-adjusted returns, social value and a low correlation with other asset classes. It did not take long to correct this view as being naïve and even detrimental to the poor. The price for getting access to finance was high, as both investors and borrowers were soon to find out, and very often for good reasons. Sometimes it was too high – leading to social unrest and protest. Examples came from the No Pago movement in

[11] De Sousa-Shields, M. and C. Frankiewicz (2004, p. vii) 'Financing microfinance institutions: the context for transitions to private capital', *Micro Report*, 32

Nicaragua,[12] the LAPO incident in Nigeria[13] or the Andhra Pradesh suicides[14] and will be elaborated briefly later in this contribution. These examples increased investor reluctance to invest additional capital in the industry.[15]

ACTIAM Impact Investing

The Trend Towards Responsible Investments

The start of the new millennium sparked the beginning of a new wave of socially responsible investing (SRI). In the twentieth century SRI particularly focused on social, ethical, and environmental policies, practices – and to a lesser extent performance – of multinational corporations. Following the IT-bubble – which to a large extent demonstrated some clear shortcomings in the governance of companies – the SRI-debate shifted. Governance-issues took centre stage, opening up opportunities for institutional investors to enter the space. In 2004 Mercer and UNEP-FI coined the term Environmental, Social, and Governance (ESG) to replace Social, Ethical and Environmental (SEE). The notion of governance was much more acceptable to institutional investors facing their fiduciary responsibility towards their beneficiaries. The shift became even more relevant to investors when research demonstrated that improved corporate governance would result in financial outperformance. As a result non-financial issues were integrated in the fundamental financial analyses of companies.

In the financial bull market that followed the IT-crisis, the institutional investment community was open to a host of innovative investments that looked for excellent financial and non-financial returns. In this environment ACTIAM – a medium-sized Dutch asset manager – stepped up its initiatives to become 'The Responsible Investor'. In itself, that was not something new for the company. In the 1980s the company integrated social and environmental factors in the process of stock selection on behalf of a Dutch ethical bank. In 2006 the company decided to integrate ESG-criteria in the entire investment process – broadening the scope from

[12] See Hrabálek, M., and Zdráhal, I., "*Microfinance and the role of the State: No Pago Movement in Nicaragua*", published on line at Academia.edu

[13] See Sinclair, H., *Confessions of a microfinance heretic*, 2012, Berrett-Koehler, San Francisco

[14] Arunachalam, R., *The Journey of Indian Micro-Finance: Lessons for the Future,* Chennai: Aapti Publications, 2011. See also: Bateman, M., "How Lending to the Poor Began, Grew, and Almost Destroyed a Generation in India", in *Development and Change*, Vol. 43 (6), p. 1385–1402, November 2012; CGAP, Andhra Pradesh 2010: "Global Implications of the Crisis in Indian Microfinance", *CGAP Focus Note,* 67, November 2010; Wright, G.A.N., and Sharma, M.K., "The Andhra Pradesh Crisis: Three Dress Rehearsals ... and then the Full Drama", *MicroSave India Focus Note 55*, December 2010; Taylor, M., "The Antinomies of 'Financial Inclusion': Debt, Distress and the Workings of Indian Microfinance", *Journal of Agrarian Change,* Vol. 12 No. 4, October 2012, pp. 601–610.

[15] In some cases it led to an outflow of capital at MIVs that were open-ended. Being closed-ended the ACTIAM funds were not confronted with investors reclaiming their invested capital.

stock selection to the selection of all assets.[16] The process was guided by the ACTIAM Fundamental Investment Principles (FIPs), which were based on the United Nations Global Compact and relevant international treaties. The idea was that the asset manager would not prioritise its own morality or that of its investors, but would take international conventions, treaties and agreements as its benchmark that were issued by authoritative organisations like the UN, ILO or OECD. The FIPs refer to (the avoidance of) violations of human rights, labour rights, corruption, controversial weapons, environmental protection, and client and product integrity.

The core of the ACTIAM's responsible investment approach was to avoid or exclude very serious violations of its principles, while it juxtaposed this strategy with an attempt to improve the performance of its investments. To an outsider it may seem odd to want to avoid only very serious violations of one or more principles. As a result, it could occur that ACTIAM condoned mild forms of child labour, human rights violations, corruption or environmental degradation – and actually that is what happened. Every investor faced – and faces – this dilemma when allocating assets. The reason is that large chunks of the investment universe of large cap companies, nearly per definition, were – and are – involved in some sort of activity that is socially, ethically or environmentally undesirable. It is for this reason that ACTIAM invested in engagement with companies involved in undesirable activities or behaviour, but that were not seen as the worst offenders.[17] By focusing on the gradual integration of ESG-factors in its portfolio management and on engagement ACTIAM was saying two things. First, the organisation expressed its concern for the social, environmental and governance side of investing. But secondly, it clearly stated it was in the business of investing – not in one of excluding – with the exception of serious violators of its principles. We should not be misled by the idea that avoiding undesirable practices changes anything to the occurrence of undesirable or reprehensible practices. The problem simply moves from one investor to another – that is, to an investor who remains committed to the company, the country or the project that others avoid. The investee will not be impacted by an investor's decision to divest when there is sufficient liquidity in the market willing to invest in the investee. This was and still is a key issue for institutional investors.

Launching Two Microfinance Funds

Apart from the avoidance of harm – which is basically what the investment principles were all about – ACTIAM also wanted to make a positive contribution through its investments. For that reason it launched its first institutional microfinance fund in 2007: the ACTIAM Institutional Microfinance Fund (AIMF). With assets under management of approximately €160mn the launch was very successful. Soon after,

[16] There were two exceptions: emerging market equity and hedge funds. The first dealt with a lack of reliable data available on ESG policies and performance. The second dealt with a general difficulty to assess their social, environmental and governance policies, practices and performance.

[17] Only producers of cluster munitions, land mines and atomic, biochemical and chemical weapons are immediately excluded. Engagement with these companies usually does not have much sense.

a second fund followed in 2008. The ACTIAM Institutional Microfinance Fund II raised an amount of capital comparable to the first fund. Both funds were non-listed mutual funds open to professional investors only. At the time the exclusive focus on pension funds, insurance companies and professional asset managers was quite unique. The funds are closed-end – leading to a situation in which ACTIAM Impact Investing actively participates in the fiduciary responsibility of the pension funds, insurance companies and professional asset managers on whose behalf it invests.

A Different Business Model

The fiduciary responsibility of ACTIAM's investors referred to their duty to invest the capital in the best interest of their beneficiaries. Practically speaking this meant that the investors were looking for market-rate returns. They considered themselves 'finance first' investors[18] – as opposed to foundations, family offices and High Net Worth Individuals (HNWIs) who are usually referred to as 'impact first' investors. Nevertheless, also institutional investors would want to look for investment opportunities that led to a world worth living in – then, now and in the future. It is precisely this 'double dividend' the ACTIAM Institutional Microfinance Funds were targeting. To serve its investors in an environment that continuously raised the bar regarding the application of professional investment standards ACTIAM Impact Investing developed an innovative business model. That is, ACTIAM operated – and still operates – as fund manager on behalf of the fund participants, while leaving the selection and monitoring of the investments up to an independent investment advisor. ACTIAM, therefore, was responsible for structuring the fund, fund governance, investment decision-making, monitoring the investment advisor and constant communication and reporting vis-à-vis its participants. The investment advisor took care of sourcing the investment deals, due diligence, writing the investment proposal and monitoring the MFIs once the ACTIAM Investment Committee decided to invest. For both funds ACTIAM selected Developing World Markets (DWM) from Stamford, Connecticut as its investment advisor. By creating this structure and dividing responsibilities between itself and its investment advisor the fund manager maximised the chances of working in the interest of both the investors and the investees in a cost-effective way. The structure contributed, for instance, to the prevention of 'deal blindness' – a not uncommon characteristic among investment managers deciding on deals they sourced themselves. The division of labour also meant that the best skills were working to provide maximum result in each step of the process. ACTIAM employed portfolio managers and relationship managers

[18] Elsewhere I have argued that instead of focusing only on financial returns institutional investors can also be seen as 'professional first' investors. They apply professional standards to their investment processes. Investees – whether direct or through funds or mandates – have to comply with these standards in order to selected. See Hummels, H. "Impact Investing through Advisers and Managers who Understand Institutional Client Needs", in WEF, *From Ideas to Practice, Pilots to Strategy. Practical Solutions and Actionable Insights on How to Do Impact Investing*, Geneva, December 2013, 40–42.

with an adequate understanding of the institutional investment market and of the microfinance market. DWM employed specialists familiar with sourcing, analysing and monitoring deals on the ground.

Investments

Since inception the first ACTIAM Institutional Microfinance Fund has made more than 256 loans to 123 microfinance institutions for a total amount of €591mn.[19] Fund II has provided a total of €260mn through 184 loans to 99 MFIs. Finally, the funds took equity stakes in 6 MFIs. The loans and equity investments have mainly been disbursed to MFIs in South America, Central Asia and the Caucasus, and South and South East Asia. Africa was clearly lagging behind due to high investment risks. In an environment where fixed income investment returns declined significantly in the developed world between 2007 and 2015 the ACTIAM Funds returned somewhere around 5% annually to their investors – net of management fees and of other costs.

Performance of the Funds

Looking back on more than 6 years of microfinance investments, what has been achieved? Did ACTIAM Impact Investing succeed in creating a decent market-rate return for its investors, while at the same time creating social value for the MFIs ACTIAM invested in and their clientele?

From a financial point of view the ACTIAM Institutional Microfinance Funds performed quite well. At the end of 2012 both funds provided a return to the investors of somewhat over 6% on the debt part of the portfolio – net of costs and net of fees. Compared to the SMX Index,[20] which returned 4.05% in 2012,[21] that leads to an outperformance of over 200 basis points (bps). But what can be said about the social performance? Did both funds actually live up to the expectation of creating added value for the micro-entrepreneurs the ultimately want to assist in getting access to finance.

As Fig. 19.1 shows the first fund reached some 1.2 million borrowers over a period of 6 years. Outreach, however, is not the most important indicator of

[19] This includes rollovers. In total the AIMFs have provided more that €850mn in debt to MFIs, which is an indication of the long-term focus of both funds. With a 7 year investment horizons the originally committed capital of €320mn has been made productive – on average – for approximately 2.5–3 years per loan. Due to the fact that many loans were rollovers ACTIAM was able to establish a long-term relationship with its MFIs.

[20] The SMX is created by Symbiotics. Currently the following MIVs are part of the index: ResponsAbility Global Microfinance Fund, BlueOrchard Microfinance Fund, Dual Return Fund Vision Microfinance, Wallberg Global Microfinance Fund, and Triodos SICAV II – Triodos Microfinance Fund.

[21] https://my.syminvest.com/microfinance-investment-vehicle/symbiotics-microfinance-indexes

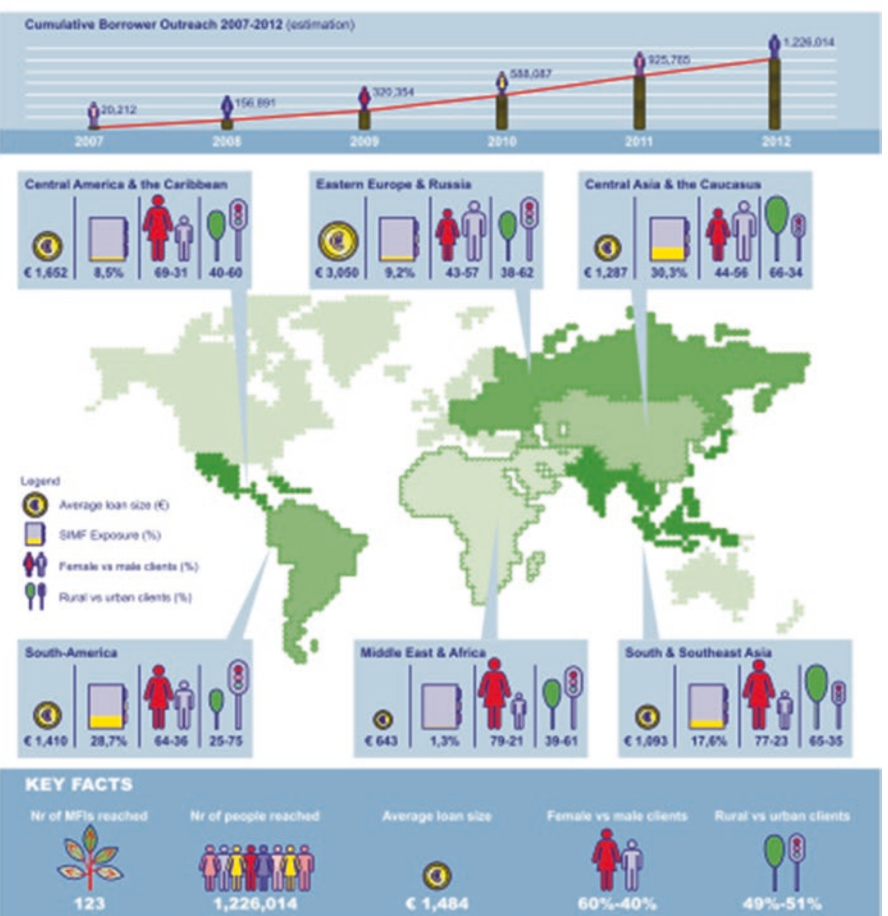


Fig. 19.1 AIMF I Outreach

non-financial success if it is not directly related to serving the needs of the poor. Products and services offered to MFI-clients have to be instrumental in providing access to finance in a responsible way. Inter alia, they have to meet criteria regarding client protection, transparency and good governance. ACTIAM particularly focused on implementing some of the most elements in the Client Protection Principles and the Principles for Investors in Inclusive Finance (PIIF). So while the cover of the Eye4Impact reported on outreach the backside informed investors on improvements in the focus and the management of MFIs as Fig. 19.2 demonstrates.

As the Eye4Impact illustrates, enlarging capital for Western pensionados while enhancing the opportunities of the poor to get access to finance can go hand in hand – even though there is still plenty room for improvement. The next section will point out that this unfortunately is not always the case in microfinance across the globe.

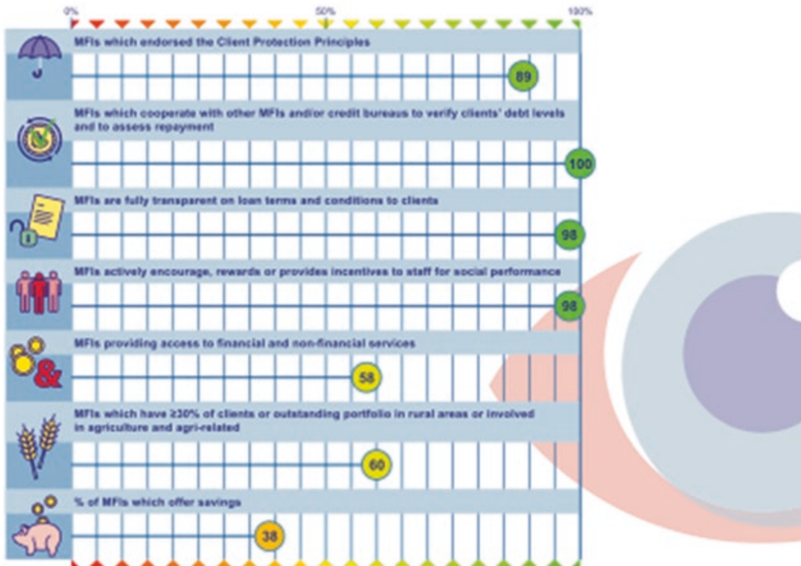


Fig. 19.2 AIMF I Improvements in MFI Focus and Management

Creating Shared Value

Mohammad Yunus saw microfinance as an example of creating shared value 'avant la lettre' by developing a range of financial products that enhance the business opportunities, capabilities and skills of poor micro-entrepreneurs. Porter and Kramer could have referred to microfinance if they would have wanted to point to an opportunity to increase society's productivity and the development of a new market. "The concept of shared value", they argue, "recognizes that societal needs, not just conventional economic needs, define markets".[22] That was precisely what Yunus had in mind when he provided access to financial services in order to alleviate poverty and offer an alternative to the so-called 'loan sharks'.

When ACTIAM launched its first two funds, microfinance institutions across the globe were looking for foreign direct investment capital to grow their businesses and to provide access to finance to poor people.[23] At that time most of this capital was still supplied by NGOs and DFIs. The rise of microfinance investment vehicles (MIVs), bringing private capital to the market, was seen as a welcome addition to the opportunities for MFIs to attract funding.

At the time of their launch the funds aimed to expand "the total pool of economic and social value"[24] by adding two characteristics that were quite innovative. In the first place the funds were exclusively open to institutional investors. Secondly, they were closed end funds that allowed for the provision of loans in local currencies. Both elements offered MFIs a significant advantage. The commitment by institutional investors to accept a tenor of at least 7 years contributed to the credibility of the microfinance sector. Apparently, institutional investors like pension funds or insurance companies were willing to provide capital to micro-entrepreneurs who had no or only very few assets – albeit via MFIs. In addition, the funds provided an opportunity to provide loans with a longer tenor and in local currencies – leaving some of the currency risk with the investors.

Bad Moon Rising

Assisting the Poor?

Since 2007 a number of crises emerged across the world that were related to microfinance. With the benefit of hindsight we can conclude that most crises were not incidents but foreseeable accidents waiting to happen. They were the result of a mix of ingredients that turned out to be poisonous to at least some of the microfinance

[22] Porter, M. E. and Kramer, M. R., 'Creating Shared Value: How to reinvent capitalism and unleash a wave of innovation and growth', in *Harvard Business Review*, 2011, Vol. 89 (1), p. 65

[23] The demand was triggered, among other reasons, by the changes in political and regulatory environments, which stimulated large-scale access to finance. In India, as a result of regulatory reforms the number of microfinance clients nearly doubled between 2005 and 2010. See Srinivasan, N., *Microfinance: The State of The Sector Report*. New Delhi: SAGE Publications, 2010.

[24] Porter and Kramer, 2011:65

borrowers. Before the 2006 ‘Krishna crisis’ emerged in Andhra Pradesh[25] (AP) the financial markets in the developed and the developing had a positive outlook on the potential of microfinance. Even after this crisis the optimistic sentiment persisted. As was explained in section “ACTIAM Impact Investing” vast amounts of foreign capital were flowing into the market leading to an environment based on conditions that did not contribute to the creation of a sustainable microfinance market. The flow of capital allowed MFIs to grow very rapidly on a commercial basis. Money became an easy to get commodity without borrowers being sufficiently aware of the conditions and the consequences of borrowing too much money. Interest rates were high and sometimes excessive, MFIs forced borrowers to save and used unethical recovery practices, and entrepreneurs ended up with having 2, 3 or even more loans.

The Krishna crisis may have provided the first sign that microfinance was more than a tool to alleviate poverty and it certainly wasn’t the last. Analysts, like Ramesh Arunachalam, pointed out that microfinance gradually became a risk as a result of the lack of appropriate regulation and oversight, combined with improper business conduct by loan officers and debt collectors. The potential risks not only became manifest in India, but also in Mexico and Nicaragua.

Mexico Compartamos Banco is the largest MFI in Mexico. In 2007 the board of what at that time still was a non-governmental organisation, decided to go public. By floating an Initial Public Offering (IPO) on the Mexican Stock Exchange the bank netted a little over US$400mn for its shareholders. In 2 years time, then CEO Maria Otero received a compensation of more than 2 million USD. At the same time the poor were paying annualized interest rates of more than 100% on a loan.

Nicaragua In January 2009 the Movimiento de Productores, Comerciantes y Microempresarios de Nueva Segovia blockaded the Panamerican Highway. The protesters introduced the phrase that would echo in Nicaraguan and even international politics for more than 1 year: ‘No Pago! No Pago!’[26] The No Pago Movement, consisting of some 10.000 members, was largely fuelled by complaints that MFIs charge interest rates that are too high, leaving borrowers swamped in unmanageable debt. The movement lobbied for the passage of a debt relief law that would fix the maximum chargeable interest rate at 12%. On 1 October 2009 protesters scored a major victory when legislators signed a bill supporting the passing of such a law. The proposal gives debtors an interest-free, 6-month grace period and up to four to 5 years to fully repay their loans.[27]

[25] Krishna is a district in Andhra Pradesh. In 2006 the state shut 50 branches of two of India’s largest microfinance institutions for charging “usurious interest rates” and “forced loan recovery” practices.

[26] No Pago can best be translated as “I do not pay”.

[27] For a more detailed report see https://nacla.org/news/no-pago-confronts-microfinance-nicaragua

Andhra Pradesh[28] The Andhra-MFI-Ordinance states: "(3.1) All MFIs operating in the State of Andhra Pradesh as on the date of the commencement of this Ordinance, shall within thirty days from the date of commencement of this Ordinance, apply for Registration before the Registering Authority of the district specifying therein the villages or towns in which they have been operating or propose to operate, the rate of interest being charged or proposed to be charged, system of conducting due diligence and system of effecting recovery and list of persons authorized for conducting the activity of lending or recovery of money which has been lent. (3.2) No MFIs, operating at the commencement of this Ordinance or intending to start the business of lending money to SHGs, after the commencement of this Ordinance, shall grant any loans or recover any loans without obtaining registration under this Ordinance from the Registering Authority."[29] These two paragraphs from the ordinance that the government of Andhra Pradesh passed on 15 October 2010 caused a shock in the Indian – and global – microfinance community. The ordinance entailed that MFIs with pending registration had to cease operations in Andhra Pradesh immediately. They were not allowed to collect loans and interest payments, which had a significant impact on their liquidity. The ordinance followed reports on unethical recovery practices and suicides as a result of client over-indebtedness.

Add to these examples the accusation in the spring of 2013 that microfinance investment vehicles made use of profit shifting and avoid taxes,[30] and the impression is easily created that microfinance is rather poisonous – for investors and for microfinance borrowers. It led MS Sriram at the Indian Institute of Management in Ahmedabad to conclude: "a fairy-tale had turned into a nightmare".[31] It is important to note that ACTIAM funds were not invested in Compartamos Banco or in India at the time of the AP crisis. The funds were, however, invested in a Nicaraguan MFI that went bankrupt as a result of the crisis. Ultimately, the investors paid the bill for the bankruptcy of the MFI, although the cost was rather limited.

Consequences for Institutional Investors

The various cases of negative publicity were quite contrary to the expectations of investors – to put it mildly. Microfinance always had been seen as a force for (moral) good and many believed – in accordance with Yunus' belief – it contributed to poverty reduction. It had produced a Nobel Prize winner and it had reached over 100 million borrowers in 2006. Hugh Sinclair, a microfinance critic, pointed to the

[28] For more information on and references to the Andhra Pradesh crisis in 2010 please see note 14.

[29] http://indiamicrofinance.com/wp-content/uploads/2010/10/Andhra-MFI-Ordinance.pdf

[30] NpM Platform for Inclusive Finance, Paying Taxes to Assist the Poor? October, 2013. See http://www.inclusivefinanceplatform.nl/documents/Documents/Publications/npm%20study_paying%20taxes%20to%20assist%20the%20poor.pdf

[31] MS Sriram, 'The AP Microfinance Crisis 2010: Discipline or Death?' *VIKALPA*, Vol. 37, Oct – Dec 2012

misplaced self-congratulatory behaviour of the microfinance sector at its summit in Halifax in 2006:

> The conference leader, Sam Daley-Harris, was about to reach the climax of the entire spectacle, when he would reveal the number of people who had been "reached" by microfinance. (…) It was something like 100 million people. (…) We, the people in this room, had performed a miracle. (…) We were no longer a fringe activity; we had 100 million clients. We were superheroes, apparently, and the microfinance sector even had a Nobel Peace Prize under its belt. (…) Sam clarified. "I would like to propose a round of applause for us, those in this room, who have worked so hard to bring this about. It is thanks to you that this has been possible, and I think you deserve a round of applause.[32]

In Halifax, the Krishna crisis had already taken shape, although the crises in Mexico and Nicaragua were still concealed in an unknown future. In the years following the summit even the most ardent proponents of microfinance were convinced of the necessity of change. The dream was over. Nevertheless, there was no reason to throw out the baby with the bath water because some MFIs fell prey to mission drift and shifted their attention towards commercializing their operations in an unethical way. There was still a need for access to finance for the poor – albeit in ways that match the needs and the abilities of poor to handle a microloan and all that comes with it. According to the Consultative Group to Assist the Poor (CGAP) and the World Bank (2010) around 2.7 billion people still lacked access to formal financial services implying a capital requirement of some USD 250–300 billion. Some of that money could come from domestic investors, but not all of it. Foreign direct investments remained an important source of funding for microfinance institutions – be it with the right specs that made it possible for MFIs to offer microfinance loans, saving and insurance in a commercial, but responsible way. Providing access to finance through microfinance products and services is relatively expensive – particularly in the not so densely populated rural areas. But that should never lead to usury, to mandatory savings (certainly when practiced without giving fair compensation to the client), or to the use of oppressive recovery practices.

Creating Shared Value as a Normative Challenge?

In this book De los Reyes and Scholz challenge the framework of creating shared value (CSV) to adequately address normative issues and corporate social responsibility (CSR). The authors take issue with Porter and Kramer's approach and their idea that the "essential test that should guide CSR is not whether a cause is worthy but whether it presents an opportunity to create shared value". More in particular, they argue that CSV "is ill-suited to handle common managerial scenarios where profitability cuts into social welfare or vice versa"[33] Business will not regain its

[32] H. Sinclair, *Confessions of a Microfinance Heretic*, Berrett-Koehler Publishers, July 2012

[33] Reyes Jr., G. De los, and Scholz, M., "Creating legitimacy and shared value with SWONT", in Lenssen, G., and N.C. Smith, (eds.), *Managing Sustainable Business*, ...

legitimacy by simply creating shared value and stimulating economic growth for a community and those who are part of that community. More is needed, and that particularly includes an integration of normative analysis in the CSV framework to address issues of redistribution and responsibility. Even though CSV may be a necessary requirement to align societal and business interests, De los Reyes and Scholz continue, it is not a sufficient component for business to redeem societal trust and win back its legitimacy. To that extent the authors offer a conceptual framework called SWONT, an abbreviation of Strengths, Weaknesses, Opportunities, Norms and Threats.

The authors have a point in addressing the normative quality of the CSV framework, which is relevant for this chapter. ACTIAM Impact Investing considered itself to be an enlightened asset manager, consciously serving both the interests of the investees as well as those of the investors. As was shown in the previous paragraph it faced several ethical challenges and opportunities in its attempt to provide capital to MFIs in a responsible way. In this respect, it acted in line with Porter and Kramer's CSV framework. So what can be said about the moral compass that CSV offered to ACTIAM? Was it sufficient? Should it have been supplemented by an explicit normative analysis as part of the strategic planning process? In this section I will spend a few words on the relevance of the discourse between CSV and SWONT, discussing the approach that ACTIAM took in the next section.

Creating Value Versus Redeeming Legitimacy

Porter and Kramer's claim that business can redeem corporate legitimacy by implementing CSV more of less has become the framework's Achilles heel. A more modest approach in which the authors simply would have demonstrated that CSV contributes to winning back public confidence and trust, would likely have prevented an argument on the (lack of) ethical quality of the framework in its current, pronounced form as I hope to demonstrate in the remainder of this article. Even though Porter and Kramer suggest that CSV can help business to regain its societal legitimacy, the framework not about awarding or allocating moral praise for solving society's problems. It simply is the intelligent business attempt to create economic and social value for business and society by listening and responding to the needs of society. It sees and conceptually frames societal problems as business opportunities. CSV is, therefore, all about common (business) sense – whatever social motives the owners and managers may have had when they started their CSV activities. The question then arises whether De los Reyes and Scholz aren't exaggerating their argument? Aren't they missing the point that managers, operating in an open and dynamic society and focusing on simultaneously creating sustainable long-term value for the business and for society, will incorporate normative arguments in their decision-making? It may be true that in Porter and Kramer's CSV framework ethics has become a caricature to the extent that it lacks guidance for managers dealing with difficult ethical challenges and choices that cannot be explained and answered by a reference to the creation of shared value. The question is, however, does this

perceived lack of guidance require adding a normative analysis to the existing SWOT-model? Wouldn't such an addition fail to appreciate that managers who are focused on long-term value creation for business and society are savvy when it comes to integrating ethics – even if they do not receive explicit guidance from Porter and Kramer? Managers are challenged by customers, NGOs, politicians, media, academics and, not at least, their own employees regarding issues of sustainability and ethics. In a global business environment – which is the environment De los Reyes and Scholz implicitly put centre stage – these are and have to be alert and responsive to the needs of society as a conditio sine qua non, with or without the support of the CSV framework. The value of Porter and Kramer's framework rests in their constant focus on opportunities for business to turn society's problems into corporate action that is both profitable and societally valuable. Those opportunities can be found everywhere across the globe – even in situations that seem quite unlikely today. It is the strength of the CSV framework that even when dealing with, for instance, the poorest of the poor, there are ways in which a business approach to solving society's problems can be beneficial to the poor and to society in a responsible way. The case of ACTIAM Impact Investing demonstrates that – even in absence of ethical guidance from the CSV framework – no SWONT model was required to conduct business in a responsible way.

A Clear Challenge

The sustainability of ACTIAM Impact Investing's business model was tested during the microfinance crises mentioned previously. Even though the asset manager was not directly involved in two of the three crises, it certainly faced some tough questions from investors, colleagues and the outside world. Microfinance's honeymoon came to a sudden and unexpected end when it appeared to have negative social effects on the lives of poor and low-income people – in addition to the value it created in allowing microfinance clients to have access to financial service and better manage their financial needs.

This unexpected development caused concern among (institutional) investors. In an environment that was confronted with the aftermath of the global financial crisis – with limited risk budgets available for niche products – institutional investors became somewhat wary to make high-risk investments in developing countries. The investment opportunities needed to be large enough to justify the high costs involved in microfinance investments. In addition, the fiduciary responsibility towards their beneficiaries required pension funds and insurance companies to generate market-rate returns. But most of all, they saw a reputation risk arising in making impact investments in developing markets in general and microfinance investments in particular.

The ACTIAM Institutional Microfinance Funds were not confronted with an outflow of capital as a result of the events taking place across the globe because they were closed-end funds. Investors were simply not able to reclaim their investments. Despite this characteristic of the funds that kept all investors on board, ACTIAM

faced the reputation issue heads on. In tackling the reputation issue the organisation's development investment arm did not operate in a moral void. On the contrary, the fundamental investment principles and ACTIAM's culture of being a responsible investor provided clear guidance.

For that reason ACTIAM adopted the Client Protection Principles, which were launched by the SMART Campaign in 2009. MFIs have to comply with the principles and with social covenants that are part of the investment contract in order to get funding – even if that would lower investment returns. A second initiative worth mentioning was the launch of the Principles for Investors in Inclusive Finance (PIIF) in January 2011. In signing the principles, investors commit to:

- Expanding the range of financial services available to low-income people;
- Integrating client protection into all their policies and practices;
- Treating their investees fairly, with clear and balanced contracts, and dispute resolution procedures;
- Integrating ESG factors into their policies and reporting;
- Promoting transparency in all their operations;
- Pursuing balanced long-term returns that reflect the interests of clients, retail providers and end investors; and
- Working together to develop common investor standards on inclusive finance.

ACTIAM played a significant role in stimulating its investors to become a signatory of the PIIF and to adopt the principles. In addition, the asset manager also pursued the observance and realisation of the principles. The adoption of the principles has had an impact on the acceptance of new MFIs as clients of the microfinance funds and the monitoring of already existing clients. Measures that were taken consisted of, inter alia:

- The use of benchmarks to assess acceptable Return on Assets and Return on Equity levels,
- Implementing a stricter focus on remuneration and incentives of MFI management and staff as part of the due diligence and monitoring of MFIs. No ethically questionable incentives – such as (excessive) bonuses for bringing in new clients or collecting interest and loan payments – will be condoned,
- Reinforcing policies and analysis regarding the risk of over-indebtedness in portfolio countries,
- Supporting the launch of credit bureaus in developing countries.

Finally, ACTIAM became a member of the Social Performance Taskforce (SPTF), initiated a round table with other MIVs to discuss the development in highly saturated markets like Peru and Cambodia, and led the study on microfinance and tax avoidance by the Dutch National Platform for Inclusive Finance (NPM).

In order to manage and mitigate the (reputation) risks, which had emerged over time in the microfinance space, ACTIAM increased and improved investor communication. In order to educate investors, the asset manager outlined its view on

social value creation in a separate paper. In addition, the organisation issued regular newsletters in which relevant topics were addressed. Finally, ACTIAM organised field trips to MFIs for its participants. These 3–4 day excursions had the character of a study trip[34] in which MFI visits were combined with meetings with sector representatives, national banks, and, of course, MFI clients.

Good Business Sense

Despite this negative effect on the cost of the operations, ACTIAM continued focusing on reducing the risks for its investors, investees and microfinance borrowers. Not only was this decision the result of the ACTIAM culture and its investment principles, it was also motivated by the idea of good business sense. Ultimately, ACTIAM wanted to contribute to building a strong and responsible financial sector in which access to finance for poor and low-income people is fully integrated. One can only achieve this aim by focusing on the long run. Integration of financial services for poor and low-income clients takes time – much time. Only those asset managers will be around in the decades to come that ultimately have the patience and the business sense to see the social needs and objectives of end clients, MFIs and investors as part and parcel of their strategic business model – and act on it.

The case demonstrates that a strategy focused on creating shared value does not necessarily preclude a focus on normative ethics. In an open and dynamic society and with a clear focus on long-term shared value creation managers will be sensitive to the moral claims of the stakeholders. The primary reason for ACTIAM Impact Investing's management to be responsive to the social needs of microfinance clients was not a sense of moral obligation – although the ethical appeal coming from NGOs and the media resonated well with management – but the anxiety of investors to be exposed to reputation damage. The leading question for management has, therefore, been:

> What can we do when our products and services meet society's responsibility standards to prevent being challenged by our clients and the outside world when the sector in which we operates is falling from grace?

Shakespeare's Tragedy

Present-day stories about 'No Pago', Compartamos Banco, or the Andhra Pradesh crises could have provided Shakespeare with interesting material for modern drama. Whether reading Julius Caesar, Hamlet, King Lear, Macbeth, Henry VIII and not to forget Richard III, self-interest and betrayal are common characteristics in his

[34] To avoid misperceptions about the intentions of the asset manager, the trips were paid for by the investors. Inviting participants was not a facilitation payment to induce investors to become loyal supporters of the funds.

historical plays and tragedies. Not always for the wrong reasons, as Marcus Brutus shows in *Julius Caesar*. Brutus is truly concerned with Julius Caesar's ambition to turn the Roman republic into a monarchy under his rule. Brutus teams up with conspiring Roman Senators to assassinate Caesar. Despite being erroneous about Caesar's motives and intentions, both friend and foe considered Brutus to be 'a noble man'. He acted for the good of Rome.

Mohammad Yunus may have felt like Julius Caesar when microfinance became a tool that could turn itself against the interests of the poor. Yunus' idea of microfinance becoming an omnipotent instrument for poverty alleviation turned into a nightmare in some cases. Against the background of the potential downsides of microfinance, ACTIAM Impact Investing faced some challenges when it simultaneously tried to serve the interests of the poor and of its investors. High investor returns resulted in undesirable social outcomes, which had to be balanced with the provision of sufficient capital to provide access to finance for poor and low-income people. Too strong a focus on eliminating poverty by offering low-cost loans and technical assistance to microfinance institutions would, on the other hand, result in an outflow of (institutional) capital in the long run.

ACTIAM found a middle of the road approach by attracting foreign capital to improve the access to finance for poor and low-income clients to increase their ability to better manage their financial affairs. This obviously required a vision and a focus on the asset manager's responsibility in terms of the prevention of excessive interest rates, over-indebtedness, or unethical recovery practices. In addition, ACTIAM and its investors were determined to contribute to a professionalization of the sector. This could, for instance, be done by speaking out on the necessity of regulation, promoting transparency, supporting the creation of credit bureaus, or building an environment in which microfinance could develop into a profitable sustainable financial practice. Poor and low-income people are willing to pay for high-quality services when the contractual conditions are fair.

Serving the interest of both business and society is in need of managers – operating within a CSV framework – who demonstrate to be streetwise in an ever-changing business environment. They need to be – and very often they are – savvy in incorporating the needs of their stakeholders in a dialectic relationship between business and its environment. This means that the CSV framework implicitly incorporates normative elements that Porter and Kramer disregard. On the other hand, there is not need for adding the 'N' to the SWOT-analysis. Analysis and discourse on social, ethical and environmental issues that managers meet along the way of implementing their strategy, are part and parcel of the conditions of doing business in a modern economy.[35] The example of ACTIAM demonstrates that, with an open mind and a

[35] Part of the problem with De los Reyes and Scholz' approach is that they fail to clarify what normative analysis and discourse entails and what it adds to the toolbox of socially, ethically, or environmentally streetwise managers. A contribution that does provide relevant support is Mitchell, Agle and Wood's Theory of Stakeholder identification and salience, focusing on power, urgency and legitimacy of stakeholders and their claims. See Mitchell, R.K., Agle, B.R. and Wood, D.J.,

responsive attitude, companies are able to engage in normative analysis, discussions and actions to address (social) threats. They can contribute to a Shakespearean drama by taking the material of the table with which Shakespeare used to write his compelling tragedies. That, in the end, is the real tragedy: Shakespeare having nothing tragic to write about anymore.

"Toward a Theory of Stakeholder Identification and Salience: Defining the Principle of Who and What Really Counts", *The Academy of Management Review*, Vol. 22, No. 4 (Oct., 1997), pp. 853–886**.** Useful are also Frederick, W.C., *From CSR1 to CSR2: The Maturing of Business-and-Society Thought,* Working paper no. 279,6, University of Pittsburg, 1978 and Ackerman, R.W., 'How companies respond to social demands'. In: *Harvard Business Review*, July–August, 1973

'Ecomagination' at Work: GE's Sustainability Initiative

20

S. S. George and S. Regani

> Ecomagination is GE's commitment to address challenges such as the need for cleaner, more efficient sources of energy, reduced emissions, and abundant sources of clean water. And we plan to make money doing it. Increasingly for business, "green" is green (Jeffrey Immelt, Chairman and CEO of General Electric, in 2005).[1]

> Ecomagination is a milestone for a number of reasons, including that it's a long-term commitment with specific targets made at the company's highest level. GE has taken this process seriously and done its homework to make sure its claims and goals are credible (Joel Makower, sustainability consultant, in 2005).[2]

Towards a Cleaner Environment

In March 2006, General Electric Company (GE), one of the largest business conglomerates in the world, announced that it had developed a prototype version of a new apparatus that could manufacture hydrogen through electrolysis.[3] According to the company's estimates, the hydrogen produced with this equipment would cost around $3.04 per kilogram to manufacture – considerably less than the $8.0 per kilogram it cost to manufacture using conventional processes in 2006.

Although the device was still at an early stage of development, it was believed that it could play an important role in the future, as in the early 2000s, hydrogen was

[1] *GE Launches Ecomagination to Develop Environmental Technologies,‖ www.nema.org, May 13, 2005. (accessed on October 31, 2006).*

[2] *In chemistry and manufacturing, electrolysis is a method of separating bonded elements and compounds by passing an electric current through them (www.wikipedia.com).*

[3] Dollars ($) refers to US dollars in this case study.

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© Springer Science+Business Media B.V. 2019
G. G. Lenssen, N. C. Smith (eds.), *Managing Sustainable Business*,
https://doi.org/10.1007/978-94-024-1144-7_20

increasingly being considered as a feasible alternative to traditional fossil fuels for powering automobile engines. By 2006, several major automobile manufacturers had launched, or were working on developing, vehicles that would run on hydrogen (**Refer to** Exhibit 20.1 **for a list of some hydrogen-powered vehicles**).

Hydrogen-powered vehicles were environment-friendly as they did not emit toxic substances, unlike vehicles that ran on fossil fuels. Besides, the use of hydrogen was also likely to reduce the pressure on the rapidly depleting global reserves of fossil fuels. However, in the early 2000s, a major limitation to the use of hydrogen was that it was considerably more expensive than traditional fuels. Therefore, if GE's apparatus caught on, it was expected to help make hydrogen- powered vehicles popular, by bringing the price of a kilogram of hydrogen down to the price of a gallon of gasoline.[4]

The hydrogen production project was a part of GE's 'Ecomagination' initiative, launched in May 2005. Ecomagination, promoted as GE's commitment to sustainable development, was a large- scale program aimed at making the company a more responsible corporate citizen. It covered among other things, GE's efforts to enhance its investment in developing sustainable technologies, and increase its revenues from sustainable products, while lowering emissions and improving energy efficiency at its production plants. According to GE, Ecomagination would help the company—imagine and build innovative technologies that [would] help customers address their environmental and financial needs and help GE grow[5].

GE was only one of the many large companies that had invested in sustainability in the early 2000s. Notable among the others were Novartis AG, Unilever Plc., BMW AG, and energy and petroleum majors ExxonMobil Corp., Chevron Corp., and BP (formerly British Petroleum). According to analysts, sustainability initiatives were especially relevant for large companies that had a huge impact on the economy as well as the environment. However, they added that most large companies were only indulging in 'greenwash' when they talked about their sustainability efforts. But GE's results in the first year after the launch of Ecomagination seemed to indicate that it was one of the few large corporations that were genuinely committed to sustainability.

Background

GE's origins can be traced back to 1879, when Thomas Alva Edison (Edison) invented the first successful incandescent electric lamp. Edison was an entrepreneur as well as an inventor, and had started several small businesses dealing with power stations, wiring devices, and appliances during the late 1870s and 1880s. In 1890,

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[4] Between January 2006 and October 2006, the retail price of one gallon of gasoline ranged from $2.25 to $3.0 in the US. (from www.wikipedia.com).

[5] GE Ecomagination,‖ http://home.businesswire.com, May 17, 2006 (accessed on November 1, 2006).

he brought all these businesses together and combined them under the Edison General Electric Company (EGEC).

EGEC merged with the Thomas-Houston Electric Company7 in 1892 to form GE. The newly formed GE was headquartered in New York. In 1894, Edison gave way to Charles Coffin (Coffin) as the CEO of GE. Coffin licensed out the electric bulb technology to other companies, thus consolidating GE's position in the emerging lighting industry. Coffin also created a formal hierarchy in the company and organized GE's various businesses in a systematic manner, arranging each unit around a product line. He was also credited with setting up financial control systems at GE.

GE was one of the earliest companies to introduce a benefits program for employees. In the 1920s and 1930s, under the leadership of Gerard Swope (Swope), GE launched several progressive industrial relations initiatives, setting up new policies to give employees pensions, bonuses, stock purchase options, profit sharing, and group insurance. It also became the first company to establish an unemployment pension plan, which guaranteed laid-off workers a stipend of $7.50 per week for a period of 10 weeks after the layoff.

However, Charles Wilson, who succeeded Swope in 1940, undid most of his predecessor's good work, and industrial relations took a turn for the worse under his leadership. In 1948, there was a major strike, which caused a rift between the blue collar workers and the top management at the company.

By the 1950s, GE had become a major industrial conglomerate with interests in a variety of businesses. But growth brought with it its own problems. From the beginning, GE had been organized like a holding company, with a few executives at the headquarters monitoring the activities of the various businesses. But for routine monitoring, each business unit enjoyed great autonomy. Over the years, the heads of individual businesses became powerful, and began operating their units like independent businesses with little reference to GE's strategic objectives.

After Ralph Cordiner (Cordiner) became CEO in 1958, he embarked on a company-wide restructuring program to bring discipline to GE. To obtain more control over the various businesses, he strengthened bureaucracy within the company. Cordiner created a team of GE executives, outside consultants, and management experts to develop strategies to streamline the company's management practices. He was also responsible for setting up GE's management training center at Croton-on-Hudson in New York, popularly known as the Crotonville School (Crotonville[6], to train future GE leaders.

GE grew rapidly in the 1960s under the leadership of Fred Borch, who became the CEO in 1964. Borch was responsible for introducing the concept of Strategic Business Units (SBUs)[7], and he created 46 SBUs within the company in the late

[6]The Thomas-Houston Electric Company was founded in 1879 by Elihu Thomson and Edwin J. Houston. It was a competitor to EGEC, until the merger of the two companies.

[7]Under the 'Number One Number Two' strategy GE had to be one of the top two players in every segment in which it operated. If any business failed to meet this criterion, it was shut down or sold off.

1960s. He also added several new businesses like computers, nuclear power, and aircraft engines to GE's portfolio.

Reginald Jones (Jones) succeeded Borch in 1972. Jones invested heavily in office automation in a bid to increase productivity, and took some strategic decisions which involved strengthening promising businesses units like plastics and divesting in the unproductive computer businesses. Under him, GE became one of the most powerful conglomerates in the world.

A significant phase in GE's history began in 1981, when Jack Welch (Welch) became the CEO. Under Welch's leadership, GE adopted its well-known Number One Number Two strateg[8]. Six Sigma was also launched at the company during his tenure. By the time he stepped down in 2001, Welch was one of the most visible leaders that GE and corporate America had ever had.

In mid-2001, Jeffrey Immelt (Immelt) succeeded Welch. Immelt became CEO during one of the most difficult phases in business history. Within days of his taking over, the September 11, 2001 terrorist attacks occurred. This was followed by corporate scandals at Enron Corporation and Tyco International Corporation, as a consequence of which investors began to view large corporations and their top management with a degree of distrust and suspicion.

As one of the largest corporations in the US and the world, GE too was affected by the changes in the business environment. Adding fuel to the fire was a report by Bill Gross, manager of Pacific Investment Management Co., one of the largest bond funds in the world. In his report, Gross criticized GE's opaque finances, and accused the company of inflating earnings through acquisitions and cheap debt rather than through organic growth. GE's share price fell drastically after the report was published.

Following this, Immelt instituted several changes at GE aimed at winning back investor confidence. He announced that the management would take steps to improve the quality of governance at the company. He also revised the compensation packages of all the top executives at GE to link compensation to company performance. The Ecomagination program launched in 2005 was also a part of this broad initiative.

In the fiscal year ended December 2005, GE posted revenues of more than $149 billion (**Refer to** Exhibit 20.2 **for GE's annual financials**). It also ranked among the largest employers in the world, employing more than 300,000 people in its various business units. At the end of 2005, GE had six core business units, and was the biggest manufacturer of power plants, jet engines, locomotives, and medical equipment worldwide[9] (**Refer to** Exhibit 20.3 **for GE's core business units**).

[8] Amanda Griscom Little,—GE's Green Gamble, Vanity Fair, July 12, 2006.

[9] Over the years, Crotonville became a major corporate training center. It was also the birthplace of several management techniques in strategic planning.

Past Controversies

In all its years of existence, GE had not been known as a particularly environment-friendly company. In fact, as a large company with interests in several industrial outfits, it had for long been one of the biggest corporate polluters in the US. While the company had built up a strong reputation for delivering outstanding returns to shareholders, it had lagged behind on the social responsibility front. Over the years, GE had been criticized on several occasions for its lack of social responsibility. But, it had chosen to ignore its critics, choosing profitability and financial performance over social and environmental objectives.

One of the biggest environmental controversies involving GE related to the pollution of the Hudson and Housatonic rivers in the US. In the early 1980s, GE was accused of dumping several million of pounds of polychlorinated biphenyls (PCBs) into stretches of the two rivers from its factories located along their banks.

PCBs are chemical compounds with low water solubility and environmental degradability, and studies have shown that people exposed to them could suffer several adverse effects. The US Environment Protection Agency (EPA)[10] had banned their production in 1977, after the US Congress passed the Clean Water Act that year. Since most of GE's PCB dumping had been done before 1972, when the substance was not banned by law, the company contended that it was not responsible for the sediments already present in the rivers. Environmentalists, however, argued that the dangerous nature of PCBs had been well known even before the law was passed, and that GE had acted irresponsibly in dumping the chemicals in the rivers.

In 1980, the US Congress passed another Act called the Comprehensive Environmental Response, Compensation, and Liability Act, popularly known as the Superfund law. This Act made companies retroactively responsible for the clean-up of all identified Superfund sites (industrialized areas heavily contaminated with hazardous waste that was discharged before the clean-water regulations came into force). GE, however, continued to fight the law, even going to the extent of filing a suit challenging the EPA's right to enforce the clean-up law. The suit reportedly cost GE millions of dollars. Welch was known for being especially passionate about this issue, going so far as to declare in public that living in PCB contaminated areas was in no way hazardous to health.[11]

In 2002, Christine Todd Whitman, the EPA Administrator at the time, issued a ruling that gave GE two options – an out of court settlement, or fines of up to $2 billion (almost three times the estimated cost of remediation).[12] GE, led by Immelt, agreed to settle the matter out of court, and promised to pay for the clean-up.

[10] The Environmental Protection Agency (EPA or sometimes USEPA) is an agency of the federal government of the United States charged with protecting human health and with safeguarding the natural environment: air, water, and land. The EPA began operating on December 2, 1970, when it was established by President Richard Nixon. (www.wikipedia.com).

[11] http://www.cleanupge.org/gemisdeeds.html (accessed on November 8, 2006).

[12] Amanda Griscom Little,—GE's Green Gamble,‖ Vanity Fair, July 12, 2006.

However, despite agreeing to bear the costs of the clean-up, GE was pilloried by environmentalists for stalling the proceedings for several years.

In 2005, GE entered into an agreement with the EPA and the US Department of Justice to begin removing contaminated sediment in a two stage clean-up of the Hudson River at an estimated cost of around $750 million.[13] The project was scheduled to begin in 2007. (An agreement to clean up the Housatonic river had been drawn up in 1999).

Remedial Attempts

Although GE had traditionally been a company that gave more importance to profitability than to social responsibility, the business environment in the early 2000s demanded that companies look beyond financial objectives. This was also the time when the Kyoto Protocol[14] was a much discussed subject, and environmental concerns were increasingly being raised at global forums like the G8[15] and WTO[16] meetings. Besides, consumers and investors had become more environmentally conscious than before, which made it all the more important for companies to consider environmental interests in all their operations.

Corporate social responsibility became a subject of greater focus at GE in 2002. In that year, a large team of GE's high-potential executives attended a training session at Crotonville on corporate social responsibility. As a part of the training, the executives visited several companies that had confronted social and environmental issues in the past, like IBM Corp., BP, Eli Lilly, and Nike Corp. They also interacted extensively with regulators, activists, and investors, who had an interest in corporate social responsibility.

During the course of their training, the executives found that although GE was highly respected for its investment value, management quality, and operations, it ranked low on the social responsibility front. If GE were to maintain its position in

[13] Dr. Elizabeth M. Whelan,—Public Health Absurdities,‖ The Washington Times, December 30, 2005.

[14] The Kyoto Protocol is an agreement made under the United Nations Framework Convention on Climate Change concerning the issues related to global warming. The countries that ratify the protocol commit themselves to reduce their emissions of carbon dioxide and five other greenhouse gases, or to engage in emissions trading if they maintain or increase emissions of these gases. The treaty was negotiated in December 1997 and came into force on February 16, 2005. As of October 2006, there were 166 signatories to the treaty, but the US Congress had not yet ratified it. (www.wikipedia.com).

[15] G8 or the Group of Eight is an annual political summit meeting of the heads of government of eight of the most powerful countries in the world. The members are: Canada, France, Germany, Italy, Japan, Russia, the United Kingdom, and the United States (from www.wikipedia.com).

[16] WTO or the World Trade Organization is an international, multilateral organization which sets the rules for the global trading system and resolves disputes between its member states. The headquarters of the WTO is in Geneva in Switzerland, and as of November 2006, the organization had 150 members (from www.wikipedia.com).

the global economy, immediate steps had to be taken to correct this perception about the company.

In 2002, Immelt appointed Bob Corcoran, a long-time GE employee, as the company's first vice president for corporate citizenship. GE also launched several global initiatives aimed at making the company more socially responsible. For instance, in the early 2000s, GE started conducting audits on its suppliers (especially those in the developing parts of the world) to ensure that they complied with globally accepted labor, environmental, health, and safety standards in their operations.

Immelt also restructured GE's business portfolio to include more companies operating in emerging industries. Over the early 2000s, Immelt acquired Enron Wind (one of the few successful companies in Enron's business portfolio), water management companies Ionics Inc. and Osmonics Inc., and AstroPower Inc., the biggest manufacturer of solar energy equipment in the US. In 2004, GE also invested in a new coal technology called Integrated Gasification Combined-Cycle (IGCC), which filtered out greenhouse gases and pollutants when coal was burned for energy, making the process cleaner. The filtered gases were usually sequestered' underground where they could not cause environmental pollution[17].

According to company insiders, GE always ensured that it had enough contacts in the appropriate political circles to gauge where the US Congress was heading on environmental issues, especially with regard to the Kyoto Protocol carbon emissions. This led GE to the conclusion that acquiring interests in emerging businesses made good business sense, as it would put the company in a better position to meet the challenges of the future. If and when the Congress imposed carbon emission restrictions, GE would be able to offer products that met environmental needs, thus obtaining a competitive advantage. For instance, if carbon restrictions were imposed in the US, eco-friendly aircraft engines would be in demand. Therefore, GE's investment in eco-friendly aircraft engines would prepare it to meet the need.

GE made several corporate level changes in the early 2000s. In 2002, the company added more independent directors to its board. Key board committees like the audit, compensation, and nominating committees, were made free of insiders[18]. Additionally, company-wide changes were made in executive compensation to make it more transparent.

Talking about GE's increased emphasis on good corporate citizenship, Immelt said,—The world's changed. Businesses today aren't admired. Size is not respected. There's a bigger gulf today between haves and have-nots than ever before. It's up to us to use our platform to be a good citizen. Because not only is it a nice thing to do, it's a business imperative[19]. In late 2004, GE was listed on the Dow Jones Sustainability Index.[20]

[17] Amanda Griscom Little,—GE's Green Gamble,|| Vanity Fair, July 12, 2006.

[18] Louis Lavelle,—GE's Mile-Higher Governance Bar,|| BusinessWeek, November 8, 2002.

[19] Marc Gunther,—Money and Morals at GE,|| Fortune, November 15, 2004.

[20] The Dow Jones Sustainability Indexes, launched in 1999, are a group of indexes which track the financial performance of companies which met detailed criteria for environmental, social, and financial sustainability. At the time GE debuted on it, around 300 other companies were listed on the various indexes.

From Imagination to Ecomagination

GE announced the Ecomagination project in May 2005. The project's name was a play on GE's corporate slogan 'Imagination at Work'. Announcing the launch, Immelt said that business was no longer a zero-sum game – things that are good for the environment are also good for business.‖ He added that GE was embarking on this initiative—not because it is trendy or moral, but because it will accelerate [economic] growth.[21]

The broad objective of Ecomagination was to meet such environmental challenges as the need for clean water, renewable energy, and reduced emissions. According to Immelt, Ecomagination aimed to—focus our (GE's) unique energy, technology, manufacturing, and infrastructure capabilities to develop tomorrow's solutions such as solar energy, hybrid locomotives, fuel cells, lower-emission aircraft engines, lighter and stronger materials, efficient lighting, and water purification technology.[22]

The slogan for Ecomagination was—green is green‖ (where the second 'green' referred to the color of the US dollar bills). The slogan implied that being environment-conscious would have significant financial benefits for business. GE felt that it was especially well equipped to help customers meet the environmental challenges of the future as it had a broad range of products that could cater to all their needs. The company was also clear that Ecomagination had been launched not for philanthropic purposes, but to create new business opportunities for GE.

GE worked on Ecomagination for almost year before launching the initiative. The company worked with GreenOrder, Inc. (GreenOrder), a New York-based firm, which provided business consulting on environmental strategy and marketing, to develop the blueprint for the project. GreenOrder started out by helping GE identify a clear vision and mission for the project. After this, the broad standards were laid down. GE and GreenOrder defined the standards of the project as those that—improve customers' operating performance or value proposition and significantly and measurably improve customers' environmental performance.[23]

GE then identified 17 products of the company that met the standards to qualify for Ecomagination projects.[24] Among other things, the Ecomagination products included energy conserving household appliances, wind turbines, a hybrid electric-diesel locomotive, a Lexan film that replaced conventional paint, lighting products, water infrastructure, advanced materials, a fuel-efficient jet engine, and energy generation.

[21] Amanda Griscom Little,—It Was Just My Ecomagination,‖ Grist, May 10, 2005, www.grist.org

[22] Joel Makower, Ecomagination: Inside GE's Power Play,‖ World Changing, May 8, 2005. www.worldchanging.com

[23] GE Taps GreenOrder to Help Create Ecomagination,‖ World Wire, June 6, 2005. www.world-wire.com

[24] By mid-2006, the number of products under Ecomagination had increased to 30.

Table 20.1 Examples of GE's product claims

If every U.S. household owning a washer not qualified by ENERGY STAR were to replace it with a GE PROFILE HARMONY washer, we could save enough water each year to fill nearly 400,000 Olympic-sized swimming pools, and consumers could save more than $1 billion in water bills
Through the use of GE's installed wind turbines, as much as 11.4 million tons of greenhouse gases will not be emitted each year, which is roughly equal to keeping nearly two million cars off the road
Compared to locomotives manufactured 20 years ago, many of which are still in use, the GE EVOLUTION Series locomotive reduces pollution by producing 83% fewer particulates and 60% fewer nitrogen oxide emissions

Source: "GE Taps GreenOrder to Help Create Ecomagination," World Wire, June 6, 2005.

After the products had been identified, GE, with GreenOrder's help, created scorecards for each. These scorecards were used to quantify and benchmark the environmental benefits of each of the Ecomagination products against competitors' comparable products, regulatory standards, and the products' past environmental performance. The scorecards also integrated these measures with product claims, which GE used in its promotions. The product claims essentially laid out the benefits that GE's customers might obtain by using Ecomagination products. Some examples of GE's product claims are given in Table 20.1.

Targets and Expected Benefits

With the help of the scorecards, GE was able to lay down clear targets for each of its Ecomagination products. In its media releases, GE identified 'four distinct and measurable behaviors' in Ecomagination[25]:

- Doubling the investment on developing cleaner technologies from $700 million in 2004 to $1.5 billion by 2010.
- Doubling revenues from environment-friendly products and services from $10 billion in 2004 to at least $20 billion in 2010.
- Achieving a 1% absolute reduction in greenhouse gas emissions by 2012 through incorporating cleaner practices at the company, and helping customers reduce emissions by offering them more environment-friendly products. (GE also planned to reduce the intensity of its emissions by 30% by 2008. The company's energy efficiency was to be improved by 30% by 2012. Both the targets were compared to 2004. In the normal course, GE's absolute emissions were forecast to increase by 40% by 2012.)
- Keeping the public informed about the progress of Ecomagination on an annual basis. These targets were developed in consultation with the Washington DC based World Resources

[25] Adapted from—Ecomagination background information,‖ www.draeger-stiftung.de/HG/internet/SD/pdf/eco_backgrounder_english.pdf, May 4, 2005.

Institute (WRI). WRI was headed by Jonathan Lash (Lash), who had been chairman of the Council on Sustainable Development in President Bill Clinton's government. WRI and the World Business Council for Sustainable Development had developed the Greenhouse Gas Protocol, which GE used to track and report internal emissions. Lash was extremely optimistic about the success of Ecomagination and described Immelt as a Visionary

> He said that as a large company, GE was in a position to influence other companies to follow in its footsteps on the sustainability issue. By delivering on the commitment that they have announced GE will demonstrate that we can decouple economic growth from growth in greenhouse gas emissions, said Lash[26] (**Refer to** Exhibit 20.4 **for some of GE's Ecomagination products**).

Promotions

GE promoted Ecomagination widely through its advertisements and other promotion campaigns, as a part of its 'keeping the public informed' objective. To announce the launch of the project, the company took out eight-page advertising inserts in prominent American newspapers like *The Wall Street Journal, The New York Times,* and *The Washington Post*. The advertisements consisted of a small picture and little copy, with most of the page left blank (**Refer to** Exhibits 20.5(A) and 20.5(B) **for a screenshot from GE's Ecomagination print advertisements**).

GE also aired several television advertisements, the most prominent of which was the 'Cleaner Coal' spot. This advertisement featured models covered in coal dust, shoveling coal in a dingy mine. The voiceover said,—Now, thanks to emissions-reducing technologies from GE, the power of coal is getting more beautiful every day.[27] Another advertisement showed a baby elephant dancing in the forest to the soundtrack of—Singing in the Rain.[28] Some of GE's critics were of the view that these advertisements were 'gimmicky', but according to analysts, they played an important role in creating awareness about the program.

In May 2005, GE instituted the Ecomagination Leadership Awards to honor the company's customers who had—demonstrated a commitment in addressing pressing environmental challenges, such as water scarcity – while at the same time conserving energy, addressing safety concerns, and reducing overall operating costs.[29] In 2005, the Ecomagination Leadership Awards were given to 10 companies (**Refer to** Exhibit 20.6 **for the 2005 Ecomagination Leadership award winners**).

[26] GE's Ecomagination: Eco-friendly?‖ Environment, July-August, 2005.

[27] Amanda Griscom Little,—It Was Just My Ecomagination,‖ Grist, May 10, 2005, www.grist.org

[28] www.ge.com/en/company/companyinfo/advertising/eco_ads.htm (accessed on November 10, 2006).

[29] Ecomagination Leadership Award,‖ www.gewater.com/pdf/

The Results

GE published its first Ecomagination Report in May 2006, to report the initiative's progress in the 1 year since its launch. According to the report, revenues from energy efficient and environment-friendly products were $10.1 billion in 2005. Orders for eco-products also nearly doubled to $17 billion in that year.[30]

In 2005, GE installed 1,300 wind turbines across the globe, and the wind energy business recorded revenues of $2 billion – an increase of more than 180% over the revenues in 2004. Sales of GE's EnergyStar certified[31] household appliances also topped $1.3 billion.[32]

Emissions remained flat over 2005, and because GE saw an increase in revenue, the intensity of the emissions actually decreased. In 2005, GE's emission rate was 74.26 tons of emissions per million dollars, while in 2004 it had been 82.64 tons per million dollars. The lowering of intensity was propelling the company toward its target of actually lowering total emissions by 1% by 2012.[33]

Ecomagination was a global initiative, and GE had undertaken several projects outside the US. For instance, in mid-2005, GE announced that it would build a water desalination plant at Algiers, the capital of Algeria, in partnership with the Algerian Government, the Overseas Private Investment Corporation, and the Algerian Energy Company. The plant, called the Hamma Water Desalination SpA, was to be Africa's largest seawater desalination plant, and was expected to supply potable water to 25% of the population of Algiers.[34]

Commenting on the progress in the first year of Ecomagination, Immelt said,— Last year, we said that 'green can be green' – that we would make money helping customers meet their environmental challenges. A year later, we know that green is green, and that it will make a difference on the bottom line for GE investors as customer interest is accelerating.[35]

The first Ecomagination Report was made available online, and GE announced that it would plant a tree at its jet engine testing facility in Ohio for each of the first 2500 downloads. These trees were expected to offset the effect of the carbon emissions at the plant.

According to analysts, one of the critical factors in the success of Ecomagination in its first year was Immelt's commitment to the project. Considering that GE had

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[30] www.ge.com/ecoreport

[31] Energy Star is a US government program to promote energy efficient consumer products. It is well known for its logo appearing on many computer products and peripherals. The program was created in 1992 by the EPA.

[32] www.ge.com/ecoreport

[33] When It Comes To Being Green, GE Walks The Walk,‖ http://ge.bloggingstocks.com, May 23, 2006 (accessed November 1, 2006).

[34] GE Announces Plans for Largest Desalination Plant in Africa Plant will Provide Desperately Needed Drinking Water, Media Release, www.gewater.com/pdf/ June 25, 2005 (accessed November 10, 2005).

[35] GE Ecomagination Revenues Cross $10 Billion,‖ www.greenbiz.com, May 19, 2006 (accessed on October 31, 2006).

never been a particularly socially responsible company, it was not an easy task for Immelt to change the mindset of the employees. However, he persisted with it, all the while reiterating its benefits to the business.

A strong link to business objectives was another factor that contributed to the initial success of Ecomagination. Analysts applauded the fact that all the Ecomagination goals were specific and clear. GE had a clear mission and vision for the project, and its targets were aspirational as well as achievable. GE had also undertaken considerable research on identifying the products that qualified for Ecomagination, and benchmarked them against competitors' products. Therefore, the company's claims were quite definite in terms of how the products contributed to the environment, and could be backed up by research. The link to business objectives helped employees see Ecomagination as a long-term objective rather than a temporary fad.

In 2006, Immelt announced that all of GE businesses, including those that did not come under the purview of Ecomagination, would be evaluated annually on how they contributed to the environment, in addition to regular measures like return on capital.[36] This was expected to be a precursor to bringing more GE products under Ecomagination.

Outlook

Although the results of the first year prompted GE's detractors to concede that Ecomagination was not a publicity exercise to clean up GE's image, but a serious project to which the company was committed, there was still a fair amount of skepticism about its success in the long run. For instance, industry observers were interested in finding out how GE, which was one of the largest suppliers of coal-fired power plants, nuclear reactors, and jet engines, would extend the Ecomagination initiative from a few projects to a company-wide exercise. It was also observed that sustainability as a corporate strategy worked only if it was made a company-wide initiative. If it remained restricted to a few products, its impact would be limited.

However, most analysts acknowledged that Ecomagination was a bold move on GE's part. For a company that was known as a laggard on the social responsibility front, GE had made remarkable progress with Ecomagination within the first year itself. They also agreed that when an influential company like GE emphasized sustainability, it could have far reaching effects, even to the extent of influencing the national government's environmental policies. Immelt reportedly met with several members of the government during the run-up to the launch of Ecomagination. Many took this to be an indication that GE wished to influence the government's policies on the environment.[37]

In the future, governments around the world were expected to make environmental regulations more stringent in keeping with the Kyoto Protocol. GE was thought to

[36] The Greening of General Electric, The Economist, December 10, 2005.

[37] Amanda Griscom Little,—It Was Just My Ecomagination, Grist, May 10, 2005, www.grist.org

be preparing for this by increasing its focus on eco-friendly products. Big, long-term successful companies have been able to spot really huge changes and be on the right side of them. Immelt believes he is going to operate in a carbon-constrained world and he will have the technologies that the world wants and needs to buy, said Lash.[38]

On the other hand, concerns were expressed over GE's heavy dependence on emerging technologies. Some analysts cautioned Immelt against moving too fast to adopt new technologies as they believed that he could turn out to be wrong about the importance of environmental concerns. They said that if these concerns subsided in the future, or new oil resources were freed up, then GE's products might become irrelevant. They also pointed out that there had been 'sustainability booms' earlier. In the 1980s and early 1990s, several large companies like the Dow Chemical Company and E. I. du Pont de Nemours (DuPont) had invested heavily in sustainable technologies. But by the late 1990s, most of them had had to scale back their investments, as sustainable technologies grew at a much slower pace than had originally been predicted.[39]

It was also thought that GE's work culture was not one that adapted easily to innovation and product breakthroughs. The Six Sigma driven company culture was extremely metrics-oriented, and worked well for incremental improvements and execution of plans. But when it came to new products with relatively uncertain results, the effect might not be the same, thought analysts.[40]

GE, however, claimed that innovation was embedded in the very foundations of the company. Edison had reportedly said,—I never perfected an invention that I did not think about in terms of the service it might give to others … I find out what the world needs, then I proceed to invent.[41]

GE was apparently doing the same thing in predicting a need for environment-friendly products and proceeding to develop them through Ecomagination. Talking about the potential of Ecomagination, Lorraine Bolsinger, vice president of Ecomagination at GE said,—We're off to a good start and see even more opportunity – but we still have a long way to go.[42]

Exhibit 20.1: Hydrogen-powered vehicles

Company	Product(s)
BMW AG	750hL, BMW H2R
Mazda Motor Corporation	RX-8
DaimlerChrysler AG	F-Cell
General Motors Corp	Hy-wire
Hyundai Motor Company	Tucson FCEV
Honda Motor Company	Honda FCX

(continued)

[38] Amanda Griscom Little,—It Was Just My Ecomagination, Grist, May 10, 2005, www.grist.org

[39] The Greening of General Electric, The Economist, December 10, 2005.

[40] The Greening of General Electric, The Economist, December 10, 2005.

[41] Imaginative Energy? http://www.halo-energy.com/analysis.htm (accessed November 3, 2004).

[42] GE Ecomagination Revenues Cross $10 Billion, www.greenbiz.com, May 19, 2006 (accessed on October 31, 2006).

Exhibit 20.1: (continued)

Company	Product(s)
Ford Motor Company	Focus FCV
Nissan Motors	X-TRAIL FCV
Toyota Motor Corporation	The Highlander FCHV and FCHV-BUS
Morgan Motor Company	LIFEcar

This list is not exhaustive
Many of these vehicles were at the prototype stage as of late 2006. Source: www.wikipedia.com

Exhibit 20.2: GE annual income statement

For the years ended December 31 (In millions of US dollars [$])	2005	2004	2003
Revenues			
Sales of goods	59,837	55,005	49,963
Sales of services	32,752	29,700	22,391
Other income	1,683	1,064	602
GECS earnings from continuing operations before accounting changes			
GECS revenues from services	55,430	48,712	39,930
Total revenues	149,702	134,481	112,886
Costs and expenses			
Cost of goods sold	46,169	42,645	37,189
Cost of services sold	20,645	19,114	14,017
Interest and other financial charges	15,187	11,656	10,460
Investment contracts, insurance losses and insurance annuity benefits			
Provision for losses on financing receivables	3,841	3,888	3,752
Other costs and expenses	35,271	33,096	26,480
Minority interest in net earnings of consolidated affiliates	986	728	308
Total costs and expenses	127,573	114,710	95,275
Earnings from continuing operations before income taxes and accounting changes			
Provision for income taxes	(3,854)	(3,486)	(3,845)
Earnings from continuing operations before accounting changes			
Earnings (loss) from discontinued operations, net of taxes	(1,922)	534	2,057
Earnings before accounting changes	16,353	16,819	15,823
Cumulative effect of accounting changes	–	–	(587)
Net earnings	16,353	16,819	15,236

Source: http://www.ge.com/ar2005/cfs_e.htm (accessed on November 9, 2006)

Exhibit 20.3: GE's Six Core Business Units

1.	Commercial finance
2.	Consumer finance
3.	Healthcare
4.	Industrial
5.	Infrastructure
6.	NBC universal

Adapted from www.ge.com

Exhibit 20.4: Some ecomagination products

- GE's EVOLUTION Series locomotive is one of the cleanest diesel-electric locomotives ever built. Its 12-cylinder engine generates the same 4400 horsepower as its 16-cylinder predecessor. Compared to locomotives built 20 years ago – many of which are still in use – it produces 83% fewer particulates and 60% fewer nitrogen oxide emissions while delivering as much as 10% lower lifecycle costs to customers and higher fuel efficiency.
- GE produces some of the world's most powerful, energy-efficient, cleanest and quietest aircraft engines. GE pioneered the use of composite materials in jet engines. These blades are used in the GE90-115B aircraft engine, the world's most powerful engine. The next generation of engine – the GEnx engine – will extend this technical breakthrough to both the composite blades and fan case. With advanced compression and combustion technology, this engine will achieve dramatic gains in fuel efficiency and durability, with significantly lower emissions than any engine in its class.
- GE has developed a reusable wire coating for automotive and other uses that is halogen- free, thereby reducing dioxin production during manufacturing. GE's NORYL wire coating is up to 25% lighter than current alternatives, which could reduce vehicle weight and help improve gas mileage.
- GE is leading efforts to develop cleaner coal technologies. The world has nearly 200 years of coal reserves compared to about 40 for oil and 70 for natural gas. GE's Integrated Gasification Combined Cycle (IGCC) technology converts coal into a cleaner-burning fuel, which is then burned in a gas turbine combined cycle system to generate electricity. Compared to conventional pulverized coal plants, the process emits less than half of the sulfur dioxides, nitrogen oxides, mercury and particulate matter. If all conventional coal plants operating in the U.S. today had been built with GE's IGCC Cleaner Coal technology, the result would be an annual reduction of nearly 320 million tons of carbon dioxide.
- GE provides custom filtration and separation solutions for diverse industries, from beverages to manufacturing to pharmaceuticals. GE's advanced membrane technologies help companies reclaim 21 billion gallons of wastewater each year, conserving water and cutting pollution.
- GE's desalination technology removes salt from brackish or sea water and creates fresh water for drinking, irrigation and industrial use. GE's current installed desalination platforms reclaim more than 2 billion gallons of water a day for a variety of purposes – enough to meet the daily water required by more than 150 million people.
- The GE PROFILE dishwasher with SMARTDISPENSE technology will save detergent by releasing just the right amount throughout the wash cycle. If every dishwasher in the U.S. could be replaced with a GE dishwasher with SMARTDISPENSE technology, it would have the potential to save more than 750,000 tons of dishwashing detergent from being washed down the drain each year.

- GE offers some of the world's most energy-efficient household appliances and lighting products. GE has been named the ENERGY STAR® Partner of the Year by U.S. environmental and energy officials for its commitment to energy-efficient products. GE's compact fluorescent lighting offers energy savings of 70–75% and lasts up to ten times as long as incandescent bulbs. If every household in the U.S. replaced one 100-watt incandescent light bulb with a GE compact fluorescent bulb equivalent in light output, we would save enough energy over the bulbs' lifetime to power more than one million U.S. homes for an entire year.

Adapted from "Ecomagination Background Information," http://www.draeger-stiftung.de/HG/internet/SD/pdf/eco_backgrounder_english.pdf, May 4, 2005.

Exhibit 20.5(A): A Screenshot of One of GE's Print Ads

Source: http://www.ge.com/en/company/companyinfo/advertising/print_ads.htm.

Exhibit 20.5(B): Text Extracts from the Ecomagination Ad Campaign

Imagine if we suddenly discovered a new resource. An inexhaustible resource. A readily available resource. One that could help solve the problems of an energy-hungry world. At GE, we think we've discovered just that. It's imagination. But maybe it's more appropriate to call it Ecomagination. We're putting ideas into action by creating some very forward- looking technologies that does the job with greater fuel efficiency, lower emissions and reduce noise. At the same time, we provide services to help upgrade our customers' existing technologies for better environmental performance. Maybe, in time, we can help make the water a little clearer, the trees a little happier, the sky a little bluer, and the world a little closer to the way it was made. Just imagine it.

Can technology and the environment peacefully coexist? Ecomagination answers yes with the Evolution Series locomotive. Who would have dreamed that a 415,000 lb. diesel locomotive could have an environmental conscience? The Evolution locomotive is designed to be more fuel efficient and more powerful while it exceeds stringent EPA emissions standards, making the air cleaner and clearer for all. No small technological feat. This is the 'little' engine that could. And will.

- Are we letting one of the world's cleanest and most renewable power sources slip through our fingers? Here's where we apply a little Ecomagination. GE Energy is one of the world's leading suppliers of wind energy products. Not only is wind energy renewable and easy to harvest, but one GE wind turbine can produce enough electricity for about 400 homes each year. Well worth a few bad hair days.

Source: Pat Murphy, "Ecomagination – You Heard it Here First," www.energy-bulletin.net, May 9, 2005.

Exhibit 20.6: 2005 ecomagination leadership award winners

1.	Agrium Redwater
2.	Auburn University
3.	Canbra Foods Ltd.
4.	Cinergy Corporation
5.	Ford Motor Company
6.	INCO, Port Colborne Refinery
7.	The International Group, Inc.
8.	International Truck and Engine Corporation
9.	Karl Schmidt Unisia
10.	Shamrock Environmental Corporation

Source: "Ecomagination Leadership Awards," www.ge.com.

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Sustainability as Opportunity: Unilever's Sustainable Living Plan

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Joanne Lawrence, Andreas Rasche, and Kevina Kenny

The Challenge

The World Bank[1] projects that the developing world's annual rate of growth will average a staggering 4.7% – nearly double the 2.3% for the developed world – between 2011 and 2025, and will account for 50% of global consumption by 2050. McKinsey estimates that annual consumption in the emerging markets will top $30 trillion by 2025, up from $12 trillion in 2010. Where these markets today represent 36% of global GDP, they are likely to account for 70% between now and 2025.[2]

This case was developed with assistance from Hult EMBA student Kevina Kenny and with the generous help of Gail Klintworth, former Chief Sustainability Officer at Unilever and Karen Hamilton, Vice President of Sustainable Business, who kindly shared their unique perspectives and keen insights with us. Developed originally as part of an Executive Series intended to initiate discussions by Boards of Directors, such as those participating in the UN Global Compact LEAD/PRME Program, and senior managers on critical issues of the day, both the original (2013) and its revision (2015) are published by Hult International Business School. Used with permission.

[1]The World Bank, *Multipolarity: The New Global Economy* Global Development Horizons 2011. Retrieved from http://siteresources.worldbank.org/INTGDH/Resources/GDH_CompleteReport2011.pdf, Overview, p.3.

[2]Atsmon, Yuval, Peter Child, Richard Dobbs and Laxman Narasimhan, *Winning the $30 Trillion Decathlon: Going for Gold in Emerging Markets,* McKinsey Quarterly, August 2012. Retrieved from www.mckinsey.com/features/30_trillion_decathalon.

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© Springer Science+Business Media B.V. 2019
G. G. Lenssen, N. C. Smith (eds.), *Managing Sustainable Business*,
https://doi.org/10.1007/978-94-024-1144-7_21

Alongside this enormous potential are equally enormous social and environmental challenges, especially as more and more of the population clusters in crowded urban centers. Growing confirmation of global warming is increasing the threat of widespread drought and flooding.[3] Estimates are that 40% – more than 2 billion hectares – of the world's agricultural land are being degraded,[4] and two-thirds of the world will be living in water stressed conditions – both factors that will have supply chain implications for most companies. Children will continue to die from malnutrition and diarrhea, even as more developed countries deal with higher levels of child obesity and its health consequences.

PWC[5] meanwhile, states that the environment is a "market driver," offering opportunities for revenue growth and value creation, especially in the rapidly expanding emerging markets.

Today, less than 17% of the revenues from the top 100 multinationals (MNCs) are coming from emerging markets, even as their local, smaller competitors are growing exponentially.[6] The reasons MNCs have fallen short have been covered in multiple research studies, and often come down to three: a failure to understand at a deep level inhabitants' needs and wants, MNCs' inability to adapt and work with limited infrastructure and resources, and the lack of trust residents place in MNCs, which they feel historically have exploited them and their country's resources.

Can integrating sustainability into their business help companies to harness the potential of emerging markets? Unilever's holistic, long-term approach suggests it can.

Unilever

Since the 1880s, Unilever has built its business on applying innovation to meet the needs of the masses, such as making soap widely available or producing margarine that could provide an affordable and transportable alternative to butter. A decentralized global company headquartered in the U.K., Unilever has operated in developing countries for more than 100 years. Its purpose – "*to make sustainable living commonplace*"[7] and *"create a better future every day, with brands and services that help people feel good, look good and get more out of life"*[8] – is deeply rooted in its

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[3] Stewart, Heather and Larry Elliot, *Nicholas Stern:' I Got it Wrong on Climate Change: It is Far, Far worse',* The Guardian, January 27, 2013. Retrieved from http://www.guardian.co.uk/environment/2013/jan/27/nicholas-stern-climate-change-davos.

[4] The Global Environment Facility, 2009.Land Degradation Fact Sheet, June 2009. Retrieved from http://www.thegef.org/gef/node/2833.

[5] PwC, *Green Products: Using Sustainable Attributes to Drive Growth and Value.* Sustainable Business Solutions, December 15. 2010. Retrieved from http://www.pwc.com/us/en/corporate-sustainability-climate change/publications/green-products-paper.html.

[6] Atsmon et al.

[7] Unilever plc. Retrieved from http://www.unilever.com/sustainable-living/ourapproach/ourcompassstrategy/

[8] Unilever plc. Retrieved from http://www.unilever.com/aboutus/introductiontounilever/ourmission

founding core values of balancing profit with responsible business behavior, and underlies the company's strategy, business processes and corporate culture.

At a Glance: Unilever at 31 December 2014

Sales	€48.4 Billion	Emerging markets	57% of sales
Pre-tax profits	€7.6 Billion	**Markets**	190 countries
Market value	€93.9 Billion	**Brands**	400, 13 > €1 billion
Free cash flow	€3.1 Billion	**Employees**	172,000

Seeking a New Strategy for the Twenty-First Century

When Paul Polman was appointed CEO of Unilever in 2009, he immediately set out to transform Unilever into an enterprise that would continue to grow and prosper, but one that would also tackle the complex global issues of the twenty-first century. His first act was to conduct a strategic review of the company that looked out to 2020. This review revealed four megatrends:

- **Shifts in Markets:** Population growth is shifting to the south and east – to Asia, Africa and Latin America – areas that offer huge market potential but also have constraints, such as residents' lack of steady income and access to water.
- **Shifts in Lifestyles**: Around the world, more and more people are moving from rural to urban centers, leaving farms behind, aspiring to middle-class lifestyles, and testing already fragile infrastructures. They are also living longer. All these changes require rethinking product design and development, as well as distribution and supply chain logistics.
- **Shifts in Environment**: Conditions under which people are living are increasingly under stress. Water scarcity, poor sanitation, deforestation, and climate change all raise product development and manufacturing questions as well as supply chain security issues.
- **Shifts in Stakeholder Empowerment**: Increasing access to communication technology has empowered citizens, requiring greater corporate transparency and stakeholder engagement to minimize the risk to reputation and limit the demand for more stringent regulations.

It became obvious that the old strategic models would not work: for Unilever to continue to grow its revenues, especially in the promising emerging markets, the company needed to "*develop a business model aimed at contributing to society and the environment instead of taking from them.*"[9]

[9] Ignatius, Adi, June 2012: *Captain Planet: An Interview with Unilever CEO Paul Polman*, Harvard Business Review, June 2012. Retrieved from http://hbr.org/2012/06/captain-planet/.

The Unilever Sustainable Living Plan

Sustainability champions at Unilever, notably operation heads in India and South Africa and the chief procurement officer, had long seen that helping to build sustainable livelihoods and communities in emerging countries was a critical first step to building markets and achieving growth. In 2005, they helped to launch the "Brand Imprint" initiative, the company's first multidisciplinary attempt to engage the two billion consumers a day who use Unilever's 400+ brands in the fight against environmental waste and in support of social causes. Product managers were instructed to work across disciplines and use both life-cycle and value-chain analyses to identify and assess the social and environmental impact of the company's top 13 (€1 billion+) brands.

Polman's ambitions were even bolder. He challenged his management team: how could the company reshape its business and redefine its strategy to reach more people, secure its supply chain, deliver better products but use fewer resources, all in ways that could withstand the scrutiny of an ever-connected, more socially and environmentally aware public?

Unilever's vision to "*double the size of the business, whilst reducing our environmental footprint*" was first discussed with the Board in autumn 2009 and subsequently refined to include "*…reducing our environmental footprint and increasing our positive social impact.*"[10]. This vision is at the heart of the Compass, Unilever's business strategy for sustainable growth, which sets out the company's vision, its purpose and how it will succeed for the long term (see Appendix 1).

The Unilever Sustainable Living Plan (USLP) – the company's "ten year journey towards sustainable growth"[11] – was launched in November 2010. It is an ambitious plan that seeks three significant sustainable outcomes by 2020:

- First, *to help more than a billion people to improve their health and well-being,*
- Second, *to halve the environmental footprint of their products*,
- Last*, to source 100% of its agricultural raw materials sustainably and enhance the livelihoods of millions of people across the value chain.*[12]

The underlying principle is to grow revenues both aggressively and responsibly. Each business was asked to examine all its brands, products and operations not just from a market perspective, but from the perspective of how each created positive social impact and reduced environmental effects.

Given the company's long history of balancing profit with responsible business practices, the Board was supportive of the strategic direction proposed. However, some members of the Board and Unilever Leadership Executive struggled with what they felt was a radical ideology: integrating social and environmental criteria

[10] Unilever plc. Retrieved from http://www.unilever.com/aboutus/introductiontounilever/ourmission.

[11] Unilever Sustainable Living Plan. Retrieved from unilever.com/sustainable-living/uslp.

[12] Unilever plc. Retrieved from www.unilever.com/aboutus/introductiontounilever/.

into the business was, they believed, inconsistent with the concept of capitalism and maximizing shareholder value, and therefore not viable in the long term. The management was unclear as to why the company couldn't use proven strategies, with minor adjustments, to address these emerging trends. Since sustainability had not previously been considered in an integrated way, the leadership team needed a fair amount of re-education.

Polman's compelling argument held: that, given the megatrends and increasing numbers of locally-grown competitors, particularly in emerging markets, sustainability was about both strategic growth and risk management. He was moving his management team in the direction of creating a new, more holistic model for growth. It would require changing mindsets, committing time and a willingness to take chances. They were charting a whole new path: it was all about Unilever "Getting to the Future First."

Embedding the Unilever Sustainable Living Plan

Unilever's approach to sustainability is systematic and holistic: it spans its entire portfolio of products and countries, it encompasses its value chain from beginning to end, and considers the lives of all those it touches, from farmers to retailers to employees to consumers. It is embedded into the business in four distinct ways: (1) within brands and categories; (2) within R&D; (3) within its reward and measurement systems; and (4) through an integrated governance system (see Appendix 2).

Managers within functions and its four categories (Foods, Refreshment, Personal Care, and Home Care) work up, down and across the organization, looking at their own operations as well as those of their suppliers and distributors, all the way to the end consumer, through a "sustainability lens." The company is accelerating the integration of sustainability into its brands, enabling brand managers to develop their own Unilever Sustainable Living Plan ambitions. These ambitions are then built into Unilever's R&D, training and communication programs to drive innovation. Using proprietary tools, managers assess the potential social and environmental impact of new products at every stage of development.

In its food category, for example, Knorr has chosen sustainable sourcing as its ambition. The brand created the "Knorr Landmark Farms" to develop and promote sustainable farming practices and today has 45 of these farms globally. By 2014, 90% of its 13 most-used vegetables were being sustainably sourced.

When it comes to scarce water resources, not only do managers challenge themselves as to how much water Unilever uses in its own manufacturing processes, they also ask how they can develop products that enable the consumer who purchases Unilever's laundry soap to conserve water, particularly in water stressed areas. The company considers its own waste and recycling, but then pushes its managers to think: how can they help the consumer reduce the waste that Unilever's own products are generating?

Unilever has extended its sustainability challenge externally: through its "Partners to Win 2020" programme, the company calls those who work with them,

such as suppliers, to create and share breakthroughs in products and packaging. It stands behind and exemplifies its commitment: in 2014, Unilever announced it would be waiving its exclusive rights to a revolutionary packaging technology whose light weight promises to reduce environmental impact in order to encourage all FMCG companies to adapt it.

A portion of Unilever's budget is committed to finding radical new technologies to help achieve aggressive sustainability targets. The Unilever Foundry is an Open Innovation Platform whereby the company seeks to "*collaborate with innovators to make sustainable living commonplace*."[13]. It offers its own executives as mentors and provides funding to help commercialize some of the more promising new technologies that support sustainable living (e.g., cold water laundry products). Its "Share-Select-Scale" model invites broad participation from all sectors, including individuals, entrepreneurs, innovators, start-ups and NGOs.

The company's innovation mindset goes beyond products and packaging to creating unique partnerships that improve lives. Roughly 50% of Unilever's raw materials come from farms or forests. Smallholder farmers (many with two or less hectares) produce 70% of the world's food and make up more than 85% of the world's farms.[14] Unilever's unique collaboration with the Clinton Foundation and Acumen Fund – the Enhanced Livelihoods Investment Initiative (ELII) – helps these smallholder farmers to scale up their enterprises so they can then be linked into Unilever's global supply chain and distribution network.

To ensure that they stay on track towards their goals, measuring progress is key. The company initially established seven commitments supported by around 50 targets and KPIs to assess its progress. After conducting a comprehensive review of their progress against these goals in 2013, the company found that fundamental to removing barriers and achieving their targets would be their ability to improve livelihoods: "*healthy societies support healthy businesses*".[15] They expanded the seven commitments to nine in 2013 to bring greater focus to driving human rights, advancing opportunities for women and developing more inclusive businesses (see Appendix 3).

All of these commitments are integrated into the company's internal and external communications, training and human resource systems, making the Unilever Sustainable Living Plan core to the company's culture. Remuneration arrangements support the sustainability agenda, with accountability starting at the top: objectives relating to the Unilever Sustainable Living Plan are integrated into both the CEO and Chief Marketing Officer's annual performance review, and are periodically

[13] Unilever plc. Retrieved from https://foundry.unilever.com/.

[14] Pingali, Prabhu, Who is the Smallholder Farmer? Retrieved from http://www.worldfoodprize.org/documents/filelibrary/documents/borlaugdialogue2010_/2010transcripts/2010_Borlaug_Dialogue_Who_Is_the_Sm_70428DF38B8BD.pdf; Unilever plc. Annual Report 2014, p.26. Retrieved from http://www.unilever.com/investor-relations/annual-reports-and-accounts/annual-report-and-accounts-2014/.

[15] Unilever plc. Annual Report 2013, p. 12. Retrieved from http:www.unilever.com/investor-relations/annual-reports-and-accounts 2013.

reviewed by the Board. Further down the organization, objectives are integrated specifically into the targets of employees driving Unilever Sustainable Living Plan outcomes. For example, in the procurement function, the team leading the sustainable sourcing of agricultural raw materials has clear targets to ensure such deliverables as security of supply, reduced costs and the protection of scarce resources.

Finally, the company actively and systematically involves external stakeholders to ensure they are aligned with its strategy. It hosted the Sustainable Living Lab, a process that engaged more than 2,000 stakeholders from 70 countries in a 24-h live dialogue to evaluate the Plan's successes, failures, and ways to move forward. Managers make a point of collaborating closely with NGOs and governments in emerging markets, embedding themselves and doing the "deep dives" recommended to really understand local markets and secure resources, building trust and reputation along the way. They tap into their employee and consumer base, encouraging "Small Actions, Big Difference" to help redefine how business gets done.

For example, in 2014, employees across Unilever's factory network – more than 240 factories in 67 countries – reduced the amount of non-hazardous waste delivered to landfills to zero – thought to be a first for a company of Unilever's size.[16] These creative "zeromakers" have found ways to recycle tea bags into wallpaper, mayonnaise into biofuels and plastic laminate into school desks.

Employees Help Lead the Way

> The old Chinese proverb, "Tell me and I'll forget; show me and I may remember; involve me and I'll understand" lies at the heart of how Unilever is aligning its employees with the Unilever Sustainable Living Plan.

Rather than simply talking about the need to integrate sustainability into its brands, Unilever actively engages its employees to give them hands-on experience with what that integration looks like, and even more important, feels like. The result: the more employees understand, the deeper their insights and greater their opportunity to contribute and innovate.

"This seems to be particularly relevant given the company's experience with the generation now joining its ranks," according to Karen Hamilton, Vice President of Sustainable Business. "Shaped by major events of the last decade, such as 9/11, Occupy Wall Street and the economic downturn, these younger employees are more open to thinking about business in a new way, and want to be involved. Unilever is tapping into their positive attitudes, energy and ideas through engaging them directly."[17]

[16] Unilever plc. www.unilever.com/Images/uslp-Unilever-Sustainable-Living-Plan-Scaling-for-Impact-Summary-of-progress-2014_tcm244-424809.pdf, p.11.

[17] Interview with Karen Hamilton, Vice President, Sustainable Business, Unilever plc, August 7, 2015.

This engagement takes the form of volunteerism, idea generation, and sharing best practices.

For example, in India, employees volunteer to work on the company's "Help a Child Reach Five campaign", going into rural villages to teach children how to wash their hands and their parents on why washing matters. (See shaded box, Unilever Sustainable Living Plan in Action: Lifebuoy Soap).

Self-confidence and self-esteem – critical to realizing one's potential – has long been linked to body image, particularly for girls. The Dove Self-Esteem Project, founded in 2004, strives to help young people build body confidence through sharing their message that beauty comes from the inside out. Employees participate in delivering self-esteem education to young people (primarily girls) aged 8–17 years through lessons in schools. In 2014, employees reached more than 20,000 young people in 152 schools across 36 countries – up 67% from the year before. More than 2700 staff attended Dove Day events, nearly double the number who took part in 2013. Ninety percent of employees say they feel proud to work for Unilever. Dove's goal: to reach 15 million young people by the end of 2015, enabling them to reach their full potential.

Small Actions Make a Big Difference

"Many employees have sustainable business ideas," explains John Maguire, Unilever's Group Manufacturing Sustainability Director. "Factory teams can apply for investment for their ideas via our "Small Actions, Big Difference" fund. Ideas are evaluated on the basis of environmental benefit and financial return. This ensures that only the best projects are selected.

"In 2014, we invested €13 million in 173 energy and emissions reduction projects. These will reduce global CO2 emissions by 4% and global energy use by 2%, achieving an average payback of less than two years."[18]

Examples of projects where Small Actions collectively have delivered a Big Difference are improvements to compressed air systems, installing energy-efficient lighting, process optimisation and increased production efficiencies, high efficiency electrical motors, and reuse of by-products of manufacturing processes.

Sharing "Proud Practice" Projects Globally

Finally, the company leverages its employees' best ideas. Unilever's "Smarter Greener Living" campaign, started in 2013, was aimed at involving as many factory workers as possible in improving the company's eco-efficiency footprint.

[18] John Maguire, Group Manufacturing Sustainability Director, Unilever, plc. Reducing Emissions in Our Own Operations, Retrieved September 16, 2015, https://www.unilever.com/sustainable-living/the-sustainable-living-plan/reducing-environmental-impact/greenhouse-gases/Reducing-emissions-in-our-own-operations.

The company harnesses the enthusiasm it created by sharing these Proud Practice projects – of which there are now more than 170 –and replicating them elsewhere, ensuring faster and more efficient delivery of environmental benefits. Employees – seeing that their best ideas are supported by the company and many are rolled out globally – are strongly motivated to keep generating new ideas.

In each case, Unilever's focus on giving employees a direct, hands-on experience with its sustainability principles results in even greater participation and enthusiasm for the Unilever Sustainability Living Plan, making employees an integral part of its virtuous circle of growth (see Appendix 1).

In the case of the two billion consumers Unilever reaches every day, classic marketing tools are often proving insufficient. Instead, it is often a matter of building awareness about the particular issue, placing it in context, and showing how slight changes in their day-to-day behavior can have a cumulative impact. In Dubai, where awareness of the need to conserve water is very low, Unilever ran a "Water Savers" campaign, partnering with the Dubai Water and Electricity Authority to reinforce its message. It then showed consumers how its products, such as Sunlight dishwashing soap, required 20% less water to get dishes clean.[19] Product sales went up, while water consumption went down. Water Savers has delivered sales of more than 20% above market growth for Unilever's brands. More importantly, attitudes have shifted: more than half the shoppers who engaged in the campaign have taken actions to save water.

Unilever's commitment is from top to bottom, inside-out and outside-in, as evidenced by its governance structure: there are two Board level committees whose sole responsibility is the Unilever Sustainable Living Plan – including one that consists of external experts who are expected to comment and critique on Unilever's approach, as well as advise on emerging trends and potential risks regarding sustainability issues (see Appendix 2).

In a further move to signal the company's long-term commitment to the Unilever Sustainable Living Plan, the company no longer issues quarterly guidance, underscoring management's belief that realizing returns from investing in sustainability takes time. When the new policy was announced, initial investor reaction was swift: share prices dropped 8% as shareholders feared the worst. But for Polman, it was a signal to the financial markets that Unilever was committed to the future: that decisions would be made to ensure the long term viability of the company, and not focused on quarterly numbers. As he later explained, "We spent a lot of time thinking about what is happening in this world and the role of companies, and to basically communicate out there that we have obligations towards multiple stakeholders …I don't have any space for many of these people that really, in the short-term, try to speculate and make a lot of money. I'm not just working for them…"[20]

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[19] Unilever plc. www.unilever.com/Images/uslp-Unilever-Sustainable-Living-Plan-Scaling-for-Impact-Summary-of-progress-2014_tcm244-424809.pdf, p.10.

[20] Boynton, Andy and Margareta Barchan, Unilever's Paul Polman: CEOs Can't Be 'Slaves' to Shareholders, Forbes, July 20, 2015. Retrieved from http://www.forbes.com/sites/andyboynton/2015/07/20/unilevers-paul-polman-ceos-cant-be-slaves-to-shareholders.

For Unilever the business case for integrating sustainability into the company's brands is clear and persuasive:

Sustainability is contributing to our virtuous circle of growth. The more our products meet social needs and help people live sustainably, the more popular our brands become and the more we grow. And the more efficient we are at managing resources such as energy and raw materials, the more we lower our costs and reduce the risks to our business and the more we are able to invest in sustainable innovation and brands. – Paul Polman, CEO[21]

Unilever's actions are consistent with the ESG (Economic, Social and Governance) Value Driver framework, whereby sustainability actions are linked to new growth opportunities, risk management and return on capital as a basis for communicating with investors (see Appendix 4). Their "sustainable living brands" are contributing to Unilever's purpose to make sustainable living commonplace, and in ways that are defined and measurable, whether that involves improving health, wellbeing or nutrition, reducing environmental impacts or using sustainably sourced ingredients. They are also contributing to the company's performance: in 2014, around 50% of Unilever's growth came from these sustainable living brands: they grew at twice the rate of the rest of the business.

Unilever Sustainable Living Plan in Action: LIFEBUOY SOAP

Echoing Unilever's founding vision – "to make cleanliness commonplace"[22] – the vision of Unilever's iconic Lifebuoy antibacterial soap is to create "more hygienic, healthier and ultimately more vital communities."

In addition to revenue targets, the goals for Lifebuoy include the triple bottom line:

- Social: Reduce respiratory infections and diarrhea, the two biggest causes of child mortality.
- Environmental: Reduce the amount of water needed to use the soap.
- Economic: Enhance the livelihoods of those in the value chain.

In locations where soap usage is infrequent and diarrhea disease strikes most frequently, Lifebuoy launched its Handwashing Behavior Change programme to promote the benefits of washing with soap. In India, where more than 1000 children die each day, Lifebuoy's "Help a Child Reach Five" campaign focuses on how simply washing hands with soap at key occasions can help a child reach the critical age of 5 years old. Since 2010, the handwashing campaign has reached 119 million people, resulting in lower incidences of diarrhea. A 2008 clinical study in Mumbai

[21] Unilever, plc. Retrieved from http.www.unilever.com/mediacentre/pressreleases/2013/UnileverSustainableLivingPlanhelpingtodrivegrowth.aspx.

[22] Unilever plc. Retrieved from http://www.unilever.com/aboutus/ourhistory.

showed that children had a 25% lower incidence of diarrhea compared to the control group, 15% fewer acute respiratory infections, 46% fewer eye infections and a 27% reduction in school absences. The programme also drove a 31% reduction in incidence of diarrhea for all subjects, showing that the campaign delivers benefits for the whole family.[23]

To further promote handwashing among children, Unilever developed the innovative Lifebuoy colour change handwash. Promoted by the cartoon character the Incredible Hulk, the lather changes from white to green when hands have been washed long enough for Lifebuoy's special formulation to deliver 99.9% germ protection. Market test results show that children (and their parents!) can't get enough of the new product.

To address the environmental issue of stressed water supplies, Unilever's R&D team developed Lifebuoy Instant Foam Handwash, an anti-bacterial soap that uses more than one-third less water than a typical bar of soap, helping the consumer to reduce water consumption. Delivered as a foam, it allows users to skip the step of wetting hands before lathering, saving water while delivering a highly effective handwash because the foam spreads quickly.

Its most recent breakthrough is Lifebuoy with Activ Naturol Shield, a re-formulation that provides ten times superior protection against all types of germs including those that cause cholera, typhoid, and stomach infections as well as combats skin and eye infections.

Finally, in further efforts to build sustainable livelihoods and communities, Lifebuoy is sold through Unilever's unique distribution network, Shakti. Shakti has recruited, trained and employed 70,000 rural women in India to become entrepreneurs, enabling them to reach millions of households in more than 100,000 of India's most remote villages. As the women become empowered and increase their income, they also help raise education levels and improve the health standards in their communities.

The brand's ambitious goal: to reach one billion consumers globally with its hygiene education programmes by 2020.

Through successfully addressing the social and environmental needs of the developing world, Lifebuoy has delivered against its financial goals as well. Globally, Lifebuoy experienced double-digit sales growth from 2010 to 2014 and is well on track to becoming one of Unilever's next billion-euro brands. It has led to product innovations that are applicable across regions, such as the foam technology, and resulted in unique and effective outreach partnerships, co-investments, and collaborations with local governments and NGOs. Its handwashing campaign has raised awareness, built trust and improved Unilever's reputation in the region. Taken together, the Lifebuoy campaign exemplifies many of the success factors cited by *The Fortune at the Bottom of the Pyramid* author C.K.Prahalad and others as critical

[23] Unilever plc. *Randomised Clinical Trial, 2000 Families,* Mumbai 2007–2008. Retrieved from http:www.unilever.com/sustainable-living/healthandhygiene/handwashing/handwashingbehaviourchange/index.aspx.

to realizing the potential of emerging markets. Today, it is the world's number one anti-bacterial soap brand.

The Lifebuoy soap experience embodies the Unilever Sustainable Living Plan and the company's commitment to grow revenues responsibly – in a way that helps improve people's health and well-being, reduces environmental impact, enhances lives and creates consistent growth.

Unilever's Sustainable Living Plan: Too Risky, Too Ambitious?

Is Unilever's growth through sustainability on track?

In 2014, more than 57% of Unilever's revenues were generated from developing markets in Asia, Africa, Central and Eastern Europe and Latin America. Its underlying growth in emerging markets rose 5.9% over 2013, and has averaged 9% for the past 5 years.[24] With the Unilever Sustainable Living Plan as its platform, the company anticipates that emerging markets will contribute around 70% of sales[25] and the company is on its way towards achieving its goal of doubling the size of its business.

Despite a challenging economic environment and unstable political conditions in some of its markets, the company managed to increase underlying sales, with several of its major sustainability-driven brands like Lifebuoy and Dove increasing by high single or double digits, and improved its core operating margin. Its dividends grew 7% in 2014, resulting in a total return to shareholders (dividends plus share price) of 18%, up 79% in the last 5 years[26] (see Appendices 4 and 5).

> *The USLP is embedded into our business model. It helps to drive long-term shareholder value by: driving growth through innovations that bring new sustainability benefits to consumers and retailers; reducing waste and energy and thereby saving cost; and managing risk in our supply chain, for example by securing long-term sustainable sourcing of materials.*[27]

The Unilever Sustainable Living Plan has the ability to provide the company with a strategic advantage and to set it apart from its competitors. It has the potential to not just transform Unilever, but to help change processes in the very societies in which the company operates, creating inclusive economies and true shared value.

Consistent with this view, Polman has grown even more ambitious since launching the Unilever Sustainable Living Plan, viewing sustainability-driven business as

[24] Unilever plc. Annual Report 2014, p. 28. Retrieved from http://www.unilever.com/investor-relations/annual-reports-and-accounts/annual-report-and-accounts-2014.

[25] *Fighting for the Next Billion Shoppers*. The Economist, June 30 2012. Retrieved from http://economist.com/nodel/21557815.

[26] Unilever plc. Annual Report 2014, p.28. Retrieved from http://www.unilever.com/investor-relations/annual-reports-and-accounts/annual-report-and-accounts-2014/.

[27] Unilever plc. Annual Report 2014, p.28. Retrieved from http://www.unilever.com/investor-relations/annual-reports-and-accounts/annual-report-and-accounts-2014.

key to *transformational* change: change whereby societies and, ultimately, business prosper as a result of reduced environmental risks and greater human development. He advocates that business take more of a "systems" approach to their operations, seeing companies as part of an interconnected web linking multiple players – including governments – that have the potential to improve living standards for billions of people, creating a new middle class and a more inclusive economy. In 2014, he made the mandate for Unilever even bigger, seeking to use the company's scale to leverage its resources and expertise in three core areas: eliminating deforestation, helping smallholder farmers, and making access to water, hygiene and sanitation universal.

For example, as one of the world's largest users of forests and farms, Unilever is partnering with governments, including Norway, the Netherlands, the U.K., U.S. and multiple NGOs as part of the Tropical Forest Alliance (TFA) to help eliminate deforestation from the supply chains of all consumer goods companies.

As one of the world's foremost experts in changing consumer behavior, Unilever is building on its core competency – marketing – to promote changes in hygiene and sanitation among the world's poorest populations. It employs what it calls its "Five Levers for Change" which seeks to make the change to sustainability-driven behavior understood, easy, desirable, rewarding and in the end, a habit.[28] In one instance, its holistic approach involves its household cleaning product brand, Domestos. The Domestos Toilet Academy is improving sanitation practices at the individual level while at the same time it is training entrepreneurs to form businesses that will supply, install and maintain hygienic toilets, helping the communities to prosper. Domestos has set the target of helping 25 million people gain improved access to a toilet by 2020.

Aside from the moral mandate, Polman sees this new way of operating and leveraging the company's scale as critical to Unilever's future: by eliminating deforestation, helping smallholder farmers, and improving access to water, hygiene and sanitation, the company is also mitigating its own risk by ensuring adequate resources and quality supply chains, and driving its growth through brands which offer health and hygiene benefits. He advocates working with governments and other partners to institute polices that will result in lasting change.

> *We are at a turning point in history, a point where we all need to change for human life on the planet to continue to prosper. A new business model with sustainability at its heart is vital for quality of life around the globe to improve. Only the businesses that grasp this will survive. Only those who grow sustainably will thrive…. Paul Polman, CEO*[29]

Underscoring its commitment to this new role for business, Unilever became the first company to sign onto the UN's Guiding Principles on Human Rights, and to issue a stand-alone report on the topic. Given its 76,000 suppliers, 172,000

[28] Unilever's Five Levers of Change. Retrieved from https://www.youtube.com/watch?jEaGM8kDac4.

[29] Unilever plc. www.unilever.com/Images/up-Unilever-Sustainable-Living-Plan-Scaling-for-Impact-Summary-of-progress-2014_tcm244-424809.pdf, p.5.

employees and the millions more who are engaged in its supply chain across 190 countries every day, the company sees human rights as key to building the relationships needed for creating healthy and viable businesses.

The objectives are bold, the plan ambitious, and the naysayers plentiful. Few, if any, companies have ever made such a public commitment, making Unilever extremely vulnerable to criticism. But is it too bold, too ambitious? Is Unilever overstepping its bounds as a business, or simply seeking to grow its markets by creating more inclusive societies through its environmental and human development efforts? Is it taking on more risk by investing so heavily in emerging markets, or realizing the opportunity these markets represent through its new, sustainability-driven model?

Appendices

Appendix 1: Unilever's Business Model: A Virtuous Circle of Growth

Our virtuous circle of growth describes how we generate profit from our sustainable growth business model.

Making sustainable living commonplace for our consumers is helping to drive profitable growth. By focusing on sustainable living needs, we can build brands with a significant purpose. By reducing waste and material use, we create efficiencies and cut costs. This helps to improve our margins. By looking at product development, sourcing and manufacturing through a sustainability lens, opportunities for innovation open up. And we have found that by collaborating with partners including not-for-profit organisations, we gain valuable new market insights and extend channels to engage with consumers.

Source: http://www.unilever.com/Images/uslp-Unilever-Sustainable-Living-Plan-Scaling-for-Impact-Summary-of-progress-2014_tcm244-424809.pdf (p. 14).

Appendix 2: Unilever's Governance of Sustainability and Corporate Responsibility

Committee	Description
Unilever Leadership Executive	The Executive, led by the CEO, has responsibility for operational leadership of the business. The Executive has also overall responsibility for sustainability and corporate responsibility.
Corporate Responsibility Committee	Board committee consisting of Non-Executive Directors. This committee ensures compliance with the Code of Business Principles and oversees progress and potential risk regarding the Unilever Sustainable Living Plan. One of its priorities is to ensure that the Unilever Sustainable Living Plan is maintained through appropriate business strategies. The committee feeds back to the Board.

(continued)

Committee	Description
Unilever Sustainable Living Plan Steering Team	Chaired by the Chief Marketing Officer (CMO), contains senior leaders from a variety of corporate functions supporting the Unilever Leadership Executive. The team meets five times a year and is accountable for driving sustainable growth, and keeping the Board informed of emerging trends and potential risks associated with sustainability issues.
Unilever Sustainable Living Plan Council	Group of six independent external experts who advise and comment on progress regarding the Unilever Sustainable Living Plan and strategy.
Audit Committee	Board committee overseeing independent assurance with regard to the Unilever Sustainable Living Plan.
Global Code and Policy Committee	Chaired by the Chief Legal Officer, this committee oversees the implementation of Unilever's Code of Business Principles.
Specialized Group: Sustainable Agriculture Steering Group	This group promotes sustainable supply chains and takes advice from Unilever's Sustainable Sourcing Board of external experts.
Specialized Group: Safety and Environmental Assurance Centre (SEAC)	SEAC provides independent scientific evidence to help Unilever manage risk and environmental impact, including the development of relevant metrics and baseline measures (e.g., for environmental assessments).

Source: Unilever Annual Report, 2014, p. 66

Appendix 3: The Unilever Sustainable Living Plan: From Seven (2010) to Nine Commitments (2013)

Commitment	Goal	Progress (2010–2014)
1. Health and hygiene	By 2020 we will help more than a billion people to improve their hygiene habits and we will bring safe drinking water to 500 million people. This will help reduce the incidence of life-threatening diseases like diarrhea.	397 million people reached through handwashing, sanitation, safe drinking water, oral health and self-esteem programmes (e.g., Lifebuoy handwashing campaign helped to reduce diarrhea and respiratory diseases, reaching 257 million people in 16 countries).
2. Nutrition	By 2020 we will double the proportion of our portfolio that meets the highest nutritional standards, based on globally recognized dietary guidelines. This will help hundreds of millions of people to achieve a healthier diet.	33% of portfolio by volume met the criteria for highest nutritional standards. (e.g., salt, saturated fat).
3. Greenhouse gases	Halve the greenhouse gas impact of our products across the lifecycle by 2020.	Greenhouse gas impact per consumer use increased by around 4% since 2010.
4. Water	Halve the water associated with the consumer use of our products by 2020.	Water impact per consumer use reduced by 2% since 2010 (e.g., laundry, washing).

(continued)

Commitment	Goal	Progress (2010–2014)
5. Waste	Halve the waste associated with the disposal of our products by 2020.	Waste impact per consumer use reduced by around 12% since 2010.
6. Sustainable sourcing	By 2020 we will source 100% of our agricultural raw materials sustainably.	55% of agricultural raw materials sourced sustainably by end 2014 (e.g., 100% of palm oil; 87% of Lipton yellow tag tea sourced from Rainforest Alliance certified growers).
7. Fairness in the workplace	By 2020 we will advance human rights across our operations and extended supply chain.	85% of 200 key suppliers meet company's mandatory responsible sourcing criteria.
8. Opportunities for women	By 2020 we will empower 5 million women.	Empowered 238,000 women, including training 70,000 Shakti micro-entrepreneurs in rural India to sell Unilever products.
9. Inclusive business	By 2020 we will have a positive impact on 5.5 million people.	Working in partnership, 800,000 smallholder farmers gain access to training and support.

Source: http://www.unilever.com/Images/uslp-Unilever-Sustainable-Living-Plan-Scaling-for-Impact-Summary-of-progress-2014_tcm244-424809.pdf p.20–21; https://www.unilever.com/Images/ir_Unilever_AR14_tcm244-421557.pdf, p.11

Note: In 2013, Unilever's management increased the original seven Commitments of the Unilever Sustainable Living Plan to nine. The orginal seventh Commitment – Enhancing livelioods – was expanded to encompass more human rights issues, such as ensuring fair compensation, healthy and safe working conditions, and employee development, to more specificaly target women by upholding diverity and offering them opportunties, and to focus on bringing more people into the economy by helping to train and support smallholder farmers in particular.

Appendix 4: Unilever Sustainable Living Plan and the ESG Value Driver Framework

The ESG (Economic, Social and Governance) Value Driver Framework was developed by the Principles of Responsible Investment Management and the UN Global Compact to help companies communicate how sustainability- related actions link with business benefits. Following are examples from Unilever's Sustainable Living Plan Reports for 2012–2014.

Growth	New markets and geographies	Gain access to new markets and geographies through exposure from ESG programmes	In 2012, efforts to save greenhouse gases by reducing hot water usage led to the successful rollout of dry shampoos in ten countries; use of "green"' refrigeration won over major new retail customers in Denmark to carry Unilever products.
	New customers and market share	Use ESG programmes to engage customers and build knowledge of expectations and behavior	Oral health campaign reached 50 million people between 2008 and 2012 and has led to increased toothpaste sales: e.g., Signal toothpaste up more than 22% since 2008, and helped to introduce the toothpaste into new markets, such as Cote d'Ivoire.
			Dove soap's "Free Being Me"' campaign to build girls' self-esteem grew from 20 countries to more than 70 in 2014, increasing brand loyalty and revenues.
			In emerging markets, brands integrating sustainability such as Dove, Lifebuoy and Domestos grew faster than average.
	Product and services innovation	Develop cutting edge technology and innovative products and services for unmet social or environmental needs	R+D efforts to reduce consumers' water usage in water-stressed areas led to Lifebuoy Foam Handwash and Comfort One Rinse for laundry; to reduce waste and emissions, new packaging materials developed (bi-modal resins) that lighten weight and save shipping costs; waived exclusive rights to package-saving technology for Dove bottle that uses 15% less plastic to encourage other companies to use the technology; re-engineered aerosol spray system so that new compressed deodorant cans use half the propellant gas and 25% less aluminum than traditional cans, reducing carbon footprint by 25%.
	Long-term strategy	Develop long-term strategy encompassing all ESG issues and shape material ESG communication based on value-driver framework	Unilever Sustainable Living Plan encompasses ESG elements and is integrated into strategy, operations and governance; human rights recently integrated more explicitly; company has a zero tolerance policy on forced labour, and trains employees on human trafficking prevention. Progress against financial and non-financial targets are included in annual report.

(continued)

Return on capital	Operational efficiency	Enable bottom line cost savings through environmental operations and practices (e.g., energy, water, waste efficiency, less raw materials used)	Eco-efficiency programme addressing water, waste, energy and materials has avoided costs of €400 million since 2008; coordinating transport, managing logistics and using lower emissions vehicles has resulted in additional savings. By January 2015, greater focus on eco-production led to all 240 factories achieving zero non-hazardous waste to landfill.
	Human capital management	Attract and retain better and highly motivated employees by positioning company and management as ESG leaders	Ensures that "employer brand" has sustainability at its core: voted No.1 FMCG employer of choice among graduates from 32 countries.
			Facebook global careers page has attracted 100,000+ likes. Third most in-demand employer on LinkedIn's global in Demand index, only behind Apple and Google. Two million job applications received in 2014.
			Engages employees regularly: 2014 Global People Survey had 75% engagement score – in line with high-performing employers in class.
	Reputational pricing power	Develop brand loyalty and reputation through ESG efforts that garners customers' willingness to pay price increases or premium	In consumer marketing, the effect of multiple touch points helps to create pricing power. Unilever seeks ways in which its holistic activities–, of which sustainability is a key part – are affecting consumers' loyalty. E.g., Kissan ketchup focused Indian consumers on its 100% real ingredients, propelling the brand to market leadership; Knorr s first ever 'on pack' sustainability logo improved its brand equity in Germany.

(continued)

Risk management	Operational and regulatory risk	Mitigate risk by complying with regulatory requirements and industry standards by addressing ESG issues in policies, systems and standards and engaging with employees	Unilever helped found industry wide initiatives such as the Roundtable on Sustainable Palm Oil and Marine Stewardship Council to set standards for these critical resources. It ranked first of 152 companies in combating deforestation by the Carbon Disclosure Project (CDP), securing its supply chain.
	Reputational risk	Facilitate uninterrupted operations and entry into new markets using local ESG efforts and community dialogue to engage citizens and reduce local resistance; avoid negative media publicity and NGO boycotts by addressing ESG issues	Unilever engages with local constituents regularly, building trust and reputation (e.g., partnering with governments and NGOs in its "Help a Child Reach Five" handwashing campaign; with UNICEF and water and deforestation initiatives.) Sector leader in the Dow Jones Sustainability Index (DJSI); ranked No. 1 by Globescan/SustainAbility as sustainability leader for the fifth year.
	Supply chain risk	Secure consistent and long-term access to high-quality raw materials and products by engaging in supply chain community welfare and development	Working with smallholder farmers and local distributors to develop sustainable agricultural practices; ensuring traceability of raw materials (e.g., palm oil, soy, tea and cocoa) helps to secure supplies; its Responsible Sourcing Policy requires suppliers to comply with such principles as fair compensation, voluntary employment, and health and safety standards, and, in some cases, to submit to third party audits.
	Leadership and adaptability	Develop leadership skills and culture to adapt to fast changing political, social and environmental situations	The Sustainable Living Plan is incorporated into management training and compensations programmes; the company offers flexible working hours, job sharing, maternity and paternity leave (women up to 43% workforce in 2014) to attract and retain women.

Source: Unilever Sustainable Living Plan Report 2012; Annual Report, Sustainable Living Report, 2014

Appendix 5: Consolidated Income Statement and Key Indicators Since USLP Launch

Statement of comprehensive income	2010	2011	2012	2013	2014
Turnover (€ million)	44,262	46,467	51,324	49,797	48,436
Operating profit (€ million)	6325	6420	6977	7517	7980
Core operating profit (€ million)	6017	6276	7050	7016	7020
Profit before tax (€ million)	5951	6066	6533	7114	7646
Net profit (€ million)	4465	4491	4836	5263	5515
Diluted earnings per share (€)	1.42	1.42	1.50	1.66	1.79
Core earnings per share* (€)	1.31	1.37	1.53	1.58	1.61

Key financial performance indicators					
	2010	2011	2012	2013	2014
Underlying sales growth (%)	4.1	6.5	6.9	4.3	2.9
Underlying volume growth (%)	5.8	1.6	3.4	2.5	1.0
Core operating margin (%)	13.6	13.5	13.7	14.1	14.5
Free cash flow (€ million)	3365	3075	4333	3856	3100

Non-financial indicators	2010	2011	2012	2012 (1)	2013 (1) (2)	2014 (1) (2)
CO2 from energy (kg/tonne of production)	133.59	118.31	99.97	104.23	98.85	92.02
Water usage (m3/tonne of production)	2.68	2.4	2.23	2.27	2.12	2.01
Total waste sent for disposal (kg/tonne of production)	6.48	4.96	3.85	3.94	2.27	1.19
Total recordable accident frequency rate (TRFR) per 1,000,000 h	1.63	1.27	1.16	1.17	1.03	1.05
(1) In 2013 we adjusted our reporting period from 1 January – 31 December to 1 October – 30 September. We also show the prior 12 months to enable a like-for-like comparison, presented as 12(1). (2) PricewaterhouseCoopers (PwC) assured						
For details and the basis of preparation see: www.unilever.com/ara2014/downloads						

Source: http://www.unilever.com/Images/charts_2005-2015_ar14_tcm244-416973_en.pdf

Appendix 6: Share Price Versus Market Index

	05	06	07	08	09	10	11	12	13	14
NV SHARE PRICE IN NEW YORK US $										
(at 31 December)	22.88	27.25	36.46	24.55	32.33	31.40	34.37	38.30	40.23	39.04
High	24.02	27.32	37.31	37.18	32.80	33.10	35.06	38.75	42.78	44.31
Low	20.89	20.72	24.94	21.27	17.04	26.02	29.07	30.79	37.27	36.72
PLC SHARE PRICE IN LONDON €										
(at 31 December)	12.81	14.28	18.90	15.79	19.94	19.63	21.63	23.66	24.82	26.28
High	13.39	14.28	19.24	19.47	20.15	20.09	21.73	24.29	28.85	27.29
Low	10.83	11.25	13.20	12.49	12.30	16.62	17.93	19.94	23.19	23.06
SHARE PRICE VERSUS MARKET INDEX *(31 December 2005 = 100)*										
NV share price in New York	100	119	159	107	141	137	150	167	176	171
Market index (S&P 500)	100	114	118	72	89	101	101	114	148	165
SHARE PRICE VERSUS MARKET INDEX *(31 December 2005 = 100)*										
PLC share price in London	100	111	148	123	156	153	169	185	194	205
Market index (FTSE 100)	100	111	115	79	96	105	99	105	120	117

Source: http://www.unilever.com/Images/charts_2005-2015_ar14_tcm244-416973_en.pdf, p.14

Part V

Introduction: Business Model Innovation and Transformation

Gilbert G. Lenssen

Sustainable development with significantly reduced environmental and social impacts is a challenge for business of serious magnitude (e.g. carbon neutral operations), often requiring significant transformations in business models and industry structures. It is likely to have deep effects comparable to the effects of the consumer revolution of the eighties and the IT revolution which started in the nineties. In addition to innovations in products, services and processes, business can create competitive advantage or avoid erosion of current market positions by exploring new business models developed to address sustainability issues. In fact, with sustainability in mind, innovation often results in new business models, as we see in Part IV with Illy and GE Ecomagination.

IBM realised that its PC business would over time not be able to compete with Chinese market entrants and so it sold the business to a Chinese newcomer (Lenovo) at a time when the market value was still relatively high. IBM moved up the value chain into a Total Customer Solution value proposition which included its Smarter Planet initiative—and a business operating model behind this which is significantly different. The IBM case thus illustrates sustainability transformation with an innovative business model.

BP Solarex was a market leader in the solar industry in 2000. It scaled back its business model to a pure Operational Excellence proposition (manufacturing and distributing solar panels), inspired by the fashion of focusing on "core competences"—arguably, a fashion already on its way out. Experiments with Total Customer Solutions, the approach adopted by IBM, were halted and abolished. Ten years later, BP was forced to close most manufacturing facilities at high cost in the face of stiff cost competition from China. In 2000, BP could have sold these facilities at market value and moved up the value chain. In 2010, it was too late.

As the significant changes in these two examples illustrate, business model innovation is clearly NOT about minor changes to the business model to capture easy gains in costs and efficiency, nor about a compliance driven adaptation to gradually minimise negative impacts.

Key Questions to Ask (Applicable to All Part V Cases)

How are synergies identified between sustainability and innovation success?

How can products, processes and systemic innovative solutions leverage sustainability issues and turn them into opportunities for companies?

How is sustainability-driven innovation leading to a new business model?

How is the transformation process rolling out?

What are the industry sector relevant competitive market positions aimed for? What needs are being addressed in the marketplace?

How is value created for each stakeholder?

What are the existing relevant resources to support these new positions?

Which new resources are required (knowledge, capabilities, relationships) and how are these resources acquired and integrated?

Chapter 22: Model Behaviour: 20 Business Models for Sustainability by Lindsay Clinton and Ryan Whisnant

The idea of business model innovation has long captivated business leaders. And yet, executives are often held back by vested interests in their current approach. But as global trends—environmental, social, political, technological—continue to shift the foundations of current business models, incremental innovation will become less effective in enabling companies, industries and whole economies to adapt and succeed. There is a pressing need for fundamentally different approaches to value creation.

The utility industry, for example, is currently confronting a mounting crisis within its existing business model. Changing regulations, rising fossil fuel prices, falling prices of renewables, and the arrival of improved energy storage solutions and other decentralized energy options will completely alter the playing field for large coal and nuclear-powered utilities. These large-scale, centralized systems have been disrupted by the rise of smaller, decentralized energy systems, especially those focused on delivering solar and other forms of alternative energy. While they once captured just a tiny, elite niche of the energy marketplace, companies in this space are now growing rapidly and helping speed the decline of the traditional, vertically integrated utility model. While many utilities are struggling to handle this disruption, some are acting quickly to adapt. RWE, a German utility with over 24 million customers across Europe, plans to shift its traditional utility model and instead use its expertise to help manage and integrate renewables into the grid, switching from being a power seller to a renewable energy enabler, what we would call a product as a service model. RWE is transforming from a "volume to value" business.

The proliferation of such innovation gets to the core of why the authors from Sustainability have written this contribution, trying to better understand which new business models are emerging, where innovation is happening, and how both new and established companies are experimenting to embed sustainability into the underlying structure of their businesses.

This is based on research and review of 87 company examples, and 20 distinct business models are indentified falling into five categories: environmental impact, social innovation, base of the pyramid, financial innovation, and diverse impact.

Chapter 23: From Incrementalism to Transformation: Reflections on Corporate Sustainability by Peter Lacy, Rob Hayward & Pranshu Gupta
This chapter provides an overview of how the sustainable business agenda has evolved over the last 10–15 years and asks whether it is now somehow stuck. This sentiment was echoed in the latest of Accenture's surveys of global CEO's carried out for the UN Global Compact in 2013. Business leaders think that, when it comes to sustainability, most of the "low hanging fruit" has been harvested in terms of efficiency and shared value and thus business model transformations are required to address major challenges like climate change, which are inhibited by only slowly emerging systems transformations necessary to facilitate sustainability transitions. System changes, going beyond system optimisation and partial system redesign—essential in areas like energy, transport, agro-food, and housing—require more than product and process innovation and are complicated by the involvement of a wide range of actors. According to global CEOs, the sustainability transitions are starting (too) slowly and at different speeds and trajectories for different sectors and different countries.[1] In the end, the feeling of CEOs is that this may end up being too little too late if vested interests prevail, sunk investments are defended to the end, and policy makers keep a short term (election-driven) horizon. CEOs concede that market forces may not suffice in driving change and that governments need to step in to correct both market failures and policy failures. The chapter argues that business leaders can do more, albeit it in a more interconnected, less firm-centric way.

Chapter 24: Umicore: A Case of Radical Reinvention by Nigel Roome and Victoria Jadot
Umicore, a Belgian multinational widely recognised as a leader in sustainable business in precious metals and materials as well as technology solutions for sustainable development, rose as a phoenix out of the ashes of its predecessor company Union Minière, which probably held the worst environmental and social record in the industry since its involvement in metal mining in the colonial era in Africa dating back to the beginning van the twentieth century. Its competitive position undermined by transformations in global markets and unable to adapt to change, its financial performance record was equally dismal. The case describes the 5 stages the company went through since the beginning of the nineties to achieve a world class position in its industry with sustainability embedded and institutionalised throughout the organisation. The case is particularly interesting because it highlights the role of change agents at the top and throughout middle management levels. They were involved in bringing about the transformation in a sequence of steps: creating vision; generating concepts relevant to the change; championing those concepts

[1] This view is underpinned by the research of Frank Geels of the University of Manchester Institute of Innovation Research (available on ABIS website supporting this book).

through organizational networks; creating communities of practice that explore, test and translate those concepts into actions and new practices, followed by creating new business models and management processes. The core concepts that senior management championed were closed material loops and clean technological applications and they committed a sixfold increased R&D budget to develop these concepts. In this way, a vision for the company developed such that it would define its future as providing material solutions to environmental problems while ensuring that the company's operations accorded with the highest possible environmental standards. At the core of the new culture were organisational learning and innovation for change. Umicore now is one of the best financially performing firms in the sector with a total return on capital consistently around 9%.

Professor Nigel Roome, a pioneer in the research on business and sustainable development passed away in early 2016 whilst we were putting this book together. His legacy will be of enduring value.

Chapter 25: IBM and Sustainability: Creating a Smarter Planet by Gilbert G. Lenssen and N. Craig Smith
IBM's *Let's Create a Smarter Planet* was launched in 2008 not by an ad campaign, as such, but by a serious speech of then CEO Sam Palmisano to the Council for Foreign Affairs in Washington. He explained how IBM wanted to contribute to a better, more sustainable world by leveraging the availability of data and networks. IBM communicated that it had something important to announce to the world, clearly going beyond a traditional marketing campaign for a new line of products and services. This was quickly followed up by a series of long text thought leadership pieces in leading newspapers like *The Wall Street Journal*, the *New York Times* and the *Financial Times* to highlight how forward-thinking leaders in business, government and civil society around the world can capture the potential of smarter systems to achieve economic growth, near-term efficiency, sustainable development, and societal progress. In 2010, Sam Palmisano followed up with another important speech at Chatham House in London, highlighting dozens of initiatives in which smarter systems were being created to solve the planet's most pressing problems. The speech aimed to inspire others to follow the leads of these innovators by helping to create a smarter planet. The case is a unique example of a major "shared value" initiative, but also of a business model transformation aimed at capturing the high value of sustainability up the value chain. Finally, IBM's initiative is hailed by marketing scholars and practitioners as revolutionary in the way it gets its messages across and maintains momentum, not in the least by employing a "Chief Story Teller" who gives the business successes a story-like narrative with human faces. It has been an outstanding success. The case asks the question: is it a long-term sustainable business model within the competitive landscape?

Chapter 26: Waste Concern: Fixing Market Failures by Joanna Wylegala and Christian Selos

Sustainable development challenges give ample opportunities for large companies, but also for entrepreneurs at the grassroots. Originating from an NGO undertaking research in waste management, Waste Concern became a for-profit enterprise inspired by the compelling idea of turning a massive problem (uncollected, unprocessed waste in Dhaka, the mega capital city of Bangladesh) into a business opportunity, thereby creating value for multiple stakeholders: the city inhabitants, local government, farmers, as well as making good returns for the business. A small scale decentralised model was piloted of house-to-house collection, composting in small plants, and marketing the compost as organic fertiliser to improve agricultural yields and reduce the toxic and land destroying use of chemical fertilisers. The newly created value chain addressed major challenges. First, the hazards caused by largely uncollected or unsafely disposed waste in a city of over 11 m inhabitants (and growing). Second, population growth far exceeding agricultural crop output due to improper waste management and the misuse of millions of tons of chemical fertiliser. To help address these major challenges, the small entrepreneurial venture needs to scale up quickly and face the critical organisational, operational, and financial choices to be made.

Chapter 27: Uber and the Ethics of Sharing: Exploring the Societal Promises and Responsibilities of the Sharing Economy by N. Craig Smith and Erin McCormick

Business models like those of Uber (transportation services by cars) and Airbnb (lodging services in private homes) with little more than an investment in a website are growing fast from small entrepreneurial start-ups to global scale companies and proving to be very profitable. They claim to contribute to the better-shared use of underutilised assets like private cars and apartments and therefore to increased environmental sustainability. The business model is disruptive, undermining the profitability of taxi companies and hotels in serious ways, a case example of creative destruction, which is inherent to growth by innovation in a market economy. However, the ethos of sharing is increasingly brought into discredit by accusations of creating a black economy with hidden employment, evasion of taxes, and omitted contributions to a social security system already under strain. To its critics, this black economy replaces an established economy which contributes to regular employment of a vast number of lowly skilled workers in the taxi and hotel industry, pays corporate and income taxes and social security contributions. This “sharing economy” also poses regulatory challenges with respect to fair competition, safety standards and consumer protection. Is the social cost of environmental gains too high? Or is this the price to be paid for disruptive innovation that promises future growth?

22 Business Model Innovations for Sustainability

Lindsay Clinton and Ryan Whisnant

Introduction

Business models—the underlying structures of how companies create, deliver and capture value—form the engine of our economy. They determine the speed at which economies grow, and the intensity at which our resources are consumed. They determine the number and type of jobs in our cities, the provenance of the products we buy, and the price of the food we eat. They contribute to the quality of our communities and our lives.

The idea of business model innovation—specifically, that a company could launch a new business model never conceived of before, or transform an existing business model to disrupt an industry—captivates business leaders and sustainability advocates alike.

Such is the enthusiasm for business models that a new vocabulary has emerged for the scale of the impact we seek: Transformational. Step change. Breakthrough. We also recognize the importance of incremental steps that add up to big change. No matter the speed or type, we all want to understand what innovations are occurring and how innovation happens. For business leaders, understanding and advancing innovation is necessary to beat competitors. For sustainability practitioners, innovation is key to meeting expanding human needs within planetary limits.

> Many existing business models are predicated on the assumption that vital, non-financial resources—i.e., natural, human and/or social capital—are in virtually limitless supply.

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G. G. Lenssen, N. C. Smith (eds.), *Managing Sustainable Business*,
https://doi.org/10.1007/978-94-024-1144-7_22

The inner workings of a business model—its products and processes, its interactions with stakeholders, what and how it measures, the transactions it requires—influence a company's ability to thrive in the future, and shape its impacts on people and planet.

But many existing business models are predicated on the assumption that vital, non-financial resources—i.e., natural, human and/or social capital—are in virtually limitless supply. Societal benefit, if considered at all, is frequently an after-thought. To truly create a more sustainable world that can thrive over time, we need business models that operate within planetary limits and are sensitive to their roles as economic, environmental and social linchpins.

To date, many companies have realized the merits of modifying their products and processes to become more sustainable. Acknowledging the business benefits of improved product performance, some have revamped their offerings to be more effective, more efficient and produced with safer, "greener" materials. Other companies have rethought their processes—for example, by utilizing renewable energy sources in production or enhancing performance and trust through various certifications. But, these innovations will only get us so far. What we need are not just better products and processes, but fundamentally different business models. We need companies and industries whose underlying structures are, at worst, zero negative impact, and at best, contributing to the regeneration and restoration of natural, human and social capital.

Examples of more sustainable business models exist today, and more are being invented by creative entrepreneurs and intrapraneurs around the world. There is a need to better understand what makes these models work, where innovation is happening and how companies with traditional models can transform to become more sustainable and more profitable.

This report takes a closer look at business model innovation, examining its real-world applicability toward advancing sustainability. We explore where business model innovation is happening, what models are emerging and what role multinational companies play in the business model innovation landscape, along with a snapshot of how some large companies are experimenting with business model innovation.

In sharing this research, we intend to shed light on the business model innovation space and identify useful patterns and practices, specifically as they enable more sustainable outcomes. We hope these findings spur a deeper exploration of business model innovation and provide actionable tools across a diverse audience, including sustainability and corporate responsibility leaders, corporate innovation and strategy teams, social entrepreneurs and environmental economists, among others.

> What we need are not just better products and processes, but fundamentally different business models.

What Do We Mean by "Business Model"?

The sustainability field has had a longstanding preoccupation with the promise of business model innovation. We've seen a good amount of hype, with surges of interest around topics like social innovation and the sharing economy, and frequently cited examples like Grameen Bank and Zipcar. But despite all the talk, the topic of business model innovation still lacks the clarity to fully deliver on its promise.

Like "sustainability", the term "business model" is used rather loosely. One has the sense that everyone is referring more or less to the same thing, but what exactly? Put another way, if a company comes up with a new business model, what is it that they've changed?

Many have attempted to define the term. Innovation researchers Osterwalder and Pigneur offer an inclusive and succinct definition in their 2010 work, *Business Model Generation*.[1] It defines business models as the "fundamental structures for how companies create, deliver and capture value." Raphael Amit and Christoph Zott offer a somewhat lengthier definition in the MIT Sloan Review: "The bundle of specific activities conducted to satisfy the perceived needs of the market, along with the specification of which parties conduct which activities, and how these activities are linked to each other."[2] This and other definitions clearly point to the fact that a business model encompasses more than just what the company produces.

> A business model is much more than the product or service a company offers.

According to a 2013 study by BCG and MIT,[3] nearly half of the companies surveyed said they had "changed their business models as a result of sustainability opportunities." However, more often than not, the innovations we see involve creating better processes and/or products, without addressing the underlying value structure.

This isn't to say that product or process innovations aren't needed or useful; in some cases, they may even support or lead directly to a significant change in a model. For example, consider when Walmart committed in 2010 to double its sourcing of local produce by 2015. On first inspection this may sound like an issue of process. But to meet the objective demanded a range of responses—paying farmers

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[1] Osterwalder, A., Yves P. *Business Model Generation: A Handbook for Visionaries, Game Changers, and Challengers*. Hoboken, NJ: John Wiley & Sons, 2010. Print

[2] Amit, R and Zott, C. "Creating Value Through Business Model Innovation." MIT Sloan Management Review. 12 March 2012. Web. August 15, 2013. http://sloanreview.mit.edu/article/creating-value-through-business-model-innovation/

[3] Kiron,D., Kruschwitz, N., Haanaes, K., Reeves, M., Goh, E. The Innovation Bottom Line. MIT Sloan Management Review, The Boston Consulting Group, Winter 2013. Web. 10 March. 2013. https://www.bcgperspectives.com/Images/MITSMR-BCG-Sustainability-Report-2013.pdf

more, offering customers a money-back guarantee, and changing the way produce is stocked in-store—which cumulatively represented a more fundamental shift in the business model. By sharing income differently along the value chain and assigning higher value to things previously externalized, Walmart engineered more sustainable outcomes directly into the structure of the business.

Business model innovation for sustainability ultimately involves a novel form of exchange at some point along a company's value chain. That exchange, sometimes completely new, other times just different, creates new value or distributes value more equitably for more stakeholders.

> Business model innovation ultimately involves a novel form of exchange at some point along a company's value chain.

The most straightforward is an exchange between a company and its customers. The development of power purchase agreements (PPAs) for solar projects, pioneered by SunEdison, provides a good example of a change in how a solar provider, in this case, captures revenue from its customers. Using PPAs has lowered the barrier for commercial and industrial customers to adopt solar because there is no upfront cost. SunEdison's customers get cleaner energy at lower rates than commercial power while also taking advantage of renewable energy credits. The use of the PPA helps spread the use of renewable energy and lower costs, providing more value to customers and the system at-large.

Other examples of novel exchanges that provide value to more stakeholders can be found in interactions between a company and its suppliers (e.g., SAB Miller sourcing from disadvantaged cassava farmers), a company and its employees (e.g., the cooperative ownership structure at Ocean Spray) or a company and its community (e.g., TwoDegrees providing a meal to a hungry child for every health bar sold).

In each case, the value created in the transaction is no longer concentrated among the company's owners or shareholders, but is distributed more equitably, usually shifting social and environmental outcomes along the way.

As a company considers its business model structure, the exchanges that occur at all points within the business model present opportunities to innovate, distribute value, and shift outcomes for the better.

Why Business Model Innovation Matters

SustainAbility and GlobeScan's 2013 report *Changing Tack*[4] spells out the urgent need for fundamentally different approaches to value creation. For companies looking to respond to this mounting urgency while reaping the financial benefits, moving beyond product and process modifications to business model innovation is vital.

Process and product innovation are not enough to generate both sustainability and financial performance.

Many novel or even radical new process or product innovations have fallen short of their potential because they were unable to compete within the constraints of an existing or traditional business model. Shifts in the underlying model are necessary to enable the innovative product or process to succeed in the marketplace.

One useful illustration of the power of business model innovation is LifeStraw, which has a growing foothold in the developing world. LifeStraw's product – a personal use straw designed to remove 99.9999% of all waterborne bacteria and 99.99% of parasites – is certainly innovative. But the product is only successful if it gets into the hands of people who need it, particularly those with less access to clean water. This is where LifeStraw's business model comes in: it relies on a unique approach to financing. The company received funding from a carbon credit market, allowing it to offer products at low- to no-cost in certain areas. The carbon credits are earned by eliminating the need for families to cut down trees for firewood to boil and purify water.[5]

Another example is a start-up based out of Stanford University, re.source, which produces low-cost mobile toilets for residents of dense urban slums who don't have access to hygienic sanitation services. Rather than try to find someone to buy the toilets, the company has created a business model that blends affordable monthly membership, waste collection services and processing of waste into useful products such as organic fertilizers and energy.[6]

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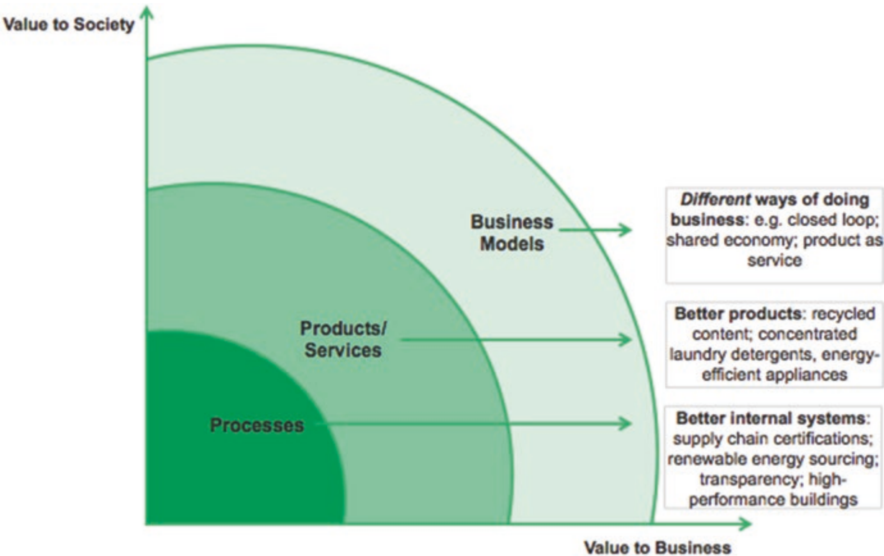
[4] Coulter, C., Lee, M. *Changing Tack: Extending Corporate Leadership on Sustainable Development*. SustainAbility, GlobeScan, 18 June. 2013. Web. 19 June. 2013. http://www.sustainability.com/library/changing-tack

[5] "Carbon for Water." United Nations Framework Convention on Climate Change, April 2012. Web. 5 December. 2013. http://unfccc.int/secretariat/momentum_for_change/items/7100.php

[6] "Our Concept." re.source. Web. 5 December. 2013. http://resourcesanitation.com/our-concept



New business models can transform industries.

The biggest reason for companies to embrace business model innovation is the threat that current models will ultimately slip or even fail. Examples of business models that have quickly transformed or even become obsolete abound across sectors including media (decline of print), retail (online retailing and sharing platforms), music (digital music services like Spotify and iTunes), telecommunications (proliferation of smart devices and associated services) and even finance (peer-to-peer lending).

In healthcare, Narayana Hrudayalaya Hospitals, winner of a *Financial Times* 2013 Boldness in Business award, uses a combination of process efficiency, revenue and cost structure and financing to make a profit while providing access to vital healthcare services for both rich and poor.[7] The company's work is beginning to change the way medical providers in India think about the cost, quality and reach of their services. For example, at Narayana Hrudayalaya, the average open-heart surgery costs less than $2000, compared to the US where it can cost well over $100,000.[8]

> Many traditional business models that still appear viable today do so as a result of mispriced resources and other market distortions that make them more competitive than they would otherwise be.

[7] *Boldness in Business*. Financial Times, 21 March. 2013. Web. 5 December. 2013. http://www.ft.com/intl/cms/5fa5bfaa-8d1a-11e2-8ee0-00144feabdc0.pdf

[8] "Heart Surgery in India for $1583 Costs $106,385 in U.S." Bloomberg, 29 July 2013. Web. 5 December. 2013. http://www.bloomberg.com/news/2013-07-28/heart-surgery-in-india-for-1-583-costs-106-385-in-u-s-.html

Many traditional business models that still appear viable today do so as a result of mispriced resources and other market distortions that make them more competitive than they would otherwise be. As sustainability trends and challenges—including energy and commodity price fluctuation, supply insecurity or demands for transparency—continue to shift the foundations of our current business models, along with our expectations around them, incremental innovation will become less effective in enabling companies to adapt and succeed.

Take the energy industry: incumbent utilities are facing startups like Mosaic, a solar company that offers an easy-to-use crowdfunding investment model enabling small individual investors to fund large commercial solar projects. This and similar models are opening a door to more democratized systems, away from traditional command-and-control business models where centralized operators decide what investments to make—in coal versus solar, for instance. This type of business model innovation is gaining more attention as it begins to challenge the established position of traditional fossil fuel-based energy producers.

Business model innovation both catalyzes and relies on broader systems change.

According to the MIT report *Creating Value Through Business Model Innovation*, it is important to innovate in areas where the competition is unable or unwilling to act—where competitors might find it more difficult to imitate or replicate an entire "activity system."[9] The classic example is Apple—the iPod would not have been the game changer that it was without the ecosystem created by iTunes. The resulting system dramatically changed how we acquire, store and listen to music, and made Apple the go-to provider of this new and better experience.

To innovate within systems, companies need the capability to adapt to shifting market conditions and larger systemic changes. They also need to be able to create systemic change, build new markets, and avoid or dampen the impacts from dramatic systems shifts. To do so, companies must be willing to see beyond the obvious, short-term business case with an eye to the viability of the broader system.

> Companies must be willing to see beyond the obvious, short-term business case with an eye to the broader system.

The demise of Better Place in early 2013 provides a cautionary tale and an illustration of the need for larger systems change. The electric car venture based on an innovative battery-swapping technology and a "subscription model" (see Business Model Innovation section below) sold only 750 cars, while amassing losses of more than $500 million.[10] Ultimately, the success of Better Place depended on changes in

[9] Raphael, A., Zott, C. *Creating Value Through Business Model Innovation*. MIT Sloan Management Review, 20 March. 2012. Web. 10 April. 2013. http://sloanreview.mit.edu/article/creating-value-through-business-model-innovation

[10] Gunther, M. "Better Place: what went wrong for the electric car startup?" Guardian Environment Network, 5 March. 2013. Web. 10 July. 2013. http://www.theguardian.com/environment/2013/mar/05/better-place-wrong-electric-car-startup

the broader system—changes that never materialized—including tax and/or subsidy support, local government approval in building battery-switching stations, and design partnerships from automakers.

Research Approach

In order to explore and better understand business model innovation, we combed recent reports, news articles and blogs and identified over 100 of companies cited for their forward-thinking approaches. We catalogued these innovations, and categorized them according to industry, company size, geography and type of innovation (product, process or business model), resulting in a winnowing of the list to 87 business model innovation examples. We then analyzed each example, and for those companies that had changed an established business model or launched a new one, we identified patterns in the particular types of models, such as *dematerialization*, *alternative marketplace* or *product as a service*.

We identify and define 20 distinct types of business model innovation. For each type, we discuss what makes the model unique and relevant to sustainability, what differentiates it from a more traditional model, what novel exchange is occurring, and any shifts in incentives.

For each model, we also give an example of a company demonstrating that model, and list a few other manifestations, where available, of other companies using the model.

Lastly, we've grouped the models into "meta" categories that help to demonstrate similarities to other models' impacts, as well as their differences.

Caveats

Purity

In our review, we documented examples that, while innovative, may not meet some readers' expectations for a "sustainable business." Our goal is not to point out perfectly sustainable business models, but rather to highlight examples of companies, new or incumbent, that have done something innovative to yield *more* sustainable outcomes. It is from these examples that we believe others can learn, and by which they will be inspired to innovate further, or simply be compelled to follow suit.

Hybrid Models

Some business models fit into multiple categories. For example, the eyeglass maker Warby Parker has elements of a *physical to virtual* model, and it also uses a *buy one give one* model focused on building social capital. Mud Jeans, an online marketplace where customers rent jeans on a monthly basis, has element of *physical to*

virtual and *innovative product financing*. Business model innovation is more art than science, and we expect other business models to emerge that exhibit more than one defining structure.

Intent to Produce Sustainable Outcomes

Innovations that produce unintentional sustainability benefits are not uncommon. Netflix, for instance, helped to dematerialize the movie rental industry by first leapfrogging brick-and-mortar stores, and eventually eliminating the need for DVDs by offering streaming content. While Netflix certainly has a good sustainability story to tell, it did not set out with the intent to improve its sustainability performance.

As we sifted through business model innovation examples, we considered whether to include examples that are not values-led, so to speak. We decided that we should do so because what matters is the outcome, rather than the intention. To drive the sustainability agenda, we must be responsive to any innovation, not just those intended for sustainable outcomes.

Business Model Innovations for Sustainability

Environmental Impact

Closed Loop Production In this model, the material used to create a product is continually recycled through the production system. Every effort is made to reduce waste in the production system, and those elements that cannot be eliminated are recaptured and reused or biodegraded and composted.[11] Few if any outside inputs are needed.

This model upsets the more traditional, linear take-make-waste production pattern that most manufacturing companies currently rely on.

Employing this model not only reduces material- and energy-related costs, but can also provide additional opportunities for interaction with consumers who re-engage with the company to facilitate product take back.[12]

Others might refer to this model as "cradle to cradle."

- **Spotlight**: **Novelis:** This global aluminum company, headquartered in Atlanta, GA, and owned by Hindalco (a member company of the Indian conglomerate, Aditya Birla Group) is the global leader in rolled aluminum products. Novelis creates 14% of the world's rolled aluminum products like beverage cans, architectural structures and consumer electronics.

[11] "Driving Sustainable Consumption Closed Loop Systems." World Economic Forum. October 2009. Web. 5 December 2013. http://www.weforum.org/pdf/sustainableconsumption/DSC%20Overview%20Briefing%20-%20Closed%20Loop%20Systems.pdf

[12] Ibid.

- The company currently sources 43% of its aluminum from recycled materials and has a goal of reaching 80% by 2020.
- Novelis aims to develop an almost entirely closed-loop business model by sourcing more recycled aluminum, coordinating post-production scrap take back, arranging end-of-life product take back, and building more of its own recycling operations and processing facilities.[13]
- **Other examples**:
  - **Interface** makes carpet tiles from reclaimed and recycled carpet and is aiming for zero waste, zero emissions, and zero use of oil by 2020.

Physical to Virtual The consumer marketplace was once almost exclusively comprised of brick and mortar stores—the corner store, grocery store, big box store or shopping mall. That model, of erecting a store on every corner or in every town, provides convenience, but can be resource-intensive and expensive.

The *physical-to-virtual* model eliminates brick and mortar infrastructure to dramatically reduce the resources needed to supply a product to a consumer. It changes where and how a transaction happens. As consumers become more comfortable with virtual shopping, we will likely see fewer retail outposts and more online-only brands, like FreshDirect, the grocery-delivery company.

Some companies in this category, such as Netflix, achieved greater environmental sustainability through this innovation. It's important to note that in augmenting some environmental elements of sustainability, this business model innovation may eliminate jobs, thereby creating questions about social sustainability.

- **Spotlight: Sungevity**: This residential solar installation and financing company has streamlined the way solar panels are sold to individual consumers.
- Rather than relying on local retail outlets or representatives, Sungevity has developed a scalable online sales model where customers can get a price quote within 24 hours. A team of remote engineers designs the solar systems based on satellite imagery. Sungevity subcontracts the installation work to smaller, local operators.
- This capital-light model has enabled the company to streamline its processes and has resulted in quick expansion to new markets across the US and to countries around the world.
- **Other examples**:
  - **Bonobos** made its name selling a single product—men's pants—online.
  - **Fresh Direct** delivers groceries straight to consumers' doors.
  - **SPUD** (Sustainable Produce Urban Delivery), in Boston, supplies mostly local produce to consumers via an online marketplace.
  - **Warby Parker** sells eyeglasses online and mails consumers four pairs to choose from to mimic the brick and mortar retail experience.

[13] "Sustainability through Disruptive Innovation: Sustainability Report 2013." Novelis. 2013. Web. 5 December 2013. http://www.novelis.com/en-us/Pages/sustainability.aspx

Produce on Demand Here, a company produces a product only when consumer demand has been quantified and confirmed. Companies do so via online platforms that enable consumers to design their own products, vote on preferred product elements, and in some cases engage with other consumers in product creation. In the process of interacting with the brand and customizing its products, consumers can develop stronger, stickier relationships with the company.

From an environmental efficiency standpoint, the company benefits; it does not have to over-produce and over-stock products because demand is confirmed. This model presents a streamlined approach to production, as supply meets demand exactly, thus reducing extraneous material in the production cycle.

- **Spotlight**: **Lego Cuusoo**: This Lego offshoot is an online platform, created through a partnership between the Japanese company CUUSOO and The Lego Group in 2008, which allows users to submit ideas for Lego products to be turned into potential sets available commercially, with the original designer receiving 1% of the royalties.[14]
- Lego Cuusoo engages consumers in a new way by including them in the design process and sharing revenue. The revenue sharing agreement incentivizes existing and new consumers to interact with the brand.
- While there is no sustainability intent behind this example, if scaled, it could streamline production and consumption.
- **Other examples**:
  - **Threadless** is a t-shirt company that invites artists to create designs, which users vote on; the most popular ones go into production; designers receive monetary compensation by the company.
  - **Walkers**, the chip and crisp maker in the UK, experimented with this model in 2008 by allowing consumers to create and vote on new flavors to put into production.

Rematerialization In this model, a company's source material is derived from recovering waste, with which the company develops and markets a new output. This model differs from *closed loop production* in that the company is creating an entirely new product from the source material. This process often requires complex technology to break down discarded material and remanufacture it.

Companies using this model have benefitted from an increasing focus by other businesses on eliminating waste to landfill. Businesses with reduced or zero waste to landfill targets are more inclined to pay to have their waste material repurposed so that they can reach their goals.

[14] While this example is more process-oriented than others, we wanted to highlight a large company using this model. The other companies named are in fact using this production method as their business model.

- **Spotlight**: **Waste Management**: The North American company provides waste disposal and recycling solutions that divert waste from landfill, transform waste into higher value materials and create clean, renewable energy.
- For example, due to its landfill-gas-to-energy efforts that recover naturally occurring gas inside landfills, Waste Management currently produces more than twice the amount of renewable electricity as the entire US solar industry. The company also has plans to invest in new recycling technologies, like converting organic waste from the materials stream to make high-end compost for local growers.
- **Other examples**:
  - **Knowaste** recycles disposable diapers and feminine hygiene products into plastic components, cardboard and construction filler.
  - **LeHigh Technologies** takes scrap rubber from customers that have zero waste initiatives, processes it and resells it to consumer goods, construction, tire and flooring customers to make new products.
  - **Rubies in the Rubble** takes surplus fruits and vegetables before they're discarded and makes them into chutneys that are sold in UK markets; in so doing, they provide employment to those struggling to get into the workforce.

Social Impact

Buy One, Give One Companies using this model sell a specific good/service and use a portion of the profits to donate a similar good/service to those in need. Consumers are compelled to purchase not only for the benefit of acquiring the new product, but also for the personal uplift that comes from feeling generous. These models often depend on a strong brand story to draw in consumers and to ensure that they spread the word.

The model has been used most frequently by consumer goods companies, in particular the apparel and accessories space, whose consumers use their purchases to express their style, and as a platform for sharing information on the benefits provided to others through those purchases.[15]

Companies using this model usually make donations by setting aside a share of the profits. The companies charge a premium for their product or accept a lower profit margin with the hope of selling more units because consumers are attracted to the cause.[16]

This model differs from the traditional corporate separation of the business and its philanthropic efforts, often through a foundation arm. It explicitly builds social impact into the business, so that it is front and center, rather than something that occurs after shareholders have been compensated.

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[15] Marquis C. and Park, A. "Inside the Buy-One Give-One Model." Stanford Social Innovation Review. Winter 2014. Web. 6 December 2013. http://www.ssireview.org/articles/entry/inside_the_buy_one_give_one_model

[16] Ibid.

While growing in popularity, the model has come under fire for its social impact claims; some see the product donations made through these models as overly simplistic approaches to large, complex social problems.

- **Spotlight: TwoDegrees:** TwoDegrees sells nutrition bars direct to consumer and through retail outlets. For every TwoDegrees bar purchased, the company provides a meal to a hungry child. The company does this by forming partnerships with nonprofit organizations that provide food assistance through health clinics, schools, and community groups in areas where children are suffering from malnutrition or chronic hunger.
- A box of nine bars sells for $17.95 on the company's website. According to TwoDegrees' 2013 report, they have donated 767,688 meals. Where possible, the company reports, they donate meals that are produced locally, using local labor and sourcing local ingredients in the region where meals are distributed.
- **Other examples**:
  - **SoapBox Soaps** donates one bar of soap for each purchased with the hope of spreading good hygiene among low-income populations.
  - **TOM's Shoes** donates one pair of shoes for every pair purchased.

Cooperative Ownership A business that is owned and managed by members is called a cooperative or co-op. Members can be retail consumers, users of services, tenants (housing co-ops), savers and borrowers (credit unions) or employees.[17] Whereas a traditional shareholder model focuses almost exclusively on meeting investor expectations, a cooperative model often takes broader stakeholder concerns into account, including those of employees, customers, suppliers, the local community and in some cases, the environment.

The novel form of exchange here is the distribution of greater value to more stakeholders in the company ecosystem.

From a social impact standpoint, co-ops often excel because their structure allows for distributed—and often more equitable—decision making, profit sharing and power sharing. Cooperative worker models often provide a sense of ownership to employees, who are incentivized by playing a direct role in profit generation and profit sharing. Cooperative retail models often pay members dividends or offer members in-store discounts.

Several co-op models, like The Cooperative Group and Fagor, part of the worker co-op Mondragon, have recently come under fire for ethical issues or financial mismanagement. The non-hierarchical structure of co-ops can translate into fewer checks and balances than more traditional ownership structures.[18]

[17] Whittle, K. "The potential of the cooperative business model." REconomy Project, 6 April 2013. Web. 15 November. 2013. http://www.reconomy.org/the-potential-of-the-co-operative-business-model

[18] Worth, T. "Can co-ops redefine sustainable business?". Guardian Sustainable Business. 21 November. 2013. Web. 4 December. 2013. http://www.theguardian.com/sustainable-business/cooperatives-sustainable-business-structures

– **Spotlight**: **Ocean Spray:** Many who drink the juice sold by Ocean Spray probably don't realize that the company, which brings in around $2 billion in revenue each year, is an agricultural cooperative of 750 cranberry and grapefruit growers. These farmers are the only shareholders in the company.
– As a result, Ocean Spray's farmers get paid well for the fruits of their labor; whereas the market price for a barrel of cranberries in 2009 was $20, Ocean Spray farmers received $64 a barrel. CEO Randy Pappadelis explains, "We seek to pay as much for those cranberries as we can, to compensate our grower-owners…the model validates the value of goodwill."[19]

– **Other examples**:
  • **Amul**, a dairy cooperative in India, is comprised of 3 million milk producers
  • **The Co-operative Group** in the UK is owned and run by more than 7.2 million members
  • **John Lewis Partnership** is an employee-owned UK company which operates department stores, Waitrose supermarkets and some other services
  • **Vancity** is a financial co-op in Canada with nearly 500,000 member-owners
  • REI is a private US-based retail company structured as a consumer cooperative.

Inclusive Sourcing As companies consider their impacts outside of core operations, one of the first targets is the supply chain. Setting supplier standards or conducting audits are first steps toward sustainable sourcing, but others go even further. They retool their supply chains to make them more inclusive, focusing on supporting the farmer or producer providing the product, not just the qualities of the product sourced (e.g., organic palm oil, sustainable timber).

Inclusive sourcing often means working with small farmers, which can require more effort on the part of large corporations. But, working with small holders and local farmers creates market connections, increases farmer learning and access, and makes for stronger links in the supply chain overall.[20]

Building inclusive supply chains can help build reputational value for large companies, but beyond that it can help companies gain legitimacy in local markets and create more 'ethical' products. The benefits can translate into better traceability and supply consistency through stronger supplier relationships.

Last year, we witnessed in rapid succession the collapse of a Bangladesh apparel factory and a factory fire there—examples of supply chain disruption and

[19] Reiss, R. "Ocean Spray's Secrets of Co-op Success" Forbes. 15 September 2010. Web. December 5, 2013. http://www.forbes.com/2010/09/15/papadellis-ocean-spray-leadership-managing-interview.html

[20] *A Participatory Guide to Business Models that Link Smallholders to Markets*. International Center for Tropical Agriculture. 2010. Web. 5 December. 2013. http://dapa.ciat.cgiar.org/wp-content/uploads/big-files/2012/LINK_Methodology.pdf

reputational damage due to a lack of attention to supplier livelihoods. Some companies have realized that it is smart business to practice inclusive sourcing to avoid disruptions like this, bolster reputation, and strengthen supply chains.

– **Spotlight**: **Walmart**: For several years, Walmart has had a plan in place to source more food directly from farmers, cutting out middlemen, and enabling farmers to boost their income. In some countries, this has meant fresher, more local produce for customers.
– Part of Walmart's plan includes providing training to 1 million farmers and farm workers in crop selection and sustainable farming, as well as a goal to increase small- and medium-sized farmer income by 10–15%. By sourcing directly from farmers, Walmart aims to strengthen local farms and economies.[21]
– **Other examples**:
  • **Interface**, the carpet tile company, sources discarded fishing nets from small fishing villages in the Philippines to make its Net Effect carpet line.
  • **Novelis'** aluminum processing center in Ho Chi Minh, Vietnam will source from local low-income trash collectors.
  • **Sylva Foods** is a Zambian SME that aims to grow demand for and increase sales of traditional Zambian foods by working with rural farmers; retail shelves in Zambia are currently dominated by imported food products.

Financial Innovation

Crowdfunding Crowdfunding enables an entrepreneur or company to tap the resources of an entire network to raise money in increments from a group of people. This model upends the traditional financing approach, usually contingent on convincing accredited investors to make upfront financial commitments based on predicted near-term returns. That approach entails a certain level of risk on the part of investor and investee. Crowdfunding removes some of that risk for both parties.

There are several types of crowdfunding: donation-based, loan-based, and equity-based. Donation-based crowdfunding enables supporters of an idea to donate money and in return to receive a non-monetary gift, such as the product initially funded, public acknowledgement, or the sense of being part of a community. Loan-based funding is neither a donation nor an investment; it is a loan to an entrepreneur that is returned without interest. Conversely, equity-based funders give money with the expectation of receiving a monetary return (this kind of crowdfunding is currently under review by the Securities and Exchange Commission (SEC) in the US and the rules governing such investments are expected to be announced in 2014).

Crowdfunding enables alternative ideas that might not otherwise attract mainstream investor attention to gain traction. They often have a community

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[21] "Sustainable Agriculture". Walmart. Web. 5 December. 2013. http://corporate.walmart.com/global-responsibility/environment-sustainability/sustainable-agriculture

development angle or social impact element. And, like the co-operative model, the traditional power structures are upended.

This model differs slightly from *innovative product financing (see below)* in that it is focused on funding an idea or enterprise for the founder/entrepreneur/organization, rather than financing a product for a customer.

There are now hundreds of crowdfunding platforms for everything from disaster relief to creative projects and green community projects.

- **Spotlight**: **Community Sourced Capital**: This online marketplace provides a platform for small businesses to source capital from those in their community. Businesses create campaigns that run on the CSC site, and the CSC team manages the platform and conducts due diligence on participating businesses. Community members fund part of a larger loan by buying a Square, a $50 unit of the larger loan made to the business. The Square is a simple loan that is meant to be repaid in full, without interest.
- CSC charges businesses that use their platform a $250 fee before launching a campaign and a $100 monthly fee until the loan is repaid. To date, the company has funded business improvements and innovations for 12 companies in Washington state.[22]
- **Other examples**:
  - **Fundly**, for individuals to raise money for medical procedures, schooling or charity
  - **GiveForward**, focused on medical fundraising
  - **IndieGoGo**, an international platform focused on funding the arts
  - **Kickstarter**, the world's largest crowdfunding platform, focused on creative projects
  - **Mosaic**, a solar project funding platform

Differential Pricing Some customers are not willing—or able—to pay as much as others for the same product. Take seniors, for example who are often on fixed incomes, and are offered reduced rates at restaurants, movie theaters or museums.

Realizing that customers might need the same product but have different payment thresholds, companies sometimes subsidize those who can't afford to pay as much by charging others higher prices. The airline industry has used this model for years by selling business class and economy tickets to fill a plane.

The model has most recently been put to use, in developing world contexts, where many consumers need essential services (e.g., health, education) but cannot afford the market price. Institutions that offer different prices enable access to a greater number of consumers from a range of economic levels.

[22] Community Sourced Capital. Web. 5 December. 2013. http://www.communitysourcedcapital.com/#section-home

– **Spotlight**: **Narayana Hrudayalaya Hospitals**: This Indian hospital chain, dubbed "Walmart meets Mother Theresa" by Fast Company,[23] uses a pricing model that is focused on reaching the poor, by treating the rich. Usually private hospitals in India build their model the other way around: they focus on the rich who can afford treatment. This hospital system was designed to service the poor from the start. These patients pay discounted prices for services like surgery and are subsidized by those who can afford to pay full price.
– Narayana Hrudayalaya set up shop in Bangalore more than a decade ago, and now manages or owns hospitals in 14 other Indian cities. Its doctors service local patients as well as those farther afield, using Skype connections, allowing the service to reach 100 additional facilities in India as well as more than 50 in Africa.
– The company also exploits every possible efficiency, negotiating for better prices from suppliers and cutting out middlemen.
– **Other examples**:
  - **Aravind Eye Care Hospital**, in India, provides free or subsidized care to two-thirds of its patients
  - **Novo Nordisk** sells insulin at or below 20% of the average prices for insulin in the Western world in the developing countries it operates within

Freemium In this business model a proprietary product or service (often software, media or web services) is provided free of charge, but money (premium) is charged for "premium" features, functionality or virtual goods.[24] A *freemium* model is sometimes used to build a consumer base when a critical mass is needed to make the product valuable to consumers.

Social networks, like Twitter, FaceBook and LinkedIn all use this model to build a user base, and only in later stages do they offer paid services or advertising opportunities.

Offering the product or service for free creates engagement with the brand. Often early adopters of the product or service inadvertently provide a free marketing function for the company, as users spread the word within their networks and encourage others to participate.

Although this model, when evaluated independently, doesn't necessarily offer greater impact, it has been utilized to extend product lifecycles, as seen in the example below, which is why it has been included in this list.

[23] Salter, Chuck. "Most Innovative Companies 2012: 36_Narayana Hrudayalaya Hospitals, For Bringing Medical Care to the Masses." Fast Company. 7 February 2013. Web. 15 October 2013. http://www.fastcompany.com/3017477/most-innovative-companies-2012/36narayana-hrudayalaya-hospitals

[24] Oxford Dictionaries. Web. 15 November. 2013. http://www.oxforddictionaries.com/definition/english/freemium

- **Spotlight**: **FreedomPop**: This company began as a free wireless Internet provider and has recently expanded into the mobile telecom service space.
- FreedomPop's phone service removes the traditional contractual arrangement with a mobile telephone service provider and enables customers to purchase a discounted phone or use an existing phone—without a contract—and make a limited number of calls and text messages for free using voice-over IP (VOIP) service. Customers have the option of adding data and additional minutes for low monthly fees.
- FreedomPop's model is unique in that it only sells refurbished smartphones, several generations old. Customers get a "new" phone for much less money than they would pay for a phone attached to a contract. The company also has a partnership with Sprint that enables customers whose Sprint contracts have expired to activate their phones without monthly fees using FreedomPop's US network.[25]
- The company extends the product lifecycle of mobile phones—providing an interesting use case for older phones—and presents a disruptive model for the traditional cellular phone lock-in contract model.
- **Other examples**:
  - **SolarCity** designs, installs, finances, and maintains solar systems; last year they started offering Energy Explorer software to customers for free so that they can pinpoint home inefficiencies and understand possible cost and savings improvements.
  - **TextNow** sells refurbished smart phones and offers commitment-free phone plans to help cost-conscious customers save money.

Innovative Product Financing Consumers lease or rent an item that they can't afford or don't want to buy outright. Often, the lease agreement can lead to ownership, which is sometimes called "progressive purchase."

While this model is not new, it is being used in innovative ways for environmentally friendly products—it is particularly popular in the renewable energy industry—and for positive social impacts.

The model has similarities to *product as a service*, but is distinguished by a focus on innovation within the financing component.

- **Spotlight**: **Simpa Networks**: Simpa sells distributed energy solutions on a "progressive purchase" basis to underserved consumers in emerging markets.
- Currently operational in India, Simpa's goal is to transform the market for solar energy systems. Customers make a small initial down payment for a high-quality solar photovoltaic (PV) system and then pre-pay for the energy service, activating their systems in small user-defined increments using a mobile phone. Each

[25] Fitchard, Kevin. "Got an old Spring phone? FreedomPop will activate it under its freemium plans." Gigaom. 19 November 2013. Web. 5 December 2013. http://gigaom.com/2013/11/19/got-an-old-sprint-phone-freedompop-will-activate-it-under-its-freemium-plans/

payment for energy also contributes towards the final purchase price. Once fully paid, the system unlocks permanently and produces energy, free and clear.[26]

- Before Simpa came along, many of its customers had limited access to electricity and used kerosene lanterns—often dangerous to health, home and environment—to illuminate their space. Solar energy systems offer health, educational and income-generating benefits, but the traditional pricing model—$200–400 per individual solar system—is not affordable for most low-income consumers. Simpa enables its customers to pay for a solar system over time. Because the Simpa system lasts 10 years, customers actually save money in the long run; Simpa has calculated that during that same period a customer might have spent $1500–2000 on kerosene, candles, batteries or phone-charging.[27]
- **Other examples**:
  - **SunEdison** offers a progressive purchase agreement (PPA) to business and retail customers; there is no upfront cost to have a solar system installed; users pay for the electricity produced and used; SunEdison installs and maintains the equipment.
  - **Sungevity** offers customers the option of leasing or buying a solar system; the company custom designs each system using an online system and satellite imaging technology.

Pay for Success This model employs performance-based contracting, typically between providers of a social service and the government, to fund anticipatory initiatives to prevent adverse outcomes. Often, private investment funds can be utilized to cover upfront program costs.

Typically, the government ends up paying for negative outcomes—they fund jails because crimes have occurred or ambulances to respond to health emergencies. Here, a government agrees to take part in a more anticipatory or preventative program to fund an evidence-based social intervention, and only pays a service provider if the agreed-on target outcomes are achieved, e.g., health improvement or reduced recidivism in prison inmates.

The intent is to save the government money and improve communities by preventing negative outcomes. This model opens the door for financing from private investors, encourages more efficacious use of government funds, and incentivizes better performance by product/service providers.

This novel exchange of funds comes with a guarantee of achieved outcomes.

- **Spotlight**: **Johnson & Johnson**: The medical devices, pharmaceutical and consumer packaged goods manufacturer Johnson & Johnson (J&J) has experimented with its business model for Velcade, a drug targeting multiple myeloma, a form of bone cancer.

[26] Simpa Networks. Web. 5 December. 2013. http://www.simpanetworks.com

[27] Simpa Networks. Web. December. 2013. http://simpanetworks.com/energy-as-opportunity/

- J&J offered the drug to European health ministries with a novel proviso—if the drug is not efficacious in 90% of patients, the ministries need not pay for it.[28]
- J&J's experiment comes as the "blockbuster" drug model proves less and less sustainable. Drug companies often charge patients extremely high prices to recoup years of R&D expenditures. But, patients and insurance companies can find themselves in difficult financial straits when expensive drugs don't work. This model places the onus of drug performance and cost on the drug company.

- **Other examples**:
  - **Goldman Sachs**: Social impact bond in New York City funded by Goldman Sachs & Bloomberg Philanthropies to support reduced recidivism by youth released from Riker's Island prison.
  - **Social Finance/Collective Health**: Social impact bond piloted in Fresno, California by Social Finance Inc. and Collective Health aims to improve the health of low-income children with asthma and reduce the costs that result from emergency treatments.

Social Innovation Focused on the Base of the Pyramid

Building a Marketplace Companies using this model to build new markets for their products in innovative and socially responsible ways, including delivery of social programs, partnerships, adapting to local markets, and bundling with other services like microfinance and technical assistance. Here, the novel exchange manifests in the creation of a new market where there was none before.

Building a marketplace involves much more than merely creating and marketing a new product. In this model, consumers usually need to be educated about the product or service and how or why it might be of value.

Beyond consumer education, the company building the marketplace might also have to arrange for financing to enable a consumer to make the purchase, and educate and empower other stakeholders in the system, like distributors, community-based organizations or local banks. In some instances, companies create entirely new sales structures to facilitate the distribution of their product.

- **Spotlight**: **Novartis' Arogya Parivar**: This multinational pharmaceutical company, known for drugs like Ritalin and over-the counter medicines like Theraflu, Excedrin and Maalox, has combined education and sales efforts to create a for-profit initiative to improve health outcomes for poor, rural communities in India. Previously, many people in these communities have not had access to healthcare

[28] Chesborough, H. "Business Model Innovations: Opportunities and Barriers." Elsevier. 2009. Web. November 5, 2013. http://www.businessmodelcommunity.com/fs/Root/8oex8-Chesbrough.pdf

or have not been able to afford it. Novartis has tried to alleviate that challenge through the Arogya Parivar model.

– Using a "1 plus 1 education" model, Arogya Parivar employs Health Educators who are trained in general health principles to educate a group of villages on a number of health topics, with the goal of creating faith in medicine. An accompanying supervisor educates doctors, service providers and pharmacies, and assesses an area's needs. Where necessary, Novartis seeks local partners to build up capacity to meet those needs.
– Novartis has also had to consider its pricing structures. For this initiative, the company has made its medications available in small packs at affordable prices, in most cases not exceeding $1.25 a week.
– Novartis reports that the program broke even within 30 months, and they now have ambitious plans for expansion to other countries. By investing in an entirely new business ecosystem, Novartis has earned trust (and revenue) from a new group of consumers – 42 million and counting.
– **Other examples**:
  • **CEMEX's Patrimonio Hoy** initiative uses a combination of microfinance, distribution innovation and sales training to reach 265 million families with home construction materials.[29]
  • **MicroEnsure** provides micro-insurance to poor people in developing countries, often through partnerships with mobile phone providers, whose access to communities helps achieve scale across communities.

Microfinance Microfinance is the provision of small loans—and in some cases access to financial services more broadly—to low-income borrowers who do not have access to a traditional bank account.

Banks are less inclined to give low-income customers loans because of the high associated costs with managing a small loan and the lack of collateral and credit history. Independent community moneylenders have served as a bank alternative in the past, but they charge borrowers exorbitant interest rates.

The model has spread widely in developing countries in the last decade as a way to advance financial inclusion and financial literacy.

Microfinance is often provided via a group lending system of 8–15 community members who vouch for one another to receive a loan. Dependent on social capital and networks within the group, borrowers are incentivized to repay their loans with interest to stay in the good graces of their neighbors.

Many believe that when microfinance loans are given to entrepreneurs and small businesses, it can alleviate poverty and drive greater prosperity for families and communities.

The microfinance concept has expanded to support the provision of housing loans, water and sanitation loans, and insurance.

[29] "Treasure at the Bottom of the Pyramid." Business Today. 11 December 2011. Web. 5 December 2013. http://businesstoday.intoday.in/story/innovation-cemex/1/20184.html

– **Spotlight**: **Water.org/WaterCredit:** Water.org, a non-profit co-founded by Matt Damon and Gary White, provides access to safe water and sanitation in developing countries. The organization operates a unique program called WaterCredit that uses microfinance loans to provide clean water and toilets to individuals and communities.
– Low-income individuals who live in informal communities and slums often have to pay premiums to access clean water because they are not connected to the municipal water system. WaterCredit starts from the premise that there are many people who can, and want to, finance safe water and sanitation if they are able to pay for these services over time, as well as have a voice in their development and operation.[30]
– To date, WaterCredit has provided $34 million in loans, with the average loan size $179. The program has had a 99% repayment since 2007.
– **Other examples:**
  - **Equitas** is a Chennai, India-based microfinance institution that extends microcredit to people who are otherwise unable to access finance from mainstream banking channels.
  - **Jamii Bora** is a fast-growing microfinance bank in Kenya.

Micro-Franchise This model leverages the basic concepts of traditional franchising, but is specifically focused on creating opportunities for the poor to own and manage their own businesses.

This model has become popular in developing economies where it is often risky to start a small business. Sometimes called a "business in a box," the micro-franchise model entails less risk for the would-be entrepreneur because it utilized a tried and tested model.

Several multi-national companies, including Unilever and SCJ, have piloted this model to reach new customers in hard-to-reach areas or to access a new, lower-income customer base.

The advantages of using the micro-franchise model for a large company include the utilization of a workforce with extensive local knowledge and networks, the financial empowerment of community members who can later become customers, and the establishment of local brand ambassadors.

Here, as in the inclusive sourcing model, the exchange between company and employee becomes much more dynamic than merely a payment for services. With a micro-franchise model, the knock-on benefits are felt within the company's value chain as well as within the communities the company operates within.

– **Spotlight**: **Fan Milk Limited**: Fan Milk is a West African dairy business, started by a Danish entrepreneur in the 1960s. The company uses a network of vendors to distribute its products to more than 200 million people across seven countries in West Africa.

[30] WaterCredit Overview. Web. 9 December 2013. http://water.org/solutions/watercredit/

- Fan Milk offers micro-franchise opportunities to people in local communities to become bicycle vendors. The startup cost is the equivalent of about US$22 for a Fan Milk bike, which is equipped with a cooler, and vendors must buy the products they will sell each day up front. Fan Milk offers vendors free bike repair, training on product handling and hygiene, and prizes for being high-sellers. It also requires its vendors to save a portion of their earnings each day.[31]
- Last year, Fan Milk sold $166 million of dairy products. In October 2013, Danone and a Dubai-based private equity firm announced their intentions to acquire it.[32]
- **Other examples**:
  - **Grameenphone's Village Phone Program** enables a woman to acquire a phone and then run a business that offers community members (in rural areas of Bangladesh) access to that phone.
  - **Hapinoy**, a Philippine network of small consumer goods stores, uses a conversion micro-franchise model which transfers existing businesses into members of a standardized network.
  - **SC Johnson's Community Cleaning Services**, a Nairobi-based program, creates income generating opportunities and drives sanitation improvements by delivering more hygienic toilets at an affordable cost for low-income clients.[33]
  - **Unilever's Project Shakti** is a rural distribution initiative providing employment to over 45,000 women in India.

Subscription Model In this model, a customer must pay an ongoing fee, usually monthly or annually, to gain ongoing access to a product or service. The customer pays a fee, irrespective of product or service use and the company receives recurring revenue and develops longer-term relationships with customers.

In some instances, the model is tied to the purchase and operation of an asset, where the consumer must pay an ongoing fee to make the asset operational. For example, a user buys a phone then pays for the minutes to make it run. This model yokes the purchase of the product, often at a discount, to a monthly or yearly contract, to make the product work. The contract guarantees financing for the company in the future, so that it can make necessary investments in infrastructure.

[31] "Microfranchise Wiki: Fan Milk Limited". Brigham Young University. Web. 5 December. 2013. http://marriottschool.byu.edu/selfreliance/wiki/controller.cfm?page=11

[32] Mathew, S. and Dzawu, M. Danone Joins Dubai Based Abraaj in Ghana Fan Milk Buyout. Bloomberg. 24 October 2013. Web. December 5. 2013. "http://www.bloomberg.com/news/2013-10-24/danone-joins-dubai-based-abraaj-in-ghana-fan-milk-buyout-1-.html

[33] "SC Johnson & Community Cleaning Services: Delivering Sustainabilty Opportunities, Incomes and Improved Hygiene in Kenya." WBCSD. Web. 5 December 2013. http://www.wbcsd.org/Pages/EDocument/EDocumentDetails.aspx?ID=14164&NoSearchContextKey=true

– **Spotlight**: **Better Place**: This now defunct electric mobility company attempted to revolutionize transportation and disrupt the global energy system by making car transport independent from oil. Better Place pioneered battery-switching technology and aimed to sell cars at a discount, then to have customers buy subscriptions for miles.[34]
– The company's success would have required a complete retooling of national driving infrastructure, and although the company failed, the business model innovation might work for other industries or help others innovate.
– **Other examples**:
  • **Blissmobox** is a membership club that provides customers with a curated box of organic, non-toxic and eco products each month.

Diverse Impact

Alternative Marketplaces An *alternative marketplace* occurs when a firm circumvents a traditional method of transaction or invents a new type of transaction, to unleash untapped value. Alternative marketplaces can reveal unused resources, disintermediate hierarchical systems, and in unique cases, create new channels for exchange. The model often, but not always, manifests through technology network innovations, like using the Internet to make a marketplace more transparent or using cellular phones to transform airtime into money.

Ultimately, alternative marketplaces provide a platform for exchange that matches unused supply and unmet demand.

While alternative marketplaces are not inherently more sustainable than other marketplaces, entrepreneurs are increasingly using this business model type to increase social and environmental impacts.

– **Spotlight: ITC e-Choupal**: This rural agribusiness arm of the Indian conglomerate ITC provides Internet access and market pricing information that can boost farmers' earnings and eliminate middlemen through a technology terminal called an e-Choupal. For over more than a decade, ITC has placed 6500 e-Choupals in 40,000 villages servicing more than 4 million families.

e-Choupal works by breaking down the information asymmetry that has long hindered rural farmers. These farmers previously had little negotiating power when they sold their goods because their only option was the government-mandated marketplace—the *mandi*.[35] ITC's e-Choupal has enabled access to market pricing information for farmers, giving them the choice of when to sell their crops and for how much.

[34] Adner, R. "Don't Draw the Wrong Lessons from Better Place's Bust". Harvard Business Review. 7 June. 2013. Web. 10 July. 2013. http://blogs.hbr.org/2013/06/dont-draw-the-wrong-lessons-fr/

[35] Kuttayan, A., Rao, S. *What Works: ITC's e-Choupal and Profitable Rural Transformation*. World Resources Institute, University of Michigan, University of North Carolina. August 2003. Web. http://www.wri.org/sites/default/files/pdf/dd_e-Choupal.pdf

e-Choupal began as an agricultural commodity sourcing business, but has evolved into a gateway for rural communities to connect to goods and services providers. The model has strengthened ITC's agribusiness supply chain and its relationships with farmer communities—e-Choupal brings in 40% of the revenues in the Agribusiness division—and increased growth for the packaged foods side of the business, while offering farmers choices and reforming the *mandi* system.

– **Other examples**:
  - **ezetop** enables people living abroad to send mobile phone top-up instantly to family and friends in over 100 countries.
  - **OneMorePallet** helps small businesses find available space in freight trucks.
  - **RelayRides** enables car owners to rent out their idle vehicles to strangers.
  - **Safaricom's M-Pesa** enables low-income Africans who can't access bank accounts to transfer money via their cellular phones.
  - **Tesla** circumvents the traditional car dealer sales model and sells direct to consumers.

Behavior Change Convincing consumers to change their behavior is a significant component of the sustainability agenda. Business models designed to stimulate behavior change for sustainability are a relatively new concept, but demonstrate that profitable models can coincide with decoupling from resource use. These models aim to reduce consumption, change purchasing patterns or modify daily habits. Most often, they empower consumers with knowledge about their consumption, helping them track product or service use, often using game dynamics to create competition between customers.

In the model, the nature of the transaction between consumer and company becomes nuanced: it is less about selling more goods or services and more about building brand trust and engagement. Companies employing this model aim to increase "stickiness" with the customer, making him or her less likely to buy from another good/service provider.

The fundamental challenge for behavior change business models is to find a way to drive revenue growth while continuing to encourage a decrease in consumption. The apparel brand Patagonia has experimented with behavior change marketing in recent years, by encouraging consumers to buy less and repair more. However, because Patagonia is a private company, it's hard to know if the company's bet has resulted in greater revenues or greater loyalty.

– **Spotlight**: **OPower**: This software company partners with utility providers around the world to promote energy efficiency among energy users. OPower helps utility companies capture and analyze large datasets to create business value, and offers various platforms for consumer engagement to help them understand their energy bills and encourage them to save energy, save money and reduce carbon emissions.

- OPower's business model is directly tied to the amount of behavior change it drives. By empowering consumers with knowledge about their energy consumption, and by leveraging proven behavior-changing techniques (e.g., social proof, commitments, and fear of loss), the company is changing the way people think about their energy use and driving further engagement between the consumer and the utility.
- The company is now serving more than 90 utilities—including 8 of the US's 10 largest utility companies, and reaches more than 22 million homes around the world.
- **Other examples**:
  - **RecycleBank** rewards people for taking "green actions" with discounts and deals from local and national businesses.

Product as a Service Frequently, when consumers buy a product, they assume the responsibility for disposing of it. How many of us have old cell phones piled in a kitchen drawer because we are not sure how to safely throw them away?

In this model, consumers pay for the service a product provides without the responsibility of repairing, replacing or disposing of it. The company takes ownership for the lifecycle of the product whereas that responsibility was previously transferred to the consumer.

This model shifts the burden of product repair and replacement to the company, and offers customers top product performance at all times, creating more accountability within the broader system for product disposal, and higher likelihood of product repair, reuse and recycling.

- **Spotlight: Hilti**: Operating across the United Kingdom, Hilti develops, manufactures and markets products, such as power tools, for the construction and manufacturing industry. Its primary customer is the professional contractor. Seven years ago, the company decided to diversify its offer with the Fleet Management tool program. Instead of selling tools, the program provides the service of tool use, allowing contractors to replace tools at any time and an evaluation system to calculate tool use and age, insurance to cover theft, and anytime-replacement, all for a monthly fee.
- **Other examples**:
  - **re:source** offers monthly membership fee for waste collection services and processing of waste into useful products such as organic fertilizers and energy.
  - **Rolls Royce,** the aerospace, power systems and defense company, handles service and maintenance of the products it manufactures; rather than charging per transaction, the company uses a TotalCare model focused on achieving outcomes for each customer; service provision comprises between 43 and 64% of annual revenue in each business unit.
  - **Xerox**, for several years, has been making the transition to a services-based company, away from being solely a hardware provider.

Shared Resource The sharing economy has changed the way consumers think about ownership and created a new level of engagement between perfect strangers in cities around the world.

Shared resource models enable customers to access a product, rather than owning it, and use it only as needed. Because the product is shared, the model enables efficient, productive use of a resource that might otherwise sit idle.

This model differs from *product as a service* in that product users depend on the participation and good behavior of other users for the model to operate effectively.

- **Spotlight**: **Fon**: Fon attempts to solve the challenge of Internet accessibility for consumers while they are away from their home, office or other readymade Internet networks. Fon allows home WiFi users to safely share a signal with others through a Fon Spot and in return use others' networks while away from home. All the Fon Spots together create a crowdsourced network where everyone who contributes connects for free.
- **Other examples**:
  - **AirBnB** provides a platform for those with an empty room or apartment to rent it out on a short-term basis.
  - **ParkatmyHouse** enables those with an available parking space, garage or driveway to rent it out to others in the community.
  - **RelayRides** allows private car-owners to rent out their vehicles via an online interface.
  - **Zipcar**, bought by Avis last year, is a member-based car-sharing company.
  - **Zilok** provides a platform for owners of things like cameras, cars, or drills to rent them to others.

Patterns: Industry, Geography, Size and Type of Innovation

We catalogued over 100 examples of business innovations, but when we took a closer look, several of them were actually product and process innovations. We culled our list to 87 business model innovation examples and arrived at the following conclusions.

Business model innovators tend not to be Global Fortune 500 companies.

Over half of the companies that demonstrated business model innovation were small- or medium-sized (less than 1000 employees) such as startup businesses like ParkatMyHouse, based in the UK, and Simpa Networks, based in India. Only seven of the 87 companies evaluated are members of the Global Fortune 500.

> Almost half of the companies that demonstrated business model innovation were small or medium sized.

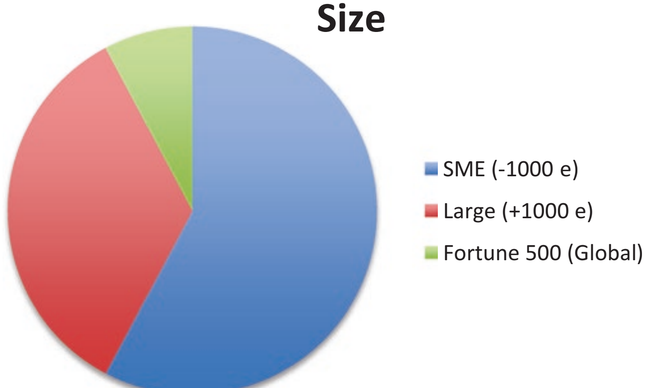


Chart 22.1 Business model innovations by company size

Within this small cohort from the Global Fortune 500, the business model innovations observed are all transformations of an established model, but are mostly limited in scope to a small segment of the business. For example, in 2012, Starbucks launched a pilot with The Climate Group and researchers at the City University of Hong Kong to experiment with the rematerialization of coffee grounds and uneaten baked goods into new products, like "detergent ingredients and bio-plastics that can be incorporated into other useful products."[36] Although the partnership is a pilot, it holds promise for a new business model transformation that would create value and a new source of revenue in the future for Starbucks (Chart 22.1).

Most business model innovations come from the ground up.

More than three-quarters of the companies we reviewed demonstrated an entirely new, more sustainable model from the start (or "from scratch" as we've called it), rather than as a transformation of an established business model. It is clearly easier to build a new model that takes social and environmental concerns into account from the ground up, rather than trying to transform a pre-existing model already in operation—to put it simply, few want to try juggling while riding a bike.

> Nearly three-quarters of the companies we reviewed demonstrated an entirely new, more sustainable model from the start.

Some large companies (those with more than 1000 employees) have explored business model transformations in parts of their businesses with varying levels of success. Until a few years ago, Panera Bread, the St. Louis-based restaurant chain,

[36] Singh, T. "Starbucks to Recycle Coffee Grounds and Baked Goods into Laundry Detergent and Other Products". inhabit. 20 August. 2012. Web. 10 September. 2013. http://inhabitat.com/starbucks-to-recycle-coffee-grounds-and-food-waste-into-bio-plastics-in-hong-kong

had a traditional food retail business model, similar to Starbucks, Chipotle or Dunkin' Donuts. Customers see a price on a menu and pay that amount to get the item they want. But, in some select locations, including 48 St. Louis area stores, Panera has experimented with a pay-what-you-want concept for certain menu items. A customer picks the item he/she wants and pays what it is worth to him/her. Panera's CEO hoped that the model would benefit hungry customers who might not be able to afford a sandwich, and that costs would be offset by more generous customers. The model depended on social capital and trust between consumers and the brand in order to work.

Unfortunately, Panera found that the model didn't have the desired effect of helping the hungry. Without the right marketing, the needy were not aware of the program, and employees stopped explaining it. Media outlets report that the company may retool the idea before bringing it back to stores.[37]

Panera demonstrates that not all business model transformations will work. That said, those transformation attempts provide tremendous opportunity to learn about consumers and test ideas. On that front, there appears to be a group of emerging pioneers from which other companies can learn. Large companies that are building base of the pyramid businesses into scalable endeavors may be ones to watch as these experimental parts of their businesses grow to comprise more revenue. Novartis' Arogya Parivar, for example, started as a pilot operating only in South India, but has now spread to 10 states and reaches over 40 million people. The program has recently expanded to Kenya and Vietnam with plans in place to open in Indonesia.

Likewise, Cemex, the global materials and construction company, has built a successful new marketplace in Central America through its program Patrimonio Hoy, which provides housing microcredit. The 15-year-old program has helped more than 35,000 families finance the construction of new homes (Chart 22.2).[38]

Business model innovation benefits from technology use.

Business model innovation examples occur across industries, but within our sample they were most prevalent in retail, food & beverage, consumer durables, and financial services, which together comprise just over a third of the companies we reviewed. However, within those industries, the models in use are diverse, making it difficult to find patterns unique to any industry. What we do see is the increasing utilization of technology to bring innovation across industries. For example, the retail apparel arena is now peppered with new online marketplaces, like Bonobos, Threadless, MUD Jeans, or Patagonia's CommonThreads initiative with eBay. In the materials industry, RecycleMatch creates a market for discarded yet recyclable material from large companies by using an online platform to match latent supply and demand. In the transportation/shipping industry, OneMorePallet uses its online

[37] "Panera shelves pay-what-you-can idea". NBC News. 10 July. 2013. Web. 4 December. 2013. http://www.nbcnews.com/business/panera-shelves-pay-what-you-can-idea-6C10588100

[38] "High Impact Social Programs". Inter-American Development Bank. Web. 4 December. 2013. http://www.cemex.com/SustainableDevelopment/HighImpactSocialPrograms.aspx

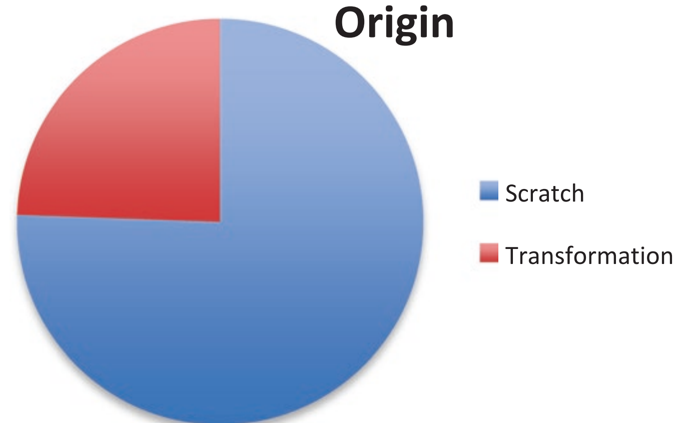
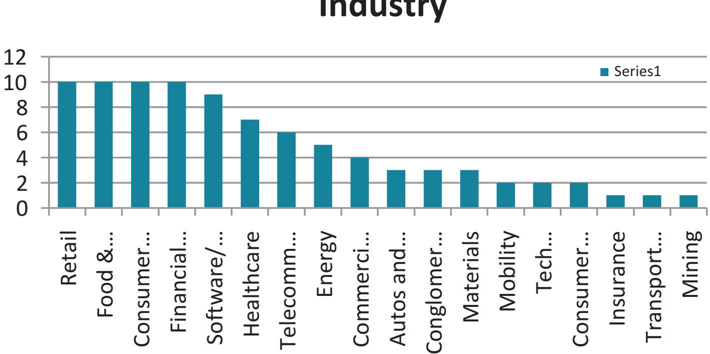


Chart 22.2 Most business model innovations start "from scratch"

platform to find empty spaces in freight trucks and auction the spaces to buyers. All use technology—particularly the Internet—to match supply and demand.

Of course, not all prevalent models are technology dependent. Plenty of innovation is happening in healthcare, largely due to experimentation with delivering affordable services to low-income customers in developing countries. This is seen in the *differential pricing* models used by Novo Nordisk and Narayana Hrudayalaya; *building a marketplace* by Novartis' Arogya Parivar; or *innovative product financing* used by Vestergaard's Lifestraw.

However, the ability to measure, track and connect instantly using technology is likely to be a major disruptive innovation across multiple industries and, if present trends continue, is likely to yield even greater innovation in years to come.



Alternative marketplaces, cooperatives, microfranchises appeared most frequently.

In part, this project started because we had grown weary of hearing Zipcar and its car-sharing competitors cited as the ultimate in business model innovation. The concept of the sharing economy in general excites us, but we felt that there had to be more to business model innovation than sharing-based models. The results suggest our instinct was correct, although sharing-based models did feature high on the list.

In fact, the *alternative marketplace* model appeared most frequently, perhaps because many of these models take advantage of relatively recent technologies like mobile messaging, remote sensing, and online networks. We hope to see more of these models emerge in the future, as they are extremely innovative, creating new currencies, circumventing traditional transactions, and reaching new stakeholders.

We also came across a surprising number of cooperatives, which, it turns out, come in all shapes, sizes and geographies. *Cooperatives* truly change the incentive system within a company, to make members—whether employees or customers—much more likely to feel invested in the company and its brands.

As companies try to expand through rural emerging markets, *micro-franchising* models have also come into fashion. Their turnkey approach to replicating a proven business model makes them a good match for low-income entrepreneurs who need good jobs, but may be averse to starting their own enterprise from scratch.

Lastly, *product as a service* models showed up frequently in our review. The transition from a product-sales model to a service-provision model may feel more comfortable for some companies for whom business model innovation becomes a matter of capturing and packaging their internal knowledge and experience to share with others. These models may be a natural evolution for large, hardware-driven companies where resource scarcity looms as a future challenge (Chart 22.4).

Business model innovation can happen anywhere.

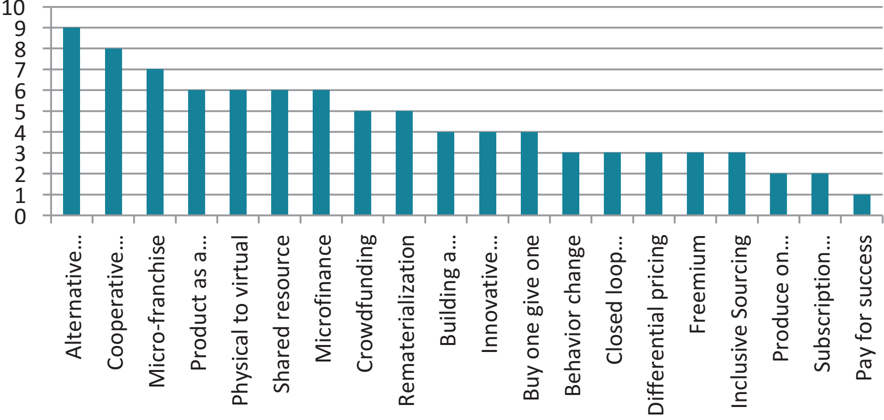


Chart 22.4 Business model innovation by type

It's important to understand where business model innovation is finding a foothold. For this paper, we considered where the *actual innovation* takes place—in established, developed markets like the Netherlands, Spain, US and UK or in fast-changing developing markets like China, India or Kenya. In other words, even if a company is based in Europe, if the innovation in question is deployed in Mozambique, we consider it a developing world innovation.

Admittedly, the division is nuanced; yet there are distinct differences between the innovations prevalent in established economies versus those seen in less developed economies, and we wanted to understand what role geography plays in business model innovation.

We assumed that most of the business model innovations we came across would originate in the developing world because of the high incidence of path-breaking enterprises, the proliferation of creative new ventures spun out of established companies (e.g., Safaricom's M-Pesa, ITC's e-Choupal), technology penetration and the freedom of multinationals to innovate for new customer segments in these markets. However, the examples that emerged from our research were geographically diverse. In fact, only about half (51%) of the business model innovation examples occurred in the developed world.

> Only about half of the business model innovation examples (51%) occurred in the developed world.

Only a handful of innovations are global (i.e., both developed and developing world), leading us to believe that either it is difficult for companies to create new business models that can succeed in both the developed and developing world, or few have moved beyond testing and succeeding in one market to rolling out in the other. For example, Walmart practices inclusive sourcing with small farmers in China and the US. The company is innovating its business model globally, but the processes and pricing models are no doubt very different.

It's clear that business model innovation for sustainability can happen anywhere. It's not limited to wealthier countries or dependent on frontier marketplaces, but is likely more successful when focused on a particular marketplace (Chart 22.5).

Not all innovation is truly business model innovation.

Sometimes, what appears to be business model innovation is in fact, process or product innovation. In searching for business model innovation examples, we found that roughly two-thirds of the examples did, in fact, include *a novel form of exchange somewhere along the value chain.* The other cases demonstrated process or product innovation—worthwhile innovations, without a doubt, but just not the ones we explored for this report.

Business model innovation can emerge from process or product changes.

While the majority of business model innovation examples clearly involve the creation of a new model, there are a handful of notable examples that evolved from process or product innovation into business model innovation. For example, when

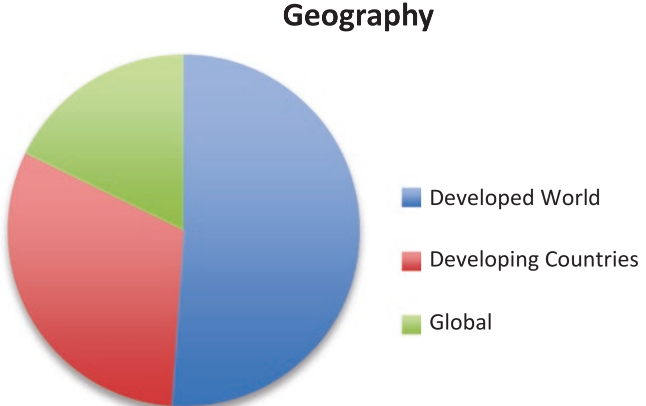


Chart 22.5 Business model innovations by geography

SAB Miller, the global alcohol beverage maker entered Mozambique, the company discovered a new local, raw material to make beer—cassava—a product innovation.

However, the company's website explains, as SAB Miller began sourcing the cassava, it interacted with local subsistence farmers, paying them a wage that boosted income, thus creating a novel form of exchange within the value chain. Meanwhile, the government supported the effort by eliminating the excise tax on cassava beer.

Because of the tax break and its local sourcing efforts, SAB Miller was able to sell the beer for 70% less than other similar beers in the marketplace making the beer an affordable alternative to informal/illicit alcohol, which causes a number of deaths from poisoning each year..[39] What began as product innovation transformed into business model innovation.

Models with the most potential.

This report highlights many types of business model innovations for sustainability, some of which are, no doubt, more catalytic than others. This comes from a model's ability to impact the systems that a company is part of while also functioning as a more commercially viable alternative to current models. As we reviewed and researched each model, we developed viewpoints on which models hold the most promise for catalyzing change while continuing to generate commercial value.

Four that we believe have great potential for the future, and which large companies can consider as they experiment with business model innovation are *closed loop production*, *product as a service*, *inclusive sourcing*, and the *alternative marketplace*.

[39] LythGoe, L. "Trouble Brewing: Africa and Alcohol Problems". Think Africa Press. 14 January. 2013. Web. 5 December. 2013. http://thinkafricapress.com/society/trouble-brewing-africa-and-its-alcohol-problems

Closed loop production models present tremendous opportunities for companies to cut costs and meet ambitious sustainability waste goals, while significantly impacting the system. These models reduce the quantum of resources extracted from the system. Several Fortune 500 companies, like Alcoa, Maersk and Nike, are experimenting with these concepts on a product level—a move that could lead to further innovation at the process or business model levels.

We're also seeing several multinational companies (e.g., IBM, Rolls Royce plc, Xerox) experiment with *product as a service* models. This approach can reduce resource use and challenge companies to focus on product performance rather than product sales. Depending on what a company produces, transitioning to a more services-based model can be a more natural and gradual shift than some other models.

For companies that source products from small producers, either at home or abroad, *inclusive sourcing* begs a closer look. As detailed in our description earlier in this paper, while inclusive sourcing can require more effort and upfront investment, it can reap dividends in the future by stabilizing the supply chain, building brand loyalty, and creating a new, economically empowered consumer base. It can also have a dramatic social impact on the populations it serves.

Lastly, we are intrigued and excited by the concept of the alternative marketplace. Technology—Internet, mobile, big data—can be used by companies to create new markets which can enhance brand value and generate trust. We have seen

BOX: Making Business Model Innovation Work

Despite the formidable barriers to business model innovation within large companies, the body of research and experience developed over the past decade about "where innovation works" offers a number of useful insights for companies looking to create new models.

1. **Don't be afraid to question existing models.** The first step in building something new is having the courage to examine the current model--as Stahler puts it, getting "all the tacit and unspoken assumptions on the table." Challenging the dominant logic may, in fact, be the most difficult step, but it's the only way to move towards identifying new options.
2. **Be willing to try something new.** If companies are best at maintaining what they already do, recognize that any true business model innovation will require building new skills and applying different capabilities. Innovators should be willing to let go of what made them successful in the past. Some experts recommend taking a "portfolio approach", maintaining focus on what's worked before, but dedicating some percentage of resources towards development of entirely new business models.

(continued)

3. **Establish and protect an innovation culture.** For business model innovation to succeed, some level of cultural support must be present within the company, or at least within a team responsible for innovation. This includes, but it not limited to, a mission and/or goals that promote the pursuit of innovative business models; the right management structure allowing for discussion and connection around innovation; incentives for identifying and cultivating breakthrough innovation; and an entrepreneurial mindset, with the ability to prototype, experiment, fail fast, and learn (as with the "lean startup" model).
4. **Stay connected to the market.** Business models are ultimately about the value delivered to customers. To innovate, companies must stay connected to ever-changing customer needs and market realities. It can be particularly helpful to understand local communities and their real needs and wants. Design consultancy IDEO, for example, has developed a strong competency around such "human-centered design."
5. **Remain open.** In this age of transparency and hyper-connectivity, innovators can benefit from the opportunity to build new capacities and generate new ideas through alliances and sharing. Whether it's new public-private partnerships or crowdsourced innovation, companies have realized the benefit of extending their innovation network.
6. **Take a structured approach.** Corporate strategy is not a conceptual exercise, nor should it be done haphazardly. Likewise, any business model innovation effort should follow a disciplined, structured approach. While a variety of sound approaches have been developed by researchers and consultancies, the specific approach is less important than insuring that some structure has been introduced.
7. **Be prepared to struggle.** It may not be the case--and if it isn't count yourself as lucky--but expect that the innovation process will take some time and muddling. Build budgets and project timelines accordingly.

Patagonia do this through its recycled clothing initiative on eBay. We have also seen the model drive new sources of revenue, as ITC e-Choupal has done in India, and create environmental efficiencies, as OneMorePallet has done.

How Large Companies Are Finding New Models

Transforming an existing business model is less common than innovating from scratch. As stated above, we see far fewer examples of business model innovation at companies with existing, profitable models. This is likely due to the complexity of transforming a working business model and the vested interests in the current model. Far more often, we observe start-ups that create business models that have interwoven social and environmental elements. The underlying reason is simple—it

is far easier to build a more sustainable structure brick by brick than retroactively retooling a business' underlying framework.

Nevertheless, companies have found creative ways to innovate and experiment with new business models for sustainable outcomes by partnering with social entrepreneurs and using diverse channels to search for and experiment with new business models.

Social entrepreneurs have become a key cohort for sustainability practitioners to watch because they are at the forefront of sustainability. The 2013 Global Sustainability Survey produced by GlobeScan and SustainAbility found that sustainability experts view social entrepreneurs as leading the way on the sustainability agenda, ahead of scientists, NGOs, large companies and national governments.

Sustainability experts view social entrepreneurs as leading the way on the sustainability agenda, ahead of scientists, NGOs, large companies and national governments.

Social entrepreneurial ventures have the advantage of being smaller and more nimble than multinational companies, able to tweak their business models as markets change and incorporate social or environmental benefits into their models from the start. A recent Harvard Business Review blog, *Meet Your new R&D Team: Social Entrepreneurs*,[40] identified social entrepreneurs as the "new R&D" for large companies, describing investments in social entrepreneurs as an important part of the innovation continuum. Indeed, companies seeking to enter emerging markets or source more ethically have benefitted from the on-the-ground intelligence, market expertise and strong relationships with suppliers that social entrepreneurs often have.

Another method of business model experimentation occurs via impact investments by companies. These investments, often led or facilitated by the corporate responsibility team, are one method of "de-risking" new market entry. As the above-referenced HBR blog mentions, this "reverses the traditional CSR model of giving back to communities that a business operates in, and places these investments at the front end of corporate innovation strategy." The writer, Robert Fabricant of Frog Design, cites the investment by the Shell Foundation into social enterprise Husk Power Systems, a renewable rural electrification enterprise in India.

Companies have also created various means to find and invest in or pilot models that have more sustainable outcomes. Several companies have launched innovation platforms, such as P&G's "Corporate Platforms." Corporate Platforms is the new business "capability building organization" within P&G, with the responsibility and resources to disrupt existing models. Through this unit, P&G is exploring new technologies and smarter products.

One partnership, with a crowdfunding site called CircleUp, allows P&G to spot business model innovations and new consumer products early. Waste2Worth,

[40] Fabricant, R. "Meet Your New R&D Team: Social Entrepreneurs". Harvard Business Review. 8 March. 2013. Web. 4 December. 2013. http://blogs.hbr.org/2013/03/meet-your-new-rd-team-social-e

another project emerging from Corporate Platforms, eliminates consumer waste to landfill in developing regions by extracting maximum value from waste, thereby stimulating economic development and sustainable infrastructure. At a Charmin plant in Latin America, Waste2Worth converts paper waste fiber into roof tiles, and waste from a site in China is being converted into fertilizer for planting trees.[41] These measures are small efforts, but could be viable models for future revenue streams and could help close the waste loop.

In-house venture funds also advance companies toward “the next big thing”—which just might be more sustainable. For example, BMW’s iVenture arm, based in New York, incubates and invests in early- and mid-stage companies with high potential in the area of mobility services. Investments have included ParkatMyHouse, the “AirBnB of parking,” MyCityWay, an app for all aspects of urban navigation and ChargePoint, an electric vehicle charging company.[42] While BMW iVentures doesn’t claim to focus on sustainability, it is an ideal illustration of the happy collision of business value and innovation for sustainability. As BMW prepares for a future that may make car ownership unaffordable or inaccessible for many, the company is working to uncover the most innovative tools for the transportation of tomorrow.

Acquisitions also enable companies to co-opt more sustainable models. This trend is most evident in the automotive industry, which has embraced the disruptive waves caused by carsharing initiatives. Large corporations have acquired carsharing start ups (Avis bought ZipCar in 2013), launched their own car sharing services (Daimler, BMW and VW) and partnered to target new consumers (Toyota connected with a real estate developer in Tokyo to offer electric vehicle sharing in local condominiums).[43] We have also seen values-led food businesses get acquired by large companies interested in reaching a different consumer segment, often in pursuit of a healthier product portfolio or products with a more ethical brand; oft-cited examples include Unilever’s acquisition of Ben & Jerry’s, Group Danone acquiring Stonyfield Farm and Coca Cola buying a majority share of Honest Tea.

One of the exciting developments coming from corporate sustainability innovation leaders is the launch of dedicated R&D centers focused on innovation that can yield sustainable outcomes. Nike’s “Sustainable Business & Innovation Lab,”[44]

[41] “Worth from Waste”. Procter & Gamble.2 April. 2013. Web. 10 September. 2013. http://blogs.hbr.org/2013/03/meet-your-new-rd-team-social-e

[42] *BMW i Ventures*. BMW Group. 20 January. 2012. Web. 5 December. 2013. http://corporateventuringconference.com/wp-content/uploads/2013/02/BMW_i_Ventures.pdf

[43] Clark, S. “The Auto Industry Embraces Its Own Disruption”. Harvard Business Review. 23 November. 2011. Web. 10 September. 2013. http://blogs.hbr.org/2011/11/embrace-disruption-to-build-yo

[44] “A New Model and Shift to Sustainable Business and Innovation”. Nike. Web.10 September. 2013. http://www.nikebiz.com/crreport/content/strategy/2-1-4-a-new-model-and-shift-to-sustainable-business-and-innovation.php

Levi's Eureka Innovation Lab,[45]and Philips' R&D unit[46] have all produced more sustainable products and processes that advance their understanding of sustainable design and innovation thereby making it more likely they will be at the forefront of business model innovation in the future.

Final Remarks

What are we to do with the 20 models identified in this paper? We hope that they will inspire, for a start, and spur creativity as business and sustainability leaders look across their own value chains for areas of opportunity and transformation.

But, if we're honest, we have to acknowledge that most of the large companies we work with are not changing their business models—many enjoy stable market positions and healthy returns, so it may be challenging to find a reason to shift what's working today.

Many business model innovations occur not as a result of deliberate effort to be more inventive, but rather as a byproduct of coming to terms with other trends and threats that a company faces. For example, Adidas, Nike, Zara and other footwear and apparel brands are only now looking deep into their multi-tiered supply chains to eliminate toxic chemicals as a result of discoveries by Greenpeace that waterways and communities were being polluted. Likewise, companies like Gap, Walmart, Kohl's, Target and Macy's are rethinking how they engage and support apparel factory owners—together they formed the Bangladesh Alliance for Worker Safety which mentions providing owners loans to improve safety—to prevent deadly accidents like the Rana Plaza factory collapse last year.

How can companies get ahead of the curve before an issue becomes urgent? How much destroyed value—lost resources, lost lives, lost sales, dilution of brand value—are we willing to accept? Business model innovation is an on-ramp to getting ahead of the curve.

When we started this report, we intended it to be a short primer covering a handful of models that seemed to hold promise for future sustainability. We have done much more than that. And yet, we haven't covered everything we would like to in this first effort. The questions and the models continue to surface. As such, we plan for this to be the start of a more in-depth exploration.

It's important to dig deeper. If business model innovation is indeed a key ingredient to transforming our economic landscape and improving social and environmental outcomes, it is worth understanding what drives it, what the most promising

[45] Philipkoski, K. "A Levi's Secret Lab Is Unveiled With a Sustainable Men's Line". Racked. 7 November. 2013. Web. 5 December. 2013. http://sf.racked.com/archives/2013/11/07/levis-opened-a-secret-lab-this-spring.php

[46] Balch, O. "How Philips is transforming its business model for sustainability". Guardian Sustainable Business. 25 September. 2013. Web. 5 December. 2013. http://www.theguardian.com/sustainable-business/how-philips-transforming-business-model

business models are, and what might compel a company to transform an existing model.

We conclude the paper with more questions than answers:

- What incentives would help companies with commercially successful, but inherently unsustainable business models transform?
- How does the business model innovation process happen within a large company? Who drives it? Who needs to be involved?
- What does a more sustainable business model look like in each industry (e.g., Fast fashion? Coal-powered utilities? Food & beverage?)
- How can we grow the business models that are inherently more sustainable but not currently as commercially successful?

We hope to explore these questions and others as our research into business model innovation deepens.

What's next? From here we plan on holding roundtable discussions in several markets to share the ideas within this paper and evolve our thinking. We will also share some of the ideas and models within this paper in a blog series to be published with the Guardian Sustainable Business.

Appendix

We reviewed business model innovation examples occurring at the following companies.

Aarstidarne
ACCION USA
AirBnB
Amul
Aravind Eye Care Hospital
Better Place
Blissmobox
BMW iVenture
Bonobos
BRAC
Care Hospitals
Cemex
eBay Inc
Equitas
ezetop
Fan Milk Ltd.
Fon
FreedomPop
Fundly

GiveForward
Grameen Bank Group
Hapinoy
Hilti Corporation
Indian Coffee House
IndieGoGo
Interface
ITC E-choupal
J&J's Velcade
Jamii Bora
John Lewis Partnership
Kickstarter
Knowaste
Lego – Cuusoo
LeHigh Technologies
Lifestraw by Vestergaard Frandsen
M-Pesa by Safaricom
MicroEnsure
Mondragon Corporation
Mosaic
Mud Jeans
Narayana Hrudayalaya
Netflix
Novartis's Arogya Parivar
Novelis
Novo Nordisk
Ocean Spray
OneMorePallet
OPower
OwnMutually
Panera Bread LLC
ParkatMyHouse
Patagonia
Re.Source
Recyclebank
RecycleMatch
REI
RelayRides' GM partnership
Rolls Royce
Rubies in the Rubble
SAB Miller
Sarvajal
SC Johnson's microfranchise initiative
Simpa Networks
SoapBox Soaps

SolarCity
SPUD
Starbucks
SunEdison
Sungevity
Sylva Foods
Tesla Motors
TextNow
The Co-operative Group
Threadless
Tom's Shoes
TwoDegrees
Unilever's Project Shakti
Vancity
Grameen Telecom's Village Phone
VisionSpring
Walmart
Warby Parker
Waste Management, Inc
Water.org's WaterCredit
Xerox
Zilok
Zipcar (now owned by Avis)

SustainAbility is a think tank and strategic advisory firm that for over 25 years has catalyzed and supported business leadership on sustainability. Through our agenda-setting research and advocacy, we chart new territory and help business leaders and their stakeholders understand what's next. Through our advisory services, we help clients anticipate trends, understand key risks and opportunities, develop effective strategies and initiatives, and build trust and unlock new possibilities through authentic stakeholder engagement and collaboration. Learn more at sustainability.com.

From Incrementalism to Transformation: Reflections on Corporate Sustainability from the UN Global Compact-Accenture CEO Study

23

Peter Lacy, Pranshu Gupta, and Rob Hayward

Over the last decade, sustainability has become firmly established on the corporate agenda. CEOs have become more confident in discussing sustainability issues and their impact; sustainability reporting has become commonplace; and business leaders talk of sustainability as a critical driver of future success. But beneath the surface, progress in embedding sustainability into companies, industries and markets may be slower than anticipated. Despite individual achievements, progress has slowed, with many companies struggling to move beyond philanthropy and corporate social responsibility. The new era of integrated sustainability, once confidently predicted by CEOs, has perhaps never seemed so far away.[1]

Over the last decade, the UN Global Compact has conducted a triennial survey of CEO opinion on sustainability. Through a series of in-depth interviews and online surveys, the three studies – published in 2007, 2010 and 2013 – together offer a unique perspective on corporate sustainability since the founding of the Global Compact in 2000. In this article, we reflect on the insights of the CEO Study in order to trace the development of sustainability, and shed light on the current pathway towards a more sustainable economy.

[1] Definitions of 'sustainability' and 'sustainable business' abound. As a working definition, and an aspiration, we use the term 'sustainable business' to mean a company or organization that creates value for owners, stakeholders and society through its products and services, operations and value chain, while delivering a 'net positive' social, environmental and economic impact; embedded within this concept is the idea of 'zero-harm' to people and planet.

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© Springer Science+Business Media B.V. 2019

G. G. Lenssen, N. C. Smith (eds.), *Managing Sustainable Business*,
https://doi.org/10.1007/978-94-024-1144-7_23

From Philanthropy to ESG: The First Wave

The first CEO Study, commissioned by the UN Global Compact in 2007 and conducted by McKinsey & Company,[2] reflected a world in which sustainability issues were just beginning to move from the domain of academic debates and NGOs to become a primary concern of business. In the early 2000s, as companies had begun to respond to the demands of NGOs, the media and their own employees, discussions of environmental and social impact became commonplace. Many companies established corporate social responsibility teams, and sought to partner with charities and NGOs on philanthropic initiatives: building wells in rural communities, for example, or donating computer equipment to schools.

By the time of this first study, *Shaping the New Rules of Competition*, a small group of companies – themselves 'early adopters', through their membership of the UN Global Compact – are seen to be considering the implications of these shifts for their competitive positions; the 'new rules of competition' would be based, they believed, on a more active role in promoting social and economic prosperity that in turn would build trust and legitimacy with the public. The study revealed that more than nine in ten business leaders were doing more than 5 years previously to incorporate environmental, social and political issues into their firms' core strategies, and showed how business leaders were becoming ever more comfortable with the language of sustainability. "If you'd talked to any CEO about what their carbon footprint was one year ago," said one CEO quoted in the Study, "you'd have been met with a fairly blank stare. Now they'd be able to give you a pretty good answer."

The authors highlighted new demands and expectations on business:

> *Many executives see the new standards and demands as burdens. But our research shows that some visionary CEOs are recognizing them as opportunities to apply their creativity and resources to gain competitive advantage, and help address some of the world's biggest challenges. As governments around the world wrestle to address issues that cross borders, there is growing recognition that the marketplace and private enterprises that operate on a global scale can and must help find solutions to global problems. Many experts believe, for example, that given the right price signals, the market is better equipped to address climate change than any central planning or state enterprise model. We are therefore witnessing the dawn of a new era in corporate innovation and experimentation, when new partnerships and standards will emerge, when new, more transparent measures will better reflect the full costs of doing business, and when greater private participation in the delivery of public goods and services will change companies' roles in society.*[3]

This anticipated shift in the role of companies in society marks an important development. After years of 'unrestrained capitalism', CEOs can be seen to be reflecting on the legitimacy of business and the challenge of building public trust, as well as the tensions between business-as-usual and the challenges of environmental and resource constraints: in the words of one Latin American CEO, "Society's expectations of our company, and business in general, have increased significantly

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[2] United Nations Global Compact and McKinsey, *Shaping the New Rules of Competition: UN Global Compact Participant Mirror* (2007).

[3] *ibid.*

in the last five years, particularly around environmental issues and broader social and economic development."

Asked about the factors motivating them to take action on sustainability issues, CEOs identify employees, consumers and governments as the most important stakeholder groups, reflecting a combination of incentives: attracting and retaining talent through a commitment to social responsibility; securing consumer preference and loyalty through 'green' branding; and responding to government and regulatory requirements. Through these various motivations, we can trace a strong current running through the Study: sustainability, rooted in philanthropy and CSR, becoming embedded more widely across business – with the early signs of a real commitment to addressing social and environmental challenges.

The Financial Crisis and the Rise of 'Sustainability'

The financial crisis of 2008–2010 fundamentally changed approaches to corporate sustainability. Economic pressures and the demands of short-term survival forced many companies to re-examine their CSR programmes and philanthropy initiatives, seeking tangible, measurable returns on investment and integrating sustainability more closely into the fundamentals of business. As the 2010 CEO Study, *A New Era of Sustainability*, notes:

> *In the course of our survey and conversations with CEOs, we have witnessed a fundamental shift since the last Global Compact survey in 2007. Then, sustainability was just emerging on the periphery of business issues, an increasing concern that was beginning to reshape the rules of competition. Three years later, sustainability is truly top-of-mind for CEOs around the world. While environmental, social and governance challenges continue to grow and CEOs wrestle with competing strategic priorities, sustainable business practices and products are opening up new markets and sources of demand; driving new business models and sources of innovation; changing industry cost structures; and beginning to permeate business from corporate strategy to all elements of operations.*[4]

Strikingly, in what quickly became the headline number of the 2010 Study, 93% of CEOs reported that sustainability would be 'important' or 'very important' to the future success of their business; sustainability, it appeared, had shifted from an optional 'nice-to-have' to an essential part of core business, with real, tangible impacts on the fundamentals of success. Consumers, employees and governments all grew in their perceived importance in setting the agenda for sustainability, as NGOs fell away – a move away from issue-based, reactive responses, perhaps, and towards sustainability as an integrated part of core business. With the crisis of trust still a white-hot issue for business leaders, CEOs identified 'brand, trust and reputation' as the prime motivating factor to take action on sustainability, followed by the potential for revenue growth and cost reduction – a further sign that sustainability was no longer considered peripheral to business, but an integral part of relationships with consumers and customers, and a strategy that could benefit the bottom line.

[4] United Nations Global Compact and Accenture, *A New Era of Sustainability* (2010).

Another notable development is the prominence of the term 'sustainability' itself. Virtually absent from the 2007 study – the word appears only twice, in mentions of 'environmental sustainability' and 'sustainability reports' – 'sustainability' appears no fewer than 360 times in the 2010 study, including in the title itself. Analysis of transcripts from interviews with CEOs in 2010 reveals the rise of 'sustainability' as a mainstream concept in business: from the ubiquity of 'ESG' in 2007, 'sustainability' has taken over, featuring on multiple occasions in every conversation.

The combination of business leaders' focus on efficiency and survival, and the maturation of 'sustainability' as a mainstream concept, had important consequences for the development of companies' approach to environmental, social and governance issues. From the broad approach evident in 2007, as CEOs discussed rebuilding the social contract within an economy that demanded more from business, 'sustainability' for many companies became shorthand for a narrow focus on incremental achievements in environmental efficiency. From a commitment motivated by a sense of responsibility and 'the right thing to do', sustainability became a business-led imperative, motivated by short-term concerns and justified by its impact on the bottom line. Throughout the 2010 Study, we can see companies focussing on the 'quick wins' of energy and resource efficiency and cost reduction: in the words of one senior business leader quoted in the Study, "If managing a business sustainably is about using resources efficiently, then it serves the cost agenda as well."

As the focus of sustainability narrowed, business leaders' confidence soared. From a nebulous concept, fraught with fundamental questions about the role of business in a healthy society, sustainability now presented a narrowly-defined set of expectations and demands. Companies built their capabilities in measuring and reporting carbon emissions; in tracking health and safety in the workplace; in promoting diversity within the workforce. Many more companies made public commitments to environmental sustainability; published annual sustainability reports; and reported year-on-year metrics under the Global Reporting Initiative (GRI). Buoyed by this progress, 81 % of CEOs surveyed reported that sustainability issues were fully embedded in the strategy and operations of their company – and more than half anticipated a 'tipping point' where sustainability would be integrated into companies and global markets within a decade.

'Frustrated Ambition': Reaching the Plateau

Fast forward to the most recent CEO Study in 2013,[5] and the bullishness of business leaders has all but disappeared. Far from continuing towards the 'new era' they anticipated in 2010, many CEOs feel that business has become complacent about progress, describing a situation in which sustainability has become embedded into communications and rhetoric, but not into the everyday realities of business. Two headline numbers from the 2013 study give a striking indication of business leaders'

[5] United Nations Global Compact and Accenture, *The UN Global Compact-Accenture CEO Study on Sustainability 2013: Architects of a Better World* (2013).

perspective: just one-third believe that the global economy is on track to meet the needs of a growing population within environmental and resource constraints; and one-third believe that business is doing enough to address sustainability challenges (Figs. 23.1 and 23.2).

Reflecting on their own progress in embedding sustainability into core business, CEOs express a sense of 'frustrated ambition'. Business leaders remain convinced that sustainability will transform their industries; that leadership can bring competitive advantage; and that sustainability can be a route to new waves of growth and innovation. In the words of Ramakrishnan Mukundan of Tata Chemicals, "There is no choice for businesses but to get on the road to sustainability: it is unsustainable to be unsustainable."

But beneath this commitment, frustration is clearly evident: business leaders are in many cases unable to locate and quantify the business value of sustainability; are struggling to deliver the business case for action at scale; and see market failure hindering business efforts to tackle global challenges. CEOs see business caught in a cycle of "pilot paralysis" – individual, small-scale projects with an incremental impact on sustainability metrics – and while they see a role for business in promoting sustainable development, their responsibilities to the more traditional fundamentals of business success are preventing greater scale, speed and impact (Figs. 23.3 and 23.4).

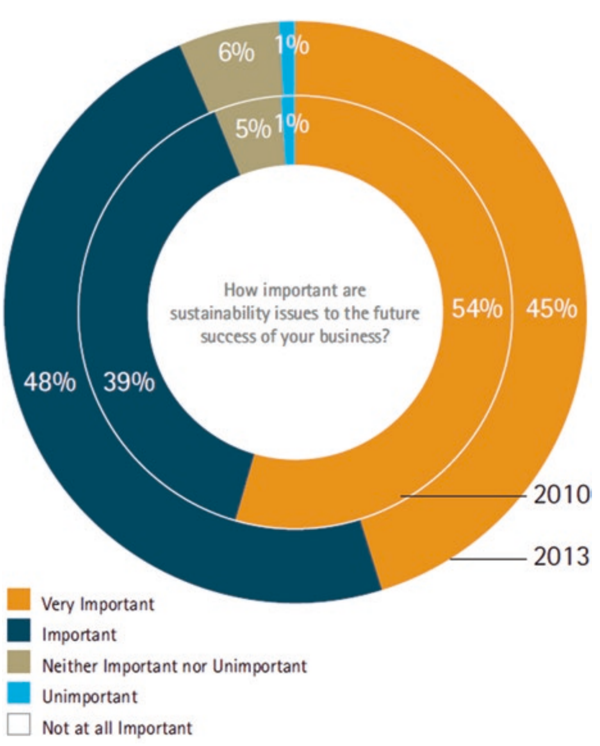

Fig. 23.1 Ninety-three percent of CEOs believe that sustainability will be important to the future success of their business (Source: UNGC-Accenture CEO Study 2013, based on 1000 completed responses)

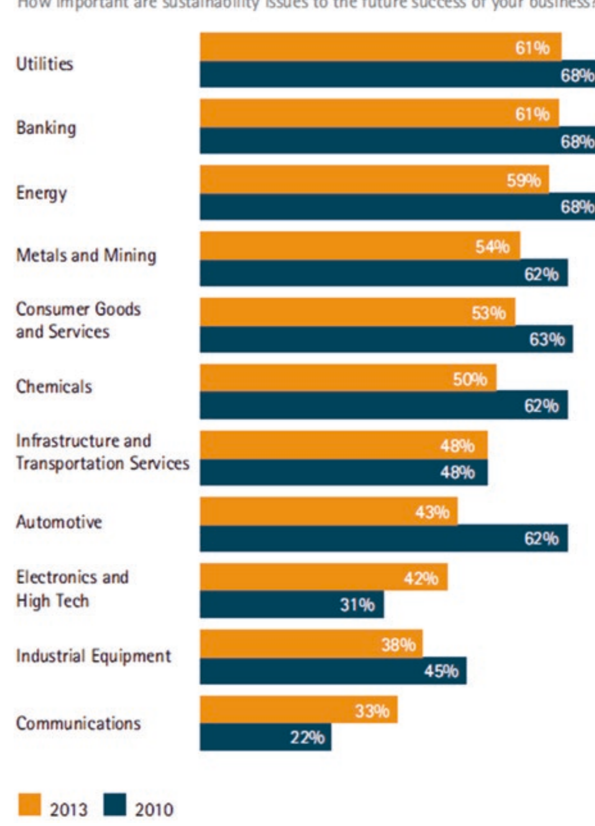

Fig. 23.2 In many industries, there is a marked decline in the proportion of CEOs who see sustainability as "very important" to success (Source: UNGC-Accenture CEO Study 2013, based on 1000 completed responses)

Consumers Are Conflicted in Their Signals: And May Not Provide the Answer

In the most recent survey, it is clear that market-facing factors are influencing CEOs' approach to sustainability: the top three motivating factors to take action are brand, trust and reputation (69%), the potential for revenue growth and cost reduction (49%) and consumer demand (47%). These factors, ranked above such motivators as employee engagement, personal motivation, or pressure from government and regulators, demonstrate how business leaders have begun to root sustainability in the business case.

The consumer emerges as the most important stakeholder when it comes to having an impact on a company's approach to sustainability. Consumers are ranked among the three most influential stakeholder groups by 64% of CEOs, continuing the trend observed in 2010, when 58% of CEOs ranked them among the top three influencers, up from 50% in 2007. For consumer-facing businesses, understanding the shifting preferences and desires of disparate consumer groups is a constant and complex undertaking. Business leaders strongly believe that their sustainability

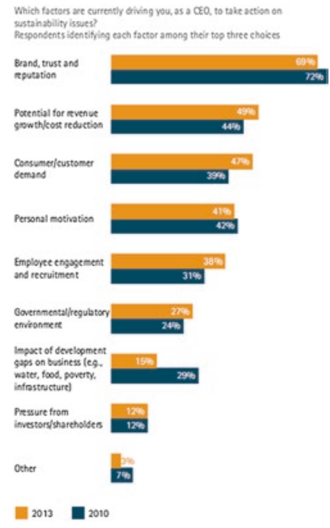

Fig. 23.3 CEOs are increasingly market-focused in their motivations to invest in sustainability (Source: UNGC-Accenture CEO Study 2013, based on 1000 completed responses)

performance and reputation are key factors in shaping consumer and customer demand: CEOs report that both the reputation and brand of their company on sustainability (81%) and the sustainability performance of products and services (77%) are important in the purchasing decisions of their consumers and customers. As one CEO in the technology industry told us, "Five years ago, sustainability was important, but not core to how we delivered value to customers; now we have products designed with sustainability in mind."

Despite their belief in the importance of sustainability for consumers, CEOs are realistic with regard to its impact in the market. CEOs remain skeptical of consumers' willingness to make trade-offs between sustainability and traditional differentiators, with 46% believing sustainability issues will *always* rank behind price, quality and availability. In the words of Peder Holk Nielsen, president and CEO of the Danish biotech company Novozymes, "Sustainable solutions have to be qualitatively or economically on par or better than the old processes that they replace; it has never been possible to charge extra for sustainability." While 28% of CEOs report securing a price premium through their approach to sustainability, many believe that this may not be sustainable or that it may not reach beyond a small segment of "ethical" consumers. "Consumers are aware of sustainability but are not willing to compromise on quality, convenience or price," said Henkel CEO Kasper Rorsted.

The recent companion study conducted by Accenture and Havas Media, on the views and expectations of 30,000 consumers worldwide, show the challenge of engaging the consumer on sustainability. The study reveals that, although CEOs see engagement with consumers as the most important single factor motivating them to accelerate progress on sustainability, less than one-quarter of consumers report that they regularly seek information on the sustainability performance of the brands whose products they purchase, and less than one-third 'often' or 'always' consider sustainability in their purchasing decisions. In essence, consumers expect superior performance on

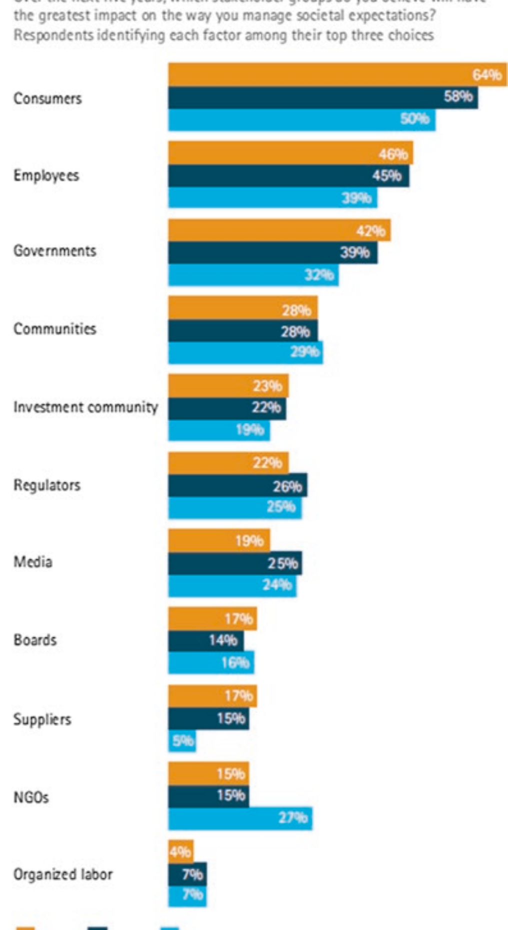

Fig. 23.4 CEOs see consumers and government growing in importance in influencing their approach to sustainability

sustainability and demand a greater contribution by business to global challenges, but that they have little appetite to pay higher prices or to actively pursue information on the sustainability performance of companies. CEOs and consumers alike are clear, though, that sustainability is becoming an expectation, and that the reputation on social, environmental and ethical issues can make or break brands – and companies.

Investors Are Showing Greater Interest: But Remain Ambivalent and Are Unlikely to Drive Change

In 2010, CEOs identified the relationship with investors as critical to making progress on sustainability: 86% of CEOs saw the accurate valuation of sustainability by investors as critical to progress. If companies could clearly communicate the value of sustainability, and investors could factor sustainability performance into company

valuations, CEOs believed that this relationship could unlock new investment and reward the leaders in the field.

But the 2013 survey reveals little momentum in the impact of investors on corporate efforts in sustainability: as in 2010, just 12% of respondents regard investor pressure as among their chief motivators on sustainability, and only 23% (from 22% in 2010 and 19% in 2007) see investors as an important stakeholder. As one CEO told us, "Investors sit and listen politely when we bring these issues up, but they really don't ask about it – we're not doing this to please shareholders." And in the words of another, "My job as CEO is to make the company bigger, better and more sustainable; I don't spend much time convincing investors, because I think if I do my job, the rest will follow."

But despite their absence from the most important stakeholders cited by CEOs, investors do have an impact: 52% of executives report that investor interest is an incentive for them to invest in sustainability, and 69% expect investor interest to be an increasingly important factor in building sustainability issues into core business. As one senior business leader put it, "We still find it challenging to convey to mainstream investors why and how sustainability can drive value creation, but they're starting to appreciate the risks of working in an unsustainable system."

Yet as with CEOs' perceptions of the consumer, this belief in the growing interest of investors is yet to be reflected in the realities of the market. Just one-third of CEOs of public companies believe that their share price currently includes value directly attributable to sustainability initiatives and performance – further evidence for CEOs' own recognition that the lack of a link to business value is a barrier to progress on sustainability. And the recent Accenture-PRI study of investor attitudes to sustainability exposes a gap in communication: 57% of CEOs surveyed in the UNGC-Accenture CEO Study reported they are able to set out their strategy for seizing opportunities presented by sustainability; when asked the same question of the companies in which they invest, just 9% of investors believe this to be the case. Similarly, while 38% of CEOs believe they are able to accurately quantify the business value of their sustainability initiatives, just 7% of investors agree – a striking gap which exposes the shortcomings of many companies in effectively communicating their approach to sustainability and its links to the traditional measures of business value and success.

Given these prolonged challenges in extending sustainability beyond the firm, CEOs believe that business is not leading on sustainability in the way that was predicted 3 years ago. But our data suggests a disconnect between CEOs' perceptions of global progress and their opinion of their efforts and achievements: fully 76% of CEOs are satisfied with the speed and effectiveness of execution on their own company's sustainability strategy, and nearly two-thirds believe that they are doing enough to address sustainability challenges. CEOs clearly recognize the scale of the global challenge – but may not yet see the urgency or the incentive for their own businesses to do more and to have a greater impact. This disconnect suggests that a gap persists between the approach to sustainability of the majority of companies globally – an approach still centered on philanthropy, compliance, mitigation and incremental improvement – and the approach being adopted by leading companies, focused on innovation, growth and new sources of value.

The Transformational Leaders: Steps to Success

The advances of leading companies, and their adoption of large-scale, collaborative projects targeted directly at value creation through addressing the priorities of global sustainable development, are beginning to demonstrate how business impact can be scaled beyond incremental advances and efficiency gains. The 2013 CEO Study, *Architects of a Better World*, identifies a group of "Transformational Leaders" that combine sustainability leadership with market-leading business performance, as measured by traditional metrics including revenue growth, profitability and shareholder returns. These companies are approaching sustainability in markedly different ways to those who are failing to achieve this distinction – with different motivations, different influencers and different areas prioritized for investment, innovation and action. At the heart of their approach is a strategy that moves beyond reactive, incremental responses to external pressures and toward a new understanding of sustainability as an opportunity for innovation, competitive advantage, differentiation and growth. Leading CEOs are already uncovering strategies for sustainability that allow them to deliver both value creation for their companies and impact on global challenges; they are not waiting for others to act, but are actively creating real value for consumers, investors and society.

From leading multinationals like Siemens and Philips, whose portfolios of products and services targeted at improving their customers' environmental performance now represent about half of their revenues, to smaller, disruptive innovators such as Zipcar and Airbnb, companies are seizing new opportunities through innovation, and devising new models and new ways of doing business. From the circular economy to new digital businesses, these innovators are finding new ways to meet the needs of their customers while impacting positively on the environment and society.

New models such as the Circular Economy are potential gamechangers in the development of corporate sustainability, as innovators move from a lens of mitigation and incremental improvement, to investment at scale in solutions, directly targeted at sustainability challenges that begin to decouple growth and prosperity from environmental impact and resource degradation. In providing a unifying framework that can solve the challenge of decoupling growth from environmental impact, understood and implemented correctly the circular economy is a genuinely systemic – and potentially transformational – approach; it is radical new models like these have the potential to shift the economy from an incremental path to a revolutionary one.

Harnessing sustainability as a radical, transformative force will require a new commitment from business leaders, as well as new skills and new ways of approaching sustainability. The CEO Study outlines seven key themes that CEOs believe can guide their own thinking and actions, as well as transforming their companies' strategies, business models, value chains and industries in order to achieve sustainability leadership and high performance.

1. **Realism and context: Understanding the scale of the challenge – and the opportunity.** Throughout our interviews, it was clear that companies taking the most ambitious action on sustainability were also the most realistic about the scale of the challenge – and are more likely to admit that business is not doing enough. Understanding the challenge also allows these companies to appreciate the opportunity for future growth in providing solutions to sustainability issues and to target strategies to achieve it.
2. **Growth and differentiation: Turning sustainability to advantage and value creation.** One of the clearest insights in our most recent research is the emergence of a two-speed world in sustainability, between those companies still reacting to external expectations on sustainability and focusing on incremental mitigation, and those that see sustainability through the lens of growth and differentiation. For leading companies, many CEOs told us that the urgency of global challenges provides an opportunity to differentiate their products and services; to access new market segments; and to grow into new regions, countries and areas where their products can meet a pressing need.
3. **Value and performance: "What gets measured gets managed."** From carbon emissions to water footprints, tracking environmental measures is now commonplace across industries. Our research suggests that, for companies seeking to go beyond incremental change and tackle global sustainability issues, the challenge is twofold: not just to measure and manage metrics of reduction and mitigation, but also to quantify the value of sustainability initiatives and more sustainable business models to the company, and to track their impact on the communities in which they operate.
4. **Technology and innovation: New models for success.** Our data suggests that leading companies are turning to innovation and technology. Environmental and resource constraints, and growing social pressures, are acting as a stimulus for innovation: From investment in renewables, to intelligent infrastructure enabled by machine-to-machine communications technology, to new Circular Economy business models, leading companies are securing business advantage through innovative R&D and the deployment of technologies ranging from cloud computing to analytics.
5. **Partnerships and collaboration: New challenges, new solutions.** We have seen a growing confidence from CEOs over the last decade that business can provide solutions to tackle global challenges. In the context of intensifying pressures and flagging efforts, CEOs more readily acknowledge the role of collaboration and partnerships in meeting their ambitions on sustainability. Business can lead the way, they believe, and can maximize companies' impact through close partnerships with governments, policymakers, industry peers, consumers and NGOs.
6. **Engagement and dialogue: Broadening the conversation.** Business leaders are increasingly conscious of the need to establish a constructive, two-way dialogue with consumers and local communities; regulators and policymakers; investors and shareholders; employees and labor unions. Rather than simply acting and then communicating, CEOs are actively engaging stakeholders to negotiate the role of their business in addressing global challenges.

Fig. 23.5 Transformational Leaders are combining sustainability leadership with superior market performance

7. **Advocacy and leadership: Shaping future systems.** Leading CEOs are clear that business efforts are not sufficient to set the global economy on track – but believe strongly that business should lead the way toward defining and delivering a sustainable global economy, not least through the post-2015 development agenda. They are realistic that individually they can only have so much impact, but recognize a need to play a part in collaborative solutions with governments and other stakeholders. Business leaders' advocacy and public commitment will be integral to further progress (Fig. 23.5).

Impact and Value: A New Approach

In the most recent study, CEOs were unequivocal in their belief that the global economy is not on the right track – and that business is not doing enough to address global sustainability challenges. They see their companies stuck on a plateau of incremental achievement, uncertain of the way to the summit of greater impact and business success. But among sustainability leaders, we can see the beginnings of a collaborative, systems approach to sustainability, focused on the impact business can make. These companies are seizing opportunities at speed through building skills, measuring value and performance, and improving the dialogue with consumers, investors and governments. Perhaps most importantly, they are aligning

sustainability with value creation, and seeking to create real advantage – put another way, competing through sustainability.

We can see the seeds of a new approach to sustainability, with pockets of real innovation both within the firm and beyond its four walls: collaborating within and across industries and sectors, and working closely with stakeholders to develop the beginnings of transformational change that can put in place an architecture that mobilizes the business contribution to the post-2015 agenda. Through the innovations of these leaders, we begin to see a pathway for business to make rapid and meaningful progress on the journey from sustainability's plateau of good intentions toward a summit where global markets are aligned with sustainable development, enabling business leaders to truly become the architects of a better world.

Signposts to the Future: Towards Transformation

The adoption of the Sustainable Development Goals in 2015, and the achievements of the climate negotiations in Paris, mark a critical turning point in the history of global development. As we look ahead to a new sustainable development agenda, business and civil society leaders see an urgent need for the rejuvenation of a global partnership focussed on development and prosperity.

Following the landmark agreement at COP21, the international community has an immediate opportunity to advance action through bold, ambitious and universal action on climate. Paris marked a collective recognition that climate change is not simply one element among multiple priorities: action to protect habitats, secure livelihoods and enshrine environmental justice can provide the cornerstone of an integrated development agenda and can lay the foundations of achievement across all 17 Sustainable Development Goals.

But achieving ambitious goals will depend on the active engagement of business, and unlocking the potential of the private sector will require enabling action on the part of governments and policymakers. The innovation required to forge the transition toward a low-carbon economy will depend on clear, coherent and consistent policy frameworks that enable companies to invest with confidence and place the big bets that will bring about new technologies and new business models to tackle the challenges of the twenty-first century. Foremost among the challenges business, government and civil society leaders face in rejuvenating their partnership for development is working together effectively across sectors, understanding common priorities and facilitating transformative action.

The forthcoming edition of the triennial CEO Study, to be published later in 2016, will grant a unique opportunity to understand the views and priorities of business leaders in this new landscape. Foremost in the minds of the study team will be understanding the progress of business since the last study in 2013, and the extent to which individual leaders and companies have moved beyond their shared sense of 'frustrated ambition' towards a clear path to competitive advantage through leadership on sustainability.

The practical import of the Sustainable Development Goals, too, will provide a key area of interest: after a decade in which progress has often been stifled by unclear and competing expectations of companies to act on 'sustainability', could the SDGs provide a new rallying point for discussions of purpose and value in business? Could 'Corporate Disruptors' – those companies finding a route to growth, innovation and competitiveness through addressing global challenges – chart a pathway towards new definitions of opportunity and success? And how will new business models and new technologies allow companies to uncover new sources of advantage through addressing the most pressing global challenges?

During the decade's lifespan of the UN Global Compact-Accenture CEO Study, we have traced the development of corporate sustainability from its roots in corporate social responsibility towards the integration of environmental, social and governance issues as a critical element in strategies for growth. Aided by the momentum of the UN's Agenda 2030, the adoption of the Sustainable Development Goals and the strides made at COP21 in Paris, growing recognition of the scale of the challenge has begun to translate into renewed advocacy for action: for perhaps the first time, we are beginning to see a united front of business leaders and policymakers setting their course toward a bold deal that can begin to close the gap between ambition and execution.

For the private sector, working in concert with policymakers and civil society, the SDGs provide a global aspiration and common direction that can stimulate innovation, investment and engagement. As companies look to grow and innovate low-carbon solutions to global challenges, they can lay the foundations of achievement, offering opportunities for business to have a meaningful impact on societal challenges through core business: new energy technologies are creating opportunities for companies to ensure access to affordable, reliable, sustainable energy for all; climate-smart agriculture solutions help to achieve food security and promote sustainable farming; and new low-carbon technologies for cities will build resilient infrastructure and promote inclusive, sustainable and prosperous industrialization.

In the context of Agenda 2030, our research with CEOs shows a striking shift in business leaders' attitudes and commitment across the decade to 2015, with a majority of companies now looking beyond an incremental approach rooted in corporate social responsibility to one motivated by the opportunities to scale innovative solutions. Many challenges lie ahead: in the assessment of business leaders themselves, companies are not doing enough to invest in the solutions of the future, and are not yet living up to their own expectations of corporate leadership.

Advancing the role of business in tackling the greatest challenges we face will depend on a new compact between business, governments and civil society, to work together to unlock the potential of the private sector in delivering a shared vision for a prosperous future.

A Case of Radical Reinvention: Umicore

24

Nigel Roome and Victoria Jadot

Introduction

Many companies have made commitments to some form of Corporate Social Responsibility (CSR) and/or sustainability. Stating that a company is involved in CSR or sustainability can mean many things as there is no universal, agreed view of CSR or sustainability. Responsibility and sustainability are descriptive terms that always require qualification provided by other words and more importantly actions. In practice these big ideas are associated with a wide range of organizational practices that are complex in their formulation, implementation and impact on the company. By definition responsibility and sustainability also have implications for the wider environment and society and the economic systems in which companies operate. At one extreme they can imply little more than a commitment to a public relations exercise or the company taking a public affairs position on an issue. At the other extreme these big ideas represent highly strategic decisions to reposition a company and its products and services in new relationship to the systems of production and consumption within which those products/services fit.

Responsibility and sustainability continue to provide the ground for many competing and contested concepts and practices, few of which have been referenced against the basic principles of the Brundtland Commission's (1987) and their seminal understanding of sustainable development. In the 27 years since the Brundtland Commission Report (1987) first articulated the rationale and principles for sustainable social and economic development a plethora of concepts have been advanced by academics and practitioners that provide an armoury of ideas, tools and actions by which companies can contribute to sustainability. These have included a range of concepts and the practices that follow from them such as the triple-bottom line (Elkington 1994), eco-efficiency (DeSimone et al. 1997), industrial ecology (Frosch

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© Springer Science+Business Media B.V. 2019
G. G. Lenssen, N. C. Smith (eds.), *Managing Sustainable Business*,
https://doi.org/10.1007/978-94-024-1144-7_24

1995), base of the pyramid (Hart, REF), environmental stewardship (Cargill 2012) or, creating shared value (Porter and Kramer 2011; Nestlé 2010). Some companies associate strongly with these concepts while some do not make use of these concepts at all.

Unilever, for example, has interpreted its contribution to sustainability in terms of growing its business by producing products with social value while taking strides to reduce the main environmental impacts of those products by given amounts (Unilever 2014). It sets out to do this by seeking out new business opportunities for innovative products and services that have less environmental impact. And by persuading customers to behave differently (Unilever 2014). The company identifies this approach because it recognizes that the environmental impacts of the fast moving consumer goods it sells mostly arise during their use by consumers and not during their manufacture.

Unilever is among a rather small group of companies that have acknowledged that sustainability is first and foremost defined by a state of social and economic development that operates within the environmental limits or carrying capacity of the planet. Managers in companies that take this view recognize that while they are economic agents whose role is to help their companies succeed as profit seeking organizations at the same time they are concerned about how their current and future products and services contribute to the sustainability or otherwise of the social and economic systems in which they operate. This position raises fundamental questions about how a company creates, captures and distributes value whilst also giving consideration to the value that is often destroyed through the sourcing, production and use of those products.

There are other notable examples of companies that have subscribed to this broader view of sustainable (economic and social) development. In the early 1990s Ontario Hydro, did not define sustainability in terms of the ‘company’ or the ‘company and its supply-chain’, rather it set out to devise a strategy for the sustainability of the system of energy development and use in the province of Ontario, Canada (Roome and Bergin 2006). The ambition of the strategy was to reshape the company’s actions and to influence the work of other actors in the energy system of the province of Ontario.

Companies that look at revising the portfolio of products and services they provide often make use of some key concepts that help them to rethink the way their company might contribute to systems change toward sustainability. These concepts include the idea of ‘closed-loop production and consumption systems’, the implementation of practices around ‘cradle-to-cradle’ thinking (McDonough and Braungart 2002) or by drawing on the principles of The Natural Step (Robert et al. 1997).

This chapter focuses on the case of Umicore – a Belgium company that sought to reinvent its approach to business as a way to contribute to sustainable development. At the beginning of the case Umicore was a conventional materials company that sourced metal ores mined in Africa, that were transported and processed in Belgium and other sites, then to be manufactured into products that were sold for applications around the World. Umicore’s operations were based on the idea of

material through-put – an approach that has dominated much industrial activity over the last 150 years. In this model the company's financial performance accompanies the sale of more and more products while costs are controlled.

For reasons discussed later in the chapter, senior managers at Umicore determined that the future lay in positioning the company at the centre of a closed material loop, where materials, recovered at the end of existing uses, would be reprocessed and manufactured into products that were then used in areas of the economy that are springing up in response to different environmental challenges. In this new approach success would depend on the company's ability to source, process, remanufacture, sell and then recover material. Success would also be determined by the ability to manage the transformation of the company from its focus original approach based on throughput to this circular material process.

This chapter does not examine the validity of the claims made for closed loop production-consumption systems as a contribution to sustainable development rather the aim is to describe the process of transformative change that took place at Umicore. The chapter pinpoints the main internal and external factors that drove this process, and identifies the internal forces that enabled actors in the company to bring about that change. In particularly it focuses on the roles and the beliefs held by internal change agents who lead the process of change.

The overall objective of the chapter is to inform our understanding of the processes of organizational change that contribute to this type of strategic transformation: An understanding that can contribute to theory as well as to practice.

To this end the chapter is divided into four main sections. Section "Case Method" provides a brief account of the methods used to collect data and the access to the company. Section "Introduction to Umicore and the Case" provides a brief introduction to Umicore as a company. It then provides a narrative account of change process at Umicore over the 19 years covered by the case. Section "Economic Restructuring – The Industrial Plan" discusses the process and the roles and beliefs of those responsible for the change process that is described in light of ideas from theory. The chapter ends with some concluding remarks.

Case Method

A case study approach was used to gain insight of the change process at Umicore. Case studies are the preferred method to use when "how" or "why" questions are being posed, when the investigator has little control over events, and the focus is on a contemporary phenomenon within a real-life context (Yin 2009). Case study research is also held to be particularly appropriate when the boundary between the phenomenon under investigation and its social context is blurred (Yin 2009). We assumed this was the situation as our focus was on a process of change that involved the organization interacting with its wider social and economic context. The case deals with past and recent processes of change over a long period. In that way the past provides a context to the present, and the present unfolds and shapes the future. No other method seemed appropriate given the extended time period of the case.

The case qualifies as a reconstructed longitudinal case which according to Yin (2009), is best studied in a single-case study,

A qualitative approach enabled account to be taken of Umicore's changing context. In addition a sensemaking approach (Basu and Palazzo 2008) was used to provide insight into how people involved in the case thought, spoke and behaved in relation to the concepts of responsibility and sustainability: As this would help to understand how these ideas influenced the strategic change at Umicore.

Data for the case were collected in two stages: first through desk research based on documents published by and about Umicore. This was followed by the collection of primary data gained through semi-structured interviews with key informants who worked for, or who had worked for, Umicore during the period of the case.

The desk research made use of material from the internet published by Umicore, from the press coverage of the company and visits to Umicore. This material was used to validate evidence from other sources. It was recognized that most of these documents were written for some specific purpose and specific audiences other than the case study reported here.

Interviews were crucial to the construct of the case study. Interviews took the form of guided conversations rather than structured enquiries. As a result of the documentary analysis six key people were identified as interviewees. The interviews began with Guy Ethier (current Vice-President Environment, Health and Safety, with Umicore since 2001), Moniek Delvou (Corporate Communications Director from 1999 to 2003) and Marc Dolfyn (Corporate Human Resources Director, with Umicore since 2003). These interviews provided a better knowledge of the transformation at Umicore. They were then followed by interviews with the three CEO's that had led Umicore over the period of the case – Marc Grynberg (current CEO, and with Umicore since 1996), Karel Vinck (former CEO and former Chairman of Umicore, 1994–2008) and Thomas Leysen (former CEO and current Chairman, with Umicore since 1989).

A short list of key questions was created for each interviewee. The interviews were conducted in an open-ended way but following a certain set of questions derived from the questions guideline. Attention was given to the advice by Yin (2009) that "specific questions must be carefully worded, so that the interviewer appears genuinely naïve about the topic and allows the interviewee to provide a fresh commentary about it" (Yin 2009).

The material from these interviews was used to construct and label the phases in the change process that were used to structure the case narrative. Because the interviewees could be subject to the common problems of perceptual bias, poor recall, or poor and inaccurate articulation, the accounts of the respondents were cross-checked for consistency.

Interviews lasted about 45–60 min each. All interviews except one were done in English, and were recorded with the permission of the interviewer. All recorded interviews were transcribed and retained. One interview could not be recorded because of background noise. In this case notes were taken manually and transcribed afterwards. This interview was done in Dutch, as preferred by the interviewee.

While the case itself cannot be replicated the following controls were used to ensure the reliability of the data that was collected to construct the narrative of Umicore (a) multiple sources of evidence were used to develop converging lines of inquiry and to provide confirmation of the data, (b) a case study database was developed and stored which provides a collection of evidence separate and distinctive from the final case study report, and (c) a chain of evidence was sought (Yin 2009). This chain of evidence explicitly links the questions asked, the data collected and the conclusions drawn. "The principle is to allow an external observer – in this situation, the reader of the case study – to follow the derivation of any evidence from initial research questions to ultimate case study conclusions" (Yin 2009).

Data from the documentary review and interviews were analysed and compared. The data comprised a mixture of qualitative and quantitative information, with an emphasis on the written and spoken word. Given the explorative nature of the research and our concern to understand how approaches to corporate responsibility and sustainability were understood and developed, we did not apply specific analytical techniques to the raw material.

Interviews were transcribed and compared with documents and archival records with the intent to develop an authentic record of how CSR/sustainability was understood and communicated in the company. Where possible the case was written to include the images, materials and language that senior managers used to describe the CSR strategy and practices in their business. Indeed, managers were explicitly asked to describe how the leaders proceeded to the organizational change. A final draft of the case was sent to Thomas Leysen, Chairman of Umicore, and to Bart Crols, Corporate Communication manager, who assessed the historical correctness of the data.

We acknowledge that our findings cannot be generalized. However, that was not the purpose of the study. The single case study provides an in-depth analysis of organizational change around CSR and sustainable development and the contribution of individuals and groups to that change process.

Introduction to Umicore and the Case

Introduction

Umicore has a history going back 200 years. Today's materials-technology company is the outcome of a history of mergers, acquisitions and transformations by companies in the mining and refining industry. Umicore has only recently evolved into a materials-technology provider. Moreover Umicore does not have an unblemished past. Changing company practices and social expectations led to a series of scandals that stained the company's reputation. These include: the extremely hard living and working conditions of employees in the Congo, seizure of uranium by the Germans and then deliveries of the same material to the Americans during WWII and – most importantly – environmental pollution and associated health concerns among employees and neighbours surrounding sites where metal ores were

processed. At the beginning of the 1990s, Union Minière – the former name of Umicore – was also coping with extremely bad financial results – the company was almost bankrupt.

Today Umicore describes itself as a materials group that focuses on clean technologies. It employs more than 13,000 people. It continues to deliver outstanding financial results and regularly outperforms the BEL20. On top of that, it has been externally acknowledged as a flagship of sustainability, receiving praise for its contribution to sustainable development. It has won multiple awards in this area.[1] *It is a member of the World* Business Council for Sustainable Development[2] and is included in the FTSE4Good Index.[3] In 2014 the company was ranked 9th in The Global 100 list for clean capitalism.[4]

In its current form, group Umicore operates through four business areas: Advanced Materials, Precious Metals Products and Catalysts, Precious Metals Services and Zinc Specialties. Each business area is divided into market-focused business units.

The Advanced Materials business area produces high-purity metals, alloys, compounds and engineered products for a range of advanced applications. The main materials used are cobalt, germanium and nickel. The business area is composed of three business units: cobalt and specialty materials, electro-optic materials and thin film products. Furthermore, the advanced materials business group comprises a 40% shareholding in Element Six Abrasives, which produces synthetic diamonds and abrasive materials for use in industrial tools.

The Advanced Materials business area makes products such as rechargeable battery materials and germanium wafers for solar cells.

The Precious Metals Products and Catalysts business area produces a range of complex functional materials based on precious metals and its expertise in technology platforms such as catalysis and surface technology. The business is organized in five business units: automotive catalysts, catalyst technologies, jewellery and electroplating, platinum engineered materials and technical materials. This business group produces products such as catalysts used in automotive emission systems.

The Precious Metals Services business area is the world market leader in recycling complex waste containing precious and other non-ferrous metals. Its core business is to provide refining and recycling services to an international customer

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[1] Examples of awards won by Umicore:

– European Environmental Press Award for innovative environment technology: recycling of
– Li-ion batteries (2004)
– Canadian Investment Award (2008)

[2] The World Business Council for Sustainable Development (WBCSD) is a CEO-led, global association of some 200 companies dealing exclusively with business and sustainable development.

[3] The FTSE4Good Index Series has been designed to measure the performance of companies that meet globally recognized corporate responsibility standards, and to facilitate investment in those companies. Transparent management and criteria alongside the FTSE brand make FTSE4Good the index of choice for the creation of Responsible Investment products.

[4] *An assessment made by the organization Green Knights and announced each year during the World Economic Forum in Davos.*

base. It is divided into three business units: precious metals refining, precious metals management and battery recycling. The Precious Metals Services business group offers services such as recycling.

The Zinc Specialties business area develops zinc-based materials for a wide variety of applications. Zinc Specialties is organized around three business units: zinc chemicals, building products and zinc battery materials. The Zincs Specialties business area produces, for instance, materials for building applications such as roofing.

Umicore generates approximately 50% of its revenues and spends approximately 80% of its research and development budget in the area of clean technology. This includes areas such as emission control catalysts, fuel cells, materials for rechargeable batteries, photovoltaic systems, and precious metals recycling. Research & development for clean and sustainable technologies is mainly done in Olen. There are also Business Unit dedicated research centres in Germany, Japan, Canada, France and Liechtenstein.

Umicore articulates the group's goal and mission in the form of the 'Umicore Way': it states "Umicore's overriding goal of sustainable value creation is based on the ambition to develop, produce and recycle materials in a way that fulfils its mission: materials for a better life."

Umicore recorded a turnover of € 6.9 billion in 2009, with an EBIT (Earnings Before Interest and Taxes) margin of 8,9% and a ROCE (Return On Capital Employed) of 8,2%. Umicore shares are listed on Euronext Brussels with 100% free float. Umicore is part of the BEL 20, the benchmark stock market index of Euronext Brussels, and does not have a reference shareholder.

At end of 2009, Umicore had 13.720 employees, located in 37 countries on 5 continents, in 79 production sites and 48 other sites. More than half of Umicore's employees were working in Umicore's largest production centres in Belgium. The other main centres of employment were 2.963 people in Germany 2.296 and 2.225 in China.

Umicore has a dual governance structure consisting of a supervisory Board of Directors and an Executive Committee. The Board of Directors, consists of at least six members appointed by the Shareholders' Meeting, Their normal term of office is 4 years, although re-election is possible. At the end of the case the Board of Directors consisted of ten members: nine non-executive directors and one executive director. On 31 December 2009, six of the ten directors were independent within the definition of independence defined by Umicore's Corporate Governance Charter.

Thomas Leysen had been the Chairman of Umicore since November 2008 after serving as Chief Executive Officer from 2000 to 2008. In addition he has numerous other functions on the board of other companies. Marc Grynberg was Chief Executive Officer of Umicore from November 2008, succeeding Thomas Leysen. He joined Umicore in 1996 as Group Controller. He was Umicore's CFO from 2000 until 2006, after which he became the head of the Group's Automotive Catalysts business unit until his appointment as Chief Executive Officer. Marc Grynberg holds a Commercial Engineering degree from the University of Brussels (Ecole de

Commerce Solvay). Prior to joining Umicore he worked for DuPont de Nemours in Brussels and Geneva.

The Executive Committee is composed of at least four members. It is chaired by the Chief Executive Officer, who is appointed by the Board of Directors. The Board of Directors appoints the other members of the Executive Committee upon recommendation of the Nomination and Remuneration Committee.

Senior Management is composed of representatives of the four business areas, as well as corporate vice-presidents in the areas of R&D, legal affairs, and Environment, Health and Safety (EHS).

In 2008 (the end point of this case study), Umicore was a materials group with a strong focus on recycling and transforming metals into materials that are used in sectors driven by environmental concerns. This is shown in Fig. 24.1. This caused Umicore to be recognized as a flagship of sustainability with a strategic focus on materials that contribute to clean technologies and eco-efficiency.

Umicore approach to sustainability continues to distinguish between the sustainability of its context as distinct from its sustainability as an organization, the direct impacts of its operations and its position as an organization with employees that is embedded in society. The company says:

> we are a company that plays a major role in providing products and services that are enablers of a more sustainable future.
>
> While our products can make a positive difference in the world we are also committed to ensuring our operations are run in such a way as to minimize our environmental footprint. We also undertake to be the best possible employer and neighbour and to adopt the best standards of business ethics and governance both within Umicore and through our supply chain. (Umicore 2014)

The Case

As shown in Fig. 24.2 *a key moment in Umicore's history arose in 1989, when Union Minière merged with its subsidiaries, Metallurgie Hoboken-Overpelt (copper, lead,*

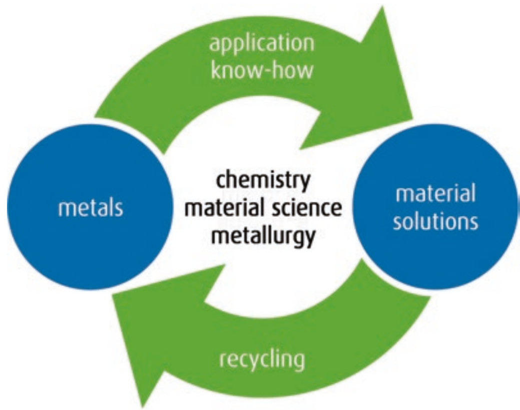


Fig. 24.1 Closed loop (Source: Umicore)

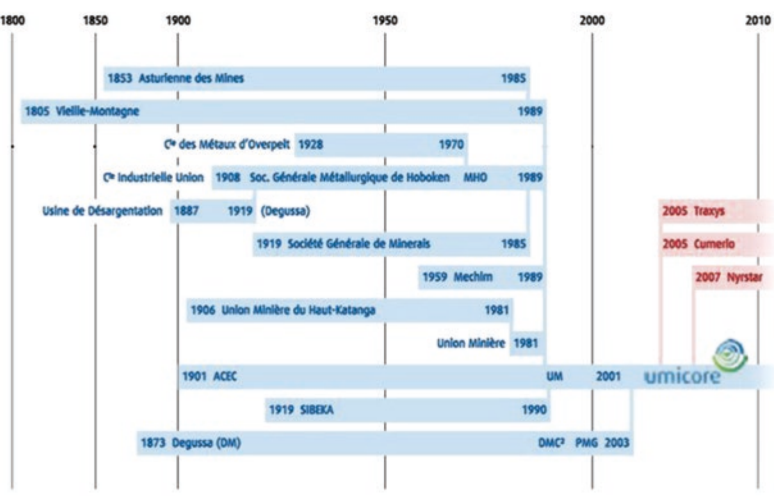


Fig. 24.2 History of mergers, acquisitions and transformations (Source: Umicore)

cobalt, germanium, precious metals and special metals), Vieille-Montagne (zinc) and Mechim (engineering).

The oldest of Umicore's predecessor companies, Vieille-Montagne was created in 1805. Another predecessor, Union Minière du Haut Katanga (UMHK), started its activities in 1906. UMHK mined the rich mineral resources of Belgium's former colony of the Congo (copper, cobalt, tin and precious metals). UMHK expanded rapidly: between 1913 and 1917 production quadrupled because UMHK supplied the basic materials for weapons manufacture (van Caloen 2001). Non-ferrous metals were transported to be processed in Europe – for instance at Metallurgie Hoboken- Overpelt, which would later merge with UMHK. The most prosperous years for UMHK were the post-WWII years: in 1955, UMHK employed 21.000 workers and 1.915 European agents in Congo. After the Zairian government nationalized UMHK's assets in 1968, Union Minière set out to develop new mining activities to feed its refining capacity. It eventually became a sub-holding company of the Société Générale de Belgique.

Historically, Union Minière was a financially well performing company albeit in a cyclical industry. However, after the company left the Congo as a result of the nationalization of the mines in 1968, it had to invest in new mines. These investment decisions were unsound leading to a very bad financial situation in the beginning of the 1990s on top of the cyclical nature of the business.

In 1989, 88,2% of the shares of Union Minière belonged to the Belgian conglomerate Société Générale de Belgique. This company had appointed a French CEO, Jean- Pierre Rodier.

Umicore has had to deal with serious social and environmental concerns. First of all, UMHK employed an increasing number of African workers in the beginning of the twentieth century: 8.500 in 1919, 17.200 in 1929 (Brion and Moreau 2006). Such an expansion in the sparsely populated Katanga province obliged the company to recruit massively outside Katanga, in particular in Rhodesia and in other Congolese provinces. Public opinion in Belgium was not always in favour of recruiting workers hundreds of kilometres outside their hometown. In addition, the living conditions of the African workforce in Katanga were very harsh. Second, Union Minière was the principal producer of uranium when WWII started. During the war, the German government seized some 2.000 tons of uranate. The American government used uranium supplied by Union Minière to create the nuclear bombs dropped on Hiroshima and Nagasaki. Third, as public awareness of environmental issues increased in the 1980s and 1990s Union Minière started to realize it had to cope with historical legacy of pollution at its production sites in Belgium and elsewhere. This was the most important problem Union Minière had to deal with.

From the interviews, we distinguished five phases in the organizational change at Umicore, which are shown in Fig. 24.3. These phases are used to structure the case narrative set out below.

At the beginning of the 1990s Union Minière was well-known for its technical competence, however the company was dealing with two principal problems. The financial viability of the company and a series of reputational problems then linked to environmental pollution. Although these problems had been developing for some

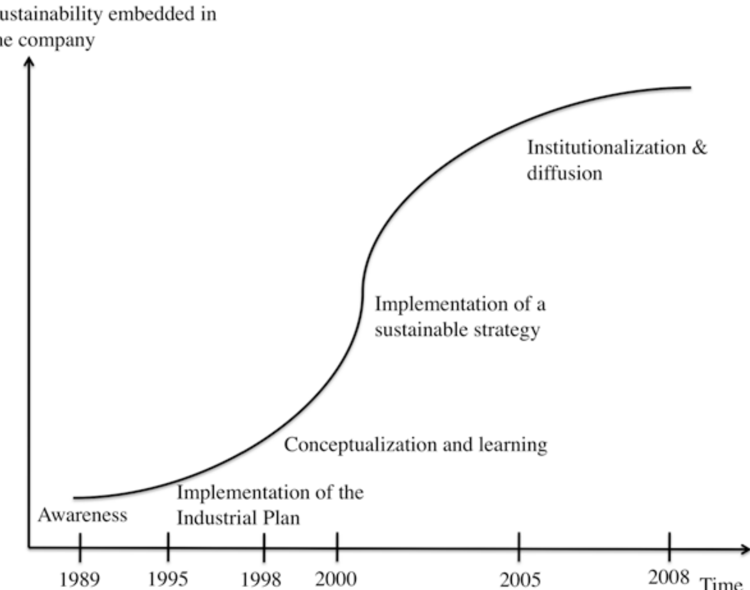


Fig. 24.3 Five stages. Increasing awareness of financial and reputational/environmental problems

time, in the early 1990s, there was a growing public and political concern and an increasing awareness that it was time they were addressed.

Union Minière was aware of both problems, but it gave priority to resolving its financial problems as it was held that unless this was solved, the company couldn't survive and the environmental problems would not be addressed.

Financial problems resulted from the bad investments in the 1970s and the 1980s when the company left the Congo and invested in new mines, for instance in Canada, as well as a project to prospect for metals on the bottom of the sea. These investments generated poor returns and there were few reserves left. Société Générale, which held almost 50% of the shares in Union Minière, realized the situation at Union Miniere needed dramatic change.

Etienne Davignon, then Chairman of Union Minière, contacted Karel Vinck, then the CEO of Bekaert, to help Union Minière survive the financial situation. Etienne Davignon did not play a significant role in the operational and financial turnaround of the company but he became involved with sustainability issues. From 1998, he hosted the first Advisory Board of CSR Europe and became one of the leaders of this initiative. In 2001, Etienne Davignon contributed to the establishment of the European Academy of Business and Society, a multi-stakeholder platform on CSR.

Marc Grynberg, the CEO of Umicore at the time of the case, summarizes the situation as follows: "In the mid-1990s Union Minière was in a really bad shape with fairly outdated industrial assets, lousy profitability and not a very strong positioning on the market place."

Karel Vinck had a reputation as a turn-around manager. He had transformed the company Eternit in the 1980s and was then restructuring Bekaert. He joined Union Minière at the end of 1994. Karel Vinck thinks he was appointed because his experiences at Eternit and Bekaert, and his excellent relationship with the workers' unions.

The company was fully aware of its environmental problems as its sites had been polluting for over 100 years. Early in 1992 the company recognized that the environment was a major strategic issue. It was decided to establish a central environment division for the whole Union Minière group to provide an organizational structure for the management of environmental issues in the company. One of the first actions of the division was to develop an Environment Charter. It was drafted by the corporate environment group, after much internal discussion until the management committee agreed that it covered all the essential values Union Minière would like to respect.

Economic Restructuring: The Industrial Plan

When Karel Vinck's took over as CEO at the end of 1994, he launched a restructuring plan for the period 1995–1998. He involved top management and used a mixture of a top-down and a bottom-up approaches to implement the plan. It was top-down in the sense that he was guided the operational aspects of the plans, had the final word on decisions and took full responsibility. On the other hand, it was bottom-up

because Karel Vinck considered that he could not make the new strategy work from his office but instead he had to be in contact with the internal mood of the company and communicate in informal ways with the workforce. In other words, this process of implementation was formal (e.g. Board decisions) as well as informal (e.g. chatting with the employees on the work floor). Karel Vinck had relied on these skills and this combined approach in previous restructuring and believed it is effectiveness.

The plan was based on investment of BEF 22 billion. (40,3399 BEF = 1€) over the period 1995–1998 to finance the gradual replacement of refining activities (e.g. zinc, copper) with new (higher margin) industrial activities based on technologies that were then available to the company. Union Minière already had a number of product applications available, such as materials for batteries and solar cells. The Industrial Plan focused on developing these areas further. Special emphasis was placed on innovation. This was given greater profile when Karel Vinck created a single global R&D centre in Olen, to replace the R&D activities that were previously dispersed over three different sites. In addition the Industrial Plan involved cost-cutting, requiring some 2.000 jobs to be lost (about 15% of the work force), accompanied by the sale of divisions with lower margins. Only those divisions in which Union Minière could become a world leader were retained.

Karel Vinck involve the rest of the management as closely as possible in his decisions and in 1995–1996, Union Minière adopted a Company Charter, as a first attempt to define the objectives that would bind the company together. This included commitments to respect the legal environment and human rights, to reject fraud and corruption, to show openness and transparency, and to respect the environment everywhere it operates. The company charter followed after the environment charter and included some of it principles.

As shown in Fig. 24.4, the Industrial Plan began to show in better financial results. In 1996 the company recorded a profit for the first time since 1990. The 1997 results led to a gross dividend payment of BEF 44 per share (40,3399 BEF = 1€) again for the first time since 1990,

In terms of environmental problems and reputation Karel Vinck, said you “couldn’t have dreamed of having the political support [sic for the company] with an image that would have been that of the worst polluting company in Belgium”.

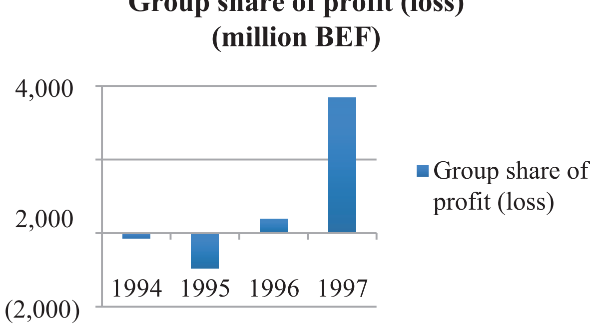


Fig. 24.4 Evolution of group share of profit (Source: Umicore)

Hence, Union Minière had to take measures and dedicate funds to its environmental problems and it had to communicate its new approach both internally and to the external world.

The reactive environmental action was set in place through an agreement Union Minière and OVAM under the supervision of the Minister of the Environment in December 1997. (OVAM stands for Openbare Afvalstoffenmaatschappij voor het Vlaams Gewest – Public Waste Agency of Flanders). This agreement, for a period of 10 years, covered the investigation of pollution sites and soil remediation to remove all the serious risks arising from the historical pollution at Union Minière's Flemish production sites. The agreement was entered into under the wider scope of a Flemish Soil Remediation Decree which came into force 22nd February 1995. Union Minière could not afford to have further environmental problems and compliance with the environmental regulations was a "must do".

Conceptualization and Learning: The First Formulation of a Strategic Approach to Responsibility

Once the Industrial Plan began to yield results the company started to look for ideas to resolve the reputational problems that followed its environmental legacy as this would that dog its future. People inside the company were encouraged to start thinking about responses that would help resolve the future financial position of the company together with its reputational problems. After all, the company had experienced financial and environmental problems because of the way it operated and the thought was that those problems might be resolved through the way it operated in the future.

However, this meant addressing the raison d'être for the emerging company. Thomas Leysen remembers three principal ideas: "First of all we wanted to be a company that was active in fields where it could make a difference through technology. Secondly we wanted to be active in fields where we could have leadership positions on a global basis. Thirdly we wanted to integrate the sustainable development thinking, not only in our operations, but also in our strategy and that this would be a core part of what we wanted to be as a company and this applied notably to a very large commitment to recycling. We saw this as a possibility for us to differentiate ourselves and to make a real contribution." Moreover, the company wanted to move from pollution reduction to pollution prevention and through that redesign itself and its operations to avoid pollution as much as possible. These principles informed the vision for the company that was emerging. Some key concepts were then identified through which to drive towards that emerging vision – these concepts were to become a closed loop company with a commitment to environment and clean technology applications, where the environment was an opportunity not a constraint.

The operational practices needed to make these concepts a reality developed gradually. In 1998 Thomas Leysen took over the lead in the Cobalt and Specialty Materials business unit. He knew the company very well as he had held different positions within Union Minière during the previous 10 years. Together with Karel

Vinck he decided to test the new idea of being a closed loop company beginning with the Cobalt and Specialty Materials business group. The two men worked closely together building on Karel Vinck's experience gained outside the company and Thomas Leysen long career with Union Minière. "We really understood each other and respected each other and I guess the success of Umicore today is linked to the fact that the CEO and the Chairman had an excellent relationship" believes Karel Vinck.

The Cobalt and Specialty Materials business group provided Thomas Leysen with the test bed where he could explore and develop the closed loop approach on a small scale. This was based on the recycling and recovery of used material that were then processed into new products. In addition Thomas Leysen tried to proactively manage the company's overall environmental position by preparing the business for upcoming legislation, coming trends, and how it should be ahead of the curve on the environmental side. This would require close contact with employees to encourage their engagement in change that was necessary from these developments.

This approach to explore closed loop production and to develop a forward looking approach was supported by the development of a more formal structured management system. In 1998, Union Minière adopted their first Environmental Management System and published their first environmental report in 1999. The aim was to provide the business units and production sites with the tools to record and manage environmental performance. The system contained three management levels that could be attained:

1. Basic level or compliance level: The main goal is to achieve compliance with regulatory and specific permit requirements;
2. Medium level or ISO 14001 certifiable: In addition to the basic level, focuses on implementing a systematic management system to promote continuous improvement of environmental performance;
3. High level or business excellence level: In addition to the medium level, the key goals are the implementation of an EFQM (European Foundation for Quality Management) model and the introduction of a benchmarking with internal and external partners.

The management and reporting systems were subject to the same type of testing and learning as found in the development of the closed loop approach to business. At this stage the reporting system was restricted to Umicore's business units or wholly-owned industrial sites within the European Union. Sites were requested to formulate objectives, state which environmental management level they were aiming for and when it would likely be achieved. These decisions were left to the business unit or the site management to determine.

A structured, standardize method was laid down at the central level in order to enable consistent reporting of each site's operational environmental performance. This enabled the company to provide an overall, transparent and structured assessment of the Union Minière's Group's environmental performance. This was accompanied by a set of Environmental Performance Indicators (EPIs) that were divided

in five groups: input indicators, output indicators, environmental performance management indicators, societal indicators, and financial indicators. This procedure was developed to prepare the company for the introduction of a more general approach to the implementation of management systems.

The development of the management system meant an environment section could be included in the 1998 annual report. This described the Company Charter and the ISO 14001 certification that applied to the Union Minière plants. It led to the first stand-alone environmental report published in 2000 related to fiscal year 1999. Through this means the company began to increase the openness of its relationships with governments, non-governmental organizations, financial stakeholders, the community and the media; and inside the company, to provide the foundation for a coherent management system, based on a set of measurable environmental performance indicators. This made clear to all employees that the environmental performance of the company would be taken seriously and any failure would be public.

The company then set out three major obligations and cornerstones that would underpin its environment policy. These were:

1. Regarding the past: to find practical solutions to the issues of historic soil and groundwater pollution, resulting from long industrial history;
2. Regarding the present: to improve production process in terms of emissions and waste management;
3. Regarding the future: to develop products that are not only environmentally safe but also "ahead of the time" by full collaboration and partnership with customers.

All plants – inside the European Union – were required to meet the company's environmental standards, as well as those established by law. In some cases, Union Minière's own requirements were more stringent than current regulations. The report was verified by the company ERM-CVS[7].

Highlights of the first environmental report were that metals emissions into the atmosphere and water had halved over the past 5 years and that Union Minière had increased the proportion of recycled products in its total feedstock. At the time, recycled products accounted for 28% of total raw materials, which was already a higher percentage than normal for the sector as a whole.

At this time Union Minière began to adapt its "corporate vocabulary" so that it was better aligned with the new vision it had begun to conceptualize. In its Annual Report 1999, the company stated: "We believe that successful companies get things right for their customers, employees, suppliers, shareholders and communities. Financial health not only depends on extracting value, but also on creating value for all the stakeholders. Sustainability driven companies achieve their business goals by integrating economic, environmental and social growth opportunities into their business strategies."

The company continued to promote the importance of working with employees on organizational change and supported this with their first employee survey. This survey has subsequently been repeated every 3 years. The company also sought out

7 ERM Certification and Verification Services (ERM CVS) is the worldwide environment, health and safety certification and verification business of the ERM Group, one of the world's largest providers of professional EHS services.

innovative ideas and in 1998 a Venture Unit was launched to create a nurturing environment to develop and test new ideas until they were ready to be absorbed by one of the existing business units or to provide the basis for a new business unit.

The Venture Unit acted as an incubator for ideas for products and product application.

During the testing and learning phase, the initial scope of the portfolio was restricted to ideas coming from inside the Group, in particular from the Advanced Materials business group. Although the company invested in some other start-ups by means of venture capital funds to create businesses or to give the chance to test new businesses. The final step in this testing and learning period was the creation of a new slogan for the company in 1999. That year, a new communications director was appointed, Moniek Delvou. She had a proven track record in the area of communications. One of the first things achieved after joining Umicore in 1999 was a change in the slogan of the company. Up to that time Union Minière's slogan was "Of metals and men" and its logo consisted of five men in different metals.

The new communication director noted that the logo and slogan did not describe what the company was now doing. She believed it would be better to have a slogan explaining putting the company and its products into context. One day, when sitting in Thomas Leysen's office the idea came forward of "Materials for a better life". The slogan for the company was changed from one day to another. Although the company continued to use its old slogan externally it was rolled-out in a meeting with senior executives without complaint. In fact there were no reactions, either positive or negative.

"Materials for a better life" was then communicated to the outside world signalling the completion of the ambitious repositioning of the company that was initiated in 1995. As recognition for its growing commitment to sustainable development and the incorporation of responsible economic, environmental and social behaviour into its business strategy, Union Minière was included in the Dow Jones Sustainability Group Index in 2000. This Index claims to track the performance of the top 10% leading sustainability-driven companies worldwide.

Implementation and Roll-Out of Strategy

By June 2000, Union Minière was beginning to be recognized as a different company but it had not yet fully completed the process of change. It was now financially sound and it had tested the new concepts that might link its future economic and environmental performance, it had promoted employee engagement and innovation. It had put a management and reporting system in place. It was now time to scale-up and implement that approach on a company-wide basis.

Karel Vinck felt that it was time to stand down as CEO. He also believed that a CEO shouldn't stay more than 8–10 years at the top of a company for three reasons:

"First of all, the business environment is changing and as a leader, you never adapt the way you should to this changing environment and its new challenges. Second, after 8 to 10 years you start to react and take decisions instinctively. Third, you get emotionally involved with the workers." His designated replacement as CEO was Thomas Leysen while he would become Chairman of the company. In addition to his key role in developing and testing the new concepts – closed loop materials with clean technology applications – Thomas Leysen had been in charge of the strategy department and the copper and precious metals business group. This gave him the necessary credibility to become the CEO of the company at the age of 39.

Thomas Leysen was confident in taking this role and setting the direction for the company. When he became CEO, he decided to change the name of the company to communicate its new vision and the new approach to business more clearly. Union Minière wanted to develop its approach to the environment and to create an excellent working environment for employees especially including health and safety. In the case of the environment this was still seen in terms of three responsibilities: past, present and future. But these three axes of responsibility were slightly adapted: the past now meant coming clean over the historical pollution problems caused by the company, the present axis represented continuous improvement of its environmental performance, and the future axis focused on the precious metals and internationalization. Special attention was given to improving the communication of these pillars to the outside world. And matching that communication to action.

Moniek Delvou, the communications director who had already triggered the change of the slogan, received a mandate from the Board to change the name of the company, as it was the moment to signal Union Minière's new direction and identity. Research on the opinions of employees, journalists, politicians, analysts and members of the general public came to the view that the name 'Union Minière' was associated with heavy industry and a colonial past. More positively it was associated with the competences of its engineers. It was decided to change the name while at the same time keeping a reminder of the old name.

Employees and others were invited to suggest names. Some 2000 suggestions were received. The names were reviewed by a small team presided over by Thomas Leysen leading to the choice of "Umicore". The selection filters were based on the link with the past, linguistic meaning, legality and Internet availability and the future. "The reason why we took finally Umicore was because of the core. It was unique: there was Union Minière – Umi was still there, and the 'core' meant that we wanted to go back to the core." explains Moniek Delvou. Beyond that the metals and materials created by Umicore were seen to be at the core of products essential to everyday life with new high technology applications. The company's commitment to contribute to sustainable development, was as a pioneer in recycling and environmentally responsible products and processes, with environmental sector applications. The consonant-vowel structure made it easy to pronounce in many of the world's languages.

Umicore also developed a new logo to go with the new name. It was based on the image of recycling, with the world also represented in the logo, through the blue sky and the green grass. The primary colours – blue and green – reflect the natural world

Fig. 24.5 The New Umicore (Source: Umicore)

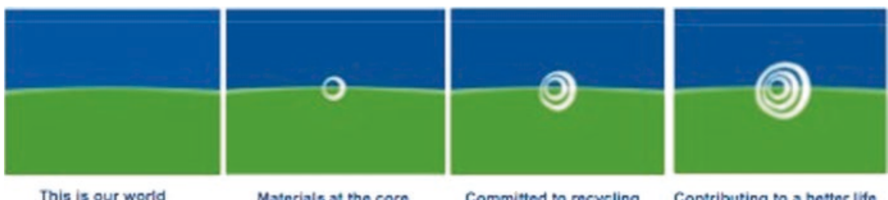


Fig. 24.6 Creation of the logo (Source: Umicore)

creating the link with sustainable development. Figure 24.5 represents the new name, slogan and logo. Figure 24.6 shows the logo and a slogan.

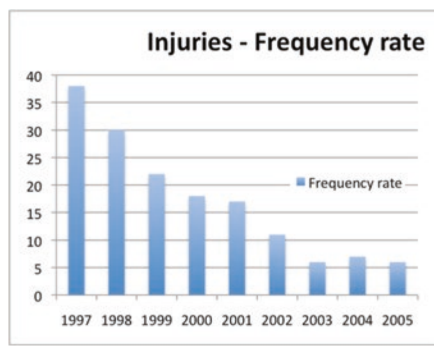
However, those leading the transformation knew that a new name and logo were not sufficient to bring about wholesale change in the company, they merely reinforced the direction of change. Delivering on the new vision would require profound change in the way employees and others saw the company. So from 2000–2005 Umicore focused on change that emphasized employees and the environment.

Umicore repeated the employee survey in 2001. With a 70% employee participation the survey showed there were clear improvements in 11 out of the 15 reporting categories compared with the 1998 survey. Organizing this survey on a regular basis brought the company closer to its stated ambition of involving people more closely in their work and workplace by communicating openly and frequently and by giving everyone a say in how their work is organized.

Great significance was attached to employees' views on health and safety and on health and safety programs and performance. Figure 24.7 show the progress in frequency and severity rates of the injuries in Umicore. Both have decreased significantly over the analysed period.

Umicore was now in a position to address its commitment to resolve its environmental legacy and to shape the future. Umicore proceeded to two site remediation programs to resolve issues from the past: first, a clean-up of a smaller plant in Bulgaria, and second, the signing of an agreement with the OVAM for the clean-up of all of its plants in Flanders.

Umicore's internationalization strategy led it to acquire plants outside Belgium. It bought a plant at Pirdop, Bulgaria with a commitment to remediate the historical pollution created by the previous owner. US$25 million was spent in 2003 on the remediation of the significant pollution. This was undertaken by the company in collaboration with the World Bank and the Bulgarian authorities. This innovative



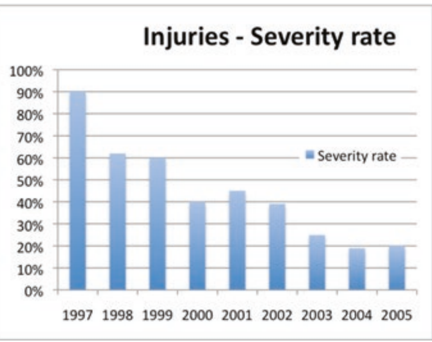


Fig. 24.7 Injuries frequency and severity rate 1997–2005 (Source: Erzmetall 60 2007 No. 3)

collaboration gained recognition, not only in Bulgaria but also abroad. It received the Belgian Environmental Prize 2003–2004 in the category "international partnership for sustainable development" from the Belgian Minister of Environment.

In April 2004, Umicore then signed an agreement with the Flemish Government and the Flemish Waste Authority (OVAM) to address all remaining issues following the 1997 Agreement over Umicore's plants in Flanders. This agreement covered the remediation of soil and groundwater contamination in and around Umicore's main Flemish sites: Balen, Hoboken, Olen and Overpelt. In signing this agreement, Umicore not only sought to tackle its historical environmental legacy but also to demonstrate its commitment towards the local community.

This agreement complemented the 1997 agreement and contained three major parts:

1. Concrete guidance for the remediation of the Umicore sites and the immediate surroundings;
2. Remediation of the wider surroundings (a radius of 9 km of each of the four main Flemish plants);
3. Smooth procedures for the transfer of remediated land.

While the agreement covered a period of 15 years, Umicore stated that it was its ambition to carry out most of the remediation within the next 3 years.

The total budget agreed by Umicore was €77 million, from which €39 million were dedicated for the remediation of its plants and the surrounding residential areas over the coming 15 years, with a further €23 million to be spent to cover related operating costs. Additionally, a joint fund with the Flemish authorities was created, to which each party contributed €15 million over a period of 10 years, to be used to address identified risks in the areas outside the plants. The agreement with OVAM had no immediate impact on Umicore's financial results for the period, as provisions had been built up in the financial statements of previous years.

In the same period beginning Umicore committed to eight environmental objectives that were to be achieved by the end of 2005. These were linked to the

Environmental Performance Indicators (EPIs) developed during the testing and learning phase (1998–2000). By 2005, Umicore had registered an increase of the input of secondary (recycled) materials to more than 30%, a reduction of use of water of 20% and a reduction of emissions of metals from process sources by 50%. Furthermore, the limits on CO2 emissions imposed by international legislation was met and ISO 14001 certificates were obtained in the majority of the operational sites.

Although there were no direct rewards for plants that complied with the EPIs, the system works because site performance is published and the performance system was linked to objectives that follow from the company's values. Umicore also committed to benchmark itself, through the employee survey, and to be in line with the Global Chemical Industry and Global High Performance Norm – a selection of companies combining good business performance and sound people management practice.

This phase was completed by the launch of two new projects in 2005: 'Umicare' and a Suppliers' Code of Conduct. 'Umicare' encouraged business units to engage in projects, which benefited their local communities. The Code of Conduct for Suppliers detailed Umicore's expectations from its suppliers in areas such as behaviour, environmental approach, employment or child labour. It states that the company seek business partners whose policies regarding ethical, social and environmental issues are consistent with these of held by Umicore. Special attention was paid to mining in the Democratic Republic of Congo (DRC). The internal audit team of Umicore conducts regular supplier audits in the DRC and Umicore committed to halt business with any company which was not able to demonstrate compliance with the code. Indeed companies have been removed from Umicore's supplier list as a result of this audit process. In the case of minor infractions a plan to help improve the supplier's operational practices can be agreed and followed-up. Umicore involved a number of NGOs and other external parties in formulating this approach.

The financial situation for Umicore was favourable when Thomas Leysen took over as CEO. The net result for 2000 of €136 million was almost twice the result of 1999. This resulted from a favourable dollar exchange rate and by the price of some metals, such as zinc as well as progress made in the transformation of the business. The divisions specializing in zinc, precious metals and specialty materials had impressive results. Thomas Leysen saw this as the moment to continue to change the orientation of the group towards products with higher value added, that provided solutions for the future. While the 1995–1998 Industrial Plan prioritized the refining activities. From 2000 on, part of the new investments would be dedicated to more sophisticated products.

In particular Umicore sought to consolidate its leadership in the recycling sector and to translate its expertise in recycling in the "precious metal" business unit to other business units dealing with advanced materials. This approach led to growth of the company through the organic growth that arose from the internal exchange of ideas between business units and through acquisitions in the area of advanced materials.

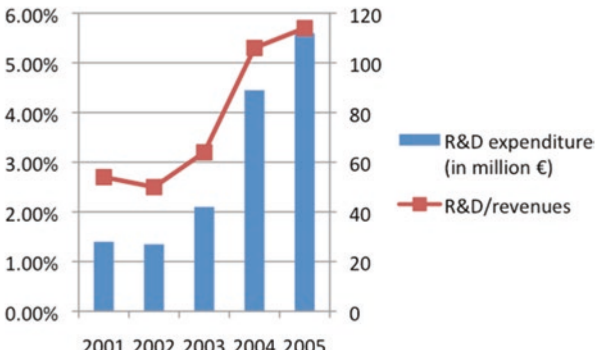


Fig. 24.8 R&D expenditures 2001–2005 (Source: Umicore)

Organic growth was pursued through increased R&D spending. A Venture Unit was created dedicated to foster innovation around materials recycling and applications. A new initiative 'Umagine' was launched to run in parallel to the Venture Unit. At the same time Umicore increased its R&D spend and sought to establish a more embedded innovation culture that stood outside a central R&D facility.

Figure 24.8 shows that during the period 2001–2005, R&D spending doubled from 3% of the revenue to almost 6%. At this time the central R&D portfolio consisted of two groups of projects:

– 70% of the total R&D budget was used to support the business plans of the individual business units. In these business plans economic performance and sustainability were important topics. The greater part of Umicore's long-term research budget was directed towards ways the company could contribute to renewable energy solutions such as fuel cells and solar cells.
– 30% (the remainder of the R&D spend was centrally managed and primarily meant to support Umagine initiatives.

Umagine was designed to stimulate and foster innovation in Umicore from the bottom up, and in that way complementing the Venture Unit. People from different businesses of Umicore, were encouraged to work together with outside participants by interacting in 'ideas labs' around selected themes such as recycling and nanotechnology. These highly interactive processes generated a wealth of ideas that were checked against criteria in line with Umicore's overall strategy. These included parameters such as their business potential and sustainability. Gradually, Umagine and the Venture Unit became less needed as the company as a whole adopted a culture of innovation based on a team approach to the generation and testing of ideas. Thomas Leysen sought to stimulate this approach by opening up the company to ideas exchanged among colleagues, across the company and across it boundary. In this way the company culture evolved from a culture of 'doing and complying' to a culture of 'learning and innovating' where all employees were invited to participate.

The company also sought to consolidate its new approach through acquisitions and mergers. In July 2003 Umicore bought the "Precious Metals Group" (PMG), a subsidiary of the American company OMG for €643 million. It was the company's largest acquisition until then.

PMG contributed new applications in the area of precious metals. It was an important producer of automobile catalysts and of a whole series of materials based on precious metals. It fitted well with Umicore's slogan of 'Materials for a better life'. Through the addition of PMG, Umicore mastered the entire life cycle of precious metals: collecting and pre-processing of recyclable waste, in particular of used automobile catalysts, refining end-of-life products and secondary industrial materials (resulting from foundry operations and refining of other metals), and fabrication of products designed for new uses. The acquisition of PMG also strengthened Umicore's geographic presence in North and South America.

The integration process of PMG was a success. But the most difficult part of the acquisition was reconfiguring precious metal refining because of the overlap between refining at Umicore plant at Hoboken and the Hanau plant of PM. As the plant of Hoboken had the most advanced technology in the world for recycling, it was decided that the plant in Hoboken would undertake all the refining activities, whereas the plant in Hanau would concentrate on the other activities of the precious metals business unit. Integration of PMG significantly increased Umicore's scientific knowledge and its applied technological know-how, with more than 500 people then active in this area.

From 2003 on, the copper business was organized in such a way that it could function as a stand-alone company. Umicore prepared this division for sale. In 2005, the copper operations were spun off into a new company, Cumerio, to enable Umicore to move ahead more swiftly in its evolution as a specialty materials business. Three plants were concerned: Olen (Belgium), Avellino (Italy) and Pirdop (Bulgaria).

By 2005, Umicore also decided to concentrate the strategic focus of its zinc division on the production and sale of zinc specialty products. This strategy reduced the output of commodity zinc and concentrated on the development of downstream zinc specialties activities.

Umicore paid special attention to its employees as part of its sustainable strategy, and hence established a new Human Resources Management Organization in line with the operational and cultural needs of the new Group in September 2003. Responsibilities for HR now largely rest with the HR functions at country or regional level while the corporate HR function guided the overall policy formulation, management development and HR networking.

All these changes in the business were supported by more transparent external communication, replacing Union Minière's previous lack of transparency. But to do this the new Umicore had to develop its expertise and gear up the range of communication tools through continuous improvement. These included: the environment report, local site reports, press releases, open-door days and improved websites.

The environment report of 2000 was extended to include health and safety issues. It was re-named the "Environment and Safety" report with the tagline: "On the

Road to Sustainable Development". It contained three major parts: the group's objectives for the period 2000–2005, occupational health and safety data and financial data. It outlined that

> We do not just want to create value only for our shareholders, employees and customers but we also want to create value for society as a whole. We endeavour to achieve this by operating in an environmentally responsible manner and by delivering materials and services that are essential both for everyday life as well as for technological progress. (Umicore Annual Report 2010)

The Environment and Safety Report of 2001 extensively described Umicore's product safety philosophy. It included a sound scientific approach to assess the hazards and the risks in using Umicore's products. By then the tagline "Responsible towards future generations" indicated Umicore was comfortable to communicate the approach to sustainability it was developing and the report was expanded in breadth as well as depth. All the company's sites reported on their performance in a report based on three main sections: the Environment, Health and Safety management at all sites, the company's responsible management of its historical legacy and responsible product management. The report was awarded the best environment report in Belgium by the Belgian Institute of Chartered Accountants.

EHS management for all sites was regulated by the new Umicore Health and Safety Care System, based on three performance levels:

- Basic level: The baseline level to be attained in every plant;
- Medium level: Compliance with EU Directives on control of major accidents (Seveso Directive or international equivalent);
- Business Excellence: The ultimate goal for all operations, which included all aspects of excellent health and safety management.

Umicore continued to develop its communication on environmental matters, through the medium of a community relations website, part of its community involvement program. The company was also proud to communicate that its Environment and Safety report was elected the best in Belgium by the "Reviseurs d'Entreprises/Instituut der Bedrijfsrevisoren". At the same time the Belgian association of financial analysts awarded Umicore the prize for best financial communication in 2002. The company was also included in the FTSE4GOOD index and received the 'best in class' rating from the Storebrand Social Responsibility Index.

In 2003, the Environment and Safety report became "Environment, Health and Safety report" with the tagline "Environment, health & safety and business growth go hand in hand". Year after year, the company was enlarging its scope of reporting and now paid more attention to the employees by including health issues. That same year, Umicore was selected for membership of the new Kempen/SNS Smaller Europe Social Responsibility Index.

The company then published "The Umicore Way", a framework of guiding principles and a statement of what was common and essential for the Group. The Umicore Way explains the vision of the Group and the values it seeks to promote. It

serves as a reference point for all employees. The Umicore Way was introduced by means of an extensive roadshow carried out by Umicore's senior management which visited seven locations in four continents.

The adoption of a Code of Conduct for all Umicore employees followed the declaration of the Umicore Way. It provided a statement of ethical business practices throughout Umicore. It was distributed throughout the group and has been translated into four languages. By 2005 the continuous improvements in performance, management systems and participation by sites led to the publication of one single annual report, including economic, environmental and social sections. The audience was enlarged: as it was recognized that the scope of people entitled to information about how Umicore did business went beyond the boundaries of the investment community and the report was therefore addressed to "Shareholders and Society". Furthermore, the Global Reporting Initiative (GRI) Guidelines were adopted, as a standard. This Annual Report begins to reflect Umicore's approach to sustainable development.

The work on reporting was supported by publishing reports for the local community (which included the families of many employees of the plants) coupled to an open doors approach at the plants in Hoboken and Olen and in the corporate headquarters in Brussels each year.

By the end of 2005, the majority of earnings derived by Umicore were from areas in which the company held global leadership positions and where it could rely on its distinctive technological capabilities. At the same time, the concept of sustainable development had become firmly embedded in the strategic thinking, and was notably exemplified by its commitment to closed loop manufacturing and recycling. In that year Umicore was elected 42nd worldwide for combined financial and CSR performance by Newsweek Japan.

Diffusion and Institutionalization

Umicore's approach to sustainability that started in the cobalt and precious metals business unit at the end of the 1990s was then implemented on a wider scale in the company's operations in Belgium 2000s. From 2005, Umicore went further taking the ideas developed in Belgium to all its plants and to the companies it had acquired. Employee engagement was also extended to sites outside Belgium and the European Union.

> We can say that over the last few years we have moved ahead on many fronts: in tackling the legacy of past activities, in ensuring that the environmental performance of our present processes are in line with ever more demanding standards, and – most importantly – by contributing to a better environment through the development of innovative products and a commitment to recycling. For the future, we will progress on this Umicore Way. (Thomas Leysen, Umicore EHS Report 2004)

The eight environmental objectives for the period to 2005 were complemented by five new objectives on the social front again to be realized over a period of

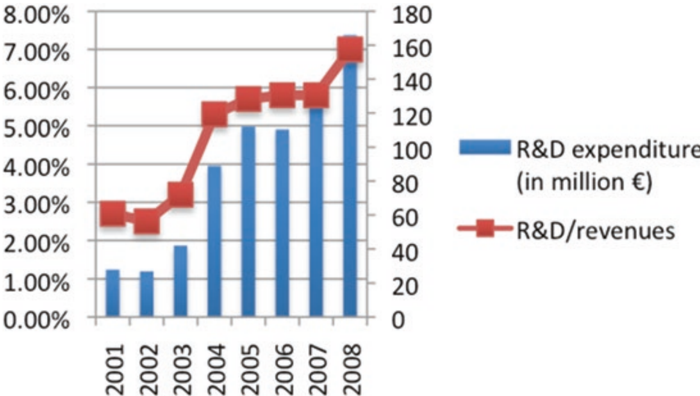


Fig. 24.9 R&D expenditures 2001–2008 (Source Umicore)

5 years. In this way, importance was given to the relationship of the company to society as well as the environment – with a focus on employees and local community. At the same time the three environmental axes were extended and disseminated on a global basis.

Cleaning up the past was extended to rehabilitation in other sites, such as the plant in Grâce-Hollogne (Walloon region of Belgium). Continuous improvement in the present was brought about by the addition of new objectives and their application across the company as a whole. As for the future, the vision of the company, in terms of closing material loops with material applications in environmental and clean technology markets was further elaborated. Figure 24.9 shows that Umicore continued to invest in R&D (with 80% in the area of clean technology). Simultaneously, acquisitions and divestitures radically changed the portfolio of its businesses. In 2007 Umicore further divested its zinc business into a new company (Nyrstar) and bought the automotive catalyst business of Delphi Group. These and other acquisitions contribute to a reinforcement of the core business.

During this phase Umicore continuously refined its communication, through its annual reports. For example Umicore applied the principles of the Global Reporting Initiative (GRI) to its reporting framework since the publication of the 2005 Report to Shareholders and Society.

Overall Umicore built on the lessons learnt in Belgium and then in wider Europe to effect organizational transformation in its other sites around the World. This followed the main themes of its overall approach employee engagement through surveys and support for innovation, fostering quality employment and health and safety of the employees and engagement with local communities around its sites, in case of the environment – cleaning up the past, continuous improvement of operations and a focus on precious metals and internationalization with this all supporting a business moving toward materials based on closed-loop systems with environmental and clean technology applications.

Discussion

The case narrative above states the main phases in the transformation of Umicore over 19 years. It follows what happened chronologically, as reported by the key informants. It identifies the overall process into five phases, the key elements and sequences of that transition and the role played by senior managers. In this way the case provides insight into the roles and beliefs of those leading the transformation process. In this discussion section we draw on theory to make some sense of the process that is described and the role of human agents in that change process.

The literature identifies the central role of change agents in transformation to sustainable development but without going in to great detail as to what the role of change agents involves (Dunphy et al. 2007; Mayon-White 2003; Beckhard 1997). Despite the emerging complexity of change agency in relation to sustainable development and its implications for business few attempts have been made to clearly define a process model and to reveal the factors that contribute to change. What is clear is that change agents are recognised as individuals or teams that initiate, lead, direct or take direct responsibility for making change happen (Caldwell 2003). A change agent can be considered as an agenda-setter, language-creator and moderator (Cramer et al. 2004). It has been argued that his/her changing personal values drive the process of organizational change (Hemingway and Maclagan 2004).

However change agents in the case of organizational transformation toward sustainable development have received less consideration as there are rather fewer close empirical studies of this process although authors have noted the importance of leaders in triggering change (Neilson et al. 2008; Spitzeck 2009; Gitsham 2008) Moreover it is also noted that those driving change are found primarily within the organization and express their ideas through the company's various implementation strategies (Jonker and de Witte 2010). It has been suggested that the leadership necessary for organizational change that contributes to sustainable development is based on "the global exercise of ethical, values-based leadership in the pursuit of economic and societal progress and sustainable development" (Globally Responsible Leadership Initiative 2005). That view seems to be based on an understanding of the interconnectedness of the world and an acknowledgement of the need for economic, societal and environmental progress. However, this kind of statement only serves to decompose and restate the qualities of sustainable development, which emphasises linking economic, social and environmental issues in ways that provide for present and future, so that this is reframed as a leadership challenge. It does not get very far into the details of the critical leadership roles and beliefs or provide more comprehensive insight into the process, especially the sequence of events that supports successful transformation for sustainable development.

In contrast D'Amato and Roome (2009) in their meta-study of companies that have engaged in transformation towards sustainable development identify eight leadership practices that contribute to the deep change required when a company sets about changing its activities to move from unsustainable practices and contribute to sustainable development. These practices include: developing vision for the future of the company; crafting strategy and policies that links commercial and

environmental practices; operationalization and translation of strategy and policy to the local, operational level; ensuring top management support and involvement; engaging with stakeholders; fostering the empowerment and development of the of key actors; high quality communication; establishing systems for performance development and accountability; and, demonstrable commitment to ethical actions. Their work also points to the supporting relationship in the companies they studied that linked a future vision for the company, with concepts that help make that vision a reality, formal strategy to provide direction and resources, business principles that underscore actions and the importance of key beliefs in holding this together. These beliefs include: a recognition of problems as opportunities; only doing what you say and saying what you do; commitment to a humanistic organizational culture that values people, recognises that everyone has the potential to contribute ideas that support change and that focuses on learning, innovation and change before it focused on control. Moreover this research emphasises that successful transitions involve people and groups that fulfil certain roles that bring about this sequence: the role of creating vision; generating concepts relevant to the change; championing those concepts through organizational networks; creating communities of practice that explore, test and translate those concepts into actions and new practices. This is supported first by communicators and then by the role of those who develop and deploy management systems.

The case of Umicore appears to corroborate the importance of these eight practices as well as providing some indication of the sequence through which the elements of the process are deployed, especially the link between vision, concepts, strategy and business principles.

The process at Umicore was as follows. Senior managers became aware of its pressing financial and environmental problems and sought a way out. The industrial plan provided an immediate a way out of the financial situation faced by the company but did not provide a longer term solution that would resolve the company's environmental problems. It was nevertheless understood that past environmental problems had to be resolved and new problems avoided. That required a leap of imagination that translated environmental problems into economic opportunities. It involved an emerging vision for the company that arose from the link between two important concepts – closed material loops and clean technological applications. More hidden in the story of Umicore was a commitment to the practice of the concept of continuous improvement. The emerging vision shaped by these concepts was fostered by the move toward an organizational climate that emphasized innovation and learning founded on the empowerment of employees: Only then to be supported by a declaration of values.

In this way a vision for the company developed that it would define its future as providing material solutions to provide solutions to environmental problems while ensuring that the company's operations accorded with the highest possible environmental standards. Moreover the company would progressively move toward a closed loop business.

The model to fulfil that vision was not immediately obvious – it came from testing and experimenting with these ideas in one business unit and then progressively

up-scaling that experience to other parts of the company and its business. This required the development of an awareness of the new approach among employees, coupled to their empowerment and encouragement of their engagement in learning and innovation to deliver the practices that would make the vision tenable. Only once this cultural change was in place could the company press ahead with the development of a management, performance and reporting system. The management system was gradually extended and expanded into the whole of the organization but it too followed the development of the culture of learning and innovation as the management system itself was seen as an innovation.

At Umicore there was an period of iteration between the emerging vision for the company on the one side and concepts that would be central to that vision based on the promotion of a more open and innovative culture, on the other.

Once the vision was clear, and the concepts had been tested and seen to provide a viable approach for the company it was able to embark on an acquisition and divestment strategy that closed its material loop in some main business areas and got out of areas that did not conform to the new approach. At the same time acquisition of businesses provided new know-how although it created challenges of integrating those businesses into the culture and approach taken by Umicore.

Intense communication by the CEO's coupled to the use of formal documents such as reports and community liaison was seen as critical and this too was gradually developed and pushed forward so that claims were in line with achievements and words matched actions. Significant attention was given to key communications – the logo, slogans and name of the company developed in a rhetorical way so that it signalled change that had been made and inspired more movement in that direction. A premium was placed on transparency and admitting to and addressing the problems of the past.

Above all the case illustrates the importance of the continuity of belief systems of the three CEO's and the matching roles that supported the accomplishment of transformation. Despite their different experiences the three CEO's all placed a premium on human relationships, communication and matched that with a commitment to learning.

Finally, the case indicate that senior managers at Umicore had a simple yet compelling understanding of the implications of sustainable development. This is not a trivial point. Senior managers understood sustainable development as a strategic challenge and opportunity some 15 years ago. And they south to work out what that would mean for change at the company. Moreover, their quest was not to claim sustainability for the company but to acknowledge clearly that Umicore was a business seeking to create value and profit but that did not pre-determine how it would create value. Given the company's history senior managers seemed to know that the company's longer term future would be based on a choice of how they did business, and how they chose to create value into the future. That would mean breaking with the ways of the past that had created value while at the same time destroying environmental value. The key issue was how to identify the path for transition and to develop the skills and know how that would make it successful.

The company's senior managers set out to determine the direction for the company through the combination of vision and concepts, to encourage the commitment and alignment of employees and others to that direction but to leave the detailed operationalization to those closer to the operational realities of the company.

Conclusions

This chapter set out to examine the process of transformation undertake by Umicore a company that is widely held to be a leader in its contribution to sustainable development. The chapter describes that process using the insights of those who were close to the process that unfolded over 19 years. That process is still not complete but much has been changed.

The chapter sheds light on the sequence of this process and the factors that contributed to the way it unfolded. It shows something of the practices that support the process of change and the roles and beliefs that were held by change agents and leaders. These conform to evidence from previous companies that have undertaken similar transitions.

What is clear is that Umicore held a somewhat unusually advanced yet simple view of sustainability, a view that is rather consistent with the original understanding of sustainable development as set out in the Brundtland report. But the real value of the case is in the charting of process that then unfolded: Creating a culture of learning and innovation to provide for change. Developing a new vision for the company that was supported by the deployment of some key concepts that were relatively new to the company. That required learning about those concepts by doing. In other words transformation, to make a contribution to sustainable development at Umicore, was essentially an innovation process that deploys some concepts that were not conventional for the business and required management to subscribe to some relatively rare skills. The fact that the transformation at Umicore involved a simple yet advanced notion of the implications for the business of sustainable development, deployed some unconventional concepts and drew on some rare skills possibly explains why so few examples of successful transformations toward sustainable development are available to study.

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25 IBM and Sustainability: Creating a Smarter Planet

Gilbert G. Lenssen and N. Craig Smith

Sometime in 2000–2001, IBM decided that companies from emerging countries would be much better placed to produce and market hardware and that it needed to move up the value chain by developing and offering more technology applications and develop the consulting capability to help clients with applications. Less focus on technology as such, and more on the enabling potentials of technology was the idea. As a result, it sold its PC business to Lenovo in 2004. The recent $2,1b sale of the server business to Lenovo completed this process.

In 2002, IBM acquired the consulting arm of PWC in order to buy in consulting knowledge and capabilities, despite its previous reliance on continuous learning and in house capability development. However, the integration of PWC consulting into IBM was not achieved without major difficulties and took many years.[1]

In 2008, the IBM Smarter Planet Strategy was launched in the midst of the meltdown of the financial crisis. It was a bold statement of hope in those dark days. It asserted that the world can be a better place with the smart use of technology and IBM would be able to provide the consulting, the software and the management systems for addressing some of the world's most pressing challenges. Addressing sustainable development was immediately one of the key objectives.

[1] IBM managers in Gilbert Lenssen's classes have testified that it took more than 10 years to overcome cultural differences.

This chapter served as the basis for "Finding Profit in Creating a Smarter Planet," published in *INSEAD Knowledge*, March 2016.

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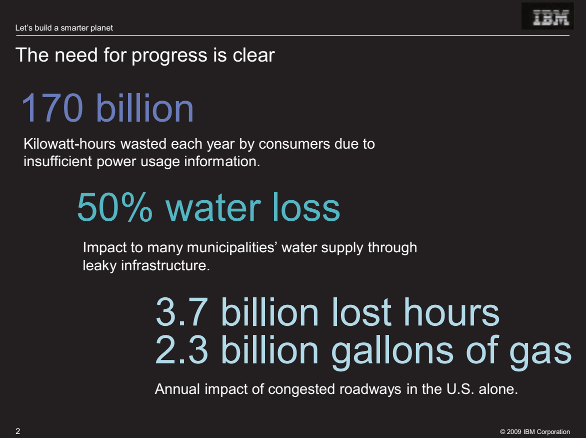
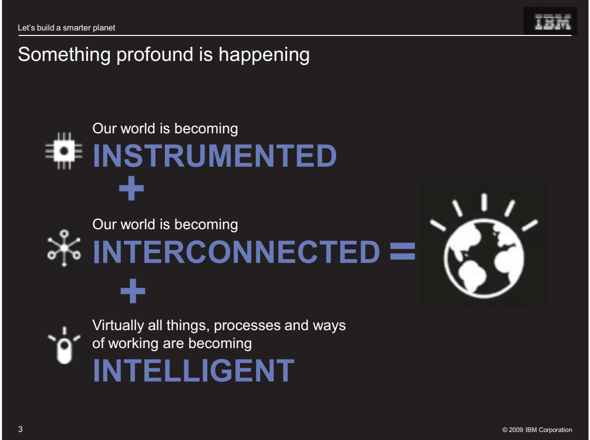
© Springer Science+Business Media B.V. 2019
G. G. Lenssen, N. C. Smith (eds.), *Managing Sustainable Business*,
https://doi.org/10.1007/978-94-024-1144-7_25

The vision is explained in a 2010 presentation from Rich Lechner, IBM VP Energy and Environment, which follows.[2] He is obviously is a business leader with an acute awareness of the business potential of sustainability and a clear understanding of the societal relevance. A clear sense of purpose around making the planet a better place is embedded throughout the presentation.

It might seem obvious or common sense, yet it has been a huge success. This is notwithstanding the fact that companies find it generally very difficult to embark on and succeed in major business model transformations, especially in the field of sustainable development where risks are high and outcomes unsure.



[2] Please find the ppt: http://globalforum.items-int.com/gf/gf-content/uploads/2014/04/Global_Forum_-_IBM_Richard_Lechner_Sustainability.pdf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Something profound is happening
Our world is becoming
INSTRUMENTED
+
Our world is becoming
INTERCONNECTED =
+
Virtually all things, processes and ways of working are becoming
INTELLIGENT
3
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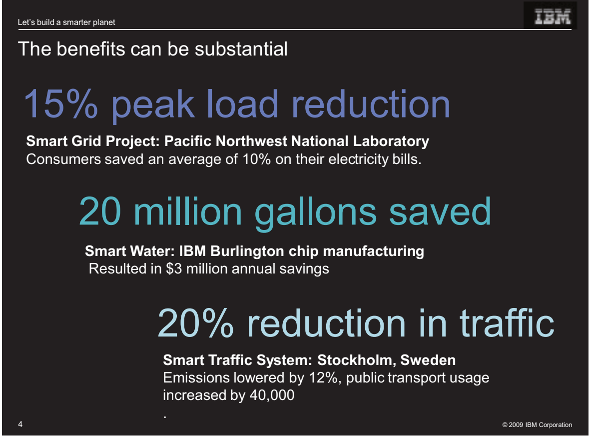
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15% peak load reduction
Smart Grid Project: Pacific Northwest National Laboratory
Consumers saved an average of 10% on their electricity bills.
20 million gallons saved
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4
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Organizations are focused on achieving
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Operational sustainability
Environmental sustainability
5
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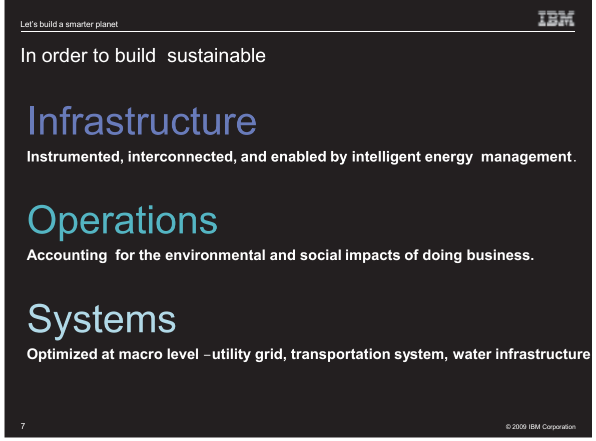
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Infrastructure
Instrumented, interconnected, and enabled by intelligent energy management.
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7
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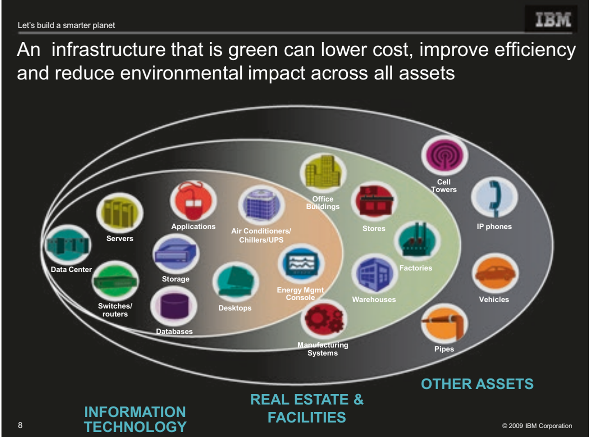
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An infrastructure that is green can lower cost, improve efficiency and reduce environmental impact across all assets
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Switches/ routers
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Air Conditioners/ Chillers/UPS
Energy Mgmt Console
Office Buildings
Manufacturing Systems
Stores
Warehouses
Factories
Cell Towers
IP phones
Vehicles
Pipes
INFORMATION TECHNOLOGY
REAL ESTATE & FACILITIES
OTHER ASSETS
8
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Let's build a smarter planet

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Sustainable operations optimize for energy, carbon, and water across all aspects of the business and value chain

CO_2

Governance & Strategy

Business Process Management

Product & Supplier Management

Distribution & Logistics Management

Workforce & Stakeholder Management

9

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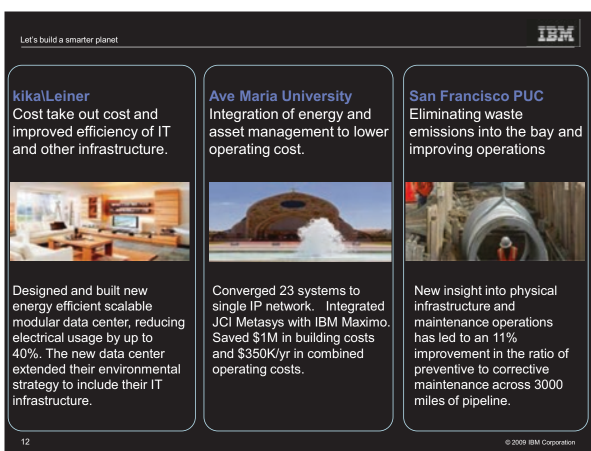

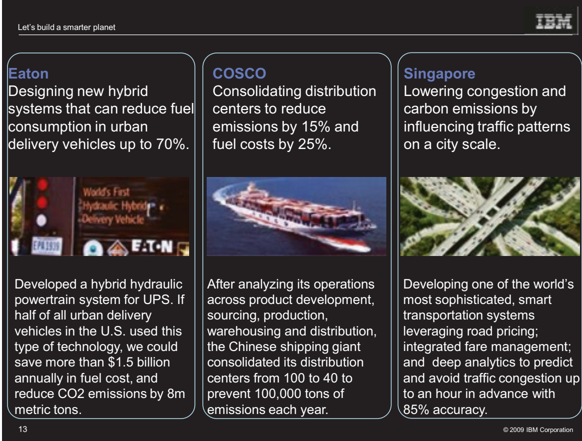

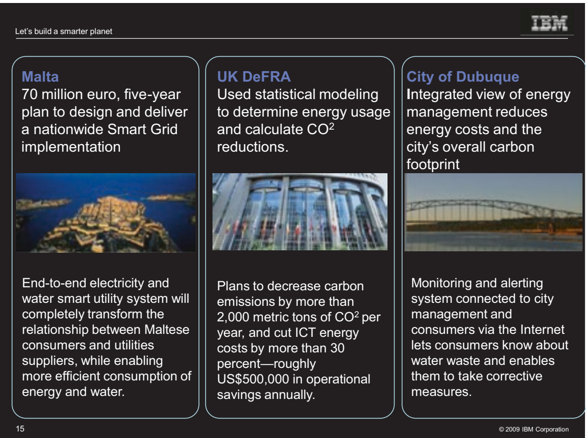

Smart Projects

By tapping into and interconnecting with new (often global) production systems and workforces, the Smarter Planet Strategy helps companies gain deep industry insight, giving them the competitive advantage of being able to identify opportunities not previously visible, and the capability to transform the way things are done.

Along with business potential, this increased knowledge opens the way for organisations to link sustainability to the purpose of their business, to integrate it into their strategy and, in the process, help change the world.

The possibilities are endless. According to IBM, smarter use of technology opens the way for smarter law enforcement, smarter water and sewer systems, smarter government services, smarter transportation and smarter operations centres.

Some of the strategy's flagship examples include working with Stockholm city authorities to design and implement a congestion-management system substantially reducing traffic build-up, vehicle emissions and encouraging greater use of public transport; and helping Syracuse University's Green Data Centre halve the energy requirements of standard data centres, using advanced techniques in building design, energy generation, cooling technology and IT systems.

Meanwhile in rural Louisiana, a Smarter Planet telemedicine initiative has helped provide advanced healthcare to patients with limited access to services, by creating a portal allowing doctors to record and share test results and vital signs, aiming for faster and more accurate diagnosis.[3]

In each of its projects Smarter Planet aims to demonstrate both the business case and the sustainability case for improving systems to become more sensitive,

[3] For projects in the US please look at www.ibm.com/smarterplanet/us/en/. For projects in France please look at www.ibm.com/smarterplanet/fr/fr/. For projects in Australia please look at www.ibm.com/smarterplanet/au/en/

collaborative and responsive, introducing the benefits of innovation rapidly and at scale.

Smarter Planet operates as a global business. Knowledge exchange and consolidation of learning from each project is obviously the basis for maintaining advantage over competitors who might be tempted to imitate IBM.

Pillar for Growth

For IBM, the introduction of 'Smart' solutions is a $66 billion opportunity and one of its four key pillars for growth. Based on the vision that data integration reinforces a united world, IBM software is the key driver for this proposition, giving clients the capabilities required to transform their industries by integrating information, empowering people, connecting global ecosystems, and optimising business processes.

In 2010, the Smarter Planet Strategy generated US$3 billion in revenue and it accounted for more than 25 percent of IBM's research work. It is in the process of doubling this to 50% by focusing its efforts on high-growth industries such as healthcare; oil and gas; energy and utilities; transportation; telecommunications; retail; banking; government; and electronics.

In order to optimally manage its business IBM develops a yearly roadmap, which includes a long – term perspective on technology, business and the global economy, and seeks to align this business model with clients' needs.

Core Strengths for Succeeding in an Integrated World

This focus on the enabling power of technology is not new to the company. IBM played a central role in scientific breakthroughs at several stages of its history, supporting NASA in putting a man on the moon and assisting with the decoding of the human genome. Seeing and solving problems has long been at the core of its operations, as has the recognition that, with innovative thinking, many different types of resource can contribute to the solution. After applying these principles to its own operations, the company is now turning its eye to the world becoming, in essence, a sustainability enabler, demonstrating the culture, structure and governance needed to adapt to a globally integrated market.

The philosophy that 'any problem can be solved as long as people are willing to think' reflects a mindset that does not accept existing boundaries while the development and subsequent sharing with the world of its advancements shows an understanding of the value of the availability and use of common standards. The company's refusal to adopt segregation policies for its plants in southern US states in the 1960s and its progressive emancipation policies towards workers throughout its corporate history, reflects its attitude of inclusion and openness. IBM believes that talented people can be found anywhere in what they call the 'human family'. It embraces the fact that all people are different and it is these differences that facilitate innovation and the ability to adapt.

These values are a cultural asset of paramount importance to any company operating as a globally integrated enterprise. But having the cultural capability alone is not enough. A company's organisational architecture needs to look beyond the traditional, and fragmented, idea of brand, process, product and country. IBM acknowledged this by putting in place an integrated design with a strong overall governance model to become congruent with the realities of today's dynamic integrated global economy.

Addressing Challenges

In 2016, the world is not short of problems, many of which have sustainability issues at their core. The number and size of these issues trump the capability of governments to solve them. IBM recognises the business opportunity for delivering systems that enhance sustainability within firms and in doing so address many of these challenges. In a world where integrated enterprises increasingly tap into global production systems and workforces, competitive advantage comes from dynamic learning, greater insight, and in the potential of transforming the way things are done to keep relevant and competitive in a high-paced, rapidly changing globalised marketplace.

Critical questions IBM needs to address are:

1. IBM's strength has always been in technology development. This Smarter Planet strategy shifts IBM from technology development to technology applications for management solutions and makes it effectively a consulting company. What are the long range organisational implications of this shift?
2. Other consulting companies like Accenture who are making major bets on sustainability have consulting as a key capability which they nurture, not in the least with being in touch with senior executives through which they can anticipate the changing executive agenda. They can consult on an entire sustainability strategy and on specific operational solutions based on smart technology. Can IBM emulate this approach?
3. IBM might ultimately lose its leadership in technology, nor be a leading consulting company. Is there enough space in between both industry sectors for it to thrive?

Waste Concern: Fixing Market Failures

26

Joanna Radeke, Johanna Mair, and Christian Seelos

In September 2005 Iftekhar Enayetullah and Abu Hasnat Md. Maqsood Sinha, the founders of Waste Concern, secured approval for their first project under the Clean Development Mechanism (CDM) program, established in the Kyoto Protocol. Under the CDM program, projects reducing greenhouse gas emissions in countries without emission targets could earn income from the sale of Certified Emission Reduction units (CERs).[1] CERs could be sold to industrialized and transition countries obliged to reduce their emissions in the Kyoto Protocol. The CDM program is supervised by the CDM Executive Board under the authority of the Conference of the Parties, the governing body for the Protocol.

The approval for the second project of Waste Concern came in May 2006. The two projects encompassed a plan for a dual-purpose operation consisting of a gas recovery site and a 700-ton per day composting plant at the Matuail landfill site in Dhaka. The Matuail Landfill site was owned and governed by the Dhaka City Corporation (DCC), which was also responsible for the collection of waste from the streets of Dhaka. For their CDM projects, Waste Concern planned to use the landfill site provided by the DCC. The organization also wanted to take over the waste collection from the markets in Dhaka, with the idea to turn the collected waste into saleable compost. In addition, it planned to earn income by selling CERs.

[1] Each unit is an equivalent to one tonne of CO_2.

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G. G. Lenssen, N. C. Smith (eds.), *Managing Sustainable Business*,
https://doi.org/10.1007/978-94-024-1144-7_26

The projects seemed a win-win scenario for all stakeholders. Firstly, the projects could earn income for Waste Concern and at the same time help the organization to achieve various environmental and social benefits, including the reduction in greenhouse gases and creation of new jobs. Secondly, they could help Dhaka City Corporation as it was struggling with collecting the growing mountains of waste generated by an increasing number of Dhaka residents. Thirdly, the emissions could be traded with industrialized and transition countries to help them achieve their emission targets and, thus, the projects could promote the CDM and help realize the Kyoto Protocol.

However, the reality faced by the two founders of Waste Concern when implementing the CDM projects differed substantially from the business plans. The carbon market plummeted and with it the prices that could be achieved through selling CERs. The Dhaka City Corporation did not allow Waste Concern to access the Matuail Landfill site. Additionally, the electricity crisis impacted the number of composting plants that they could built as no new grid connections were allowed by the government.

Yet, Enayetullah and Sinha and Waste Concern managed to deal with these challenges and turn them into opportunities: (1) They found a new site for the composting project and built their first composting facility on that site; (2) They gradually increased the capacity for the first composting plant when they were not able to build more plants; (3) They introduced technological innovations such as Refuse-Derived Fuel to gain additional sources of income for their projects; (4) They exported the compost outside of Bangladesh for higher prices than possible within the country; (5) They secured an agreement with the Asian Development Bank to sell their CERs at the lowest cut-off point predicted in the business plan. At the same time, Waste Concern focused on scaling up its waste management solutions outside of Bangladesh with the help from the Bill and Melinda Gates Foundation. It also started a new company promoting organic produce in Bangladesh. Waste Concern, founded in 1995, was growing every day.

As a result, on the cusp of the eighteenth birthday of Waste Concern, its founders were running a different organization. They were proud of their achievements, but – keeping recent challenges in mind – they were also wary of the future and the tasks lying ahead.

From a simple non-profit, Waste Concern evolved into a hybrid organization doing business with a social mission of making waste a resource. It literally was “making cash from trash” (Ashoka n.d.), dealing with the challenges that no private business in Bangladesh wanted to deal with.

In addition, by engaging in CDM projects, cooperating with the Bill and Melinda Gates Foundation, and engaging in the marketing and sale of organic products, Enayetullah and Sinha expanded their organization in Bangladesh and abroad. The evolution from a lean research, development and advisory services operation to a broader diversified venture encompassing four companies, dealing with waste management and organic agriculture as well as managing the Waste 2 Resource Fund also created new organizational challenges.

The identity of the organization was in constant flux. For one, Enayetullah and Sinha saw themselves as serial entrepreneurs, designing and developing innovative solutions to improve the waste management situation in Bangladesh. With the two founders representing both the identity of Waste Concern towards external stakeholders and most of its management capacity the question of how to structure the organization for future growth and impact became more prominent.

Bangladesh

Located between India and Burma, Bangladesh has a land area of 144,000 km^2 and a population of nearly 164 million people (Central Intelligence Agency 2013).[2] The country has the eight largest populations in the world and also one of the highest population densities at 1137 people per km^2. It was estimated that approximately 28% of the country's population lives in an urban area. This was expected to increase at 3.1% annually.

Observers cited extreme monsoons and cyclones as the central impediments to growth creating climatic instability. Additionally, poor transportation and communication infrastructure, insufficient energy sources and ineffective government reduce growth potential. However, last year the Economist named Bangladesh "one of the most intriguing puzzles in development" (The Economist 2012) describing the country as making social progress, especially when it comes to mortality rates of infants and mothers at birth, as well as life expectancy. Social progress, though, did not go hand in hand with economic development, with GDP per capita ranked 192nd out of 229 countries. GDP per head was around USD 2000 in 2012 and approximately 31.5% of the population lived below the poverty line. See Exhibit 26.1 for more facts about the country.

Exhibit 26.1: Bangladesh at a Glance

	2005	2013
People and society		
Population	144,319,628	163,654,860
Median age	21.87	23.9 years
Population growth%	2.09%	1.59%
Birth rate	30.01 births/1000 population	22.07 births/1000 population
Death rate	8.4 deaths/1000 population	5.67 deaths/1000 population
Maternal mortality rate	330/100,000 live births[a]	240 deaths/100,000 live births
Infant mortality rate	62.6 deaths/1000 live births	47.3 deaths/1000 live births
Life expectancy at birth	62.08 years	70.36 years
Total fertility rate	3.13 children born/woman	2.5 children born/woman

(continued)

[2] All data in this section (except where otherwise noted) come from the Central Intelligence Agency (2013), The World Factbook: Bangladesh. Retrieved from https://www.cia.gov/library/publications/the-world-factbook. Accessed 18 June 2013.

Exhibit 26.1: (continued)

	2005	2013
Economic indicators		
GDP (purchasing power parity)	299.9 billion[b]	305.5 billion
GDP growth rate	5.2%	6.1%
GDP/capita	2100	2000
Inflation	6.7%	8.8%
Unemployment	2.5%	5%
Population below poverty line	45%	31.5%
Public debt as% of GDP	46.1%	32%
Industrial production growth rate	6.7%	7.4%
Current account balance	−591 million	−942 million
Exports	9.372 billion	25.79 billion
Imports	10.03 billion	35.06 billion
Currency	Taka (BDT)	Taka (BDT)
F/X rate to US$	64.26	82.17
Energy and environment		
Electricity production	17.42 billion kWh	35.7 billion kWh
Crude oil production	6825 bbl/day	5200 bbl/day
Natural gas – production	9.9 billion cu m	20.13 billion cu m
Carbon dioxide emissions from consumption of energy	37.65 million Mt[c]	56.74 million Mt

Source: CIA World Fact Book 2005 and 2013, www.cia.gov, Accessed 12 June 2013
[a]Estimate by the Global Health Observatory of the World Health Organization, www.who.int, Accessed 12 June 2013
[b]Values in US$ except where otherwise noted
[c]Estimate by the United Nations Statistics Division, http:/unstats.un.org, Accessed 12 June 2013

Dhaka and Waste Management

Population in urban areas such as the nation's capital, Dhaka, reached 43,000 people per km^2. Dhaka is home to 15.4 million people and is expected to grow to 22.9 million by 2025 (World Urbanization Prospects, the 2011 Revision 2011). The residents of Dhaka generate almost 5000 tons of waste per day (CNN 2012). This compares to over 16,000 tons of waste generated per day in urban areas of Bangladesh (United Nations Centre for Regional Development 2011). This number is projected to nearly triple by 2025–47,000 tons of waste per day (United Nations Centre for Regional Development 2011). In Dhaka, approximately 70–80% of the waste is organic and the remainder is paper, plastic, glass and other man-made materials.

The Dhaka City Corporation (DCC) is responsible for collecting all solid waste in Dhaka. Estimates from the late 1990s show that the DCC was able to collect only 51% of all waste (Hai and Ali 2005). Nearly 9% of the waste was collected by individuals known as Tokais, informal waste collectors seeking plastic, glass or paper to

sell it to recycling factories for cash. See Exhibits 26.2 and 26.3 for some photos and the link to the video with more information on the waste problem in Dhaka and Bangladesh.

Exhibit 26.2: Dhaka Waste Problem

Source: Waste Concern documents, Accessed 02 June 2014

Exhibit 26.3: CNN Documentary Video on Waste in Dhaka and Bangladesh, Featuring the Founders of Waste Concern

Source: CNN (14 May 2012), Dhaka's Uncollected Waste, http://edition.cnn.com/video/data/2.0/video/business/2012/05/14/future-cities-dhaka-waste-rubbish.cnn.html, Accessed 12 June 2013

Early Trajectory of Waste Concern

Enayetullah and Sinha met in 1993 while conducting research for their Master theses in Dhaka. These two graduate students with backgrounds in urban planning found that they had something else in common. They believed that the increasing amount of waste produced in Bangladesh was a serious problem. They both had ideas on how to mitigate it: *"Both of our research findings had one common feature which was that we must do all we can to convert waste into resources, because the conventional system of collection and dumping will not solve the problem."*[3]

As part of their postgraduate research, Enayetullah and Sinha set up a model of waste management whereby solid waste was collected and composted. The compost would then be used as a substitute for chemical fertilizer. They initially decided to approach governmental officials with this model, offering advice on waste management, but they were not successful: *"Nobody was interested initially; they laughed and said we were graduates fresh from university, with new theories and ideas which were not practical"*. One official suggested to them that they should pursue their ideas solo. That is what they decided to do: *"This advice changed our life, although we were little bit frustrated but it showed us to think differently."*

First they secured a piece of land in Mairpur, Dhaka with the help of a local Lion's Club. They used the land for experiments with different methods of composting, including the Chinese Covered Pile System (anaerobic method, where waste was placed underground in a pit) and the Indonesian Windrow Technique (aerobic method, where waste was piled in large heaps on top of a wooden structure and turned every 4–5 days). The latter method proved to be the best solution for Dhaka,

[3] All quotations in Italics come from our conversations with Enayetullah and Sinha.

as the first radiated smelly gas. Enayetullah and Sinha further adapted the Indonesian method to Dhaka's conditions. As a result, they produced good quality compost and the Lion's Club allowed them to continue work on the land.

Waste Concern (1995)

In 1995 Enayetullah and Sinha decided to register Waste Concern with the aim of promoting the idea of converting waste into a resource. The organizations proceeded to use the Lion's Club land as a demonstration ground for its composting solution. See Exhibit 26.4 for a regional presence map and more information about Waste Concern.

Exhibit 26.4: Waste Concern at a Glance

Vision

Making waste a resource.

Mission

To contribute towards waste recycling, environmental improvement, renewable energy, poverty reduction through job creation, and sustainable development.

Regional Presence

Source: Waste Concern, www.wasteconcern.org, Accessed 29 November 2012.

From the beginning, Waste Concern experimented with different methods of waste recycling in order to reduce time and space needed for waste composting. To replicate its solutions in other communities in Dhaka, Waste Concern teamed up with the United Nations Development Programme (UNDP) in 1998. Replications outside Dhaka were possible from 2000 – again due to UNDP support.

In 2002 Enayetullah and Sinha assumed the role of technical partner/consultant for the United Nations Children's Fund (UNICEF) and the governmental Department of Public Health Engineering. Thus, they extended their work to additional cities in Bangladesh. Next, in 2000, international replication started in partnership with the United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP).

Waste Concern Consultants (2000)

Waste Concern relied on external funding as the organization was structured as a non-profit: *"Financing was coming either from UN agencies or the government. That was the area where we again thought that we are having impact but we are dependent too much on financing from the public sector."* Waste Concern as a non-profit was not able to generate its own income, nor get a bank loan. During meetings with potential loan providers, it was suggested that the founders need to make a change in Waste Concern's organizational structure through introducing a for-profit arm.

As Enayetullah and Sinha were often approached by external organizations and asked to provide consulting services, they decided to open a consulting business: *"People are requesting us to give advisory services to different projects. And then we look into it that this is not possible through Waste Concern. If we do it, at one point of time, there would be a question mark within the board, and with the government, like why are you doing it? This has happened with many of the organizations in Bangladesh."*

As a result Enayetullah and Sinha decided to register their first for-profit venture, Waste Concern Consultants, in 2000. Thirty percent of the profits from this venture were going directly to Waste Concern non-profit to provide funding for researching new solutions on how to convert waste into resources.

WWR Bio Fertilizer Bangladesh, Ltd and Matuail Power Ltd (2005)

In 2002, Enayetullah and Sinha as consultants were approached by the UNDP and the Ministry of Environment and Forest of Bangladesh. They were asked to identify the starting points for the Clean Development Mechanism (CDM) projects in Bangladesh. As a result, they produced a baseline study and business plans of the first CDM projects in the country.

After completing this assignment, Enayetullah and Sinha were concerned about the lack of efforts to implement any of these business plans. This triggered the idea to implement them as a part of Waste Concern. Thus, in 2003, Waste Concern started pursuing the landfill gas recovery and composting projects envisaged in the baseline study and business plans from 2002. The majority of waste in Bangladesh was organic and the founders of Waste Concern saw a great potential in converting this

waste into compost and thus, on the one hand – solving the problem of waste, on the other hand – selling compost and generating other revenue using the CDM. No other organization in Bangladesh was doing something like this.

Waste Concern started looking for investors for these ideas and decided to continue the CDM work: *"Then we informed UNDP that we are going to carry this on beyond the project. They actually got really interested in that."*

Enayetullah and Sinha also engaged in the policy making activities and helped to create and develop the Designated National Authority for CDM projects in Bangladesh.

In 2005, in continuation of their work on CDM projects in Bangladesh, Waste Concern established two special purpose companies – WWR Bio Fertilizer Bangladesh, Ltd. and Matuail Power Ltd. See Exhibit 26.5 for more information about the two companies.

Exhibit 26.5: Information About the CDM Projects Invented by Waste Concern

	Landfill gas extraction and utilization at the Matuail landfill site, Dhaka, Bangladesh	Composting of organic waste in Dhaka, Bangladesh
Project number	Project 0078	Project 0169
Project design document date	1 July 2004	9 December 2005
Registration date	17 September 2005	18 May 2006
Project participants	World Wide recycling BV, Netherlands; Waste Concern, Bangladesh	Waste concern; World Wide Recycling B.V; WWR Bangladesh Holding BV; and Asian Development Bank, as trustee of the Asia Pacific Carbon Fund (approved November 2012)
Brief description of the project activity	The project aims to realize a landfill gas extraction and utilization project at Matuail landfill site near the capital Dhaka in the People's Republic of Bangladesh. The extracted gas will be used on-site for electricity generation by gas-engines. The project comprises the design and engineering of the extraction system according to modern standards, all equipment delivery (wells, piping, compressor(s), flare, gas-engines, grid connection, etc.). It is the intention of the project proponent to reshape the landfill (in order to extend the lifetime of the landfill) and introducing proper landfilling techniques such as a.o. leachate collection	The project objective is the realization of a composting plant for organic waste on a site in the capital Dhaka of the People's Republic of Bangladesh. The project comprises the design and building of composting plants for waste from Dhaka city, with a total maximum daily input capacity of 700 tons, according to proven standards. The project contributes to the reduction of greenhouse gas emissions as the project activity provides an alternative to the original baseline scenario in Dhaka in which organic waste is disposed at local landfills. The anaerobic conversion of organic waste at the landfill generates methane gas (CH4) that emits into the atmosphere. By converting the organic waste from land filling towards composting, landfill gas methane emissions are for 100% being prevented

(continued)

Exhibit 26.5: (continued)

	Landfill gas extraction and utilization at the Matuail landfill site, Dhaka, Bangladesh	Composting of organic waste in Dhaka, Bangladesh
Public-private partnership model	Project participants intended to use the landfill site of Matuail near Dhaka, operated by Dhaka City Corporation (DCC). WWR and WC intended to take over the activities at Matuail landfill and introduce proper landfilling techniques	The establishment of composting plants in Dhaka is based upon a concession contract with the Dhaka City Corporation in which the local company WWR BIO has been granted the right to collect organic waste from local street markets in Dhaka. Under the concession contract, which has duration of 15 years with a starting date of January 2006, WWR BIO can collect up to 700 tons of organic waste per day

Source: CDM Project Registry, Project 0078 and Project 0169, http://cdm.unfccc.int/Projects/DB/SGS-UKL1121091128.62 and http://cdm.unfccc.int/Projects/DB/SGS-UKL1134142761.05, Accessed 19/06/2013

To establish the companies, Waste Concern first searched for suitable partners. This was one of the external requirements for implementing CDM projects: *"To do the CDM project, you need a partner from a developed country and from a developing country. It is a trading. We cannot do it with Bangladesh organizations alone."* In the process of looking for a suitable business partner, the organization rejected those businesses that were clearly focused only on profit maximization, operating without social objectives. In the end, it opted for more socially minded partners – World Wide Recycling (WWR), Triodos Bank and the Netherlands Development Finance Company (FMO).

Next, Waste Concern secured funding for the companies: "*Why don't we make the project bankable? We talked to several foreign banks, they said they were able to finance our projects, although it had a low rate of return for them and it was not commercial project (ed.). But it had a huge social environmental benefit (ed.).*"

Later, Waste Concern registered its CDM projects with the CDM Board. It also established a clear financial structure for these new ventures. All investors became shareholders in the created companies. In the case of Waste Concern, Waste Concern Consultants became a shareholder and Waste Concern took a role of a project participant in the CDM activities: "*Project participant is that Waste Concern will ensure in the project that the low income people are benefiting (ed.).*" Profits generated by the companies were distributed proportionally to all shareholders. Waste Concern Consultants' profit share was used to finance non-profit activities of Waste Concern – that is was used for research and development.

Waste Concern CDM Projects

CDM Plans

Waste Concern created its first special purpose company, Matuail Power Ltd., to extract landfill gas and generate grid connected electricity at the Matuail landfill site in Dhaka. The Matuail landfill site was owned and governed by the DCC.

Under the second special purpose company, WWR Bio Fertilizer Bangladesh, the organization wanted to construct three composting plants in Dhaka. Initially, it aimed at building the plants on the Matuail landfill site governed by the DCC. It also wanted to secure an agreement with the DCC to collect waste from Dhaka: *"We collect the waste free of cost for the city, so that we are helping the city. That was one of the mandates."*

CDM Challenges

As mentioned above, both special purpose companies relied on the access to the Matuail Landfill of DCC. However, access to the site was eventually not provided by the DCC. In addition, Waste Concern experienced some problems due to the volatility of the carbon market. When it started its CDM projects, the price of CO_2 was high, at some point even above 30 euros per tonne. Then the price plummeted down, at some point even to near zero. Although Waste Concern planned for decreases in prices, nobody envisaged that the carbon market could be close to crashing down. Waste Concern planned for 4.5 euros as the lowest price for 1 tonne of CO_2.

Furthermore, Waste Concern was not able to open additional plants as planned, as due to the energy crisis in Bangladesh, the government did not permit new grid connections.

CDM Strategic Reactions

Although the problems with the access to the Matuail landfill, volatility of the carbon market, as well as the power and energy crisis in Bangladesh created severe financial risks and delays to the CDM projects of Waste Concern, the organization managed to proactively deal with these challenges, pointing out that *"when there is a problem, there is also an opportunity"*. Waste Concern used the following five strategies:

Strategy 1: New site for the second project

First compost plant created by WWR Bio Fertilizer Bangladesh opened in November 2008 in Bulta. Arranging for financing, land and governmental permits took considerable time and delayed the opening of this plant.

Strategy 2: Increased capacity for the existing compost plant

Waste Concern decided to gradually increase the capacity of the existing plant when the electricity crisis in Bangladesh made it difficult to open new plants.

Strategy 3: Refuse-Derived Fuel

The founders of Waste Concern developed a new technology for utilizing waste rejects from the compost plant and turning them into fuel. This Refuse-Derived Fuel can be sold and increase the cash flow for the CDM projects.

Strategy 4: Exports of compost outside of Bangladesh

Waste Concern also looked for opportunities to sell its compost abroad to Malaysia and the Middle East Countries. The organization was successful and obtained higher margins than for selling compost within Bangladesh.

Strategy 5: Agreement with the Asian Development Bank

Moreover, Waste Concern signed the agreement with the Asian Development Bank to sell its carbon credits at the lowest price predicted in the original business plan (4.5 euro). See Exhibit 26.6 for more information about the CDM challenges encountered by Waste Concern and how the organization responded to them.

Exhibit 26.6: Challenges and Strategies for Waste Concern CDM Projects

Project name	Project number	Challenges	Strategies
Landfill gas extraction and utilization at the Matuail landfill site, Dhaka, Bangladesh	Project 0078	1. Dhaka Municipality does not allow the access to the Matuail landfill site	1. Waste concern could not implement this CDM project. The organization focused on the second CDM project as well as on other activities (e.g., waste to resource project and waste concern Baraka Agro Products company)
Composting of organic waste in Dhaka, Bangladesh	Project 0169	1. Problems with the access to the Matuail landfill site	1. Changed the project site to Bulta
		2. Only one composting plant built due to power crisis in Bangladesh – no new power connections were allowed	2. Expanded the capacity of the existing plant
		3. Lower than expected prices of CER	3a. Diversified income sources by innovating with RDF and exporting compost outside of Bangladesh
			3b. Secured an agreement with the Asian Development Bank to buy out all CERs for set prices (higher than at the market)

New Ventures of Waste Concern

Recycling Training Centre (2005)

At the same time as developing CDM companies, Waste Concern engaged in yet another project. In 2005 the organization started working on the first dedicated recycling training centre in Dhaka supported by the UNDP Sustainable Environment Management Program. The aim was to increase Waste Concern's impact through promotion of recycling among governmental officials, Waste Concern staff, and prospective entrepreneurs: *"We thought that we needed to bring more people into this, so we established a training centre in Dhaka. (…) We tried to create an entity so that at one point it raises awareness and creates manpower (ed.)."*

Waste Concern Baraka Agro Products (2006)

Enayetullah and Sinha also innovated around organic produce and created another new company – Waste Concern Baraka Agro Products. The company's aim was to promote organic food and sustainable agriculture and create green jobs in Bangladesh. On this venture, they partnered with Ahmed Amin Group.

Initially, Waste Concern Baraka Agro Products was to produce organic food. With time, the company added solar power irrigation and organic cotton to its products. The idea to grow organic cotton was driven by the governmental programme promoting cotton cultivation in Bangladesh. Enayetullah and Sinha seized this external opportunity.

Additionally, through their Schwab Foundation networks, they managed to convince a British based organic clothing company, People Tree, to pre-order their first organic cotton yield.

Waste Concern Baraka Agro Products succeeded in growing first organic cotton in Bangladesh. However, shortly afterwards, the company experienced some problems with cotton seeds, which had to be shipped from India. Thus, it rethought its organic strategy and decided to focus efforts on growing other organic produce as well as securing organic certification: *"The Agro Product project is on, and we are working for certification. It takes around three to four years to get full certification for organic crops, and we are in the process of doing so."*

Waste 2 Resource (2009)

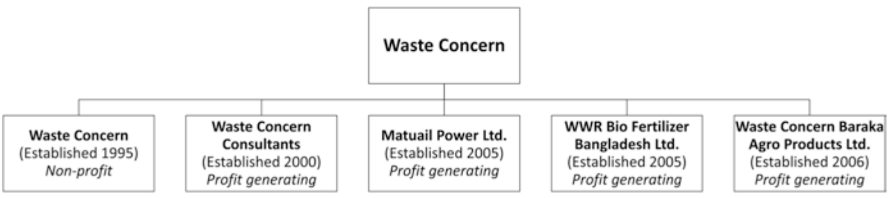
Then, in 2009, Enayetullah and Sinha were approached by the Bill and Melinda Gates Foundation to extend waste recycling training to other countries in Asia and Africa. They decided to start providing training for interested organizations from abroad. They also opened a new training centre in Sri Lanka and developed manuals for composting plants to allow easy replication. Additionally, they convinced the

Bill and Melinda Gates Foundation to create a special fund under their management to support pro-poor and sustainable solid waste management projects that reduce greenhouse gases in developing countries.

Going Forward

When looking back at what had been achieved in the 18th years Enayetullah and Sinha could point to an ever growing list of accomplishments of Waste Concern. The organization and its creators engaged in waste management activities in Bangladesh and abroad. They also started a number of innovative companies, including those implementing CDM projects which performed well despite the CDM market crisis. See Exhibit 26.7 for Waste Concern's organogram.

Exhibit 26.7: Waste Concern's Organogram



Enayetullah and Sinha saw themselves as serial entrepreneurs, developing new ideas, patenting them, passing to others, and moving on to the next problem: *"Our idea is to develop technology. Patent it. Give it to others. Create more companies to do it. Not by ourselves (ed.) because then you create enemies!"*. When they were evaluating new ventures they followed clear principles: *"One of the criteria is market failure. We always looked at whether someone has done it. If there is a private sector operating there, if there are legal instrument in place, then there is no market failure. If there is a market failure there, then we step in. This sector there was a market failure with the solid waste. We stepped in. (…)."*

They also highly valued the importance of flexibility, and flexibility was possible with creation of spin-offs and letting go off their inventions: "*For social entrepreneurs, or any entrepreneurs, what I believe is that you cannot make a business plan too rigid. For social enterprise, if you make a business plan that is going to be for five years, it is very difficult. It has to be very flexible, and you have to always adapt. It has to be a living document kind of thing. It cannot be a fixed master plan. If you do this, then you are in trouble. If you are opening a clear for-profit business, such as a garment factory or a software company (ed.) you can do a business plan and stick to it (ed.). But in social enterprises, operating in difficult contexts (ed.) making a pure and rigid business plan is difficult because there are many unpredictable situations."*.

This also created competition for Waste Concern: *"There are now 40 companies registered, private sector and not-for-profit. Now even Dhaka city has given a contract to develop waste energy to an Italian company, just last year. People will say: "are you worried"? We say: "No, we are not worried, we are happy. We are happy that the Italians are coming with new technology, new ideas. That's what we wanted."*

This attitude enabled Enayetullah and Sinha to start a number of innovative businesses. But at the same time, Waste Concern was increasingly facing human resource constraints that made it difficult to develop new ideas and projects. The biggest challenge was to find qualified and socially motivated professionals: *"Now what we see is that the professionals who are coming to us (ed.) they are not focused. Their goal is to become rich in the shortest possible time. They apply for your company. They want a salary of 100,000 Taka, with only two years' experience."* Another problem was connected to the lack of leadership skills among young job applicants, the problem that is probably too difficult to address for a single organization and Waste Concern has not tackled it yet: *"I think for a developing country this is going to be a huge challenge because there is a leadership vacuum not only in Bangladesh but in the entire developing world. We have seen this thing in Sri Lanka. We have seen this in Nepal, in India, Pakistan, wherever you go. It's a huge amount of population, which is too young and without role models. It's going to be serious problem."*

Over the years, Enayetullah and Sinha became experts on waste management, not only in the eyes of the officials from the government of Bangladesh, but also among the international development organizations. They received the most prestigious awards and joined the most respected networks. See Exhibit 26.8 for more information on their network exposure and awards. At the same time, none of these achievements were accomplished easily. Enayetullah and Sinha knew too well that the path to success was not a paved road but a bumpy up-hill struggle.

Exhibit 26.8: Waste Concern's Exposure to Networks and Awards Received

Clean Dhaka Ward Contest Award 2008 and 2009

CLEAN DHAKA

GREEN DHAKA

JICA

Clean Dhaka Ward Contest 2009

BEST COMMUNITY AND PRIVATE INITIATIVE AWARD

This is to certify that **Waste Concern** was awarded from "Zone 8" as **Best Community and Private Initiative Award** in Clean Dhaka Ward Contest 2009 at Nagar Bhaban, Dhaka City Corporation.

Commander M. R. Chowdhury
Chief Waste Management Officer
Dhaka City Corporation

Mahmoud Riad
Deputy Chief Advisor
JICA Expert Team

The 6th Annual Fast 50 Award 2007

Environment Award 2007

Global Tech Museum Award 2003

UNDP The 2002 ‘Race against Poverty’ Award

Schwab Outstanding Social Entrepreneurs 2003

The Fast 50 Social Entrepreneurs 2001

Ashoka Fellowship for the year 2000

Source: Waste Concern, www.wasteconcern.org, Accessed 26 June 2013

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27 Uber and the Ethics of Sharing: Exploring the Societal Promises and Responsibilities of the Sharing Economy

N. Craig Smith and Erin McCormick

- In San Francisco, a six-year-old girl was run over by a driver for the ride-hailing service Uber, as the driver drove around waiting for the company's mobile app to direct him to his next passenger.
- In Paris, taxi drivers rioted in the streets, protesting that a subsidiary of Uber, the fastest growing company in the so-called "sharing economy", was stealing their business without respecting the rules and regulations of the trade.
- In London, Uber drivers sued the company, insisting it pay the minimum wage and follow the same safety regulations as other employers.
- In Australia, the tax office cracked down, demanding that Uber drivers pay the national business tax on each fare.

In each case, Uber has argued that it is not the primary responsible party. In questions of safety, transportation regulation, labour rights and business taxes, Uber often defers responsibility to its "driver-partners' – many of whom are ordinary people picking up passengers in their personal cars. The company maintains that it only provides an online platform to connect customers with "independent contractors" – drivers in business for themselves.

"It's a technology platform that connects riders and drivers," said Travis Kalanick, co-founder and CEO of Uber.[1] "So you want a ride, we are going to connect you to all the transportation providers that are available in a market, and we're going to get you the quickest pick-up time, highest quality ride, and get it to you at the lowest cost that's possible."

With operations in 300 cities worldwide and more than $8 billion in equity funding, Uber is quickly becoming one of the world's most highly-valued companies, at

[1] Laurie Segall, Uber CEO: 'Our Growth is Unprecedented' CNNMoney, June 12, 2014, http://money.cnn.com/2014/06/12/technology/innovation/uber-ceo-travis-kalanick/

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G. G. Lenssen, N. C. Smith (eds.), *Managing Sustainable Business*,
https://doi.org/10.1007/978-94-024-1144-7_27

the forefront of a growing breed of tech-based companies leveraging the powerful economic engine dubbed the "sharing economy". The company, and thousands of other start-ups like it, provide ways for people to share their underutilized possessions – cars, bedrooms, parking spaces and even clothing. In the meantime, they are turning basic norms – about consumption, work and regulations – on their heads.

The whole nature of what it means to do business is being redefined by companies like Uber, Airbnb, which rents out space in people's homes, and Taskrabbit, which lines up workers to help customers with odd jobs. But while "sharing economy" companies hold out a promise of increased sustainability and democratization of the workplace, they raise questions about how such changes affect societal safety nets.

Are they merely "technological platforms", facilitating transactions for individual business people? Or are they real-world companies, with the same responsibilities as transport companies, hotels and employment agencies? In some cases, their very survival depends on the answer to these questions.

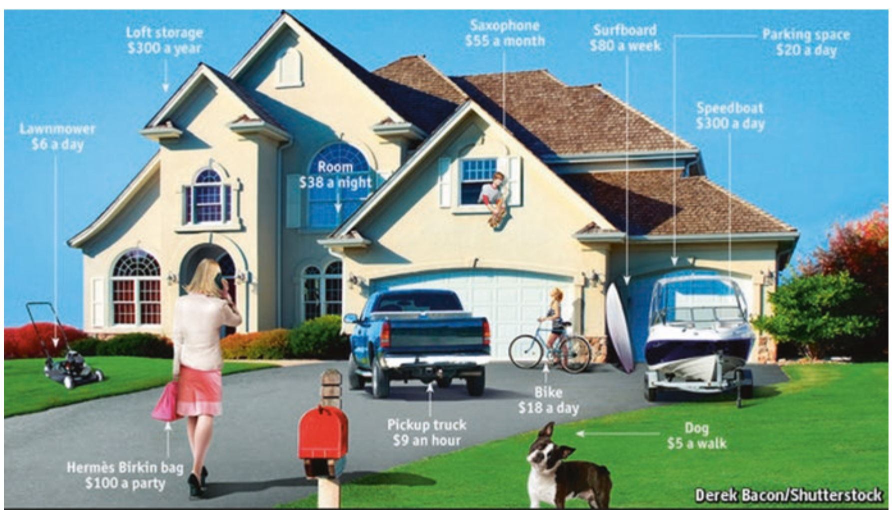

Exhibit 27.1 The Economist cover illustrates some facets of the "sharing economy"
Source: The Economist, Derek Bacon/Shutterstock

An Economy Built on Technology and Trust

If you own a power drill, "that drill will be used for 12 to 15 minutes in its entire life time," Rachel Botsman, one of the early proponents of the sharing economy, told a Ted Talk audience in 2010. "It's kind of ridiculous, isn't it? Because what you need

is the hole, not the drill. Why don't you rent the drill? Or rent out your own drill to other people and make some money from it?"[2]

Launched with this vision of cooperation amongst a broad internet community, the sharing economy was described by Botsman as "an economic model based on sharing underutilized assets from spaces to skills to stuff for monetary or non-monetary benefits."[3] The term – used interchangeably with the "peer-to-peer economy" or the "collaborative economy" – depicts an enterprise platform in which regular people do business with their neighbours rather than relying on big companies.

The sharing economy was made possible by the ease of sharing data brought on by the internet age. Be it a person's Facebook profile or their location as tracked by the GPS on their smartphone, free-flowing information has made it possible to make transactions to share goods and services which once might have gone unused. In the past it was so hard for people to find others with whom to share goods like unused tools and extra bedspace, that it wasn't worth the trouble. But the internet and the availability of data have dramatically reduced the "transaction costs", ushering in an era of collaborative consumption in which underutilized goods can easily be turned into cash.

A new sense of trust in the online community, based on feedback, is another key building block of the new economy. Where consumers might once have been afraid to catch a ride or share a house with a stranger, they now can check out a person's trustworthiness based on ratings from previous passengers or reviews from former houseguests.

The sharing economy gives access to all kinds of products and services without having to commit to ownership or hiring. Why own a car, when in minutes you can borrow one? Supporters extol the benefits for the environment: if commuters share rides, there are fewer cars on the road; if people share their rollerblades instead of buying new ones, it reduces the use of raw materials and the pollution of production.

Yet as it has grown, the sharing economy hasn't always lived up to the early vision of "sharing" among "peers".

Sharing as Big Business

A host of creative technology start-ups emerged to develop the intricate internet platforms and smartphone applications needed to make these peer-to-peer transactions easy. Uber, Lyft and BlaBlaCar connect drivers to people who need rides. Airbnb helps people rent out their extra beds. Parkatmyhouse connects drivers to

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[2] Rachel Botsman, "The Case for Collaborative Consumption," TedxSidney, May 2010, http://www.ted.com/talks/rachel_botsman_the_case_for_collaborative_consumption?language=en#t-945236

[3] Rachel Botsman, "The Sharing Economy Lacks A Shared Definition," Fast Company, November 21, 2013, http://www.fastcoexist.com/3022028/the-sharing-economy-lacks-a-shared-definition

parking spaces. TaskRabbit in the US and TaskPandas in the UK line up workers for people needing help with small jobs. NeighborGoods helps people share tools. But as the sharing economy has grown from a fringe concept to a huge industry, some of these companies have acquired the scale and characteristics of the big businesses they were supposed to replace.

Unlike traditional brick and mortar businesses, these new firms can sell rides or rentals without having to invest capital to buy cars or build hotel rooms. Whereas it took the world's biggest hotel chain, InterContinental Hotels, 65 years to build a chain of 650,000 rooms in 100 countries, Airbnb did it in four years.[4] Uber wasn't founded until 2009, but it is already valued at more than $60 billion – twice the estimated value of Hertz Car Rental[5] – without owning a single taxi.

Many of these companies and their users appear to have none of the altruistic motivations connoted by the term "sharing". Proponents of the sharing economy, including Rachel Botsman, who co-founded Zipcar, one of the first companies to emerge under the umbrella term, have proposed an alternative terminology: they suggest that companies giving consumers instant online access to other people's goods and services should be called the "on-demand economy" or "the access economy".

Despite little agreement as to what this new business phenomenon should be called, PricewaterhouseCoopers has identified five sectors of the so-called sharing economy – peer-to-peer finance, staffing, car sharing, accommodation and music and video streaming. PwC estimates that collectively these earned global revenues of $15 billion annually in 2014, a figure that could jump to $335 billion by 2025.[6]

As they have grown, many of these companies have sidestepped the local regulations that competitors in traditional businesses face. While taxi companies operate within local limits on the number of cabs and regulations about using airports, Uber has often managed to avoid such rules. Similarly, Airbnb has faced complaints that a large number of rentals on its site are illegal. A 2014 report by the State of New York's Attorney General found that 72% of private short-term units offered on Airbnb in New York City appeared to be illegal under state and local zoning laws.[7]

Some fear that these companies can use their size and the advantages gained by side-stepping local laws to drive traditional competitors out of business, much as Amazon.com has done with local bookstores. "There is often room for just one successful platform in a market and the "winner takes all"", wrote Felix Barber of Ashridge Business School. "It's no surprise that the old monopoly concerns are arising anew."[8]

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[4] *Ibid.*

[5] Ycharts, Hertz Global Holdings Enterprise Value, https://ycharts.com/companies/HTZ/enterprise_value

[6] PricewaterhouseCoopers, "Five key sharing economy sectors could generate £9 billion of UK revenues by 2025," press release, August 15, 2014, http://pwc.blogs.com/press_room/2014/08/five-key-sharing-economy-sectors-could-generate-9-billion-of-uk-revenues-by-2025.html

[7] New York State Attorney General Eric Schneiderman, report: "Airbnb in the City," October 2014, http://www.ag.ny.gov/pdfs/Airbnb%20report.pdf

[8] Felix Barber "How do we fight twenty-first century monopolies like Amazon, Google and Uber?" Upstart Business Journal, December 11, 2014, http://upstart.bizjournals.com/resources/author/2014/12/11/fight-21st-century-monopolies-like-amazon-uber.html?page=all

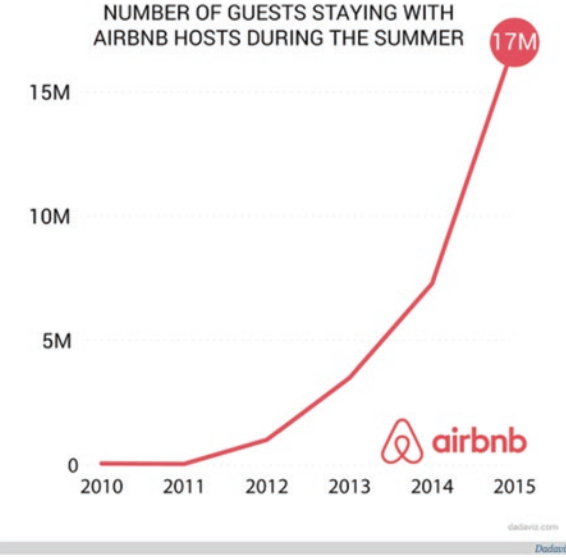
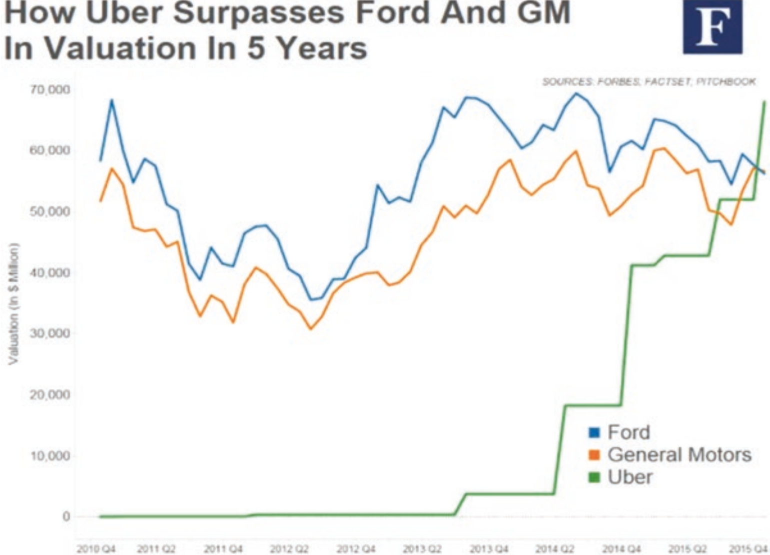


Exhibit 27.2 A chart showing the increase in AirBNB's summer guests
Source: Dadaviz.com, Business Insider

Exhibit 27.3 A man leaving Uber headquarters in San Francisco
Source: AP Photo/Eric Risberg



It only took Uber five and a half years to surpass the valuation of 107-year-old General Motors GM +0.00%.

Exhibit 27.4 A chart showing Uber's growth compared to Ford and GM
Source: Forbes Magazine, Factset, Pitchbook

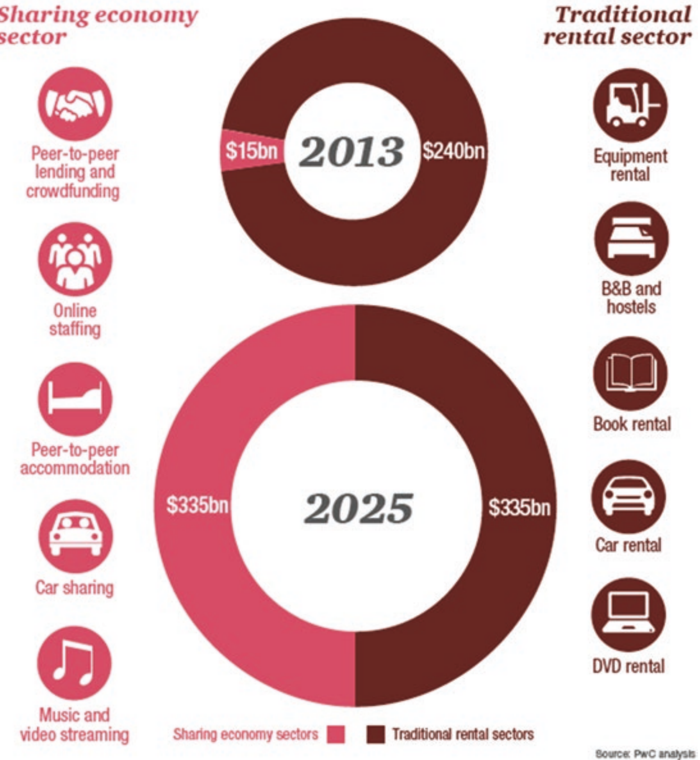


Exhibit 27.5 A chart showing PwC's predicted growth for the sharing economy
Source: PricewaterhouseCooper, PwC analysts, The sharing economy

Uber

From the day it first launched its app in its home town of San Francisco in 2010, Uber has used the latest technological advances to make ride-hailing super-efficient. Founded by tech entrepreneurs Travis Kalanick and Garrett Camp in 2009, Uber

developers spent nearly a year building systems to predict rider demand and get cars to those areas, then set the price based on demand. Early on, Uber hired a rocket scientist, a computational neuroscientist and a nuclear physicist to develop an algorithm for predicting how long it would take for cars to reach their passengers.[9] "There is a ton of math, which basically makes sure that riders get a car in five minutes," said Uber founder Kalanick, promoting the then-new company at the 2011 Tech Crunch Disrupt conference.[10]

Passengers can look at the app on their smartphones and see all the Uber cars travelling the streets near them. Once they request a car, the app allows passengers to see their driver approach via a city map. The fare is calculated by the app, based on time and mileage: if it is a busy period, fares can be doubled or more, based on Uber's "surge pricing". At the end of the ride, the app automatically deducts the cost from the user's Paypal or credit card account. Drivers are paid by Uber after it has deducted its commission – usually 20%.[11]

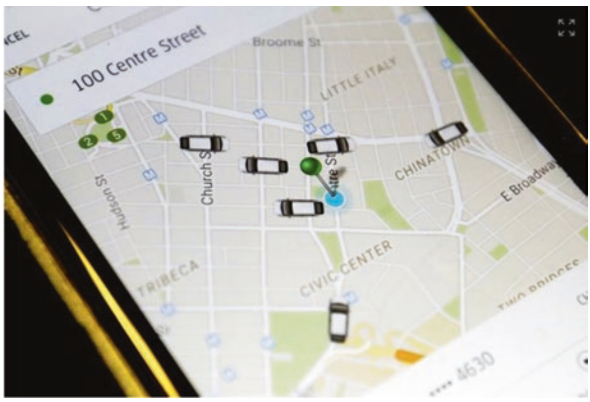


Exhibit 27.6 The Uber app shows available cars in the area on a map
Source: Mary Altaffer/AP

[9] Sarah Lacy, "Uber Out-Maths Google on NYC ETAs," TechCrunch, June 15, 2011, http://techcrunch.com/2011/06/15/uber-out-maths-google-on-nyc-etas/

[10] Sarah Lacy video interview "Travis Kalanick on How Uber Started", TechCrunch, June 15, 2011, http://techcrunch.com/2011/06/15/uber-out-maths-google-on-nyc-etas/

[11] Joann Weiner, "The hidden costs of being an Uber driver," Washington Post, February 20, 2015, http://www.washingtonpost.com/news/get-there/wp/2015/02/20/the-hidden-costs-of-being-an-uber-driver/

As the app became hugely popular, investors poured billions of dollars into the company, which is still privately held. The company expanded to one new city per month as of 2011, quickly adding Washington DC, New York City and Chicago. The first city outside the US was Paris in 2011, followed by a push to launch in cities around the world. By mid-2015, Uber had service in 177 North American cities and in 60 countries around the world, in places as diverse as Seoul, Lima, and Cape Town.[12]

Uber describes its mission as "evolving the way the world moves…by seamlessly connecting riders to drivers."[13] With Uber, instead of standing on the street or calling a cab and waiting, passengers can stay inside and watch the progress of the car on their smartphones. "This is a real boon for consumers who don't like long waits or uncertainty—which is to say everyone," writes Brishen Rogers, Associate Professor of Law at Temple University. "The result is that Uber may be creating what once appeared impossible: a functioning market for car-hire services that is governed largely by supply and demand."[14]

Customers praise the app for allowing them to reliably hail taxis around the world and have all their transactions conveniently billed to the same credit card – without having to worry about having the right currency or having to negotiate fares with local drivers.

Dozens of competitors to Uber have emerged around the world, including Lyft in the US, Didi Kuaidi in China, Grab in Southeast Asia, Chauffeur-Privé and Snapcar in France, and Gett in the UK. But Uber is by far the biggest. With its huge valuation, aggressive business practices, and no-holds-barred approach to dealing with adversaries, the company is quickly gaining a reputation as the bad guy of the new business model. Its behaviour raises the question: What are the responsibilities of sharing economy enterprises?

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[12] Uber.com, "Our Cities," https://www.uber.com/cities

[13] Uber.com "About us," https://www.uber.com/about

[14] *Ibid.*

Logo	Company	Estimated value in billions	Areas of operation	Information source
UBER	Uber: UberPop, UberX, UberPOOL	$62.50	58 countries and 300 cities worldwide	
lyft	Lyft	$5.50	More than 100 U.S. Cities	http://www.bloomberg.com/news/articles/2016-01-04/gm-invests-500-million-in-lyft-to-bolster-alliance-against-uber
DiDi	Didi	$16.40	China	http://www.technewstoday.com/28080-uber-china-now-valued-at-7-billion-as-war-with-didi-kuaidi-continues/
OLA	Ola	$5	India	http://www.forbes.com/sites/saritharai/2015/11/18/ola-ubers-india-rival-raises-500m-in-funding-now-valued-at-over-5-billion/#12e381757f4b
GRABCAR Rides Made Awesome	Grab, Grabtaxi, Grabcar, etc.	$1.50	Malaysia, Singapore, the Philippines, Indonesia, Vietnam and Thailand	http://www.forbes.com/sites/forbesasia/2015/11/17/grabtaxis-other-founder-talks-about-return-to-company/#160de9f01e5c

chauffeur-prive	Chauffeur-prive	?	France: Paris, Nice, Cannes	
Gett	Gett/GetTaxi	$0.60	More than 50 cities, including London, Moscow, New York and 13 cities in Israel	http://www.haaretz.com/israel-news/business/.premium-1.687031
SnapCar	Snapcar	?	Paris	

Exhibit 27.7 A chart comparing some competing ride hailing apps operating in 2016

Source: INSEAD Research/Erin McCormick

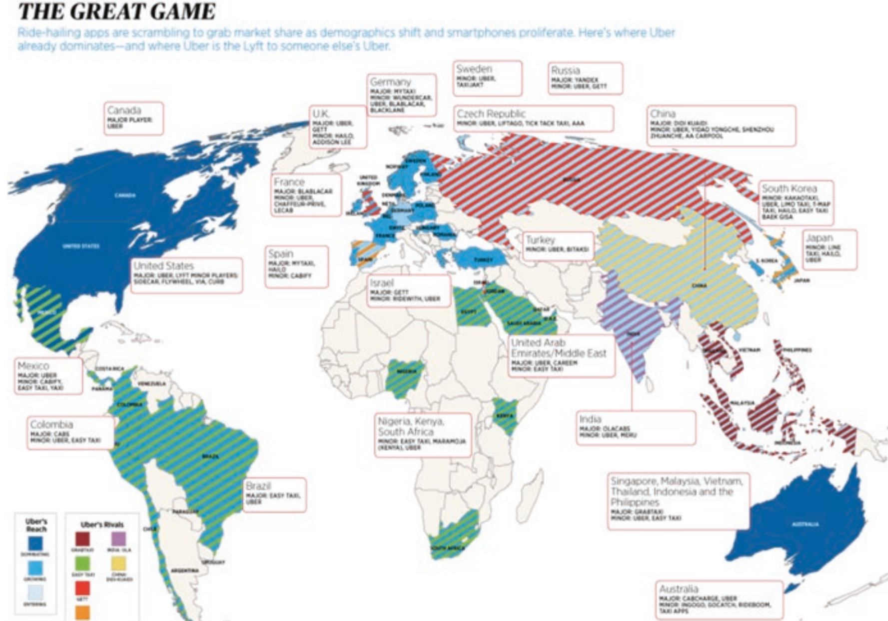

Exhibit 27.8 This Forbes Magazine map shows areas where Uber is dominant (in solid blues) and (striped) areas where it is fighting a local competitor
Source: Forbes Magazine: Pitchbook, Quettra, Analysis International

Exhibit 27.9 Taxis in Portland parked to protest lack of regulation for ride-hailing apps in 2015
Source: Aaron Parecki /Wikimedia Commons

Regulating Disruption or Disrupting Regulation?

When it comes to dealing with government rules for the strictly regulated transportation industry, Uber's policy is to launch its business in new markets first and respond to questions later. It has sidestepped regulations, refused to comply with demands to cease business in certain markets, and angered traditional industry competitors (mainly taxi drivers) at every step.

The patchwork of Great Depression-era regulations governing the transport industry in cities around the world has long served to reduce competition. In the current climate of rapid change, these regulations have left taxi cabs at a disadvantage in competing with Uber. In most cities, cabs follow strict rules – stringent vehicle inspections, set fares monitored by standard meters, and strict driver training and screening. Companies pay permitting fees, local business taxes, and must have commercial insurance. In exchange for complying with these regulations, many cities protect cab owners by issuing only a limited number of licenses to operate– essentially creating a quasi-monopoly. These limits are designed to ensure that taxi drivers make a reasonable wage, but in some instances they have created a shortage of cabs and inadequate service. In some cities, taxi drivers have made a business of reselling medallions (licences), which have become a commodity worth hundreds of thousands of dollars. Uber is a threat to that practice as well.

When it started operations in the San Francisco area in summer 2010, under the name "Ubercab", Uber avoided taxi regulations by positioning itself as a limousine service. It hired only licensed chauffeurs with charter vehicles, who ostensibly used the app to find extra riders. Three months later, the California agency that regulated limousines ordered Ubercab to cease doing business because it wasn't licensed as a transportation company. It responded by simply changing its name to "Uber". Thereafter it continued to operate under threat of penalties, including $5000 per instance of violating the order.[15]

Soon Uber (and several competing start-ups) started contracting with regular car owners to provide rides to passengers in San Francisco – claiming the arrangements were exempt from regulation because they were "ridesharing". Today, both regular car owners and professional drivers drive for Uber. In the US, Uber signs up licensed chauffeurs to drive for its upscale "UberBlack," service, but the majority of its drivers are ordinary people driving their personal cars for "UberX".

After it was found that people without a license were driving for Uber, cab drivers cried "foul play" and began a series of protests against Uber and its competitors – claiming the online ride-hailing services were unfair, unregulated and unsafe. As ride-hailing services grew, protests spread to cities around the world. Taxi drivers shut down the streets in Boston, London, Rio de Janeiro, Guangzhou and Mexico City, complaining that it was harder for them to find fares and make a living because of competition from Uber and other ride-hailing services which did not follow the same regulations. The value of taxi licenses has seen a sharp fall. In New York City,

[15] TechCrunch blog, "UberCab Ordered to Cease and Desist," October 24, 2010, http://techcrunch.com/2010/10/24/ubercab-ordered-to-cease-and-desist/

taxi medallion prices dropped from a high of $1.2 million in the spring of 2014 to $840,000 that fall.[16]

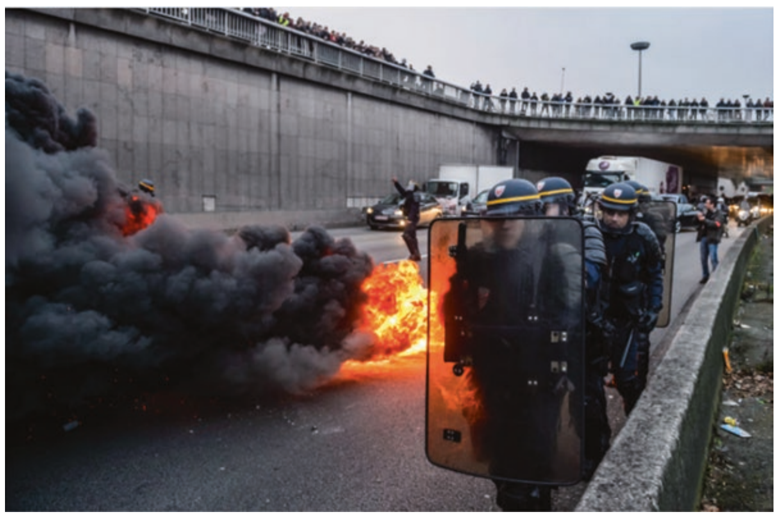

Exhibit 27.10 French taxi drivers confront riot police in Paris in a protest against Uber in 2016
Source: Christophe Petit Tesson/EPA

In Paris, where drivers undergo hundreds of hours of study and often get into debt to purchase taxi licenses for as much as €240,000,[17] drivers complain that Uber is devaluing government-issued licenses. In the summer of 2015 and again in early 2016, taxi drivers burned tires and blocked airport access in a series of strikes protesting against Uber.[18] The 2015 Paris protests, in which drivers presumed to be driving for Uber were attacked, were sparked by its refusal to shut down the UberPop service, which was deemed illegal by the French government because it used regular drivers without a chauffeur's license. The company continued to operate the service until June 2015, when police arrested its top executives in France on charges of enabling illegal taxi services.[19] Uber suspended the operations of UberPop in

[16] Aamer Madhani, "Once a sure bet, taxi medallions becoming unsellable," USA Today, May 18, 2015, http://www.usatoday.com/story/news/2015/05/17/taxi-medallion-values-decline-uber-rideshare/27314735/

[17] Nicholas Vinocur, "French PM calls for truce in taxi-Uber war," Politico, January 26, 2016, http://www.politico.eu/article/france-braces-for-new-taxi-uber-war-road-uberpop/

[18] Alissa J. Rubin and Mark Scott, "Clashes Erupt Across France as Taxi Drivers Protest Uber," New York Times, June 25, http://www.nytimes.com/2015/06/26/business/international/uber-protests-france.html?_r=0

[19] Sam Schechner, "Two Uber Executives Indicted in France," Wall Street Journal, June 30, 2015, http://www.wsj.com/articles/uber-executives-ordered-to-stand-trial-by-french-prosecutors-1435667386

France while its managers awaited trial, but continued to operate UberX, which used licensed chauffeurs.

"We understand that new technology is disruptive: not just for established companies, but for the people who work in them and their families," Uber said, in a statement. "This is especially true at a time of high unemployment. But we believe there is a way forward …Hundreds of taxi drivers have already switched over to Uber and are making a better living, with a work schedule to suit their family's needs. It is heartbreaking to see the violence in the streets when we know that taxi drivers can earn more on the Uber platform. It's why we need to do a better job explaining and communicating the advantages of Uber to all drivers."[20]

Armies of Lobbyists

When it comes to dealing with government regulators, Uber co-founder Travis Kalanick espouses a strategy of "principled confrontation": "We're totally legal, like totally legal, and the government is telling us to shut down. And you can either do what they say or you can fight for what you believe," said Kalanick of Uber's refusal to give in to government requests that the company cease service in San Francisco.[21]

When Portland, Oregon asked Uber to refrain from starting service until the city could draft new rules for transportation services, Uber simply threw a launch party and sent drivers out to pick up passengers.[22] Three days later, Portland sued, charging that Uber services violated more than 20 civil and criminal regulations requiring private transportation services to have permits, insurance, decals, rates and record-keeping.[23] According to Portland officials, Uber unleashed a lobbying effort like none ever seen before. The company hired 10 lobbyists, including one who had been campaign advisor to the same Portland officials making the decisions. It used its customer database to get thousands of people to sign an online petition, calling on city officials to allow Uber to operate in Portland.[24] City officials caved in and allowed Uber to operate for a "trial period".

With billions of dollars in investor capital, Uber is able to hire a fleet of lobbyists to overwhelm officials in places it wants to launch. According to *Bloomberg News*,

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[20] Romain Dillet "Uber Suspends UberPop in France Following Turmoils and Arrests," TechCrunch, July 3, 2015, http://techcrunch.com/2015/07/03/uber-stops-uberpop-in-france-following-turmoils-and-arrests/

[21] Kara Swisher, "Man and Uber Man," Vanity Fair, November 5, 2014, http://www.vanityfair.com/news/2014/12/uber-travis-kalanick-controversy

[22] Karen Weise, "This is how Uber takes over a city," Bloomberg Business, June 23, 2015, http://ww.bloomberg.com/news/features/2015-06-23/this-is-how-uber-takes-over-a-city

[23] Bloomberg, "Uber Suspends Portland Service While Seeking Clearance," Bloomberg Business, December 18, 2014, http://www.bloomberg.com/news/articles/2014-12-19/uber-suspends-portland-pickups-as-startup-works-with-officials

[24] Karen Weise, "This is how Uber takes over a city," Bloomberg Business, June 23, 2015, http://ww.bloomberg.com/news/features/2015-06-23/this-is-how-uber-takes-over-a-city

Uber has hired 250 lobbyists and 29 lobbying firms to negotiate with US state and federal officials – more than the entire Walmart chain – and this doesn't include those lobbying cities.[25] It hired David Plouffe, former campaign manager for President Barrack Obama, to spearhead its campaign to win government approval.

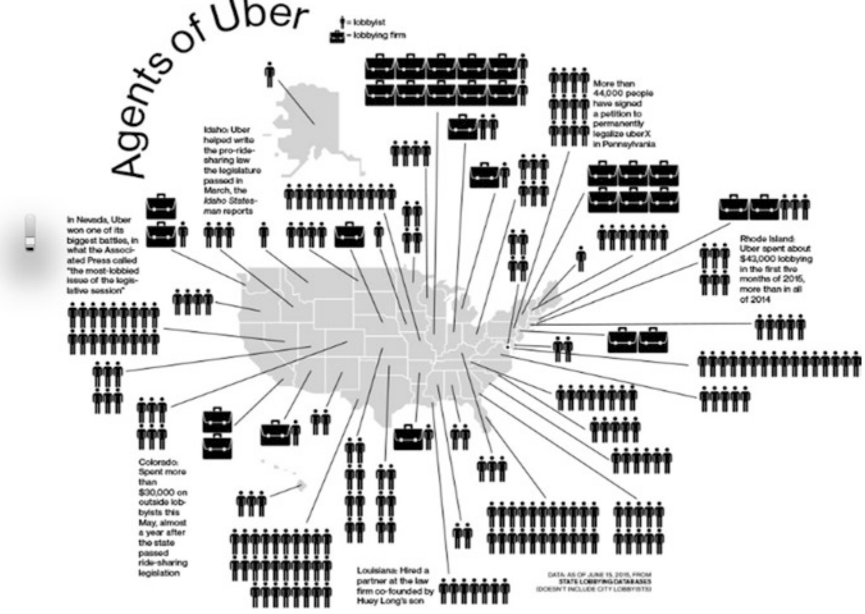

Exhibit 27.11 A Bloomberg graphic illustrating the number of lobbyists hired by Uber to lobby state and federal governments as of June 2015, does not include city lobbyists
Source: Bloomberg News/ state lobbying databases

In New York, Mayor Bill de Blasio proposed capping the number of for-hire drivers to deal with growing congestion and pollution on the city's streets. The number of for-hire vehicles had increased by 25,000 cars or 63% between 2011 and mid-2015 – largely because of the growth of Uber drivers.[26] But the mayor backed down and agreed to a four-month study of the situation after a barrage of lobbying that included Uber releasing a feature on its app called "de Blasio view" which showed how much service would be slowed if the cap were enacted.

In France, attempts to limit Uber had an almost comical air. Officials attempted to impose a 15-minute delay for customers ordering a ride "to level the playing

[25] *Ibid*.

[26] New York Times Editorial, "Limiting Uber Won't End Congestion," New York Times, July 17, 2015, http://www.nytimes.com/2015/07/18/opinion/limiting-uber-wont-end-congestion.html

field" for taxis. "It's the technological equivalent of limiting the speed of automobiles to match a horse-drawn carriage," wrote John Sununu, a former Republican US senator..[27]

In London, where drivers spend years studying "The Knowledge" of every city street to get a license to drive a black cab, taxi drivers paralyzed the streets with a protest against Uber in summer of 2014. The authorities threatened to crack down on Uber drivers with new regulations, including a ban on apps that show cars immediately available for hire and a requirement that cars wait at least five minutes after being booked to pick up their passengers. Uber called on its customers to lobby against these proposals, claiming these rules would be "the end of the Uber you know and love". While still planning to issue new rules governing driver qualifications, the transportation authorities dropped the most threatening proposals after receiving 16,000 responses from the public.[28]

Business Tactics Questioned

Uber has repeatedly been accused of using aggressive business practices to stifle competition and silence critics:

In 2014, a number of investigative reports outlined the steps the company took to hinder its largest competitor, Lyft. *CNN Money* obtained documents backing up Lyft's claims that Uber employees were making bogus calls to order thousands of Lyft rides, then cancelling them, thereby jamming the efficiency of Lyft's services.[29]

The tech industry blog, *The Verge*, reportedly obtained internal documents from Uber showing it had a programme called "SLOG," by which it gave contractors dummy cell phones to order Lyft rides and then attempt to recruit the competitor's drivers.[30] Uber called the charges of cancelled rides "patently false", but acknowledged running incentive programmes encouraging drivers and riders to recruit Lyft drivers to join Uber.[31]

[27] John E. Sununu, "Uber isn't the problem; taxi regulations are" Boston Globe, June 23, 2014, https://www.bostonglobe.com/opinion/2014/06/22/uber-isn-problem-taxi-regulations-are/5tBvAe8rcnGFcDYDT0jx3N/story.html

[28] Philip Georgiadis, "Uber Avoids London Regulations It Said Would Be the 'End of Uber,'" Wall Street Journal, January 20, 2016, http://blogs.wsj.com/digits/2016/01/20/uber-avoids-london-regulations-it-said-would-be-the-end-of-uber/

[29] Erica Fink, "Uber's dirty tricks quantified: Rival counts 5560 cancelled rides," CNN Money, August 14, 2014, http://money.cnn.com/2014/08/11/technology/uber-fake-ride-requests-lyft/

[30] Casey Newton, This is Uber's playbook for sabotaging Lyft," The Verge, August 26, 2014, http://www.theverge.com/2014/8/26/6067663/this-is-ubers-playbook-for-sabotaging-lyft

[31] Gail Sullivan, "Lyft accuses Uber of sabotage," Washington Post, August 12, 2014, https://www.washingtonpost.com/news/morning-mix/wp/2014/08/12/lyft-accuses-uber-of-sabotage/

Uber co-founder Kalanick surprised business journalists by admitting in a *Vanity Fair* interview that he had approached potential Lyft investors just before a Lyft fundraising round and tried to get them to fund Uber instead.[32]

Uber was forced to apologize after an Uber senior vice president outlined to guests at a dinner party the idea that Uber could spend a million dollars hiring opposition researchers to dig up dirt on journalists who criticized Uber. The remarks of Emil Michael were reported by a technology blog editor who attended the dinner party, which Uber said were supposed to be off-the-record.[33] Michael later issued an apology through an Uber spokeswoman, saying his remarks were "born out of frustration during an informal debate" and were "wrong no matter the circumstance".[34]

Competitors charge that the company uses the 'war chest' obtained from investors to set prices so low it will drive taxi companies and other car services out of business. In order to outdo competitors, Uber has repeatedly cut fares to the point where they are lower than most taxi fares. In some cases it has even made a loss, paying its drivers more than customer pays for the ride.[35] In order to lure drivers and build its service in France, Uber paid drivers bonuses of $1100 a week – more than it made from those drivers, according to documents obtained by the business journal *TechCrunch*.[36] "Uber is a steam roller that wants to flatten everything," said Chauffeur-Privé CEO Yan Hascoet.[37] "People need to know how Uber does business, in particular when it comes to anti-competitive practices. We are looking into possible legal action."

Some compare Uber's business tactics to those of Andrew Carnegie and John D. Rockefeller, the monopoly-building tycoons of the American industrial revolution. "Uber's ambitions are limitless and it has the bankroll to do what it wants. Indeed, there is some irony to the fact that Uber has so much cash in the bank that it need not comply with the most basic premise of capitalism — the notion that survival is predicated on making more money than you spend," wrote Andrew Leonard,

[32] Jay Yarrow, "The CEO Of Uber Proudly Admits He Tried To Nuke His Biggest Rival's Fundraising," Business Insider, Nov 5, 2014, http://www.businessinsider.com/uber-ceo-on-messing-with-lyfts-funding-2014-11

[33] Ben Smith, "Uber Executive Suggests Digging Up Dirt On Journalists," BuzzFeedNews, November 17, 2014, http://www.buzzfeed.com/bensmith/uber-executive-suggests-digging-up-dirt-on-journalists#.fa9XwjR83

[34] Frank Pallotta, "Uber exec suggests digging up dirt on journalists," CNN Money, November 15, 2014, http://money.cnn.com/2014/11/18/media/buzzfeed-uber-dinner-journalists/

[35] Ellen Huet, "Uber's Newest Tactic: Pay Drivers More Than They Earn," Forbes, July 2014, http://www.forbes.com/sites/ellenhuet/2014/07/02/ubers-newest-tactic-pay-drivers-more-than-they-earn/

[36] Romain Dillet, "Uber Wants To Take Over The French Market With Aggressive Bonus Tactics," TechCrunch, February 28, 2014, http://techcrunch.com/2014/02/28/uber-wants-to-take-over-the-french-market-by-using-dumping-tactics/?utm_campaign=fb&ncid=fb

[37] Romain Dillet, "Uber Wants To Take Over The French Market With Aggressive Bonus Tactics," TechCrunch, February 28, 2014, http://techcrunch.com/2014/02/28/uber-wants-to-take-over-the-french-market-by-using-dumping-tactics/

a columnist with *Salon* magazine.[38] "With access to an astonishing $1.5 billion in capital, Uber can simultaneously wage regulatory battles in multiple cities, engage in recruitment wars in which smartphones are distributed like candy, subsidize drivers at below cost, and employ whomever is necessary to achieve long-term goals." (Uber's capital funding has since grown to more than $8 billion).

The company waves aside claims that it is overly-aggressive, saying it is natural for market disrupters to make enemies. "I don't subscribe to the idea that the company has an image problem," Uber strategist David Plouffe told *Vanity Fair*. "I actually think when you are a disrupter you are going to have a lot of people throwing arrows."

Seeking New Rules in a Regulatory Hodgepodge

In its first years, Uber often operated beneath the radar of local law enforcement agencies that regulated cab services, portraying its drivers as private citizens who were just sharing rides. It often avoided airport charges, taxes and permit fees. In California, airports complained that drivers for Uber, Lyft and similar apps, picked up passengers at airport curbsides without paying for the permits required of all other transportation operators.[39]

More recently Uber has begun to negotiate regulatory frameworks – and fee structures – with some local governments. Airports in San Francisco and Washington DC now officially allow drivers affiliated with Uber and other transportation apps to pick up passengers for a fee of $4. Chicago levies a tax of 52 cents a ride on each Uber ride, while Nevada recently legalized car-share pick-ups and charges a 3% excise tax on each ride – which could raise $100 million over two years.[40]

The company has fought aggressively to avoid the tight regulations and fees that taxi companies have traditionally faced. It has shut down service in some cities rather than comply. These include Frankfurt and Hamburg (Germany), where a judge ruled drivers must get the same licenses as taxi drivers, and Galveston, Texas, where Uber ceased operations in early 2016 after the city passed a law requiring its drivers to get chauffeur licenses, including fingerprint background checks. "A very small handful of cities have decided to impose burdensome regulations on this new economic engine," Uber said in a letter to its drivers in Galveston. "We know from

[38] Andrew Leonard, Salon, "Why Uber Must Be Stopped," Salon, August 21, 2014, http://www.salon.com/2014/08/31/why_uber_must_be_stopped/

[39] Carolyn Said, "California Regulators Warn Lyft and Uber About Airport Pickups," San Francisco Chronicle, June 12, 2014, http://skift.com/2014/06/12/california-regulators-warn-lyft-and-uber-about-airport-pickups/

[40] Sophie Quinton, "The Debate Over How To Regulate Uber Is Far From Over," Huffington Post, November 24, 2015, http://www.huffingtonpost.com/entry/uber-regulation_us_56548c38e4b0d4093a5933f7

experience in other markets that these rules can have a devastating impact on our ability to provide the experience that riders and drivers have come to expect."[41]

In Australia, the company is challenging a tax ruling which says Uber drivers must pay the same 10% Goods & Service Tax that taxi operators pay. Uber has told its drivers there not to pay the tax unless a financial consultant advises it.[42] The company said a whole new set of rules needs to be developed to cover the new economic model of the on-demand economy. "We don't think that it is appropriate that the tax office has essentially applied a 1999 law to what is a brand new business model that didn't envisage this type of activity," said Brad Kitschke, Uber director of public policy for Oceania, at a hearing on the Australia tax ruling.

Many jurisdictions which initially proposed new regulations designed to regulate Uber similarly to taxis, have backed down after lobbying by Uber and its drivers and customers. Proposals seem to have been dropped in both New York City, where Mayor Bill de Blasio proposed limits on the number of Uber cars in the city, and London, which proposed rules to make Uber cars wait before picking up passengers – after thousands of people sent messages of protest.

In San Jose, the city dropped a plan to require drivers for Uber and other ride-hailing apps to pass a fingerprint background check similar to those required of taxi drivers in order to pick up riders at its airport. Instead, it ended up loosening requirements for taxi drivers. "Either the city should deregulate us completely, like them … or regulate them at least closer to us, and let there be fair business competition," said Kirpal Bajwa, a taxi driver and union leader in San Jose.[43]

It may take time for regulators to catch up to the disruptive changes hitting the transportation industry, says Susan Shaheen, co-director of the Transportation Sustainability Research Center at the University of California, Berkeley: "Innovation has gotten out ahead of the public policy environment," she said. "Things haven't changed in 100 years in this industry and suddenly it's changing rapidly and I think everyone is still figuring out what that means."[44]

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[41] Jacqueline Crea, "Uber shuts down service in Galveston," KHOU 11 News, February 2, 2016, http://www.khou.com/story/news/local/2016/02/02/uber-shuts-down-service-galveston/79722932/

[42] Ariel Bogle, "Uber fights back over tax in Australia," Mashable, August 3, 2015, http://mashable.com/2015/08/03/uber-fights-tax-australia/#t0bZs82OaPqH

[43] Sophie Quinton, "The Debate Over How To Regulate Uber Is Far From Over," Huffington Post, November 24, 2015, http://www.huffingtonpost.com/entry/uber-regulation_us_56548c38e4b0d4093a5933f7

[44] Dug Begly, "Uber remains popular in Houston as questions about safety, access persist," Houston Chronicle, September 25 2015, http://www.houstonchronicle.com/news/transportation/article/Uber-remains-popular-in-Houston-as-questions-6530022.php

Environmental Promise?

"Ride-sharing" has long been hailed by environmentalists as a way to avoid the traffic, pollution and the environmental scourge of millions of single-occupancy vehicles moving around city streets. Uber and other ride-hailing companies tout their services as part of the solution for improving cities, but exactly how services like Uber and Lyft affect the environment is open to question.

For example, if using ride-hailing apps means consumers no longer have to own a car or if they make it easier for people to go out at night and leave their cars at home, that could help ease the difficulty of providing parking places and mean that fewer cars are manufactured. But if Uber rides add extra miles or replace trips taken on public transport, the environmental effect would be negative.

In Los Angeles, where historically residents have depended on cars, ride-hailing apps are spawning a new era of car-free socializing, according to the *New York Times*, which reported that users were flooding the nightclub scene: "Untethered from their vehicles, Angelenos are suddenly free to drink, party and walk places."[45] Despite investing billions in new public transport options, Los Angeles has seen a drop in residents' usage of such forms of transport – which experts blame, in part, on the popularity of ride-hailing services, as well as low gas prices.[46]

More promising for the environment is Uber's carpooling service – UberPOOL, which was launched in San Francisco in 2014 and has been expanded to include Los Angeles, Boston, New York, Philadelphia, Washington D.C. and several European cities. When they sign up for the service, users authorize their driver to pick up other passengers on the way to their destination in exchange for a lower price. Uber advertising claims that by sharing rides for a single month, LA residents using UberPOOL cut potential carbon dioxide emissions by 41 metric tons and offset 154,000 miles that might otherwise have been driven.[47] Lyft operates a competing carpool service called Lyft Line.

Uber co-founder Kalanick has said UberPOOL is not as profitable for the company as its regular service, but it is the direction Uber wants to take. He said the service has already become tremendously popular in San Francisco and, as it grows, will gain efficiency and become even more attractive to riders. "You'll no longer have parking problems in San Francisco, no longer traffic congestion... and you also

[45] Melena Ryzik, "How Uber Is Changing Night Life in Los Angeles," New York Times, October 31, 2014, http://www.nytimes.com/2014/11/02/fashion/how-uber-is-changing-night-life-in-los-angeles.html

[46] Laura J. Nelson and Dan Weikel, "Billions spent, but fewer people are using public transportation in Southern California," Los Angeles Times, January 27, 2016, http://www.latimes.com/local/california/la-me-ridership-slump-2016012"7-story.html

[47] Uber Earth Day promotion, "Make your impact with UberPOOL this Earth Day," April 21 2015, https://newsroom.uber.com/us-california/make-your-impact-with-uberpool-this-earth-day/

create tens of thousands of jobs in the city," he told attendees at a major San Francisco technology conference.[48]

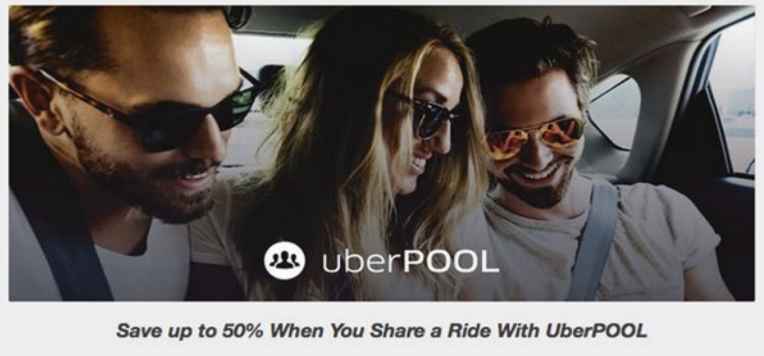

Exhibit 27.12 Uber ad for UberPOOL in the United States
Source: Uber/ www.driveuberaustin.com

But until recently, neither Uber nor Lyft has released internal data that would allow independent researchers to assess their impact on the environment, such as the number and length of rides and the miles driven by drivers.

Researchers from the University of California Berkeley's Transportation Sustainability Research Center have announced they will team up with the Natural Resources Defense Council (NRDC) to analyse the environmental impacts of Uber and Lyft. They plan to conduct their own passenger surveys and use internal ridership data, which Uber and Lyft have promised to release. "The pace of growth of these companies, which didn't exist just a few years ago, is exponential," wrote Amanda Eakin, a deputy director of the NRDC. "In San Francisco, 25% of residents say they have used Uber or Lyft at least once in the last month. A key unanswered question for those of us who think daily about strategies to reduce emissions is: What is the climate impact of these new options?"[49]

Safety Questions

Uber touts its service as improving city safety by eliminating the need for people to stand on the streets waiting for cabs and by reducing the number of drunk drivers on the roads. It advertises that in the US, drivers are pre-screened with a commercial

[48] Eugene Kim, "Billionaire Salesforce CEO Marc Benioff loves the cheapest version of Uber — here's why," Business Insider, September 16, 2015, http://www.businessinsider.com/uber-ceo-says-billionaire-marc-benioff-using-uber-pool-says-everything-about-its-vision-2015-9

[49] Amanda Eaken, "NRDC Urban Solutions to Lead First Climate Analysis of Uber and Lyft," Switchboard: National Resources Defense Council Staff Blog, November 13, 2015, http://switchboard.nrdc.org/blogs/aeaken/nrdc_urban_solutions_to_lead_f.html

review of motor vehicle and criminal records. It adds that its user review system enhances the safety of passengers by allowing them to preview drivers' reputations.[50]

Yet its Terms and Conditions specify that Uber is merely a technology platform which links passengers with third-party transportation providers and states "the entire risk" of using the service lies with the user.[51]

From the six-year-old girl who was run over and killed by a San Francisco Uber driver, to the woman in New Delhi who was allegedly raped by an Uber driver, the question of who is responsible for safety repeatedly arises:

- The family of six-year-old Sophia Liu was crossing a street in San Francisco on New Year's Eve 2013, when an Uber driver making a right turn struck the group – killing the girl and injuring her brother and sister. The family sued Uber, saying the driver was using the app to search for riders at the time of the accident, but the company argued it was not responsible because the driver didn't have a passenger in the car at the time. Uber eventually settled out of court with the family, with no ruling on who held responsibility. Uber has since added some insurance coverage for drivers who are not yet carrying passengers.
- The capital of India temporarily banned Uber after a woman alleged she was raped by an Uber driver in December 2014. Uber used its technology to help New Delhi police identify and arrest the driver. The woman filed charges in a US court, alleging that Uber failed to screen its drivers properly and the service amounted to modern-day electronic hitchhiking. Uber responded that she was suing the wrong party, as the driver had a contract with Uber BV, a Netherlands-based entity with no US operations. The woman dropped the case without explanation in 2015.[52]
- In San Francisco, an Uber driver was arrested for hitting a passenger in the face with a hammer in 2014, after the passenger argued about directions. The passenger suffered serious eye injuries. Uber said its insurance company was talking to the victim. Critics said the case pointed to a lack of driver screening and training.[53]
- In Houston, Texas, an Uber driver was arrested for allegedly taking a drunken woman to his home and raping her. It turned out the driver was an ex-con who had spent 14 years in prison on drug charges before being released in 2012,[54] but

[50] Uber website customer promotion regarding safety, "Safe rides, Safer cities, Going the distance for everyone on the roads," accessed February, 7 2016, https://www.uber.com/safety

[51] Uber Legal, "Terms and Conditions," updated April 8, 2015, https://www.uber.com/legal/usa/terms

[52] Reuters, "Delhi Uber rape victim ends lawsuit against company in US court," Sep 03, 2015, http://www.hindustantimes.com/delhi/delhi-uber-rape-victim-ends-lawsuit-against-company-in-us-court/story-AVqUDwVanOwfffTlxcWSFJ.html

[53] Ellen Huet, Uber Rider Might Lose An Eye From Driver's Hammer Attack. Could Uber Be Held Liable, Forbes, September 30, 2014, http://www.forbes.com/sites/ellenhuet/2014/09/30/uber-driver-hammer-attack-liability/

[54] Dara Kerr, "Uber's background checks don't catch criminals, says Houston," CNET, April 17, 2015, http://www.cnet.com/news/ubers-background-checks-dont-catch-criminals-says-houston/

he had passed Uber's background checks. He was also driving without a required city permit, which would have involved him passing an FBI fingerprint screening. At the time Uber was not enforcing the city's requirement that drivers have permits.[55]

Uber's Terms and Conditions that users agree to (to sign up for the Uber app) explain that Uber "does not guarantee the quality, suitability, safety or ability of third party providers (i.e. its drivers.) You agree that the entire risk arising out of your use of the services…remains solely with you."[56] Drivers who sign up online are expected to carry their own insurance and take care of required permits and inspections required by the city where they work.

Nonetheless, Uber has upped the amount of commercial insurance it carries to cover liability of its drivers to $1 million. It touts its driver screening process – online background checks conducted by an outside firm that looks at court records, criminal databases and motor vehicles records. Uber requires a vehicle inspection before drivers can start work[57] and charges a $1 safety fee on every ride to pay for these services. "Safety is our top priority and foundational to the Uber experience – for both riders and drivers – and we take any potential breach of safety seriously," said an Uber spokesman after the hammer assault incident.[58]

The district attorneys of Los Angeles and San Francisco filed a lawsuit charging Uber with misleading customers about the safety of its services, alleging systemic failures in Uber's background checks, which have allowed convicted sex offenders, identity thieves, burglars, kidnappers and a murderer to drive for Uber.[59] It said Uber's record checks are not as good as the fingerprint checks required of most taxi drivers. Uber responded that the system used to vet taxi drivers also misses previous convictions and other red flags.

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[55] *Ibid*.

[56] Uber Legal, "Terms and Conditions," updated April 8, 2015, https://www.uber.com/legal/usa/terms

[57] Dara Kerr, "Uber's background checks don't catch criminals, says Houston," CNET, April 17, 2015, http://www.cnet.com/news/ubers-background-checks-dont-catch-criminals-says-houston/

[58] Dara Kerr, "How risky is your Uber ride? Maybe more than you think," CNET, Oct 8, 2014, http://www.cnet.com/news/how-risky-is-your-uber-ride-maybe-more-than-you-think/

[59] Carolyn Said, "DA: major flaws in Uber background checks allow criminal drivers," San Francisco Chronicle, August 19, 2015, http://www.sfgate.com/business/article/DA-major-flaws-in-Uber-background-checks-allow-6453865.php

Exhibit 27.13 A discontinued Uber safety ad
Source: Uber ad reprinted in dna.india.com

An article in *The Atlantic* noted that, while reports of assaults in Uber cabs have gained a lot of publicity, there are no reliable statistics to show whether assaults in cars dispatched by ride-hailing apps are any more common than such problems in taxicabs. Cities don't keep track of where assaults occur, the article noted.[60] It quoted Uber spokesman Taylor Bennett saying that 10% of Boston taxi drivers who underwent background checks for Uber failed the test. "Unlike the taxi industry, our background checking process and standards are consistent across the United States and often more rigorous than what is required to become a taxi driver," said Bennett, who said Uber used a company called HireEase to do all its background checks.[61]

Since the suit by the California district attorneys, Uber has removed advertising that claims its background checks are "industry leading."[62] California state legislators tried to pass a bill that would require fingerprinting for all transportation drivers

[60] Adrienne Lafrance and Rose Eveleth "Are Taxis Safer Than Uber?," The Atlantic, March 3, 2015, http://www.theatlantic.com/technology/archive/2015/03/are-taxis-safer-than-uber/386207/

[61] *Ibid*.

[62] Carolyn Said, "DA: major flaws in Uber background checks allow criminal drivers," San Francisco Chronicle, August 19, 2015, http://www.sfgate.com/business/article/DA-major-flaws-in-Uber-background-checks-allow-6453865.php

in the state, but the legislation failed after Uber and other ride-sharing companies lobbied ferociously against it.

Uber has touted numerous ways that its services make cities safer, claiming its services keep drunken drivers off the road by providing easy-to-access transportation when bars close, so people who have been drinking have no need to drive. Since all transactions occur through the customers' credit card accounts and no money changes hands, Uber says its system avoids the problem taxi drivers face of being robbed of their cash. "I work events late at night and with Uber I feel safer knowing I don't have to go wait outside and hope I can flag down a cab," said a Portland Uber user, quoted in one of the company's safety promotions.[63]

Exhibit 27.14 Uber drivers protesting working conditions in Santa Monica in 2014
Source: Lucy Nicholson/Reuters

Labour Issues

How Uber is regulated – and indeed, whether the company's business model can survive – may ultimately be decided by how courts rule on several thorny labour issues.

In its advertising, Uber offers drivers the opportunity to "Drive your car. Be your own boss. Work when you want."[64] Its model depends on independent contractors providing the vehicles, the labour and the gas. Drivers in numerous jurisdictions, however, have sued the company on the grounds that it treats them as employees and thus should give them the same protection as traditional workers, rather than consid-

[63] Uber website customer promotion regarding safety, "Safe rides, Safer cities, Going the distance for everyone on the roads," accessed February, 7 2016, https://www.uber.com/safety

[64] Uber.com, advertising on Google search engine.

ering them "independent contractors." Contractors don't get wage guarantees, paid overtime, expenses, unemployment insurance, health benefits and other benefits given to employees.

The number of drivers working for Uber in the US went from almost none in 2012 to 160,000 by the end of 2014, according to a paper co-written by Jonathan Hall, a researcher for Uber, and Alan Krueger, a professor of economics at Princeton.[65] In mid-2015, Uber CEO Kalanick said the company had 26,000 drivers in New York City alone; 15,000 in London; 22,000 in San Francisco; 10,000 in Paris; and 20,000 in Chengdu, China.[66]

An Uber driver survey cited in Hall and Krueger's paper indicated that drivers tend to be younger and much more educated than taxi drivers. The survey of 601 "driver-partners" in 20 US markets found that Uber drivers were more likely to be women (still only 14%) and more likely to identify themselves as non-Hispanic whites (40%) than those in the taxi profession.[67]

Most Uber drivers (61%) had another part-time or full-time job. Half of all drivers had not worked in the transportation industry before joining Uber. 8% percent were unemployed just before they started driving for Uber. 87% of drivers said one of their reasons for joining Uber was "to be my own boss and set my own schedule." Half worked less than 15 hours per week and 86% worked less than 35 hours.[68]

Since most Uber drivers had not been recently unemployed and many said they liked being their own bosses, Krueger and Hall concluded: "Most driver-partners do not turn to Uber out of desperation or because they face an absence of other opportunities in the job market, but rather because the nature of the work, the flexibility, and the compensation appeals to them."[69]

Krueger and Hall queried Uber's internal data, which showed that during a month at the end of 2014, 162,000 drivers made at least four trips for Uber, and during the last three months of 2014 Uber paid out $656.8 million to US drivers. The data showed that in 2014, drivers made between $16 and $30 an hour depending on the city they drove in. The hourly rates cited in the study did not include the drivers' costs of gasoline, insurance and the expense of owning their own cars. Some Uber drivers claim that, after paying these expenses, they didn't make the minimum wage. Drivers have sued Uber in London, demanding to be guaranteed basic worker protections like the minimum wage and regular breaks.[70]

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[65] Jonathan Hall, Alan Krueger, "An Analysis of the Labor Market for Uber's Driver-Partners in the United States" January, 2015, http://arks.princeton.edu/ark:/88435/dsp010z708z67d

[66] Mike Isaac and Natasha Singer, "California Says Uber Driver Is Employee, Not a Contractor," New York Times, June 17. 2015, http://www.nytimes.com/2015/06/18/business/uber-contests-california-labor-ruling-that-says-drivers-should-be-employees.html?_r=0

[67] Jonathan Hall, Alan Krueger, "An Analysis of the Labor Market for Uber's Driver-Partners in the United States" January, 2015 http://arks.princeton.edu/ark:/88435/dsp010z708z67d

[68] *Ibid*.

[69] *Ibid*.

[70] Hannah Jane Parkinson, "Uber faces legal action in UK over drivers' rights," The Guardian, July 29, 2015, http://www.theguardian.com/technology/2015/jul/29/uber-legal-action-uk-drivers-rights

Table 1: Characteristics of Uber's Driver-Partners, Taxi Drivers and All Workers

	Uber's Driver-Partners (BSG Survey)	Taxi Drivers and Chauffeurs (ACS)	All workers (ACS)
Age 18-29	19.1%	8.5%	21.8%
30-39	30.1%	19.9%	22.5%
40-49	26.3%	27.2%	23.4%
50-64	21.8%	36.6%	26.9%
65+	2.7%	7.7%	4.6%
Female	13.8%	8.0%	47.4%
Less than HS	3.0%	16.3%	9.3%
High School	9.2%	36.2%	21.3%
Some College / Associate's	40.0%	28.8%	28.4%
College Degree	36.9%	14.9%	25.1%
Postgraduate Degree	10.8%	3.9%	16.0%
White Non-Hispanic	40.3%	26.2%	55.8%
Black Non-Hispanic	19.5%	31.6%	15.2%
Asian Non-Hispanic	16.5%	18.0%	7.6%
Other Non-Hispanic	5.9%	2.0%	1.9%
Hispanic	17.7%	22.2%	19.5%
Married	50.4%	59.4%	52.6%
Have Children at Home	46.4%	44.5%	42.2%
Currently Attending School	6.7%	5.0%	10.1%
Veteran	7.0%	5.3%	5.2%
Number of Observations	601	2,080	648,494

Notes: ACS data pertain to the same 20 Uber markets as the BSG survey, and are for 2012 and 2013.

Table 2: Distribution and Median Hourly Earnings of uberX Driver-Partners by Hours Worked, Oct. 2014

	1 to 15 hours/week		16 to 34		35 to 49		Over 50	
	Percent of driver-partners	Earnings per hour	Percent of driver-partners	Earnings per hour	Percent of driver-partners	Earnings per hour	Percent of driver-partners	Earnings per hour
BOS	58%	$19.25	30%	$20.41	9%	$20.78	4%	$20.48
CHI	56%	$15.60	31%	$16.12	9%	$16.21	4%	$16.03
DC	53%	$16.61	31%	$17.46	10%	$17.70	6%	$17.41
LA	59%	$16.37	29%	$17.07	8%	$17.07	4%	$16.97
NY	42%	$26.03	35%	$28.47	16%	$29.65	7%	$29.61
SF	53%	$23.74	34%	$25.51	10%	$25.36	3%	$25.36
BSG Survey Uber Markets	55%	$16.89	30%	$18.08	10%	$18.31	5%	$17.13

Source: Uber. Data aggregated at the driver-partner-week level. Figures exclude incentive payments that are offered to new drivers in some markets. Earnings are net of Uber fees but do not adjust for expenses.

Exhibit 27.15 These two tables from Alan Krueger and Jonathan Hall's Analysis of the Labor Market for Uber's Driver-Partners in the United States show driver characteristics

Source: Alan Krueger and Jonathan Hall

Exhibit 27.16 Uber Promotion recruiting drivers

Source: Uber/from website joannbecker.com/uber/california/city/oceanside

In California, Uber has lost some key labour decisions. The state Labour Commission ruled that a San Francisco woman who drove for Uber for eight weeks, and claimed not to have made minimum wage, was indeed an employee. The commissioner ordered Uber to pay her $4152.20 expenses and other reimbursements.[71] "The defendants hold themselves out as nothing more than a neutral technological platform, designed simply to enable drivers and passengers to transact the business of transportation," the Labour Commissioner's Office wrote about Uber. "The reality, however, is that the defendants are involved in every aspect of the operation."[72]

While this case applies to only one worker, a bigger case, which seeks employee status for the entire class of Uber drivers in California, is working its way through the US court system. Scheduled for a jury trial in the District Court of California in the summer of 2016, this could have major implications for all on-demand economy companies that rely on workers who choose which jobs they take and set their own schedules. By deeming them "independent contractors", Uber is not liable for paying drivers' gas and vehicle maintenance expenses, minimum hourly wages and benefits. Using contractors instead of employees allows Uber and other companies to keep their labour and capital costs low, while tapping into a huge pool of drivers and other workers who perform services around the globe.

In the above case, filed on behalf of three named drivers, the claimants argue that Uber imposes a "litany of detailed requirements" on its drivers and can terminate them for failure to comply. They also argue that despite Uber's claim that it is a technology platform not a transportation company, providing car services is Uber's main business. Thus, they say, drivers are integral to its service (a legal indication that they should be classified as employees.)

The lawsuit's backers won a series of victories near the end of 2015, when the federal judge overseeing the case ruled that as many as 160,000 drivers who had worked for Uber in California were eligible to join the case. The court also entitled some of them to seek reimbursement of 57.5 cents per mile for their vehicle expenses. Uber is appealing against the ruling.

Uber argues that forcing it to classify drivers as employees would hurt its drivers the most. "Nearly 90 percent of drivers say the main reason they use Uber is because they love being their own boss," the company said. "Drivers use Uber on their own terms; they control their use of the app along with where and when they drive."[73]

Several other on-demand companies are facing similar lawsuits demanding employee protection for workers. Uber's competitor Lyft settled a similar class-action lawsuit in January 2016, agreeing to pay $12.25 million to drivers. The company also vowed to change the terms that drivers agree to when they sign up for the

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[71] Mike Isaac and Natasha Singer, "California Says Uber Driver Is Employee, Not a Contractor," New York Times, June 17. 2015, http://www.nytimes.com/2015/06/18/business/uber-contests-california-labor-ruling-that-says-drivers-should-be-employees.html?_r=0

[72] *Ibid*.

[73] Carolyn Said, "Calif. Uber drivers get class-action status in employment suit," San Francisco Chronicle, September 1, 2015, http://www.sfgate.com/business/article/Calif-Uber-drivers-get-class-action-status-in-6479042.php

service to make them more consistent with their status as contractors. One change, according to the attorney who brought the suit, is that Lyft will no longer be able to terminate drivers at will.[74]

The company Homejoy, which used contractors to provide house-cleaning services, abruptly shut down in summer of 2015 after being targeted by similar suits.[75] Instacart, which provides shopping and delivery services, changed some of its workers to employees following a similar lawsuit. Postmates and Caviar, both delivery services, and Handy, which provides cleaners and household repair experts, have also faced lawsuits.

Economists and labour activists have raised the question of whether sharing economy companies are fuelling a shift in which traditional jobs are being replaced by short-term "independent contractor" gigs.

Exhibit 27.17 Taxi drivers protest Uber practices in New York City in 2015
Source: Spencer Platt/Getty Images

Many worry that this new "gig economy" might not be a good thing for either workers or the economy.

"For anybody who has to pay the bills and has a family, having no labour protections and no job security is at best a mixed blessing," said Robert Reich, former secretary of labour and a professor of public policy at the University of California,

[74] Mike Isaac, "Lyft Agrees to Settle Class-Action Lawsuit With California Drivers," New York Times, January 27, 2016, http://bits.blogs.nytimes.com/2016/01/27/lyft-agrees-to-settle-class-action-lawsuit-with-california-drivers/

[75] Carolyn Said, "Calif. Uber drivers get class-action status in employment suit," San Francisco Chronicle, September 1, 2015, http://www.sfgate.com/business/article/Calif-Uber-drivers-get-class-action-status-in-6479042.php

Berkeley.[76] "At worst, it is a nightmare. Obviously some workers prefer to be independent contractors — but mostly they take these jobs because they cannot find better ones."

Others argue that the on-demand economy represents a powerful new economic opportunity for individual entrepreneurs who maybe don't fit into either the category of "employee" or "independent contractor." "The jury in this case will be handed a square peg and asked to choose between two round holes," California Judge Vince Chhabria wrote in a case concerning Lyft in 2015. "The test the California courts have developed over the 20th century for classifying workers isn't very helpful in addressing this 21st-century problem."[77] Some, including Krueger, have proposed creating a new worker classification that meets the needs of the new online economy and provides more protection for workers. Some suggest calling these new workers "dependent contractors".[78]

Depending on how these questions are decided, Uber's model for hiring independent contractors could end up dramatically changing the world of work. "The Uber question is part of a bigger one facing the global economy," writes John Gapper of the *Financial Times*.[79] "More and more people work for virtual platforms instead of companies; work is auctioned to pools of contractors; median wages stagnate while returns on capital rise; some duties of doctors and lawyers may soon be done by machines. Is this what we want?"

Conclusion

The question of how to regulate Uber and other sharing economy companies has rocketed up the agendas of the world's highest-ranking governing agencies and become a major political debate.

The EU Court of Justice has been asked to rule on whether Uber should have to comply with laws pertaining to local transportation companies in EU member states, after a Spanish court ruled that Uber violated national law and amounted to unfair competition with taxis. The European Commission is considering whether to regulate ridesharing on a European level, rather than leaving it to local jurisdictions. The Commission has said it welcomes innovative new companies, but does not want them to circumvent national laws on safety, taxation and labour protection.[80]

[76] *Ibid*.

[77] Annie Lowry, "The Uber Economy Requires a New Category of Worker, Beyond 'Employee' and 'Contractor'," New York Magazine, July 9, 2015, http://nymag.com/daily/intelligencer/2015/07/uber-economy-requires-a-new-category-of-worker.html#

[78] *Ibid*.

[79] John Gapper, "Technology has to create more than disruption," Financial Times, January 21 2015, http://www.ft.com/intl/cms/s/0/b0e9e5f0-9fea-11e4-aa89-00144feab7de.html#axzz3n3bldrIg

[80] Julia Fioretti, "To regulate or not to regulate? EU to launch study on Uber," Reuters, August 28, 2015, http://www.reuters.com/article/2015/08/28/us-uber-eu-idUSKCN0QX1W920150828

The on-demand economy has also become a major campaign issue in the US, with Democrats, including Hilary Clinton, lining up on the side of regulation, and Republicans calling for unfettered free enterprise. “This on-demand, or so-called gig economy, is creating exciting economies and unleashing innovation. But it is also raising hard questions about work-place protections and what a good job will look like in the future,” said presidential candidate Clinton in a speech laying out her economic strategy.[81] She promises to “crack down on bosses who exploit employees by mis-classifying them as contractors.”

Jeb Bush, a one-time competing Republican candidate, rode in an Uber car to a campaign event. “There’s going to be a big tension between companies that are disrupting the old order and if they’ve done something wrong, they should pay a fine,” he said. “But it’s a pretty vital service.”[82]

Exhibit 27.18 U.S. Presidential candidate Jeb Bush rides in an Uber car
Source: Jim Wilson/New York Times

[81] “Hillary Clinton Transcript: Building the ‘Growth and Fairness Economy’” Wall Street Journal, July 13, 2015, http://blogs.wsj.com/washwire/2015/07/13/hillary-clinton-transcript-building-the-growth-and-fairness-economy/

[82] Ashley Parker, “Jeb Bush’s Uber Ride: A Journey and an Economic Message,” New York Times, July 16, 2015, http://www.nytimes.com/politics/first-draft/2015/07/16/jeb-bushs-uber-ride-a-journey-and-an-economic-message/

Part VI

Introduction: Managing Change: Developing Dynamic Capabilities and Managerial Talents

Gilbert G. Lenssen

Michael Porter pays little attention to the organizational and leadership prerequisites that need to underpin strategy implementation. He failed to do so in his classical work on competitive strategy and also his work on Shared Value gives scant attention to these prerequisites. More broadly, Porter's industry sector based theory of competitive differentiation may not be able to reveal the dominant logic of value capture in most new industries. This dominant logic is now recognized to be the way businesses develop core resources that are unique, rare, difficult to imitate, and by definition take a long time to grow and materialize. This is the resource-based view of the business as the source of sustained advantage, developed by Jay Barney, a strategy professor at Ohio State University. Core resources are Knowledge, Relationships, Capabilities and Business Purpose. "Business Purpose" as a strategic resource is a concept I explored with Robert Grant, a strategy professor at Bocconi University Milan. Our hypothesis is that one of the main reasons that the shareholder value movement had such detrimental effects on business was its disregard of business purpose as the cohesive binding commitments that sustain a business in the long term. We need to make this "hard" by more research. Stakeholders are of course key in generating strategic resources like knowledge, relationships and business purpose.

A further strategic resource is capability, more specifically "Dynamic Capability", as identified by David Teece, building on the work by Gary Hamel and CK Prahalad. It is defined as the capability of the firm to purposefully creating, extending and modifying the resource base of the business, by building, integrating and reconfiguring internal and external competences to respond to rapidly changing environments and contexts. The challenge of sustainable development requires a shift in the dynamic capabilities of firms and it is beginning to show as we have explored in Part V.

Dynamic capabilities of the organisation depend on the development of new managerial talents. In the field of sustainable business, these seem to be grasping of the context, embracing complexity, and maintaining connectedness in the business environment.

- Grasping Context requires understanding macro trends, understanding economic, political, and cultural globalisation processes, sensing maturity stages of issues, and scenario building. It presupposes intellectual curiosity and a rather eclectic mindset.
- Embracing Complexity requires a deep awareness of systemic interdependencies, the ability to thrive in conditions of ambiguity, uncertainty and low agreement, and to act on emerging processes. It presupposes emotional intelligence, fast learning loops, comfort with the unknown, and mindfulness.
- Maintaining Connectedness requires empathic engagement with multiple actors, building effective professional and social networks, and an ability to forge groundbreaking partnerships. It presupposes a capability for self awareness, deep dialogue, and boundary spanning in order to generate legitimacy and trust.

This will be elaborated on by Marc Jones and Matthew Gitsham in the Chaps. 28 and 31.

Teece, David; Pisano, Gary; Shuen, Amy (August 1997). "Dynamic Capabilities and Strategic Management". Strategic Management Journal. ***18*** *(7): 509–533.*

Key Questions to Ask (Applicable to All Part VI Cases)

How are the business knowledge, relationships, capabilities and purpose developed for a sustainable future?

Which dynamic capabilities will be required for innovation?

What organisational structures and processes are required to support a shift to a sustainable enterprise model?

What kind of leadership, decision-making and managerial frameworks would support this?

What are the implications for talent development and HRM, strategy development and implementation, performance management, organisational change management?

Chapter 28: Taking the Future Seriously: Preparing for Global Gigatrends by Marc T. Jones

In a similar vein to the authors of Chap. 6, Marc Jones lists the following giga trends: climate change, energy depletion, the rise of the emerging economies, demographic shifts, fiscal crises, threats to the democratic state and the emergence of the permanent "crisis state". He demonstrates how these trends are intertwined and reinforce each other. The implications for executive education may amount to a paradigm shift in cognitive and social skills development. The conventional ways to analyse the larger business context are no longer adequate. Single leaders cannot provide the capacity to grasp the complexity of the business context and horizons at an abstract level, connect with the merging issues at the grassroots level, and design strategies to keep business on a sustainable footing. Intensive teamwork and networking will need to be fostered in executive education.

Chapter 29: Unilever's Super Stretch Goal for 2020 by Aileen Ionescu-Somers and Jacqueline Brassey

In Chap. 21, Unilever's Sustainable Living Plan strategy was presented as an outwardly ambitious if not iconoclastic attempt to decouple growth from negative impacts and instead to couple it to social and progress. In this chapter, the authors go deeper into the organisational characteristics and requirements of this strategy and the change management in relation to organisational structure, systems, processes and culture that is required, without which Unilever's ambitious goals cannot be achieved. From the outset, the HR department was seen as being at the centre of strategy delivery by developing the managerial talents and getting the requisite managerial profiles on board. Organisationally, the hardware reconfiguration required new performance metrics and new core decision-making and business processes. The software reconfiguration required leadership alignment on the sustainability strategy reaching to the middle management levels, which are crucial for consistent and streamlined implementation. "Winning hearts and minds" at all organisational levels and in all regions of the world was seen as imperative, with experiential learning as a useful tool in achieving this. In a nutshell, the challenge is very simple, yet very difficult: how can the product managers of 250 branded products, who care about market share, product performance, brand performance, profitability, and return, equally care about reducing environmental footprints and enhancing social performance? The jury is still out as to whether the SLP will be viewed as a brilliantly conceived business strategy that ultimately failed because organisational alignment proved to be to insufficient; or whether it becomes a showcase for organisational change management and talent development for a sustainability-led strategic transformation. The stakes are huge for Paul Polman and the company alike.

Chapter 30: Novo Nordisk A/S: Integrating Sustainability into Business Practices by Mette Morsing, Dennis Oswald, and Susanne Stormer

This case offers an in-depth analysis of the organisational and management processes implemented by Novo Nordisk to underpin its sustainability strategy in a successful way. These processes are based on a vision and on values and commitments for financial, environmental and social responsibility. The company recognised through a number of controversies that the health care and pharmaceutical sector has a huge impact on society and is very sensitive to social issues and political backlashes in developed and in developing markets. Therefore, it needs the organisational built-in assurances that its business is conducted consistent with and as integral to its sustainability strategy. If sustainability is integral to business strategy, it needs to be integral to business operations in a consistent way, which can be monitored systematically. This is the Novo Nordisk Way of Management. A key management process is built around a cascading balanced scorecard integrating sustainability KPI's with financial and operational objectives at all organisational levels. The management reporting process is based on the "triple bottom line" model, reporting financial, environmental and social performance concurrently, both

internally and externally. Internal consultants or "facilitators" who audit operational units on meeting sustainability targets, provide on-site consulting and identify and communicate best practices to support continuous improvement.

Chapter 31: The Changing Role of Business Leaders and Implications for Talent Management and Executive Education by Matthew Gitsham

This book contains a number of success stories of companies like IBM, Unilever, Umicore, Novo Nordisk, General Electric, and illy. They all have a few characteristics in common. First, their CEOs and top leadership are inspiring and committed to making their companies a force for good. They consider themselves public leaders instead of merely executive administrators. These leaders take a long term view and are committed to delivering value to shareholders and other stakeholders. The financial performance of their companies has been stable and above average in the industry sector over time. Second, these companies excel in human resource and talent development and maintain high quality processes in recruitment, training and development, career progression, organisational learning, and networking. As a consequence, they are able to attract the best talent available. Third, they are keeping a broad economic, social and political perspective in strategic processes and encourage intellectual curiosity and literacy beyond the traditional boundaries of business. Fourth, they are committed to continuous innovation by setting ambitious targets for business renewal from the top and allowing for experiments in the margins to encourage bottom up and lateral creativity. Fifth, they grasp sustainability issues as opportunities for profitable business investment growth, and business model transformations. In keeping with these observations, this chapter goes deeper into the requirements for new leadership and new talent for sustainable business.

Taking the Future Seriously: Preparing for the Global Gigatrends

28

Marc T. Jones

Introduction

Mohamed El Erian (recently retired CEO of Pimco) is credited with the observation that for the foreseeable future investment decisions will be taken in a context of the 'new normal', characterised by much higher levels of economic (and political, social, etc.) instability and uncertainty than was evident in past decades. The fundamental question, then, is what are the key trends shaping the business landscape going forward? Our answer to this question is the *gigatrends.*

Included among the gigatrends is climate change; energy depletion; the rise of the BRIC nations; profound demographic shifts driven by both the genome revolution, widely divergent birth rates across countries, and the rise of a new middle class in the global South; the fiscal crisis that will embroil nearly all 'advanced' states in coming years; and the possibility that we are within sight of an end to substantive democracy and its replacement with a permanent 'crisis state'.

At the organisational level, each of these gigatrends will require some form of effective response in order to realise latent opportunities and/or mitigate looming threats. A much greater challenge, of course, is that these gigatrends will not unfold in isolation of each other, but rather in complex and largely unpredictable *interactions*. Yet corporate actors are not only passive bystanders to these developments, but also in many instances *active shapers* of market, industry, and sector evolution operating at various geographical levels. An understanding of the gigatrends also needs to be incorporated within executive education interventions to foster more ethical, enlightened and effective future leaders.

Yet the gigatrends, while already each in train, also constitute a *collective metaphor* on the future. More specifically, they challenge organisations to reflect upon how seriously they take the future; the meaning of 'the long-term' in context; and

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© Springer Science+Business Media B.V. 2019
G. G. Lenssen, N. C. Smith (eds.), *Managing Sustainable Business*,
https://doi.org/10.1007/978-94-024-1144-7_28

the extent to which conversations about the long-term eventuate in decisions which drive resource commitments *today*. The gigatrends provoke senior leadership to clarify its *strategic posture* (Courtney 1998) – the manner in which it interacts with its ecosystem – which in turn has implications for the organisational 'muscles' it will invest in to best realise the chosen posture of industry shaper, fast (or more cautious) follower, or committed bystander.

The Global Gigatrends

The first and preeminent gigatrend facing not only economic actors but the entire biosphere is that of climate change. The overwhelming judgement of the scientific community is that global warming is a fact, and that human industrial activity (based on burning fossil fuels) is a major contributor to the process (Hamilton 2010; IPCC 2008; Stern 2007). Sea levels are already on the rise, fostering "climate refugees" (Klein 2007); weather patterns appear increasingly unstable in comparison to historical norms, undermining agricultural productivity; and recent estimates of temperature increases suggest we are approaching a 'tipping point' which could be sufficient to trigger positive feedback loops which will drive runaway temperature increases in a catastrophe scenario (Guardian 2009a). Scientists from the Global Carbon Project state that the most likely scenario is for a 6 degree (Fahrenheit) rise by 2100, due to the manifestation of feedback loops through the failure of natural 'carbon sinks' to absorb greenhouse gas emissions, which increased 29% over the 2000–2008 period (Independent 2009). More recently the *National Climate Assessment* report issued by the United States government in 2014 confirmed climate change as a 'clear and present danger' to national security (USGCRP 2014).

The fundamental point here is that there is actually very little (serious) debate that global temperatures (and, consequently, sea levels) are rising. The key uncertainties concern the rate of warming and the point at which temperatures will peak. The policy debate circles around whether to concentrate attention and resources around containing and mitigating carbon emissions, or accommodating to living in a warmed world. A salient point here would be to consider that humanity has proven able to exist and function effectively, in a reasonable degree of comfort, in such extreme climates as northern Alaska or the Antarctic in winter as well as Dallas or Dubai in summer. Humanity has been able to survive in prosper under highly adverse climactic conditions due to the existence of effective heating and cooling technologies fuelled by abundant and affordable energy resources. This period of human history is quite possibly coming to an end, with epochal implications for contemporary techo-industrial civilisation (Greer 2008). This is why the next gigatrend is the most significant of all.

The second gigatrend is that of continuing (and accelerating) energy depletion. Up until very recently, the relevant science indicated that we were at or near the point in time in which known global petroleum reserves exceed consumed reserves (the definition of 'peak oil'), meaning we were in the early stages of an extended decline in which first oil, then other fossil fuel (coal and natural gas) reserves will

be run down to minimal levels (Guardian 2009b). In this scenario, alternative energy sources and technologies (e.g., geothermal, hydro, solar) would not be sufficient to offset the energy deficit left by fossil fuels because their *net energy yield* – the difference between the amount of energy one unit of a substance generates and the energy that has been expended in producing it – is only a fraction of that typical of fossil fuels (Heinberg 2005).

However, the 'fracking revolution' now well underway in the USA considerably changes this equation, pushing 'peak oil' – which the IEA had has recently as 2011 identified as occurring in 2006 – back some years, potentially even decades. As long as oil prices remain in the $100/barrel range, it will be economic to exploit shale oil and other forms of 'tight oil'. The real danger, it seems, isn't that there isn't enough oil, but that there will be *too much*! This will undermine the development of clean alternatives, vastly increase the release of carbon into the atmosphere, and thereby possibly catalyse runaway climate change (Carbon Tracker 2013).

Since industrial (and post-industrial) economies are based fundamentally on an ample supply of cheap energy from fossil fuels, the ramifications of energy depletion are *totalising* – think, for example, of the rapidly rising levels of electricity needed to power Google's servers![1] Unless there occurs an as yet unforeseen technological breakthrough which leads to some alternative energy source taking up the slack as affordable fossil fuel stocks wind down, the type of civilisation which developed in Western Europe and the United States in the nineteenth century, extending itself throughout most of the world in the twentieth century, will be *literally* unsustainable. That is, available energy resources will not be able to generate levels of electrical and other forms of cheap energy necessary to power the built environments and transportation grids integral to an advanced technological civilisation.

The third gigatrend driving large scale structural change in the world is the rise of the so-called 'BRIC' nations and the consequent (at least relative) decline of the West (and Japan) in terms of their role and status in the global economy. Inevitably, with rising economic power also comes political clout – witness the recent morphing of the G-8 into the G-20 as the world's most important international forum on economic affairs, along with China's major role in scuppering the 2010 climate negotiations in Copenhagen (Lynas 2010). Perhaps most significant from a longer-term perspective, however, will be the eroding value of the Western narrative of development through markets and democracy so celebrated in the 'end of history' thesis (Fukuyama 1992) and manifested in the neoliberal policies of the Washington Consensus (see Panitch and Konigs 2009).

The extent to which the Western development model has been discredited should not be underestimated. Some observers trace a growing conflict regarding the global 'rules of the road' back at least to the aftermath of the Asian Financial Crisis of 1997 (Aglietta and Berribi 2007). Conversations within key international institutions going forward will likely take on a much more pluralistic tone where multiple

[1] On a global basis, servers are currently estimated to account for 2% of all energy consumption, a number expected to grow dramatically in coming years (BBC 2013).

varieties of capitalism with differing roles for market, state and democracy will compete for policy influence over the institutional architecture of the global system. The BRIC nations can also be expected to compete with the West for access to key global resources such as energy, strategic minerals and arable land (see Klare 2012), a contest which is already evident in the neo-colonial 'race for Africa' between China and the United States (Financial Times 2010). Significant here is the fact that for China and many other emerging nations the benchmark development model is not the United States or Western Europe, but rather Singapore. With its effective mix of strong state, political stability, attenuated democracy, and social 'harmony', the success of Singapore puts into question the robustness of the Western formulation of democratic-capitalism as the modal institutional framework for developing countries (see Kagan 2009).

The fourth gigatrend impacting future history relates to massive demographic changes driven by biotechnology, birth rates, and migration patterns. We are on the brink of the genome revolution, which will foster a wide range of life extension technologies. While some scientists believe that we are within reach of living up to 1000 years (c.f., de Grey 2008), more widely held opinions expect a significant percentage of children born today to experience life spans considerably in excess of 100 years (Fukuyama 2003). Yet technological possibilities need to take into account political, social and cultural factors. The impacts on superannuation systems, labour markets and occupational structures are only the most obvious areas of disruption, but there are even more fundamental issues at stake.

The most starkly apparent characteristic of the genome revolution – in great contrast to the 'open-sourced' spread of the internet – is that it is unfolding in an overwhelmingly *privatised* organisational field composed of research labs (often spin-offs from public universities), biotech and pharmaceutical firms, medical equipment manufacturers, healthcare delivery providers (hospitals and clinics), insurance companies, and regulatory agencies. The trajectory of technological development and commercialisation of basic research will likely mean a profound skewness in the direction of treating those illnesses (e.g., diabetes, obesity) that afflict relatively well off citizens/customers in wealthy countries, rather than dealing with age-old maladies (e.g., tuberculosis, malaria) which torment hundreds of millions of poor people across the globe because, after all, a functioning market requires not only that a demand exists but that potential customers have the means to make payment. As noted by John Sulston, who led the UK branch of the Human Genome Project, "The fact of the matter is that many human genes have patent rights on them and this is going to get in the way of treatment unless you have a lot of money" (Guardian 2010). This unequal access to life preserving and extending technologies for the global minority, while the global majority may well experience *shortening* life spans as the ravages of climate change and energy depletion undermine states' ability to fund public health initiatives (Cecchetti et al. 2010; Greer 2008), raises issues of natural justice which clash directly with the 'ethics' of property rights. The bottom line here is that in a world of vastly unbalanced life chances due to chronic inequality, it is entirely likely that only those who can afford it will get to live longer – that is, just like today, only MUCH more so.

Another important aspect of demographic change is the rise of massive megacities in the South and the related shift of purchasing power to the 'second tier' cities of emerging market economies, particularly China. Foreign Policy (2006) noted that by 2015 almost all of the 21 global megacities will be in developing countries (Tokyo and Seoul are the only exceptions) and will be wracked by pollution, inadequate services, and crime. Observing these trends and linking urbanisation and age demographics, Magnus (2010) poses the question of whether key developing nations (most notably China) will 'get old before they get rich'.

Significantly, the 'southern' megacities' unfolding development represents a *reversal* of the classical (and functional) labour-intensive countryside/capital-intensive industrial metropolis couplet. We now witness capital-intensive hinterlands and burgeoning deindustrialised cities with shrinking formal economies, with few linkages between the two save for a one-way flow of urban migration. Davis (2007) attributes this urban influx to contemporary 'enclosure' measures aimed to open up formally subsistence acreage for agro-industrial production of specialised crops for export. He explores the linkages between global neoliberalism, the increasing urbanization of world poverty, and the rise of a 'surplus humanity' which is excluded from formal networks of production and exchange, forced to survive by any means necessary in the midst of increasing resource scarcity and environmental degradation.

Significantly, although they capture the imaginations of both optimistic and dystopian observers, it will not be the megacities that drive global economic development in the future. This at least according to a report by McKinsey (2012) which identified the 'second-tier' cities of emerging markets as the primary hubs of economic growth over the next few decades. This report notes that 80% of global GDP growth to 2030 will come from cities, with 600 second-tier cities (mostly in China) to account for 3/4 of all urban growth. By 2025 most middle class consumers will be located in emerging market cities, signaling a permanent shift in focus for the global giants of the B2C industries. Given that the axis of global growth is tilting increasingly to the emerging world, is it not inevitable that an increasing portion of global firms' key corporate functions and activities eventually follow the same pathway? The implications of this shift for the capability profiles of future corporate leaders – and, consequently, executive development programs – are clearly profound.

The final gigatrend, impacting nearly all 'advanced' countries, concerns the fiscal crisis of the state. It is universally acknowledged that the Global Financial Crisis (GFC) wreaked havoc with the accounts of most OECD nations as governments came to the rescue of their banking systems, using public funds to bail out private interests. Yet the dislocations following from the GFC pales in comparison to longer-term financial challenges. In seminal research, Cecchetti et al. (2010) examined the unfunded liabilities in health and welfare of OECD member countries to the year 2040. The results were staggering: under the condition of maintaining current levels of service provision, ALL states would effectively be bankrupted by the impacts of aging populations, shrinking tax bases (as fewer income earners were required to support more retirees), and rising per capita health care costs. The

magnitude of these impacts was far greater than that of the GFC. The primary conclusion of this research was that it would be inevitable that governments would have to renegotiate the 'social compact' with their citizens (possibly unilaterally) wherein which retirement ages increased substantially and state provision for public health and welfare was downscaled dramatically – with the consequent rise of 'user-pays' regimes to replace what had been public goods. Piketty's (2014) recent landmark analysis of contemporary capitalism offers insights which are fully consistent with the trends outlined above.

The pending fiscal 'train wreck' outlined above is even more alarming when we consider how this gigatrend might interact with others (e.g., climate change), almost inevitably in ways which will put increasing strains on public purses. This crisis of the state could easily lead to an institutionalization of a permanent 'state of crisis', which incorporates the enshrining of democracy as a normative ideal while formally embedding anti-democratic 'technocratic' regimes under serially renewing emergency legislation. Such a 'state of exception' situation was observed and theorised in Weimer Germany in the 1920s by Carl Schmitt (Teschke 2011). One could also argue that this is essentially characterises how the key allied powers functioned during the existential crisis of World War 2.

As a bankrupted state withdraws from many sectors of society and renegotiates the 'social compact' with citizens over the manner in which rights and responsibilities are to be allocated, the private corporation will be increasingly called upon to provide for the legal, economic and civil rights of individuals. To some extent this process is already underway. For example, the European Group for Organisation Studies (2009) observed that

> Today, many multinational business firms have started to voluntarily regulate their activities or produce global public goods. As the widespread participation in the UN Global Compact shows, these firms assume political responsibilities that once were regarded as belonging to government. They contribute to public health, education, social security, and the protection of human rights, or engage in self-regulation to fill gaps in legal regulation and to promote societal peace and stability.

Matten and Crane (2005) have explored the empirical conditions under which the corporation might be expected to engage in administering the political, legal and civil rights of citizens. This expanded corporate role is depicted as filling an institutional vacuum resulting from the withdrawal (or complete absence) of the state from significant areas in society. While it seems inevitable that corporations will become more fully involved with the societies in which they operate – whether by inclination or necessity – Fleming and Jones (2012) articulate at length the many dangers that such elevated engagement entails for the future of democracy.

Interactions

We could speculate endlessly on the potential interactions between various gigatrends; such an exercise is practically best conducted from the perspective of a specific organisation, industry or business ecosystem. Here we will briefly discuss two of the most obviously important interactions which will impact a wide spectrum of sectors and industries.

The gigatrends associated with climate, resources and development are, to a greater or lesser extent, interlocking. For example, clearly there is a direct causal connection between the globalisation of capitalism and ever-increasing levels of production, consumption and waste as societies transition from subsistence to consumerist orientations. While the immediate environmental impacts of this economic activity have shifted in recent decades from the North to Asia and parts of the South as Western and Japanese TNCs have restructured their supply chains (Dicken 2011), the aggregate amount of environmental degradation continues to increase with the volume of industrial activity, despite improvements in productivity which allow more outputs from fewer inputs.

The key gigatrend interaction, however, is that between climate change and energy depletion. This interaction is all about carbon in the sense that the burning of carbon-based fossil fuels drives global warming, while the challenges of dealing with the latter require increasingly elaborate and energy intensive technological solutions (most obviously desalination plants), most of which are powered by electricity. Of course the vast majority of electricity is generated by the burning of fossil fuels (primarily coal and natural gas), so the destructive cycle continues.

A challenge for democratic countries going forward will be their structural disadvantage in dealing with the long-term challenges of climate change and energy depletion due to their preoccupation with short electoral cycles and reliance on market forces, both of which tend to discount the future heavily. It may well be, then, that only some form of authoritarian-capitalism (i.e., the Singapore model) has any hope of surviving the twenty-first century *and* dealing effectively with the gigatrends.

For example, the increasing incidence of ‘climate refugees’ may well also drive the institutionalisation of de facto authoritarian-capitalist regimes (justified through narratives based on ‘law and order’, ‘border control’ and the like) throughout most of the democratic-capitalist West over the next few decades as fears of ‘barbarians at the gates’ intensify. Such a development would likely amplify the ‘weaponising’ of urban space noted by Sassen (2006), as police and private security organisations expand to cope with the challenges of internal security and border control in check so that key flows of people, goods and information can continue to interact in a functional manner.

The Gigatrends and Executive Education

Findings from some significant recent leadership research indicate that, compared with the generation that preceded them, future business leaders will require a different general outlook and understanding of the role and purpose of their organisations in society. They will need to employ a range of leadership approaches to deal with a new range of issues. This, in turn, will entail the development of new leadership capabilities.

Following a particularly germane report by Ashridge (2011), we can understand these developmental areas in terms of capabilities to manage *context*, *complexity*, and *connectedness*. According to this research, the global leader of tomorrow needs to understand the changing business *context* – the business risks and opportunities of social, political, cultural and environmental trends. They will need to know how their sector and other actors (regulators, customers, suppliers, investors, NGOs) are responding to events and trends. These leaders will need to be able to factor social and environmental trends into their strategic choices.

The second cluster of knowledge and skills is around the ability to lead in the face of increasing *complexity* and ambiguity. The challenges and opportunities that these issues and trends present are by definition complex – there is often little certainty or agreement both about their precise nature and the response that is required. Leadership in these circumstances requires a range of discrete skills, including the ability to be flexible and responsive to change; the ability to find creative, innovative and original ways of solving problems; the ability to learn from mistakes; and the ability to balance shorter and longer-term considerations. Future leaders will also be required to understand the interdependency of actions and the range of global implications that local level decisions can have, as well as the ethical basis on which business decisions will be made.

The final cluster of knowledge and skills is around *connectedness* – the ability to understand the actors in the wider political landscape and to engage and build effective relationships with new kinds of external partners. For different businesses this can mean regulators, competitors, NGOs and/or local communities. The mindset with which current leaders are groomed does not encourage productive engagement with partners outside the organisation. For example, leaders receive plenty of training in negotiation skills, but on the whole lack the skills for engaging in effective dialogue and partnerships. To survive and thrive, the global leader of tomorrow needs to be able to identify key stakeholders that have an influence on the organisation, understanding at the same time how the organisation impacts on these stakeholders. Senior executives will need to engage in effective dialogue in order to build productive partnerships with internal and external stakeholders.

The previous insights are largely echoed in a report by HayGroup (2011), which argues that the strategic thinking and cognitive skills leaders will need to navigate a gigatrend world are unprecedented. The task is so enormous that it is beyond the power of one single individual to accomplish, making collaboration among a range of different people and perspective essential even at the stage of conceptualising challenges. As well as being multilingual, flexible, internationally mobile and

adaptable, and culturally sensitive, future leaders will also have to be collaborative and good conceptual and contextual thinkers. They will need outstanding cognitive skills to balance the competing demands of financial success, social responsibility and environmental custodianship. Leaders must also act as change agents, advocating environmentally responsible business practice within and outside their organisations, forging new levels of intra-and inter-company collaboration in order to encourage shared solutions.

Clearly, this suggests that executive development programs will accordingly need to evolve their content and structure to foster leaders who are not only technically competent, but also emotionally intelligent, ecosystem conscious, and comfortable making rapid strategic decisions under highly uncertain conditions. Intensive experiential exercises which foster team building under pressurised conditions clearly have a prominent role here. In terms of content, a 'return' to the humanities and social sciences may be in order, supplanting (for more senior executives at least) foundational and genuinely research-based disciplinary knowledge for the more mechanical content typical of business functions (marking, strategy, etc.). A third inclusion would be to incorporate genuine dialogic conversations (Bohm 2004) into program structures in order to promote a mutual understanding of the parameters of reality attached to individuals within each unique executive cohort. This dialogic understanding could then be practically applied by program graduates by treating organisational boundaries within their relevant ecosystems as highly permeable, thus enabling effective communication between ecosystem members to promote understanding, learning, and, ultimately, genuine sustainability.

Discussion Questions

1. How do the concepts of organisational *agility* and *resilience* relate to the global gigatrends?
2. What are some outstanding examples of companies which are *already* acting in ways which exploit some of the business opportunities created by the gigatrends?
3. Identify some companies and sectors which seem *most vulnerable* to the unfolding gigatrends.
4. Discuss the *potential contradictions* between short-term pressures from the financial markets and the type of long-term resource commitments necessary for organisations to position themselves advantageously with respect to the gigatrends.
5. Based on your understanding of the gigatrends and their interactions, create an *investment portfolio* for a hypothetical 30-year trust fund.

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29 Unilever's Super Stretch Goal for 2020

Aileen M. Ionescu-Somers and Jacqueline Brassey

1 **February** 2011: Let's zoom in on a cold, crisp, blue-skied day in central London, to an impressive neoclassical art-deco style office building overlooking the Thames: Unilever House. Appearances are deceptive. Proceeding through the doors, flanked by heavy ionic pillars, visitors and employees enter a thoroughly modern glass-fitted atrium that allows light and color to pervade the building on multiple stories. The building symbolizes the evolution of the historically patriarchal soap-making company, Lever Brothers, into Unilever in 1930, around which time Unilever House was built as the UK base of this Anglo-Dutch fast-moving consumer goods giant. In this millennium, the company has carefully honed a new and shiny modern image in tune with successes and challenges of the twenty-first century.

A conversation in a top-floor office also reflected new realities. Paul Polman, CEO of Unilever since 2009, was briefing Douglas (Doug) Baillie on his first day as Unilever's new chief human resources officer (CHRO). In November 2010 the company had set out the Unilever Sustainable Living Plan (the USLP), committing to a 10-year journey toward sustainable growth as the organization's core strategy. This meant doubling its growth to €80 billion while greatly reducing its negative environmental and social impacts.

Baillie was not new to Unilever, a company in an industry that stood out for the career longevity of senior executives within firms. A marketing and sales executive by training, he had been with the company for 35 years, in multiple posts, including managing transformational change in post-apartheid South Africa. Polman looked keenly at Baillie:

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© Springer Science+Business Media B.V. 2019
G. G. Lenssen, N. C. Smith (eds.), *Managing Sustainable Business*,
https://doi.org/10.1007/978-94-024-1144-7_29

Here's the thing, Doug. For me the talent and leadership agenda is a key component for the USLP's strategic success. Question is: Can HR be ahead of the business, laying the road before we arrive on our growth trajectory…or will it be – as HR departments are prone to be – behind it, filling in the cracks? To be successful, we need to be "ahead of the posse" at every level. HR's role is crucial. That is our – and your – challenge.

Polman: Aiming to Buck the Mega-trends

On 1 January 2009, Paul Polman succeeded Patrick Cescau as CEO of Unilever. Polman was hired "from the outside," a somewhat unusual move in a company better known for promoting its own executives to senior positions from the inside. Polman had previously worked as chief financial officer and executive vice president for the Americas at Nestlé and had also held positions at Procter & Gamble and other companies.

Polman was a man with a mission. He had strong beliefs about the role of business in a resource-restricted world pervaded with social inequity. He had deeply reflected on global megatrends and their implications for business as well as for the planet and humanity. Having worked in industries dependent on natural resources and social equity for growth, he had witnessed a marked shift from abundance to increased scarcity in the course of his career.

He knew the world's population would reach a landmark seven billion by 2011, and over two billion more people would inhabit the planet by 2050. This was both a risk and an opportunity for Unilever. The growth and aging of world populations had increased the strain on natural resources and social welfare systems. Polman had long realized that this had implications for driving future growth and improvements to quality of life upon which his company had built its business model. People had become more mobile, which fueled urbanization. Some 70 % of people were expected to live in urban areas by 2050, which meant that they would be increasingly dependent on companies like Unilever for their food and personal care products. However, these shifts – particularly in emerging and developing economies such as China and India – were increasing the demand for water, food, minerals, metal, agricultural land and energy. This also meant an increasing waste problem, deforestation, soil degradation through inefficient agricultural methods and linked threats to habitats and biodiversity worldwide.[1]

From an economic standpoint, Polman was convinced that political and economic systems were failing and that capitalism needed to be reframed for the common good. His view was that too many companies had prospered at the expense of society and nature, and that companies had a business imperative to be successful while giving back to society and supporting ecosystems and biodiversity. He felt that the writing was on the wall for what he called a "new kind of capitalism". Whilst he supported management incentives that encouraged a longer-term focus, a broader form of stakeholder driven capitalism, and stronger and better-informed

[1] http://www.youtube.com/watch?v=S0yQ4pmlPCk

boards of directors, he also believed that these shifts alone would not be sufficient for transformational change:

> Changes in policy will mean little if not accompanied by changes in behavior. That's why we need a different approach to business – a new model led by a generation of leaders with the mind-set and the courage to tackle the challenges of the future.[2]

Polman also felt that companies failing to respond to the obvious social and environmental challenges of the modern era risked going out of business. He spoke eloquently about what he termed a VUCA[3] world, one that had become more Volatile, Uncertain, Complex and Ambiguous:

> We have increasing income disparity within the developed world. We have a political system that barely functions after the economic and financial crisis. So continuing the way we are going is simply not a solution. Increasingly consumers are asking for a different way of doing business and building society for the long term together.[4]

"Full Steam Ahead!"

Following the maxim "start as you mean to go on," Polman took some controversial first steps as Unilever's CEO. Exasperated by the short-term perspective dictated by what he termed "Wall Street," in 2009 he abolished earnings guidance and quarterly reporting for investors, and was vocal about the fact that short-term oriented hedge funds, for example, were not the company's most welcome investors. These were ambitious moves that created shock waves in the global press at a time when the banking and finance industry was under increasing scrutiny because of multiple scandals and scams.

Then, in 2010, he launched an ambitious plan to double revenue to €80 billion while halving the company's environmental footprint and increasing positive social impacts considerably over the same period. This was not the first time that Unilever had set itself an ambitious objective. In 1997, in partnership with the conservation organization WWF, Unilever had created the Marine Stewardship Council (MSC) and committed to source 100 % of its fish from sustainable, certified fisheries by 2005. In fact, by 2005 it had reached only 70 % of the overall goal. However, it had been a bold and effective move, which set the MSC on a trajectory that would see some of the world's biggest retailers, such as Walmart, agree to include MSC products in their product mixes. Unilever later sold its fish business but the

[2] http://www.mckinsey.com/features/capitalism/paul_polman

[3] The concept of a VUCA world – one that is volatile, uncertain, complex, and ambiguous – was introduced by the US military as the Cold War ended and as the United States looked out over the emergence of a multilateral, rather than a bilateral, global landscape. The VUCA concept gained currency in the private sector with the onset of the financial crisis in 2008/09, when companies and organizations all over the world suddenly found themselves faced with turbulence in their business environments and, subsequently, in their business models.

[4] http://www.theguardian.com/sustainable-business/unilever-ceo-paul-polman-interview

company-specific goal that it had achieved went way beyond what any other company had ever done. Even then, executives at the company felt that setting the stretch goals had been a highly effective way of accelerating innovation and aggressive target setting within the organization.

At the Helm of a New Strategy: The Unilever Compass

Like any new CEO, Polman wanted to define a fresh vision and purpose for the company, a vision that would act as a beacon to the strategy. He was determined that ongoing pressures – economic, social and environmental – would frame the approach to Unilever's core business strategy and model. The Unilever Compass (see text box below) was born. It was a concise summary that set the course to lead Unilever closer to a long-term visionary business perspective. It outlined an ambitious vision and purpose and defined four so called "winning with" pillars that would leverage profitable volume growth, stimulate innovation and create efficiencies.[5] They were: (1) winning with brands and innovation; (2) winning in the market place; (3) winning through continuous improvement; and, finally, (4) winning with people (Fig. 29.1).

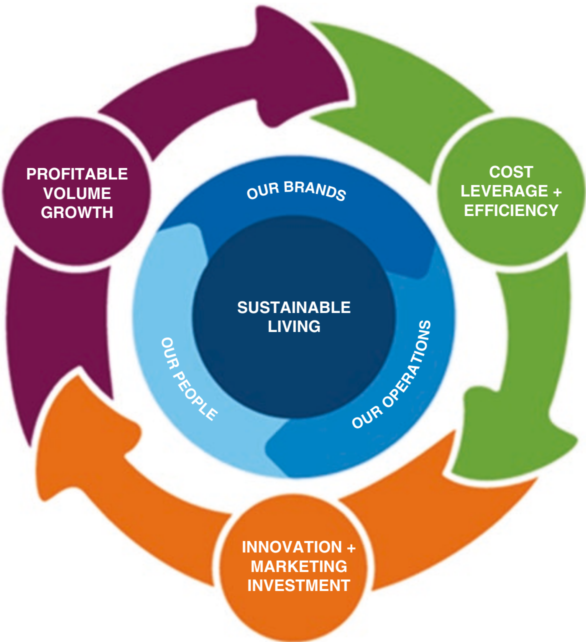


Fig. 29.1 The Unilever compass: developing a business model behind the strategy

[5] http://www.unilever.com/sustainable-living/ourapproach/ourcompassstrategy/

Our brands: Strong brands and innovation are central to our ambition to double in size. We are investing in brand equity, finding and strengthening the connections between consumers and the products they buy. Where equity is strong, we are leveraging it – creating efficiencies by focusing on fewer, bigger projects that enhance margins. And we are seeking superior products which consumers will prefer, driving profitable growth.

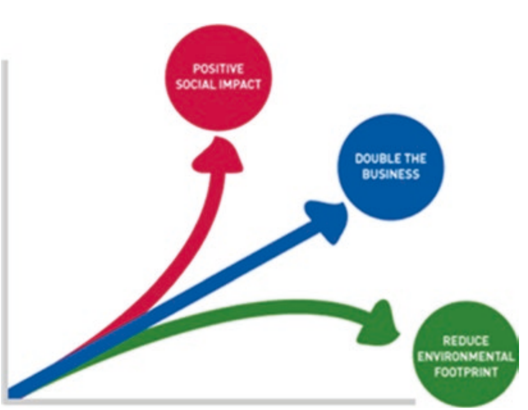
Our operations: On any given day two billion consumers use our products and we want to reach many more, by developing innovative products that address different consumer needs at different price points. To do this we use our global scale to help deliver sustainable, profitable growth by seeking to add value at every step in the value chain by enhancing product quality and customer service, and rolling out innovations faster across all markets.

Our people: Sustainable, profitable growth can only be achieved with the right people working in an organization that is fit to win, with a culture in which performance is aligned with values. We are increasingly an agile and diverse business with people motivated by doing good while doing well. We are building capability and leadership among our people and attracting some of the best talent in the market place.

Sustainable living: For us, sustainable, equitable growth is the only acceptable business model. Business needs to be a regenerative force in the system that gives it life. For example, by reducing waste, we create efficiencies and reduce costs, helping to improve margins while reducing risk. Meanwhile, looking at more sustainable ways of developing products, sourcing and manufacturing opens up opportunities for innovation while improving the livelihoods of our suppliers.

The Unilever Sustainable Living Plan (USLP)

Now, what Unilever needed was the development of a robust business model to back up the pillars. In November 2010, the company set out its Unilever Sustainable Living Plan (the USLP), committing to a 10-year journey toward sustainable growth by doubling growth, halving its environmental footprint and increasing positive social impacts significantly (Fig. 29.2).



The Unilever Sustainable Living Plan (USLP)

The USLP will result in three significant outcomes.

1. We will help more than a billion people take action to improve their health and well-being.

2. We will decouple our growth from our environmental impact, achieving absolute reductions across the product lifecycle. Our goal is to halve the environmental footprint of the making and use of our products.

3. We will enhance the livelihoods of hundreds of thousands of people in our supply chain.

Fig. 29.2 The Unilever Sustainable Living Plan (USLP) objectives

The strategic approach reached across the entire Unilever value chain. The company proposed taking responsibility not just for its own direct operations but for its suppliers, distributors and – crucially – for how its consumers were using its brands.[6]

The ambitious goals sent shock waves throughout the company, and the strategy attracted considerable interest from corporate stakeholders such as NGOs and sustainability "think tanks" which had recently struggled to convince companies to move beyond the "low-hanging fruits" with their sustainability strategies. What's more, Paul Polman set off on a highly public campaign to advertise these goals. Convinced that to achieve them, others would have to come on board, he embarked on a virtual "crusade" to persuade governments, NGOs and other stakeholders to help get policy instruments implemented to enable progress.

A Navigation Challenge for the Chief Sustainability Officer

Gavin Neath, the CSO who had accompanied Unilever on many ambitious sustainability journeys, retired from Unilever in 2010. Gail Klintworth was recruited as his successor. Klintworth was a South African with over 25 years of experience with varied challenges in human resources, sales and marketing, across Unilever's Foods, Home Care and Personal Care businesses. She had a no-nonsense business head and had achieved success as CEO of Unilever South Africa from 2007 to 2010, a time of great social change in the country. Commenting on why she was selected to steer this new challenge, Klintworth said:

> *At the end of the day, this is a change management challenge. I had already led large-scale change within Unilever, plus I had a huge personal passion as well as a strong strategic*

[6] http://www.youtube.com/watch?v=d8gMdGLTqPY

belief that this is a future we have to embrace. It was about the right time. The challenge was now to embed sustainability into the core of the business.

She went on to explain where this passion came from:

I grew up in South Africa, during apartheid, and finished university as a strong believer that things needed to be different. I played an active role in promoting the move to a different society. After 1995 I took on Business Leadership South Africa, a joint private/public partnership addressing some of the key issues that we needed to tackle to make the transition from apartheid, autocratic society to more social equity. If you look at where we are today against where it could have been, we have achieved a lot. I crafted the business to address environmental issues and meet social needs since you simply have to make that part of the business in South Africa. I was fortunate that I grew up in this space.

Klintworth knew that the strategy had to be integrated throughout the company:

I know that there are crucial units to bring on board with the strategy. However, the role of the HR unit in driving such an ambitious change program is critical and is often what has been missed in terms of driving through sustainable business issues. Because of this, we miss opportunities related to people/human rights and change of behaviors and mindsets. We need to bring that more on board now!

Overhauling the Engines: The HR Mega-challenge

After leaving Polman's office on that cold February day in 2011, Baillie remarked to a senior colleague back at his own office:

To ensure that HR is ahead of Unilever's growth ambition, there are three things that will keep me awake at night: First, where am I going to find, grow, develop and keep the right talent, in the right place, at the right time, to build a new Unilever? Second, linked to that, as I look at the next 5 to 10 years, what will leaders of Unilever look like in 2020? What are the unique skills required to operate effectively in a VUCA world? What are the unique competencies that are going to help executives a) manage that world and b) get competitive advantage for Unilever within it? Third, how do I help evolve a performance culture that truly drives inclusion, with the richness of full diversity in our business, to allow our leaders to contribute fully to this new and integrated sustainable business agenda? That is our opportunity, and my challenge.

Case Analysis: What Shifts Culture in Corporate Organizations?

There are a number of factors that shift cultures in organizations. One lever is leadership engagement; those who have engaged and are advocates at the leadership level can drive the change and embed it as a way of thinking and operating.

However, Unilever as an organization needed to explore the value systems and characteristics of corporate culture to be put in place and/or reinforced to induce leaders and managers to change and facilitate its USLP strategy implementation and alignment. Baillie and his senior colleagues needed to get to the bottom of how

Unilever could promote and enhance the optimum corporate culture and value systems for USLP strategy alignment. Baillie himself, as senior HR officer, needed to unlock the key to a new role for the human resources function, in recruitment/selection, policy-making, training and in developing reward/recognition systems that reinforce culture and value systems that best promote success with the USLP.

New Expectations from Senior Human Resources Officers

C- Suite roles can and should evolve over time in corporate organizations. Polman's conversation with Baillie was indicative of evolving new leadership expectations of Chief Human Resources Officer (CHRO) in the VUCA world. It is increasingly clear that CHROs will need more general management skills with broader business perspectives than human resources management itself. The role will most probably evolve towards more of a strategic leadership mindset. The reason for this is that talent management, in a complex business context, in a complex world, will become an instrument for business transformation. Optimally in the future, the CHRO will be the "chief change officer" for his or her organization.

For organizations that are advanced with their sustainability strategies – such as Unilever – a CHRO could in the future replace many of the previous expectations of a Chief Sustainability Officer (CSO). For example, HR can take a lead role in the development of a culture to support delivery of any ambitious embedded sustainability driven strategy such as the USLP. Currently, few HR departments are set up to take on this challenge.

Any HR department can draw on various tools to diversify its approaches and "hardwire" its involvement and perceived support in strategy delivery. First, they can draw on defined principles (corporate values/principles) and frameworks that executives can apply in real day-to-day life. Second, they can bring HR insight to the types of skills and competencies that are needed to succeed in delivering sustainability objectives. Third, they can focus on defining the recruitment and induction or training requirements to bring the right people on board. Fourth they can play a significant role in developing ways of measuring performance more holistically against broader strategic expectations and – in a closed loop system – ensuring that such new criteria are incorporated in the selection of leaders for promotion.

Paradoxically, many HR departments do not actually perceive that they have the potential to play such an important strategic role. The result is that – instead - they actually become a "drag" on the strategy, rather than promoting it and building organizational capability to tackle the challenges head on. This mistaken perception is a substantial barrier to change, as is the fact that HR departments are not necessarily equipped to take on these new tasks. Some large and global organizations have skeletal teams that do not correspond to the immensity of the challenges of shifting organizations to entirely new cultures and value systems and to new ways and means of achieving objectives. Organizations have usually not have even thought about how to empower their CHRO and HR department to bring expected changes. And yet, whilst business unit leaders and ambassadors for the strategy

throughout the corporation are catalyzers for action throughout organizations, the HR department's role is as a crucial enabler.

Getting the Requisite Managerial Profiles on Board

Perhaps because of its historical evolution as a company, Unilever arguably had a head start in terms of getting the right values in place to make the USLP a success. Sustainability leadership had been a part of its "corporate DNA" for a very long time. The long history of sustainability leadership and the existence of this corporate DNA made Unilever one of the few companies capable of making sustainability leadership an integrated part of the way it did business and be the market leader in realizing the challenging goals it had set itself related to the triple bottom – line.

But many companies do not have that advantage. The short term pressure that companies are put under clashes with the longer term perspectives and goals required for being successful with strategies such as the USLP. And even at Unilever, there can be expectations gaps. By this we mean that there may be a general internal nervousness about the fact that the external world has high expectations and that these expectations might not be easily met internally. Although a light tension between what is communicated and where a company is internally is healthy and will challenge the company in the right direction – it is important to ensure that the gap between expectations and realizations does not become too wide.

Given its history, it is easy to take for granted even at Unilever that an implicit set of values will convert into corporate action around the USLP. Whilst the "implicit" corporate DNA/culture may be very well understood by long-standing members of staff, it still very definitely needs to be made much more "explicit" for all, but most especially for new leaders coming on board. Changes in the business leading to more throughput of senior managers may produce a shift in the corporate culture that might eventually filter towards a stepping away from the company's traditional values. To hardwire the corporate culture that will help achieve long term sustainability objectives, more explicitness will allow new leaders to unlock the corporate code for sustainability leadership more quickly. Also – interestingly – this will help to impede a potentially divisive "them" (longer term executives) vs "us" (new generation managers) culture from emerging.

Moreover, regional differences highlight the fact that in many areas a 'one-size-fits-all' approach is not relevant. Explicit regional differences at Unilever, for example, relate to (a) talent availability and quality; (b) governmental involvement and regulations; (c) skills and competencies maturity; and (d) market maturity related to sustainability questions.

Globally Relevant Opportunities for Change

In considering the key opportunities for change when implementing an ambitious sustainability strategy, five areas currently need most attention. Two of these relate more to the 'hardware' of the organization; two to the software and one opportunity is right at the heart of both, as summarized in the model below (Fig. 29.3):

Software: Top Leadership Alignment
By aligning top leadership on the organization's sustainability strategy, it becomes possible for "leading by example" in a consistent way to take hold. This is a fundamental requirement for the success of the strategy. Many managers hear ambitious claims in speeches from "the top", but never in their day to day discussions with their direct reports where they are focusing on other topics; so called "regular" topics such as meeting bottom line objectives and optimizing prices and so on. A good understanding of the "dis-connects" that exist within the organization on these issues will be necessary in order to address and close them, and to establish more cohesive leadership.

Software: Winning Hearts and Minds
Winning hearts and minds of executives within all managerial layers and all functional areas is increasingly not a "given". There can be regional differences that impede this from happening. Interestingly, senior executives at Unilever found that talented managers from China or South Africa have either grown up with or been exposed early in their careers to severe impacts of social and environmental issues and are thus more likely to have (a) higher awareness than European or US managers of their economic business relevance and (b) a greater passion and understanding of the roadmap to implementing a strategic vision that addresses these very issues.

To counter this, Unilever is increasingly looking at introducing experiential learning programs. In fact, experiential learning will in future be an essential part of training sustainability leaders, especially where those leaders have no explicit experience on the ground of sustainability issues and impacts. Developing differentiated

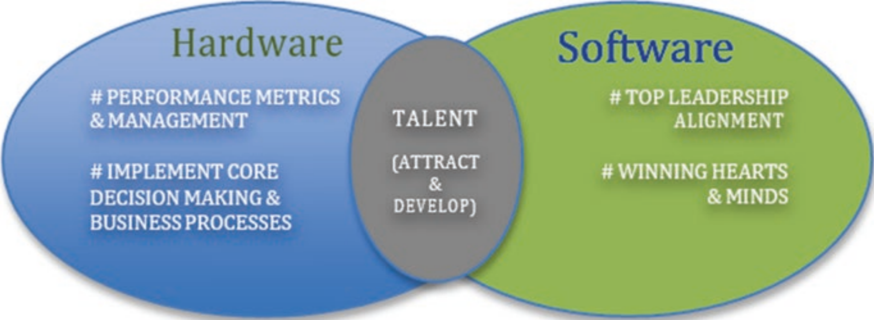


Fig. 29.3 Key opportunities for change to leverage the USLP

leadership training to respond to regional differences will also be required. To win all "hearts and minds", the senior leadership team will always be important role models. Consistent communication, creation of sustainability "champions" or "ambassadors" and best practice/success story sharing are also essential elements for success.

Attracting and Developing (Top) Talent

Many younger future executives aspire to having loftier purposes in their careers than spending their time meeting shareholder value expectations. Those that make up Generations X, Y, and increasingly Z will want to make a positive difference in the world. Whilst these generations are increasingly aware of existing risks in areas such as energy, food, health, water, and climate security, they are more likely than the current generations of mid- to senior level executives to tackle those risks by converting them to opportunities, applying entrepreneurship, achieving positive impact and setting up collaborations.

Attracting and retaining these types of people has a two-fold requirement. Firstly it is about understanding and describing explicitly the right profiles for top talent of the future. This needs to happen, not only on an organization-wide basis, but on a function-specific basis – i.e. what does the profile of the marketing leader of the future look like? Then, the organization needs to set about attracting and developing key players for every part of the business. Next, it is about clarifying the necessary skills and competency frameworks that will be needed to deliver the strategy. Subsequently and naturally, it will then mean developing all employees in line with these skills and competency profiles. As one Unilever senior executive put it:

> *Where do I find the leaders and how can I develop them to be ideal leaders for Unilever in 2020? Where do I find the right people to strive in a world that has nothing to do today with what it will be tomorrow? That is one of my challenges.*

Royal DSM, for example, has instigated a new way of engaging its younger employees by launching DSM Next which now has regional hubs around the world. DSM Next is a global network of more than a thousand young professionals that advances professional development, the creation of a unique "one DSM culture agenda" and sustainability. Through the hubs, young professionals are connected, learn about and from each other, and can implement innovation projects that are related to sustainability and other value-adding themes. We do that by organizing social and business related activities through our local hubs. We connect early career professionals inside and outside DSM to learn about DSM and about each other. We provide a platform to contribute the brainpower of our members to DSM, by allowing them to act on their ideas and to start a project, for example in the areas of sustainability or innovation.

Hardware: Performance Metrics and Management

To be successful within the firm, sustainability must be perceived as an enabler of future growth and profitability. So for Unilever, it is important to ask two questions. How does the company define good sustainability performance in terms of business results? What is the quality of these results and do they align with the purpose and values?

Getting performance metrics in place so as to integrate core themes of a strategy within performance management systems so that they are driven forward is a crucial part of the due diligence when it comes to embedding sustainability strategy. This holds managers accountable for their actions and allows progress to be monitored and evaluated properly. If this is ignored – as all too often it is – then cascading a strategy throughout the organization is unlikely to be effective, and approaches will remain slow and fragmented, and essentially non-strategic. It is also important that internal communications ensure that there are no ambiguities, uncertainties or lack of clarity about the systems in place. As senior leaders in Unilever pointed out:

We need all parts of the organization – including crucial units such as marketing, to have sustainability in their targets, against which managers are rewarded. And that's where HR will have an important persuading role. Reward is an important driver of growth. Non-financial metrics related to brands, customer satisfaction and so on must also be considered. We need to find the right ones that are meaningful across the organizations.

Hardware: Implementation in Decision: Making and Core Business Processes
Alignment between strategic intent and decision-making as well as core business processes will also support behavior and mindset change. Most companies are not at all clear on how this can be done. There are standardized business processes in most organizations that deserve a strategic "revisit" in order to align these processes with strategic purpose. At Unilever also, there is broad agreement that longer-term sustainability considerations need to be more embedded into decision-making processes through core internal systems. Interestingly, some executives saw it taking up to 7 years for this embedding to properly take hold within the company; they saw it as that big a challenge. For example, marketers have an important role to play in the strategic decision-making process for longer term considerations and yet it is difficult to get them on board mainly because of hardwired business behaviors and ways and means of attaining traditional objectives that have been honed and rewarded handsomely over many generations.

Attracting and Developing (Top) Talent
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Overall, organizations need to challenge the human resources community on what their role is in trying to embed a purpose. In trying to embed strategic purpose when built around a sustainability driven vision and objectives, we will find in the future that human resources will be an important enabler with a crucial leadership mandate to ensure that culture and values align with the organizational strategy. After all, when culture and strategy collide, there is only one winner every time, and that is culture.

30 The Ongoing Dynamics of Integrating Sustainability into Business Practice: The Case of Novo Nordisk A/S

Mette Morsing, Dennis Oswald, and Susanne Stormer

Prologue

The data for this case study was collected in 2005. Today, 10 years later in 2015, some of the content of the systems (for example the KPIs) and the persons (for example Eric Drapé) have changed. But the tools and the challenges to integrating sustainability in Novo Nordisk remain. Instead of re-writing the case from 2005, we decided to produce an epilogue that provides the reader with an update on some of the important areas that have influenced the way that Novo Nordisk works. We hope that the epilogue anno 2015 will further stimulate discussions in the class room – and beyond – about integration of sustainability into the organization and how such integration is never a "quick fix" that is done once-and-for-all, but an ongoing and dynamic process that needs careful managerial attention and development over time.

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© Springer Science+Business Media B.V. 2019
G. G. Lenssen, N. C. Smith (eds.), *Managing Sustainable Business*,
https://doi.org/10.1007/978-94-024-1144-7_30

Introduction

> *We all have a vision of how we'd like the world to be. For a company like Novo Nordisk committed to sustainable development, that vision is one of trust, openness, shared values and partnerships. We translate that as the Triple Bottom Line – social and environmental responsibility and economic viability. In an age where companies are scrutinised and transparency is the only way to gain trust, social responsibility is vital to maintain a business advantage.* CEO Lars Rebien Sørensen, Novo Nordisk.[1]

Novo Nordisk is an excellent example of an organisation that attempts to consider sustainability as an integrated part of its strategy and in all of its business decisions. To meet this goal, the company has adopted a management philosophy which they call the 'Novo Nordisk Way of Management' to ensure all actions taken by employees meet corporate objectives. Within this management tool are three pillars that are used as control mechanisms to integrate sustainability into Novo Nordisk's business practices: facilitators, sustainability report, and the balanced scorecard. However, it is not certain to what extent each of these pillars is effective in influencing behaviour at the operational level.

Novo Nordisk defines sustainable development as being about preserving the planet while improving the quality of life for its current and future inhabitants. From a business perspective this involves the inclusion of economic, social and environmental considerations in the business strategy. During the 1990s many companies experienced an enormous pressure from critical stakeholders, governments, media, NGOs, and international organisations to demonstrate that they had adopted sustainable business practices.

> The days when Aristotle Onassis could tuck his whalers out of sight behind convenient icebergs are almost gone. New technologies and open borders render most forms of economic, environmental, and social abuse increasingly visible. Indeed, far from being drowned in a floodtide of useless information, many of the world's citizens – thanks in large part to the public interest groups a number of them support – are becoming increasingly adept at keeping track of the activities of corporations and governments.[2]

The concept of 'sustainability' is often traced back to the World Commission on Environment and Development (the Brundtland Commission) report which coined the following definition: "Sustainable Development is development that meets the needs of the present without compromising the ability of future generations to meet their own needs".[3] As the number of organisations that claim to adhere to sustainable business practices increases, so does the number of pieces of information that is prepared and disseminated about these practices. In a recent publication, the ACCA (Association of Chartered Certified Accountants) and CorporateRegistar.com reported that in 1993 there were fewer than 100 cases of corporate non-financial

[1] Novo Nordisk, "Take Action. Make the Triple Bottom Line Your Business", May, 2003, p. 2.

[2] Elkington, J. "Cannibals With Forks. The Triple Bottom Line of 21st Century Business", Oxford: Capstone Publishing Ltd., 1999, p. 161.

[3] World Commission on Environment and Development, Our Common Future, 1987.

reporting worldwide, but by 2003 there were over 1500 reports produced worldwide on an annual basis.[4] As these practices have become more common amongst corporations, there has been criticism as to whether these same firms are purely 'window dressing', with no ambitions to embed sustainability in their business practices. A survey on corporate social responsibility in *The Economist* stated:

> Under pressure, big multinationals ask their critics to judge them by CSR criteria, and then, as the critics charge, mostly fail to follow through. Their efforts may be enough to convince the public that what they see is pretty, and in many cases this may be all they ever intended to achieve. But by and large CSR is at best a gloss on capitalism, not the deep systematic reform that its champions deem desirable.[5]

This case raises the question of how managers can adopt appropriate management control systems to communicate to employees and other stakeholders what behaviour is desired, and to ensure that their corporate sustainability claims are implemented at the operational level. That is, how can organisations demonstrate that their sustainability declarations are not just "good looks". Specifically, this case unfolds Novo Nordisk's long-term commitment to sustainable business practices and the company's validations of these practices by focusing on how issues of sustainability have been integrated and cascaded throughout the entire organisation via the company's 'Way of Management'. The Novo Nordisk business unit – Diabetes Finished Products – is used an example.

Introduction to Novo Nordisk A/S

Novo Nordisk A/S was founded by August Krogh in the 1922, a Danish Nobel laureate in physiology. He was inspired by two Canadian researchers, Frederick Banting and Charles Best, who had begun extracting insulin from the pancreas of cows in the previous year. August Krogh's wife, Marie, had type 2 diabetes; therefore, he established Nordisk Insulinlaboratorium to produce insulin for the treatment of diabetes. In 1925 two former employees, Harald and Thorvald Pedersen, established a competing insulin company, Novo Terapeutisk Laboratorium. In 1989, the two companies merged and became Novo Nordisk A/S.

By 2005, Novo Nordisk was a world leader in diabetes care; the company also held a leading position in hemostasis management, growth hormone therapy and hormone replacement therapy. Novo Nordisk previously was involved in the production of enzymes. However, a demerger in 2000 saw the establishment of Novozymes, which took over the enzymes production, leaving Novo Nordisk to focus entirely on healthcare. Novo Nordisk headquarters is located in Denmark, on

[4] ACCA and CorporateRegister.com, "Towards transparency: progress on global sustainability reporting 2004", p. 8.

[5] Crook, C., "A survey of corporate social responsibility", *The Economist*, January 22nd, 2005, p. 2.

the outskirts of Copenhagen, and employed in 2005 approximately 20,000 employees in 78 countries. Novo Nordisk marketed its products in 179 countries.

Appendix 1 provides Novo Nordisk's organisational structure anno 2005. From 2002 Corporate Stakeholder Relations became part of the executive management team along with R&D, Quality, Regulatory & Business Development, Finance and Operations.

Novo Nordisk is a company based on research. Research and development expenditures equalled 43.2% of the total wage costs in 2004 and have been in the range of 15.0–16.6% of total turnover over the period 2000–2004. During this same period, Novo Nordisk had between 526 and 778 active patent families, with between 85 and 145 new patent families per year.[6]

Financially, Novo Nordisk has performed well, with strong growth in turnover combined with continued high profitability; the market value of the Novo Nordisk has followed the booming American pharmaceutical sector and it outperformed the European pharmaceutical index. In 2004, Novo Nordisk reported an operating profit of 6980 million Danish kroner (DKK), turnover of DKK 29,031 million and a diluted earnings per share of DKK 14.83. Additionally, Novo Nordisk reported a return on invested capital of 21% in 2004. Over the period May 1, 2004 to April 30, 2005 Novo Nordisk had a negative share return of 1.55%; however, over the last 5 years (May 1, 2000 to April 30, 2005) Novo Nordisk's share return equalled 44.17%.[7] Appendix 2 provides key financial data for the last 5 years, and return data for Novo Nordisk, the Danish market, and other large European pharmaceutical companies over the same period.

The share ownership of Novo Nordisk is developed to ensure that the organisation has a high degree of freedom, as it is not open for takeovers, for example, from larger pharmaceutical companies. Specifically, total share capital is divided into A-shares and B-shares (each B-share carries 1/10 of the votes of an A-share). The A-shares are non-listed and held by Novo A/S (which is a private limited Danish company that is 100% owned by the Novo Nordisk Foundation which was established with the merger in 1989). The B-shares are publicly traded on the Copenhagen, London and New York stock exchanges. As reported in the 2004 Annual Report, Novo A/S controls 26.1% of the B-shares, giving it 70.6% of the total number of votes. Large block-holdings of the remaining B-shares included in 2005 large institutional investors like the Danish ATP Pension Fund (4.3%), The Capital Group Companies (10%), and Fidelity Investments (4.4%). Additionally, the company itself held 6.4% of the shares. 'Other' investors held the remaining 48.8%, which included employees.[8] Novo Nordisk's board of directors consisted of ten members: seven elected by the shareholders and three by the employees.[9] Novo Nordisk's six executive directors as

[6] Novo Nordisk A/S, Annual Report 2004, pp. 49, 60 and 98.

[7] Sources: Novo Nordisk A/S, Annual Report 2004, p. 38 and Thompson Financial Datastream.

[8] Novo Nordisk A/S, Annual Report 2004, p. 108.

[9] For more than 30 years it has been mandatory to have employees represented at the board of directors in Danish companies, see for example: Rose, C., "Medarbejderrepræsentation i danske bestyrelser". Center for Kreditret- og Kapitalmarkedsret, Copenhagen Business School Press, 2004, p. 21–32.

well as the directors of the Novo Nordisk Foundation were not represented in the Novo Nordisk board, which was in accordance with the general guidelines of corporate governance at the Copenhagen, London and New York stock exchanges. It was increasingly important issue to demonstrate that Novo Nordisk was doing business according to these guidelines. However, in 2000, the former CEO, Mads Øvlisen, assumed the role as chairman of the Board of Novo Nordisk..

Sustainability as Part of Novo Nordisk's Business Strategy

Novo Nordisk has worked strategically with environmental and social responsibility since the beginning of 1990es, and in 2005 sustainability was an integrated part of the business strategy. Engagement in stakeholder dialogue and corporate social responsibility was extremely important to Novo Nordisk, and CEO of the company, Lars Rebien Sørensen, believed trust to be imperative:

> Public authorities and NGOs have sharpened their tone, and we must take them seriously", stated President and CEO of Novo Nordisk, Lars Rebien Sørensen. "It is important to be open and honest about our stand and our actions. Trust has to be earned[10]

Executive management at Novo Nordisk had made corporate values and sustainability an integrated part of the company's corporate brand. Mads Øvlisen, Novo Nordisk's chairman until 2006, often expressed strong views in the business press, and on a number of occasions on the front pages, on issues of sustainability. Many Danish business managers considered him the embodiment of corporate sustainability.[11] He has participated in a number of government and business initiatives in this area, as well as contributing to the foundation of the European Academy of Business in Society and he is Senior Advisor to the Un Global Compact. He is also an adjunct professor of corporate social responsibility at Copenhagen Business School.

Novo Nordisk's annual financial report of 2003 demarcated top management's dedication to sustainability, as it carries the same title as the sustainability report 2003: "What does being there mean to you?" In the welcome letter the CEO, Lars Rebien Sørensen and the chairman, Mads Øvlisen, explained why stakeholders matter to core business:

> Whom do corporations serve? Not so many years ago, we would have said 'shareholders', without hesitation. But increasingly business enterprises are recognising commitments to serve other stakeholders – such as customers, employees, societies at large – in addition to

[10] Novo Nordisk A/S, Annual Report 2004, p. 18.

[11] For example: "This is Mads Øvlisen, the former CEO of Novo Nordisk and one of the most admired individuals in Danish business. As he retired in 2000 after 19 years as chief executive officer in Novo Nordisk, he had increased the number of employees from 4.000 to 15.000. He has won prizes for his management style of trustworthiness, and he has made Novo Nordisk synonymous with corporate social responsibility. But he has remained the approachable Mads with tucked-up sleeves. Øvlisen is a success, a living legend, a walking lump of gold", Euroman, March 2005, p. 46.

> shareholders. In order to serve the long term interest of stakeholders, companies must regards it as core part of their business to assume a wider responsibility and consider broadly the wide range of factors which may impact its ability to generate returns over long periods of time[12]

The conspicuous commitment to sustainability was reinforced in the 2004 annual report, which was the company's first integrated triple bottom line report combining economic, environmental and social results. In the opening, the commitment was stated clearly collectively by Lars Rebien Sørensen and Mads Øvlisen on page 1 of the 2004 Annual Report:

> Novo Nordisk takes a multi-pronged approach to providing better access to health through capacity building, a preferential pricing policy for the poorest nations and funding through the World Diabetes Foundation, which is now reaching out to many millions of people with diabetes. In terms of sustainability, Novo Nordisk demonstrates its determination to play a leading role by setting a target for an absolute reduction of CO_2 emissions over the next decade. When people can overcome the challenges of diabetes, we must as a company tackle the global challenges of social and sustainable stewardship.

In 2002, the inclusion of Stakeholder Relations as part of the executive management team demarcated a strengthening of Novo Nordisk's sustainability focus. In 2004, the Stakeholder Relations area was expanded and Lise Kingo (Executive Vice President) became responsible for corporate communications, human resources and occupational health service in what was in 2005 referred to as "People, reputation and relations" with approximately 200 employees working in this group. Ms. Kingo believed that her group was responsible for the two most important assets in Novo Nordisk: the people and the brand. This department was responsible for driving, challenging and monitoring Triple Bottom Line strategies and helping the business units to implement new activities in relation to sustainability by[13]:

- Monitoring issues and spotting trends that may affect future business
- Engaging with stakeholders to reconcile dilemmas and find common ground for more sustainable solutions
- Building relationships with key stakeholders in the global, international and local communities of which Novo Nordisk is a part
- Driving and embedding long-term thinking and the Triple Bottom Line mindset throughout the company
- Accounting for the company's performance and conveying Novo Nordisk's positions, objectives and goals to audiences with an interest in the company
- Translating and integrating the Triple Bottom Line approach into all business processes to obtain sustainable competitive advantages in the marketplace

[12] Novo Nordisk, Annual Report 2003, p. 2.

[13] Corporate Stakeholder Relations' Strategic Plan 2004–05, March 2004, slide 2.

History of Sustainability

The focus on sustainability was not new for Novo Nordisk. In the late 1960s Novo Nordisk was confronted with severe stakeholder criticisms for the first time, and a close interaction with a broad variety of stakeholders have been part of the company's strategy since then. Novo Nordisk's first encounter with stakeholder criticism was surrounding new production methods that introduced genetically engineered micro-organisms, resulting in the development of a new product line of enzymes. These enzymes were important ingredients in many products (e.g., detergent). Environmentally oriented NGOs, as well as scientific articles, first raised awareness that the use of detergents with enzymes could lead to those in contact with the product developing allergies, and that the dust from the production process could have implications for employees' health. Novo Nordisk's sales fell dramatically, and the company reacted with a strong and fast response by developing dust-free enzymes presenting no risk for the consumers.[14] Sales rose again and enzyme production became an important part of Novo Nordisk's production in Denmark, USA and Japan.

In 2001, Novo Nordisk was once again confronted with criticism from NGOs. The pharmaceutical industry association in South Africa,, including Novo Nordisk, raised the issue of protecting intellectual property rights with the South African government. This led to major public criticism of the consortium members, who were accused of giving priority to profits at the expense of the health of less advantaged people. Again, Novo Nordisk reacted fast. By engaging in dialogue with the NGOs, the company defined a new policy to strengthen the company's presence and development of medicines to combat diabetes in developing countries. A new pricing policy and the establishment of the World Diabetes Foundation in late 2001 can be seen as a strategic result of Novo Nordisk's response to the criticism.

Issues of importance for sustainability in Novo Nordisk had changed from a predominantly environmental focus to a focus that includes health, safety and bioethics issues, and a focus on how to integrate issues of social responsibility. To illustrate the concurrent broadening of the scope Novo Nordisk had developed a learning curve, shown below in Fig. 30.1.[15]

The learning curve shows that Novo Nordisk perceived sustainability as a continuous learning process, in which the company needed to be able to take in new issues and integrate these concurrently in the business strategy towards "full business integration".

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[14] See Novo Nordisk History, p.15; available at: http://www.novonordisk.com/about_us/history/milestones_in_nn_history.asp

[15] Source: Corporate Stakeholder Relations Strategic Plan 2004–05, March 2004, p. 15.

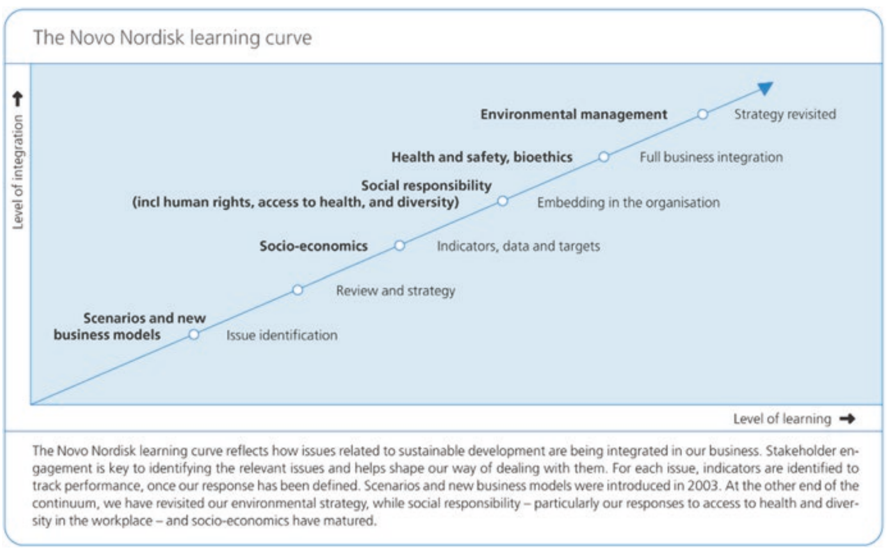


Fig. 30.1 Novo Nordisk learning curve

How Did Novo Nordisk Meet Its Objectives of Being Sustainable?

In 1997, the Novo Nordisk Way of Management (see Fig. 30.2, below) was introduced as an overall guideline to ensure that Novo Nordisk's strategic goals were reached at the operational level. A central part of the strategic goal was the integration and implementation of sustainable business practices:

> The Novo Nordisk Way of Management serves as the solid footing from which innovative ideas can take off. Its immediate strengths lie in its consistency, coherence and systematic follow-up methods. It is the way we do things.[16]

The Novo Nordisk Way of Management was designed and introduced to strike a balance between corporate control and decentralized decision-making. It was implemented as a reaction to the situation in the previous year where company systems, procedures and routines were standardized and centralized at headquarters in Bagsværd in Denmark, and this had led to dissatisfaction among managers in the foreign subsidiaries who found that the systems did not always fit with the local situation and needs. As an illustration of this balance, Henrik Gürtler, CEO of Novo A/S, saw the Novo Nordisk Way of Management as an

[16] Ibid, p. 13.

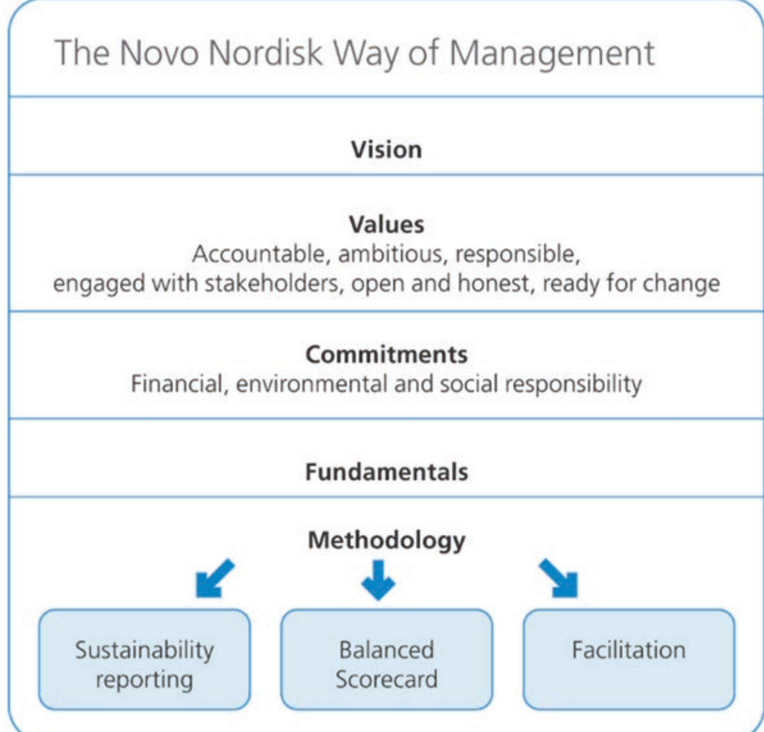


Fig. 30.2 The Novo Nordisk way of management

opportunity to develop new and motivating control systems throughout the entire organisation:

> New initiatives and management programmes were introduced regularly, but they had no effect across borders. They were encapsulated and never seemed to make much difference outside corporate headquarters. It annoyed me, and when the Novo Nordisk Way of Management was designed as a new and overall guideline, I decided to do something about it.[17]

[17] Quote from CEO Henrik Gürtler, Novo A/S, June 2, 2005

Then CEO, Mads Øvlisen explained the Novo Nordisk Way of Management for all managers and employees in a letter in January 1997:

> The Novo Nordisk Way of Management is a comprehensive and easy-to-use guide which should allow you to use your insight and judgment in complying also with the "local" management and quality system derived from this corporate basis for use in functions an departments throughout Novo Nordisk."[18]

The Novo Nordisk Way of Management extended beyond products and manufacturing operations to include all activities, and as such it was a broad frame that described the rationale that should set the tone and the standards amongst managers and employees in the entire organization. Additionally, Novo Nordisk also developed a vision, values, commitments, and fundamentals in order to inspire and guide its employees to achieve superior performance. These are included in Appendix 3.

To ensure that the entire organisation understood and adhered to the Novo Nordisk Way of Management, the company has developed a methodology consisting of three elements: facilitators, sustainability reporting and balanced scorecard. Each of these elements is discussed below.

Facilitators

The Facilitators were a team of around 16 high-profile professionals at the holding company, Novo A/S. Each of them had a professional background from senior specialist or managerial positions in Novo Nordisk or Novozymes. They travelled in pairs to visit all business units and levels of the entire organisation every third year. The first team of facilitators was recruited internally in 1996; the Facilitator team had a blend of ages, gender, professions and nationalities. They served to assess, assist and facilitate units and projects to perform better. Their tasks were[19]:

1. Through on-site auditing/faciliting of departments, factories, affiliates, assess whether or not the company-wide minimum standard requirements or "ground rules" as specified in the Novo Nordisk Way of Management are met.
2. Through on-site advice and help, assist the unit in question in correcting identified non-compliance with these requirements.
3. Through on-site identification of "best practices" applied, facilitate communication and sharing of these across the organization.

A facilitation was a structured, planned assessment of the status the Novo Nordisk Way of Management within the unit or project with the aim of developing agreed actions for improvement. In conducting the facilitation, the facilitators would[20]:

[18] "Novo Nordisk Way of Management: a short interpretation guide to the fundamentals", preface, 1997.

[19] Novo Nordisk: "The facilitation process: charter of standards, procedures and guidelines", 1998.

[20] Ibid.

- Obtain objective evidence through a fact-finding process
- Provide objective, validated assessments and conclusion
- Include recommendations for improvements where appropriate
- Agree on action plans with unit or process managers
- Follow up on the implementation of the action plan
- Fulfil their responsibilities in a manner demonstrating integrity, objectivity, and professional behaviour

The facilitation process consisted of three stages. First is the pre-facilitation, in which the scope of the facilitation was identified and material to support the process was developed. Second was the facilitation itself, in which facilitators meet with the individual unit or project members, and an agreement was made on how to improve. Finally, a post-facilitation process was conducted, in which the facilitator was responsible for following up and reporting to executive management on the achievements with respect to the action points agreed upon in stage two. Appendix 4 provides excerpts from a facilitation at the Diabetes Pharmaceutical Site Hillerød.

Sustainability Reporting

Sustainability reporting was used to ensure that sustainability thinking became part of everyday business practices at Novo Nordisk. In 1989 Novo Nordisk produced its first environmental management review as part of its proactive stakeholder strategy – long before environmental reporting became compulsory for companies like Novo Nordisk. In 1994 Novo Nordisk produced its first environmental report including resource consumption, emissions and use of experimental animals. Later, in 1998, a social report was issued, and since 1999 Novo Nordisk has published annual reports on sustainability integrating environmental, social and economic concerns.[21] For the first time in 2004, Novo Nordisk integrated this information with its financial results and reported a combined social, environmental and economic report – The Annual Report 2004. These reports addressed issues recommended by United Nation's Global Compact, the Global Reporting Initiative's 2002 Sustainability Reporting Guidelines, and followed the approach laid out in the AA1000 Framework; the reports delivered a comprehensive documentation of Novo Nordisk's ambitions, goals, initiatives, results and new targets for environmental and social responsibility.

Novo Nordisk was renowned nationally and internationally for its dedication to corporate sustainability and for pioneering new agendas and concurrent development of stakeholder relations. Recent recognition included being ranked by Corporate Knights Inc. in February 2005 amongst the top 100 sustainable companies in the world, and being ranked second in the world by SustainAbility and the United Nations Environment Programme in November 2004 for its ability to identify and manage social and environmental issues as accounted for in its sustainability report. Additionally, their Sustainability Report 2003 won the 1st prize (for the

[21] These reports are available at http://www.novonordisk.com/sustainability/sustainability_in_short

sixth time!) of the European Sustainability Awards (sponsored by the Association of Chartered Certified Accountants), and in Denmark, Novo Nordisk had won six prizes for the best annual social report awarded by the Association of Danish Accountants and the Danish business newspaper Børsen.[22] In the annual image analysis reported in Børsen, Novo Nordisk had in 1992, 2001, 2002, 2003 and 2005 ranked either one or two, with a high score on the corporate social responsibility element. In 2004 Novo Nordisk was second to A.P. Møller.[23]

In order to measure its progress towards sustainability, Novo Nordisk used a Triple Bottom Line approach which linked a set of key targets to sustainability goals. Appendix 5 provided details from Novo Nordisk's Annual Report 2004 on the specific indicators used, and the reason for using them (impact). As shown in this appendix there were six strategic areas for Novo Nordisk's Triple Bottom Line performance:

1. Living our values
2. Access to health
3. Our employees
4. Our use of animals
5. Eco-efficiency and compliance
6. Economic contribution

'Living our values' aimed to measure whether business actions are consistent with corporate values. Three performance metrics were used to gauge how well the company performs in this area; two of which were taken from an annual employee survey (eVoice) and one was directly related to the use of facilitators (discussed above).

'Access to health' was included as a means to ensure that the company as a pharmaceutical company was involved in promoting improvements in global health standards. Two measures were used to gauge Novo Nordisk's presence in less developed countries.

'Our employees' was included to ensure Novo Nordisk maintains high standards in relation to its workforce. Four performance measures were used to gauge Novo Nordisk's treatment of their employees; two of these measures were taken from the eVocie employee survey.

'Our use of animals' was included to ensure Novo Nordisk, as a pharmaceutical company was in good standing with a key stakeholder group – animal welfare groups (in particular, the Danish Animal Welfare Society). Two metrics were used to ensure the ethical treatment of all animals used in research.

'Eco-efficiency and compliance' was included to measure Novo Nordisk's impact on the environment. Four performance measures were included to measure

[22] For further accolades, refer to http://www.novonordisk.com/sustainability/news

[23] Berlingske Nyhedsmagasin, no. 13, April 29.-June 13, 2005, p. 28.

the organisation's use of water and energy, their compliance with regulations and the implementation of ISO 140001.[24]

'Economic contribution' was more than the traditional area of financial performance – it also covered the company's socio-economic impacts. Five metrics were used, including traditional measures such as operating profit margin and return on invested capital, but also one metric that measured how much the company contributes to the national economic capacity (total taxes as a percentage of turnover).

The Triple Bottom Line was used as a firm wide tool to ensure Novo Nordisk took actions that were consistent with operating as a sustainable company. All metrics used in the Triple Bottom Line reported aggregate performance across all business units to present the full picture. Novo Nordisk did not report Triple Bottom Line performance at a disaggregated level (i.e., for each business unit), but did provide specific and detailed data for eight major production sites.

> *Transparent reporting is a vital instrument for us in accounting for our performance on the Triple Bottom Line. This is where we can account for our approach to doing business in a single document and cohesively present performance, progress, positions and strategic initiatives as well as the dilemmas and key issues we face as a pharmaceutical company. Most importantly, what we present in the report is the result of our interactions and engagements with stakeholders,* said Susanne Stormer,[25] then manager in Corporate Stakeholder Relations and responsible for Novo Nordisk's sustainability reporting.

Balanced Scorecard

Rather than assessing each division with a Triple Bottom Line performance report, Novo Nordisk relied on the balanced scorecard:

> The Balanced Scorecard is the management tool for embedding and cascading the Triple Bottom Line approach throughout the organisation. The Scorecard is a vital element of the corporate governance set-up in Novo Nordisk and thus a very powerful tool to ensure integration of the sustainability approach into all business processes.[26]

Novo Nordisk had been using balanced scorecards since 1996; it was introduced primarily as a financial management tool. The administration of the scorecards rested with the Finance, Legal and IT department, which had a mandate to use the best management methods, of which balanced scorecards are viewed as an effective tool. The involvement of finance personnel with respect to balanced scorecards was to facilitate workshops (that is supporting management teams), assist in setting of targets, reviewing balanced scorecards, and changes to/improvements in financial management (i.e., integrating the balanced scorecard with processes).

Novo Nordisk cascaded its balanced scorecard down to the business unit level, from which it translated into individual employees' personal targets, which were set

[24] ISO 14001 is an environmental management standard with auditing tools and procedures.

[25] Quote from Susanne Stormer, June 19, 2005

[26] Corporate Stakeholder Relations' Strategic Plan 2004–05, March 2004, p. 13.

and reviewed on a biannual basis. Specifically, a balanced scorecard was prepared for the organisation as a whole; this scorecard was then cascaded down to the executive VP level (there were five executive VPs, each with their own scorecard). From this level, each of the 20 Senior VPs also had a balanced scorecard (i.e., the business unit level). From this level there was no formal mandate that the scorecards were further cascaded; however, in some business units, scorecards could be prepared for each individual sub-unit (e.g., a particular factory). In general, the sub-unit typically was evaluated on a collection of KPIs, rather than having objectives in each of the four traditional sections of a balanced scorecard.

Novo Nordisk currently had a total of 24 objectives in its balanced scorecard under the following four headings: (1) Customers & Society, (2) Finance, (3) Business Processes, and (4) People & Organisation. To facilitate the operation of the balanced scorecard, each objective was 'owned' by one of the five executive areas at Novo Nordisk. Corporate Stakeholder Relations was responsible for seven of the 24 objectives. These were:

1. Increase internationalisation
2. Support diversity
3. Ensure talent development
4. Ensure performance management
5. Ensure superior company reputation
6. Ensure environmental, social, and ethical performance
7. Improve our collaboration with key stakeholders in diabetes care worldwide

The Use of the Balanced Scorecard at Diabetes Finished Products

One of the key business units at Novo Nordisk was Diabetes Finished Products (DFP). This group was responsible for the production and distribution of all products related to the treatment of Diabetes. In 2004, the group produced 807 million units of its four key products (Penfill® 3 ml filling, Prefilled 3 ml total, Penfill® 3 ml blister, and Insulin vials).[27] There were approximately 3100 employees, spread across eight sites and DFP headquarters. Appendix 6 provides the organisational chart for DFP. Specifically, there were five production sites (three in Denmark, one in the United States, one in France); moreover, Novo Nordisk was expanding with another production facility in Brazil. Additionally, there was a logistics unit, and a manufacturing development unit that worked to take new products to mass production. Eric Drapé was the Senior Vice President of Diabetes Finished Products. Eric was a pharmacist by training, and had been with Novo Nordisk since 1990. He had been in his role since January 2004; his previous position was as a site manager (VP) at the French production facility.

[27] Source: information supplied by Eric Drapé.

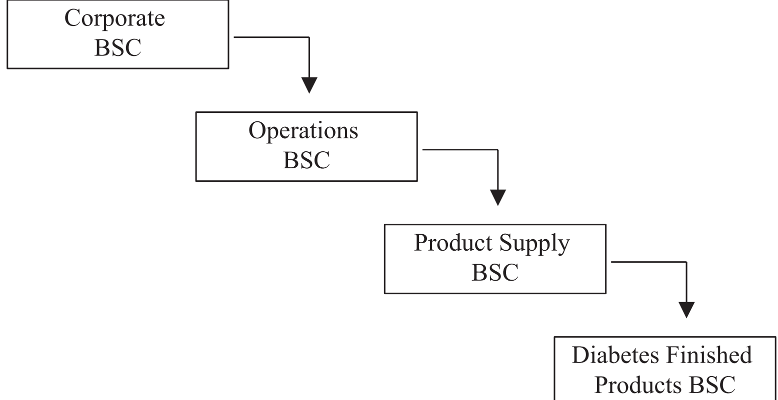


Fig. 30.3 Cascading of the balanced scorecard

Figure 30.3 illustrates how the Balanced Scorecard was cascaded from Corporate to DFP. In our illustrations (Appendices 6, 7 and 8), we chose to not include the corporate level.

To illustrate how specific critical success factors (CSF) were cascaded through the organisation, Appendices 7, 8 and 9 describe the KPIs, the KPI definition and the 2005 target for three CSFs for Operations, Product Supply and Diabetes Finished Products. The three CSFs illustrated were those that were most closely aligned with the social and environmental issues in Novo Nordisk's Triple Bottom Line.

The first CSF (Appendix 7) is to ensure environmental, social and ethical performance. With respect to DFP only one KPI was included, EPI performance, which was intended to measure the relation between total yield of product and consumption of water and energy. Further up the organisation, the emission of carbon dioxide (CO_2) was also measured. Noticeably missing from the corporate balanced scorecards[28] were any KPIs which measured social and ethical performance – most likely a reflection of the general difficulty of defining meaningful and quantifiable social indicators at a corporate level.

The second CSF (Appendix 8) was a focus on supporting diversity and social responsibility. Throughout the organisation three KPIs were used. The first was intended to ensure that each level of the organisation supported diversity and ensured equal opportunities to its employees. The second was the number of employees that had evaluated progress according to the OA. Finally, was a metric which focused on the functioning and value of the Job Transfer Centre, which was a centre that had been established in connection with the company's global sourcing strategy, according to which new jobs were created abroad, not in Denmark. The Job Transfer

[28] Please note that the corporate balanced score card is not printed in the case. The balanced scorecard from Operations, Product Supply and Diabetes Finished Products are presented in Appendix 7.

Centre assisted Novo Nordisk employees in those units that were facing staffing changes to find a new job within, or outside Novo Nordisk.

The third CSF (Appendix 9) was to ensure talent development. Similar to the previous CSF, the use and number of KPIs was consistently applied throughout the organisation. Specifically, two KPIs were used. The first was the utilisation of talent pools with respect to the filling of new or vacant VP positions. The second KPI was the results of the section of questions on an annual employee survey (eVoice) which aimed to gauge perceptions of employee development.[29]

As a SVP, Eric was responsible for the balanced scorecard for his business unit, and he believed that it was an effective management tool:

> The primary benefit [of the balanced scorecard] is to secure that people are aligned to the strategic goals of the company, and that they are not working for something which is not necessary to work for. We have full alignment, and that's very convenient and comfortable.[30]

Eric was responsible for the 2005 DFP balanced scorecard, which had 27 KPIs: three in Finance, 12 in Business Processes, eight in People & Organisations, and four in Customers & Society, (Appendix 9 illustrates the CSFs, CSF rationale and KPIs for DFP's 2005 balanced scorecard). There was no formal cascading of this balanced scorecard to the seven VPs. Nevertheless, each site was responsible for, and evaluated on, the majority of KPIs that were in the DFP balanced scorecard (each site is evaluated on approximately 20 KPIs).

The formal monitoring of the sites was done on a monthly basis. Specifically, data on all KPIs was calculated and updated into Novo Nordisk's IT system (PEIS), and each site manager had to prepare a monthly report which explained any deviations from targets. Additionally, any deviation that was significantly large (gaining a red designation in the system) must be answered with a specific action plan. Eric also had informal discussions with his VPs every one to 2 months. The purpose of these meetings was to gauge how performance is proceeding. In addition to the monthly monitoring and informal discussions, Eric met each of his site managers twice a year as part of a formal Business Review. The purpose of these meetings was to discuss the monthly action plans, but also to discuss the overall site's balanced scorecard.

In addition to being evaluated on the balanced scorecard, Eric's (and his VPs) bonus compensation was also tied to balance scorecard performance. Appendix 10 provides Eric's Performance Index for 2005. As shown, Eric was compensated

[29] eVoice was an annual survey which asks a minimum of 48 questions around eight mandatory themes (Vision and Values, Development of employees, Employee engagement, Equal Opportunity, Stress and workload, Quality mindset, Performance orientation, and Internationalisation). In addition, each unit and project group could include up to an additional 72 questions from 12 themes (Customer orientations, Winning culture, Working climate, Empowerment, Cooperation across functions, Communication, Innovation, Planning and execution, Working conditions, Novo Nordisk policies, Best Practice, and Reporting).

[30] Interview with Eric Drapé on October 26, 2004.

based on 13 KPIs (two in Finance, three in Customers, six in Processes and two in People & Organisation). The weighting scheme worked as follows: if Eric achieves each target, he received a score for that KPI of 100. If he exceeded the target, then the score for the particular KPI was greater than 100; if he did not achieve the target, then the score for the particular KPI was less than 100. Each KPI score was multiplied by its respective percentage weight (e.g., 15% for Investments). The achieved index score was equal to the sum of the weighted scores across all of the KPIs. For Eric, the amount of bonus he received was 50% dependent on his achieved index score and 50% dependent on the achieved index score of Product Supply. For each VP in DFP, their bonus calculation was similar, except each VP only had ten KPIs influencing their bonus calculation. Of these ten, some were mandatory (across all sites) and some were voluntary (agreed between Eric and each VP). The voluntary KPIs tended to be related more to social objectives, as they were geared towards addressing issues which reflected the local environment. The payment of the bonus to each VP was 50% dependent on their achieved index score, and 50% dependent on the achieved index for DFP. Finally, Novo Nordisk used stretch targets in that in 2005 to receive a full bonus Eric (and his VPs) must have had an achieved index score of 105 (if targets were only hit (i.e., not exceeded) then only a 50% bonus was paid) (Appendix 11).

Conclusion

As illustrated Novo Nordisk was prime example of one organisation that included sustainability as an integrated part of its strategy, and attempts to consider it in all of its business decisions. To help managers consider sustainability in all of their business decisions, the company had adopted the Novo Nordisk Way of Management as one of their primary operating tools. Included in the Novo Nordisk Way of Management were three pillars that should help to operationalise Novo Nordisk's corporate objectives: the facilitators, the annual (sustainability) reporting and the balanced scorecard. The significant question that remained, however, is to what extent each of these pillars was effective in influencing behaviour at the operational level.

Epilogue 2015

Ten years can seem like a lifetime. Especially when working in a dynamic business in a rapidly changing environment. Similarly, the field of research into sustainability in business practices has evolved dramatically since this case was written.

By the entry into 2015 Novo Nordisk had grown significantly and had become the most valuable company in Scandinavia, and even surpassed the Volkswagen group, measured by market capitalisation. It had enjoyed more than 10 years of double-digit sales growth, maintained competitive operating growth rates, expanded its global operations and almost doubled the number of employees. Yet, the

company retained its culture and values, rooted in the Scandinavian tradition, and many of its senior managers remained in the company, albeit not necessarily in the same positions. They would often grow with the business, thereby reinforcing the values and behaviours that were seen as the right thing to do.

When the long-standing CEO, Mads Øvlisen, stepped down and left his desk to Lars Rebien Sørensen there had been concerned voices expressing doubts whether he could fill the shoes of his predecessor, and whether the strong company values would live on.

Indeed, Lars Rebien Sørensen had a rough start, faced with the South African court case, but in that situation, and in many that would follow, he demonstrated that his leadership style was formed through many years of working in the organisation. And so his intuitive reactions in times of crisis would always be consistent with the values that the company had lived by for generations: essentially these were about acting responsibly and striking the right balance, respecting the integrity of business partners and other stakeholders, fairness and good old-fashioned decency.

By 2006, Mads Øvlisen had left Novo Nordisk, but had made his mark after 34 years in the company, of which 19 years in the role as CEO. And through their partnership while he was chairman of the Board and with Lars Rebien as his CEO successor, a step was taken that would ensure the longevity of the company's commitment to the Triple Bottom Line principle: In connection with an update of the company's Articles of Association (the bylaws) a proposal was presented for adoption at the Annual General Meeting in 2004 to include a sentence in the clause 'objects': *"The Company strives to conduct its activities in a financially, environmentally, and socially responsible way."* The proposal was, unsurprisingly – given the majority vote of the owner, the Novo Nordisk Foundation, and the broad support from both institutional and private shareholders – adopted. The Triple Bottom Line principle had been institutionalised and was as of then safeguarded, regardless of who would be in the CEO chair.

The intent was to send a very clear signal to investors and other business partners that this is how the company is managed, and will make decisions accordingly. It also specified to people working in Novo Nordisk the philosophy that would guide their decisions and actions, and emphasised the need to get the balance right, particularly when faced with difficult dilemmas.

That decision paved the way for further integration of sustainability thinking into business practices. First, the company's reporting – which had hitherto like many other companies consisted in a financial report as the legal document and a supplementary, voluntary sustainability report – was merged into one document. This was presented to, and approved by the Board, as the logical consequence of the decision to emphasise the Triple Bottom Line in the bylaws. Some were concerned it would be the death to sustainability reporting, and with that the company's leadership position, while others were convinced that this would be the future of corporate reporting.

In 2009 Lars Rebien Sørensen found it was time to revisit the Novo Nordisk Way of Management, which had been used since the mid-1990s as the guide for managers on the company's values-based approach to doing business. In light of the

company's growth, particularly outside of Denmark, time had come to do a sanity check to assess if a revision was needed. He travelled to meet with employees and stakeholders in all corners of the world and came back with a strong conviction that the values were very much alive and that the Triple Bottom Line was important to employees and stakeholders alike. So he and the management team worked together to update and simplify the document that was quite lengthy, and in 2010 announced a renewed, much shorter Novo Nordisk Way. A short credo-like stosryline of the purpose and mission of the company, supplemented with 10 statements, so-called *essentials*, on the behaviours that should be expected of people working at Novo Nordisk. And it was emphasised that this was not intended for managers, but for every employee.

While the wording was changed, most of the contents remained, and so did the management system around it. Including the function of the facilitators to ascertain the extent to which the values are being put into action, the principles of remuneration, the stakeholder engagement approach, and the responsible business practices across the value chain. Over time, management control and reporting systems became more sophisticated, and much effort was invested in upgrading the quality of social and environmental data so they could stand the test of being represented in the Annual Report side by side with financial data that were subject to the strictest international standards for internal controls. Integration came at a cost, and a clean-up of data points was begun to ensure that data were robust and similar in scope. Social and environmental reporting became more streamlined over time, and more aligned with strategic business priorities.

In parallel with these internal changes the sustainability agenda matured, too. While originally companies would typically be pressured by stakeholder groups to adapt criticised practices that were considered harmful to people, communities or the environment, regulation took over, complemented by soft law and voluntary initiatives, often made by industry sectors rather than individual companies. Responsibility had become common practice and a floor was set for expectations of 'good behaviour' by companies in Denmark and abroad, not least facilitated by the growing adoption of the UN Global Compact's principles for responsible business.

In 2010 Novo Nordisk framed a new strategy that would divert from the issues-based approach of the past decade, described in the case. Now focus would be on continuing the integration by making the *business case* to demonstrate how the Triple Bottom Line approach generates value – for the business and for stakeholders. As it happened, this was an act of foresight; the efforts preceded the concept of shared value articulated by Professor Michael Porter of Harvard Business School, which gained significant traction in boardrooms and business school classrooms.

The strategy was to create, capture and communicate value by using the Triple Bottom Line. To articulate an approach that combined rationales such as retaining the social contract (licence to operate), promoting smarter and more sustainable solutions (competitiveness) and experimenting with innovative and collaborative initiatives to address systemic challenges (game changers). And, most importantly, to bring it all to life in everyday practice, so that there would be consistency between '*what we say'* and *'what we do'*. And it appeared to be successful, for as the

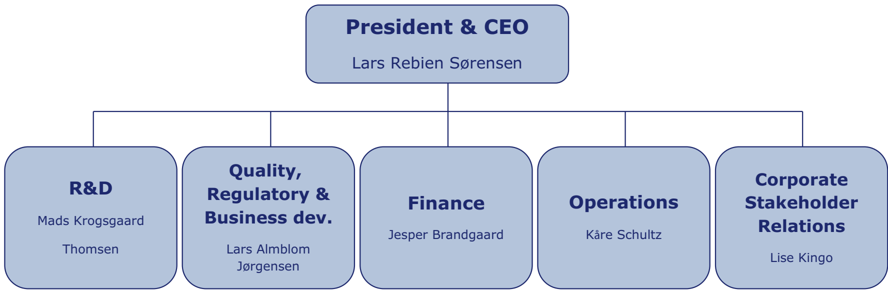
business continued to grow, so did the company's reputation, brand value and influence. Still, it was important to have a team to support, align and drive efforts to be a sustainable business. And, importantly, with a mandate to challenge current practices. That was, and is, the role of the Corporate Sustainability team.

Many lessons have been learnt, and although by now almost a cliché, one should be reminded that sustainability is a journey with no end destination. To Novo Nordisk, sustainable business means prospering as a result of doing business that is responsible *and* profitable. This is what guides decision-making, and this is what is built into the performance management and reward systems described in this case. Then and now.

Acknowledgments We sincerely want to thank Novo Nordisk A/S for inviting us to collect data and for checking facts and figures for this case study. From Novo Nordisk we also want to thank Lito Valencia, business analyst in Finance and Business Integration, Hanne Schou-Rode, VP of Knowledge, IT & Quality in Corporate Stakeholder Relations, and Eric Drapé, SVP in Diabetes Finished Products for their time and constructive reflections. And we appreciate the valuable input to the case from professor Niels Mygind, Copenhagen Business School, Stephanie Robertson, Lene Hougaard Pedersen, Henrik Nielsen, research assistant at Copenhagen Business School, and Henrik Melgaard. Finally, we gratefully acknowledge financial support from Copenhagen Business School, London Business School and the Academy of Business in Society (ABIS).

Appendices

Appendix 1: Novo Nordisk A/S Organisational Structure 2005



Source: internal document provided by Susanne Stormer.

Appendix 2: Selected Financial Information

Panel A: Financial Statement Information (in DKK million)[a]

	2000	2001	2002	2003	2004
Sales	20,485	23,385	24,866	26,158	29,031
Operating profit	4703	5410	5927	6422	6980
Net profit	3154	3620	4116	4833	5013
Total assets	24,597	28,662	31,612	34,564	37,433
Total current liabilities	5860	6138	6152	7032	7280
Total long-term liabilities	2117	2824	2983	2756	3649
Equity	16,620	19,700	22,477	24,776	26,504
R&D/sales	16.6%	16.6%	15.9%	15.5%	15.0%
Net profit margin	15.4%	15.5%	16.6%	18.5%	17.3%
Return on invested capital	22.3%	22.7%	20.5%	19.5%	20.6%

Panel B: Share Return Information[b]

Company	Country	Current	5 Year
Astrazeneca	U.K.	−11.47%	−3.99%
Glaxosmithkline	U.K.	16.48%	−22.78%
Novartis 'R'	Switzerland	2.16%	9.08%
Novo Nordisk 'B'	**Denmark**	**−1.55%**	**44.17%**
Roche holdings 'B'	Switzerland	−11.29%	−11.82%
Sanofie-Aventis	France	32.65%	80.82%
Schering	Germany	18.89%	7.08%
Shire pharmaceuticals	U.K.	5.87%	−39.68%
UCB	Belgium	13.74%	9.71%
Danish market (KFX)		23.14%	17.77%

[a]Source: Novo Nordisk A/S – Annual Report 2004; Net profit margin equals net profit as a percentage of sales; Return on invested capital equals operating profit after tax (using the effective tax rate) as a percentage of average inventories, receivables, property, plant and equipment and as well as intangible assets less non-interest bearing liabilities including provisions (the sum of above assets and liabilities at the beginning of the year and at year-end divided by two).

[b]Source: Thompson Financial Datastream; the current return is calculated over the period May 1, 2004 – April 30, 2005 and the 5 Year return is calculated over the period May 1, 2000 – April 30, 2005.

Appendix 3: Novo Nordisk's Vision, Values, Commitments and Fundamentals

The Vision

We want to be the world's leader in diabetes treatment
We offer products and services in other areas where we can make a difference
We deliver competitive business results
A job with us is more than "just a job"
Our values are reflected in our actions
Our history shows that it can be done

The Values are six corporate values to guide decision-making and action: accountable, ambitious, responsible, engaged with stakeholders, open and honest, ready for change.

The Commitments are a reflection of the commitment to sustainability and to integrating the Triple Bottom Line thinking in organisational practices.

The Fundamentals consist of ten behavioural guidelines on how to organize and behave in everyday organisational life in all units at all levels in Novo Nordisk:

1. Each unit must share and use better practices.
2. Each unit must have a clear definition of where accountabilities and decision powers recide
3. Each unit must have an action plan to ensure improvement of its busienss and performance and working climate
4. Every team and employee must have updated business and competency targets and receive timely feedback on performance against these targest
5. Each unit must have an action plan to ensure the development of teams and individuals based on busienss requirements and employee input.
6. Every manager must establish and maintain procedures in the unit for living up to relevant laws, regulations, and Novo Nordisk policies
7. Each unit and employee must know how they create value for their customers
8. Every manager requring reporting from others must explain the actual use of the report and the added value
9. Every manager must continuously make it easier for the employees to liberate energy for customer related issues.
10. Every manager and unit must actively support cross-unit projects and working relationships of relevance to the business

Source: http://www.novonordisk.com/about_us/about_novo_nordisk/the_charter.asp

Appendix 4: Example of a Facilitation

Following are excerpts from a recent facilitation at Diabetes Pharmaceutical Site Hillerød:

Facilitation Start Date:	15 November 2004
Facilitation End Date:	22 December 2004

Purpose and Scope of Facilitation
The purpose and scope of the facilitation is to assess the state of compliance, within Pharmaceutical Diabetes Site Hillerød, with the Novo Nordisk Way of Management, excluding Financial Commitments, and to agree and follow up on actions resulting from the facilitation and to report the results.

At the time of the facilitation the organisation is influenced by a number of changes. The unit VP and the QA (quality assurance) VP were appointed in the Q4 2004 and several department managers have been appointed to their current position within 2004.

Executive Summary
The facilitation of DPSH in Site Hillerød has shown a unit dedicated to live up to the targets and challenges set by Diabetes Finished Products (DFP). All interviewees were aware of Novo Nordisk Way of management and feel that the unit and management are living up to the values of Novo Nordisk. Facilitations show that there are different levels of compliance amongst the departments with respect to the implementation of Fundamentals.

The unit is highly focused on achieving its business targets, sometimes at the expense of overlooking the quality of some of the management processes such as APIS and development planning.

DPSH is currently developing its own strategy in alignment with DFP strategy and business plans. There is a clear understanding by all in the unit that focus must be on supporting the needs defined in the production agreements. Roll out of cLEAN™ is at variable stages within the different functions within DPSH.

Target setting based on the DPSH Balanced Scorecard and follow up needs to be improved for both teams and individuals. The lack of specific targets in some teams also influences the frequency and quality of feedback given in the organisation and needs to be enhanced.

DPSH is as an organisation in close daily contact with its key stakeholders within Novo Nordisk and interviewees are aware of their customers needs.

Source: internal document provided by Eric Drapé, SVP Diabetes Finished Products.

Appendix 5: Indicators of Triple Bottom Line Performance

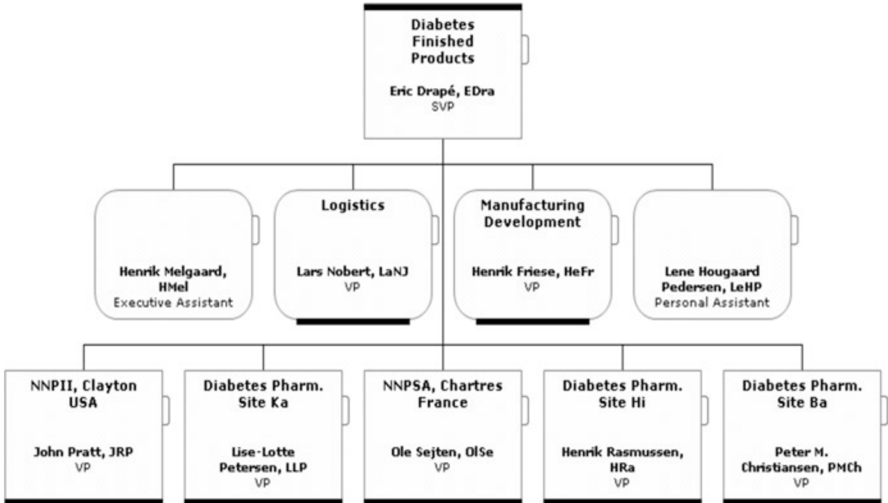
Strategic area	Indicators	Impact
Living our values		
Two indicators show how we live up to the company's values, as perceived by employees. This is measured as part of the climate survey, eVoice, conducted annualy. One indicator showws follow-up on the facilitation process.	Average of respondents' answers as to whether social and environmental issues are important for the future of the company.	Organisational support for and understanding of responsible business practices.
	Average of respondents' answers as to whether management demonstrates in words and action that they live up to our values.	Integration of corporate values in all decisions.
	Percent of fulfilment of action points planned arising from facilitations of the Novo Nordisk way of management and values	Corrective actions on values following facilitations.
Access to health		
Two indicators measure progress on one of the programmes for global access to health, the best possible pricing scheme in least developed countries (LDCs). In 2004 there were 50 LDCs.	Number of LDCs where Novo Nordisk operates.	Access to essential medicines.
	Number of LDCs which have chosen to buy insulin under the best possible pricing scheme.	Affordability of essential medicines.
Our employees		
Four indicators measure standards of health and safety in the workplace, employee development and equal opportunities.	Frequency of occupational injuries.	Increased quality of life for employees, improved work flow and productivity, and less absence due to illness.
	Employee turnover rate.	Influx and outflux of knowledge.
	Average of respondents' answers as to whether their work gives them an opportunity to use and develop their competences/skills.	Increased competence level for employees and increase competence capital in the company.
	Average of respondents' answers as to whether people from diverse backgrounds have equal opportunities (for example in terms of hiring, promotion and training) at Novo Nordisk, regardless of gender, race, ways of thinking etc.	Increased diversity in the workplace.

(continued)

Strategic area	Indicators	Impact
Our use of animals		
Two indicators track efforts to reduce the number of experimental animals and improve their welfare.	Percent of animal test types removed from external and internal specification.	Reduction and replacement of experimental animals.
	Housing conditions for experimental animals, considering the needs of the animals.	Improved welfare of experimental animals.
Eco-efficiency and compliance		
Two environmental indicators, eco-productivity indices (EPIs), are based on eco-effeciciency thinking and reflect internationally adopted views. Full compliance with local laws and regulations is a company policy. Certification of production facilities is instrumental to that end.	Annual improvement in water efficiency.	Water use efficiency.
	Annual improvement in energy efficiency.	Energy use efficiency.
	Compliance.	Compliance with regulatory requirements.
	ISO 14001 implementation.	Accidental releases.
		Pollution prevention through decreased use of raw materials, water and energy and decreased environmental impact per produced unit.
Economic contribution		
Five financial measures for reporting to shareholders and the financial markets serve as indicators for economic contribution.	Operating profit margin.	Contribution to company efficiency, growth and investors' economic capacity.
	Growth in operating profit.	Contribution to company growth and investors' economic capacity.
	Total corporate taxe as share of sales.	Contribution to national economic capacity.
	Return on invested capital.	Efficiency of invested capital, contribution to asset base, and investors' economic capacity.
	Cash to earnings (3-year average).	Contribution to the company's degree of freedom in terms of available cash funds (resources).

Source: Novo Nordisk A/S Annual Report 2004

Appendix 6: Diabetes Finished Products – Organisational Chart



Source: internal document provided by Eric Drapé, SVP Diabetes Finished Products

Appendix 7: Cascading of Balanced Scorecard 2005 – Ensure Environmental, Social and Ethical Performance

	Operations	Product supply	Diabetes finished products
KPI	1. EPI performance	1. EPI performance	1. EPI performance
	2. CO_2 emission reduction target	2. CO_2 emissions reduction strategy and action plan.	
		3. CO_2 emission reduction target.	
KPI definition	1. EPI is calculated as the relation between the total yield of product to the respective consumption of water and energy. Performance is tracked annually against previous year.	1. EPI is calculated as the relation between the total yield of product to the respective consumption of water and energy.	1. EPI is calculated as the relation between the total yield of product to the respective consumption of water and energy. Performance is tracked quarterly against previous year. Simple average of the two index is the target.
	2. CO_2 emission reduction target to be approved by Environment & Bioethics Committee and communicated to relevant stakeholders	2. A CO_2-compliance plan for Bagsvaerd and Hillerod to be drafted and implemented.	
		3. Establish an implementation plan for the CO_2 strategy with base year 2004.	
Target 2005	1. Increase the eco-productivity index for water in the period 2001–2005 by an annual average of 5% corresponding to a total increase in EPI of 30% end of 2005. Increase the eco-productivity index for energy in the period 2001–2005 by an annual average of 4% corresponding to a total increase in EPI of 25% end 2005.	1. Increase the eco-productivity index for water in the period 2001–2005 by an annual average of 5% corresponding to a total increase in EPI of 30% end of 2005. Increase the eco-productivity index for energy in the period 2001–2005 by an annual average of 4% corresponding to a total increase in EPI of 25% end 2005.	1. 2005: Water: 101 energy: 99
	2. S&R to set target .	2. CO_2-complaince plan approved by PS management. Information seminar for key internal stake-holders to ensure effective implementation of the CO_2 strategy.	
		3. Include the CO reduction target in PS BSC06.	

Source: internal documents provided by Eric Drapé, SVP Diabetes Finished Products

Appendix 8: Cascading of Balanced Scorecard 2005 – Support Diversity

	Operations	Product supply	Diabetes finished products
KPI	1. Equal opportunity implementation.	1. Equal opportunity implementation.	1. Equal opportunity implementation.
	2. Number of EVPs/SVPs that have evaluated progress achieved according to plan as part of the OA process.	2. Number of employees that have evaluated progress achieved according to plan as part of the OA process.	2. Number of employees that have evaluated progress achieved according to plan as part of the OA process.
		3. JTC (job transfer Centre) process is running smoothly.	3. JTC process is running smoothly.
KPI definition	1. Action plans for 2005 achieved.	1. % of targets in the action plans for 2005 achieved.	1. % of targets in the action plans for 2005 achieved.
	2. EVPs/SVPs have evaluated progress.	2. % of EVPs/SVPs that have evaluated progress.	2. Progress evaluated.
		3. The KPI measures: A) JTC's ability to send the right people to the right job; B) the interviewers acceptance of these candidates.	3. The KPI measures: A) JTC's ability to send the right people to the right job; B) the interviewers acceptance of these candidates.
Target 2005	1. % of targets in the action plans for 2005 achieved; red <80%, yellow 80%, green >80%.	1. 80%	1. Target > = 80%
	2. % of EVPs/SVPs have evaluated progress according to plan from OA (combined SVPs); red <95%, yellow 95% – 99%; green 100%	2. 100%	2. Target = 100%; evaluation done according to templates from corporate responsibility management.
		3. When JTC has relevant candidates for vacant positions, 90% of those vacant positions must be filled by a JTC candidate.	3. When JTC has relevant candidates for vacant positions, 90% of those vacant positions must be filled by a JTC candidate.

Source: internal documents provided by Eric Drapé, SVP Diabetes Finished Products.

Appendix 9: Cascading of Balanced Scorecard 2005 – Ensure Talent Development

	Operations	Product supply	Diabetes finished products
KPI	1. Utilisation of talent pools – % of VP positions filled from talent pools.	1. Utilisation of talent pools – % of VP positions filled from talent pools.	1. Utilisation of talent pools – % of VP positions filled from talent pools.
	2. Employee perception of development based on eVoice survey (development theme).	2. Employee perception of development based on eVoice	2. Employee perception of development based on eVoice
KPI definition	1. VP positions (new or vacant) filled from talent pools.	1. VP positions (new or vacant) filled from talent pools.	1. VP positions (new or vacant) filled from talent pools.
	2. Percentage of units score.	2. Units to score an average of > = 3.0 on the mandatory eVoice theme "development of people".	2. Percentage of units score 3.0 or above 0 on the mandatory eVoice theme "development of people".
Target 2005	1. % VPs filled from talent pools. Red <55%, yellow 55%–60%, green >60%.	1. 60%	1. Target > = 60%
		2. 85%	2. Target = 85%

Source: internal documents provided by Eric Drapé, SVP Diabetes Finished Products

Appendix 10: Diabetes Finished Products – 2005 Balanced Scorecard

CSF	CSF – Rationale	KPI
Finance		
Realise growth in operating profit	Secure industry competitive growth	Operating profit
Ensure competitive ROIC – Working capital and investments	Ensure industry competitive return on invested capital	Inventory
Investments	Ensure investment management	Investments
Business processes		
Improve productivity in DFP	Secure cost efficiency in production	Output vs. cost (unit costs)
		Approval of batch records
		Reduction in number of NCs
		Quality cost
		COGS
Timely and efficient execution of investment portfolio	Critical to increase production capacity in future demand and to improve productivity	Progress on major investments projects
Ensure successful implementation of IT projects	Successful implementation and use of IT	IT project milestones
Improve quality management focus in all business processes	Quality issues and documentation will be subject to increasing attention from both customers and authorities	% of non-conformity reports approved
		Audit NC timeliness
		Inspection readiness
		QAP
		Recalls
People & organisation		
Increase internationalisation	Support the globalisation of Novo Nordisk	Internationalisation initiatives carried out
Support diversity/social responsibility	Enhance and promote innovation, attraction and reputation	Equal opportunity implementation
		Evaluated progress achieved
		JTC process is running smoothly
Ensure talent development	To ensure specialist and leadership capabilities that will support and drive growth	Utilisation of talent pools
		Employee perception of development
Ensure performance management	Improve individual performance and alignment with overall business goals	Implement uniform global performance management system
	All units with absence due to illness >5% have to decrease this absence	Absence due to illness

(continued)

CSF	CSF – Rationale	KPI
Customers & society		
Ensure superior customer satisfaction – Improve production quality	Product quality is a critical parameter for achieving customer satisfaction	Customer complaint
Ensure environmental, social and ethical performance	Help the organisation to ensure social, environmental, social and bioethical performance	EPI performance
Ensure timely and efficiently delivery to market	In order to be the world's leading diabetes care company we have to have products ready to meet customer demands	Affiliate inventory level
		Levemir® finished product production
	Launch of Levemir®	

Source: internal document provided by Eric Drapé, SVP Diabetes Finished Products

Appendix 11: Performance Index 2005 – for Eric Drapé

	Diabetes finished products						
			YTD Dec 2005 results		Weighted		
	Weights		Target	Expected	Index	Perf.	Perf. +/–
Finance	**40.0**					**40.0**	**0.0**
Investments		15.0	1762	1762	100	15.0	–
Operating costs*		25.0	2539	2539	100	25.0	–
Customers	**30.0**					**30.0**	**0.0**
Stock outs		5.0	10	10	100	5.0	–
EPI performance		5.0	100	100	100	5.0	–
Production output**							
3ml Penfill, fill		10.0	345	345	100	10.0	–
disposables pack (NL,FP,IL)		5.0	164	164	100	5.0	–
vials pack		5.0	102	102	100	5.0	–
Processes	**20.0**					**20.0**	**0.0**
NN248 timeliness***		2.5	100	100	100	2.5	
Unit cost		2.5	100	100	100	2.5	–
Number of actual recalls		5.0	4	4	100	5.0	–
FDA Inspection readiness		2.5	100	100	100	2.5	
QAP		2.5	80%	80%	100	2.5	–
COGS20, volume/fte		5.0	100	100	100	5.0	–
People & Organisation	**10.0**					**10.0**	**0.0**
Decrease in absence		5.0	10	10	100	5.0	–
JTC		5.0	90	90	100	5.0	–
Total		**100.0**				**100.0**	**0.0**

Source: internal document provided by Eric Drapé, SVP Diabetes Finished Products

*Operating profit target is AB05 plus logbooks and approved target corrections

**Target to be corrected downwards if reduced demand in local markets create excess capacity

***Final product specification. Target is August. If target is reached in September = index 66,6, October = index 33,3, November or later = index 0. If target is reached in July = index 133,3, June = index 166,6, and May or sonner index 200

The Changing Role of Business Leaders, and Implications for Talent Management and Executive Education

31

Matthew Gitsham

It may have been happening quietly in the background without attracting much attention, but look around and you'll notice that there's been a fundamental development in the scope of the role business leaders are required to play for their businesses to survive and thrive in today's turbulent, uncertain and volatile times.

Putting Creating Value for People at the Heart of Strategic Goals

In recent years more and more organisations have been formulating goals in terms of the problems and needs they will help address in society. Rather than articulating goals solely in terms of the financial value that will be created for shareholders, they have been instead defining goals in terms of the value they will create for people – end consumers and wider stakeholders – which will allow them to create value for shareholders in the process. Think of Unilever announcing in 2010 that to meet its aim to double the size of its business in 10 years, it would focus on strategic goals including helping a billion people improve their hygiene, bringing safe drinking water to 500 million, and halving the greenhouse gas impact of their products across their lifecycle. Or Philips' strategic goal to improve the lives of 3bn people a year by 2025, Kingfisher's strategic goal to make it easier for their customers to have better and more sustainable homes, GSK's goal to improve the quality of human life by enabling people to do more, feel better and live longer. While still only a minority, the number of companies framing their purpose and future activities in these terms is growing fast.

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© Springer Science+Business Media B.V. 2019
G. G. Lenssen, N. C. Smith (eds.), *Managing Sustainable Business*,
https://doi.org/10.1007/978-94-024-1144-7_31

Fundamental Shifts

Although these kinds of strategic goals are a recent phenomenon, what we're seeing is the outcome of some much longer term trends.

Think back to the 1970s. The prevailing view was that government leaders dealt with society's challenges. For business leaders, what it took to survive and thrive was to keep their eyes squarely on their industry and focus on making money. Broader societal issues were seen as none of their business, and to get involved would only add cost.

Fast forward to the 2010s and much has changed. Not only have civil society organisations become much more influential, but so has a much more globally-integrated private sector. In 1970, the world's biggest economic entities were all countries, but now a sizeable number of them are private companies.[1] Now there is a widespread view that most big challenges are pretty hard for governments to address on their own, and that a much wider group of actors need to be at the table.

CEOs' thinking about fundamental business models has been changing too. The 1980s saw business adopt the model of 'maximising shareholder value', as a way of fixing some of the problems of poor profitability in the 1970s.[2] But as business leaders have seen first-hand the weaknesses of this model become clearer in the past few years, many have begun experimenting with alternatives, like Michael Porter's 'creating shared value' model.[3] For business leaders to survive and thrive in today's world means developing strategies that focus primarily on creating value for wider stakeholders to ensure they generate return for shareholders in the medium and long term as well as the next quarter.

All these shifts have had some pretty fundamental implications for the kind of leadership role senior executives are now finding themselves having to play.

A More Collaborative Leadership Role at the Heart of Society

The much greater economic clout and influence of globally-integrated business has thrust business leaders, whether they like it or not, into a far more overtly 'political' kind of role on the world stage – you might say as much 'statesman' as 'businessman' (leaving aside the unfortunately gendered nature of these terms).

There have been plenty of business leaders over the past decade or so who did not recognise how these forces had started to shift the ground under their feet and what this meant for how they needed to play the role of business leader differently, and

[1] Global Trends (2013). *Corporate Clout 2013: Time for Responsible Capitalism.* Global Trends.

[2] Dobbin, F. & Jung, J. (2010). The misapplication of Mr Michael Jensen: how agency theory brought down the economy and why it might again. *Research in the Sociology of Organizations*. Vol 30B. pp. 29–64.

[3] Porter, M., & Kramer, M. (2011, Jan). Creating Shared Value. *Harvard Business Review*. Vol. 89 Issue 1/2, pp. 62–77

got themselves and their companies into trouble as a result – remember former Nike CEO Phil Knight trying to defend sweatshop labour, former GSK CEO Jean-Pierre Garnier leading the pharma industry in suing Nelson Mandela's government over access to medicines, former BP CEO Tony Hayward thinking it was a good idea to call the Gulf of Mexico oil spill 'relatively tiny', or Google CEO Eric Schmidt trying to defend tax avoidance. These leaders did not recognise how the balance of power between government and business has shifted and what that means for how they need to play their role differently.

But in the past few years, more and more business leaders seem to be embracing this new scope to the senior executive's role that comes with leading the fundamentally more influential kind of institution business has become, whether it be:

- Unilever CEO Paul Polman sitting on a UN High Level Panel with presidents, prime ministers and the UN Secretary General to help shape the UN Sustainable Development Goals.
- Kingfisher CEO Ian Cheshire chairing the UK Corporate Leaders Group on Climate Change, lobbying for stronger government policy on the low carbon economy.
- Sainsburys CEO Justin King speaking out on tax avoidance, challenging his peers in other industries to contribute a fair rate of tax in the countries where they benefit from investments in infrastructure and communities.
- GSK CEO Andrew Witty partnering with NGO Save the Children on innovation in child-friendly medicines and reinvesting 20% of profits made in the world's least developed countries back into projects which strengthen healthcare infrastructure in those countries, primarily through training community health workers.

Playing this new kind of leadership role well isn't some kind of vanity project aimed at securing a knighthood. It has emerged in response to fundamental shifts in global geopolitics – and an ability for business leaders to play this role well has increasingly become a key variable in the success or failure of both their organisations and wider society. A vanguard of today's CEOs are now playing this role well. Others still need to learn, and learn fast.

What's Required to Be Able to Play This New Role Well?

We've been leading a programme of research around this at Ashridge Business School for a number of years now, partnering with networks like the Academy of Business in Society, the UN Global Compact, and the International Business Leaders' Forum. We've been talking with some of the CEOs who've been at the forefront of this trend – people like Neville Isdell, former Chairman & CEO of the Coca Cola Company; Paul Walsh, CEO of Diageo; John Brock, Chairman & CEO of Coca Cola Enterprises; Lord Browne, former CEO of BP; Sir Mark Moody Stuart, former Chairman of Shell and Anglo American; Frederick Chavalit Tsao,

Chairman of IMC Pan Asia Alliance Group; Carolyn McCall, CEO of easyJet; and Mark Foster, former Group Chief Executive, Accenture. We asked them what their experience said about how the role of a business leader is different now from what it was in the past. Their experiences can be summed up in three themes: context, complexity and connectedness.

Context: understanding the strategic implications of societal trends, and developing a broader view on the role of business leaders in society

What is clear from their experiences is that it is essential that business leaders today have a nuanced understanding of the major societal forces shaping our world and a genuine personal passion for running a profitable business out of serving the interests of wider society; that helping address societal challenges through their core business is the primary means by which they create value, not a source of cost, and at the heart of their job description – a quite different view on the role of a business leader compared with the norm of a generation ago.

Mark Foster, former Group Chief Executive at Accenture, summed up how his thinking about his role had changed like this:

Senior executives we surveyed[4] told us that leaders at their level must be able to:

- Understand the business risks and opportunities of environmental and social trends — and how their sector and other stakeholders (regulators, customers, suppliers, investors, NGOs) are responding to them (82%)
- Align social and environmental objectives with financial goals (81%)

> The journey I'd been on was first of all an understanding that there was a world out there above and beyond the piece of business you're in. The second thing is then a movement from business challenges to global challenges. And then you move into asking: 'What's the role we're playing in participating in those challenges?' And then, 'What can we do about it?' As a business, both in terms of the business opportunity and secondly, the broader ethical engagement with the world and what you see around you".[5]

John Brock, Chairman and CEO of Coca Cola Enterprises argued:

> In today's world I don't think you have a choice. If you're going to be an effective leader you've really got to be driving all aspects of sustainability as part of what you're doing, because it's the right thing to do and because it's the right thing to do for the business … If you're not personally persuaded then you've got a little bit of an issue, and maybe there are some people in that category, in which case I think leading – in some hypocritical sense – is quite hard to do. It helps a lot if you've got the personal passion and commitment.[6]

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[4] Gitsham, M. & Lenssen, G. et al. (2009) *Developing the Global Leader of Tomorrow.* Ashridge and ABIS for the UN Principles for Responsible Management Education.

[5] Gitsham, M. et al. (2012) *Leadership in a rapidly changing world*. Ashridge and IBLF.

[6] Gitsham, M. et al. (2012) *Leadership in a rapidly changing world*. Ashridge and IBLF.

Sir Stuart Rose, former CEO and Executive Chairman of Marks&Spencers, spoke about the significance of the changing balance of governments and companies: "The 100 largest financial entities in the world used to be governments. Now over 50 of them are businesses, so suddenly the whole scale in the world has changed, and businesses have become much more important than they used to be."[7]

For Sir Stuart, the commercial implications of this, and case for acting differently was clear:

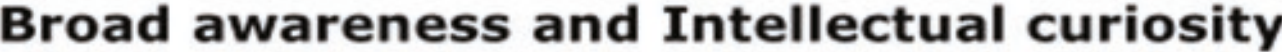
> In 2007 I said Plan A wouldn't make any profit in the first five years. In the 2010 annual report, £50million of extra profit was attributable to doing the right thing. So there's the proof. Any chief executive that says: 'I can't afford to do it, I haven't got the people, it's all too expensive, the consumers don't want it, they haven't asked me for it, it's the wrong thing to do and it's going to cost me money' is wrong, wrong, wrong, wrong and wrong.[8]

The senior executives we spoke with were also clear that doing this well means getting involved in activities that require a different skill set. Not only are senior executives now playing some very specific roles in leading innovation and change within their own organisations to drive the execution of shared value strategies, they're also now playing a much more significant leadership role in wider society too.

Context – Understanding and being able to integrate and respond to macro developments affecting the business environment and the business model in the medium term

- Understanding macro trends: Geopolitical, Demographic, Social, Environmental
- Understanding Globalisation: Economic, Cultural, Political and technological change
- Skills and capabilities: Scenario Building, Horizon Scanning, Issues Maturity Assessment

CONTEXT
COMPLEXITY
CONNECTEDNESS



Complexity: a leader's role in leading change in organisations

Organisations don't change because one individual says so, they are complex communities of relationships where people's decisions and actions are guided by multiple different influences. The chief executives we spoke to talked of seeing their own role in influencing change in their organisations in terms of opening up the space for others to behave differently – through the goals they articulated and the

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[7] Rose, S. (2012) Sir Stuart Rose on the changing role of business leaders. *Guardian Sustainable Business*. 29 March. http://www.theguardian.com/sustainable-business/sir-stuart-rose-changing-role-business-leaders

[8] Gitsham, M. et al. (2012) *Leadership in a rapidly changing world*. Ashridge and IBLF.

rationales they developed for pursuing them, the stories and people they celebrated, the conversations they started, the questions they asked, what they were seen to spend their own time doing, and which individuals and groups got recognised and rewarded and for what.

Senior executives we surveyed[9] told us that leaders at their level must be able to:

- Articulate the business rationale for pursuing social and environmental objectives (75%)
- Integrate social and environmental trends into strategic decision-making (70%)

Paul Walsh, CEO of Diageo, talked about the significance of the questions he asked in leading change: "It's interesting how word gets around. I'm a great believer that if I want to focus the organization on X I just walk round the organization and I ask about X. And the word gets out."[10]

For Mark Foster, the significance of how he was seen to spend his time was important: "I would try and give a week a year to Accenture Development Partnerships for them to send me somewhere and engage with their programmes, as a very clear signal to the organisation that I thought this mattered."[11]

Carolyn McCall talked about the CEO's role in empowering more junior employees to play leadership roles in change, and challenging more senior leaders not to discourage them: "I got younger people involved, I got champions in each of the divisions, and they started driving things rather than the more senior leaders. All I said to the senior leaders was 'What I need is for you not to be an obstacle.' I wanted them not to be blockers. I wanted them to also not roll their eyes, because a lot of it is body language."[12]

Lord Browne argued that to sustain the right kind of behaviours, people had to know that they would receive some kind of recognition, whether that be financial, a promotion, or just a sense of wellbeing that comes from being highly regarded by their peers. "The biggest thing about getting anything done in an organization of course is to really get to the point where everyone in the organization owns the objective as if it's their own, and they recognize that by achieving the objective something good will happen to them. And these statements are as old as the hills but you must never ever forget them."[13]

[9] Gitsham, M. & Lenssen, G. et al. (2009) *Developing the Global Leader of Tomorrow.* Ashridge and ABIS for the UN Principles for Responsible Management Education.

[10] Gitsham, M. et al. (2012) *Leadership in a rapidly changing world*. Ashridge and IBLF.

[11] Gitsham, M. et al. (2012) *Leadership in a rapidly changing world*. Ashridge and IBLF.

[12] Gitsham, M. et al. (2012) *Leadership in a rapidly changing world*. Ashridge and IBLF.

[13] Gitsham, M. et al. (2012) *Leadership in a rapidly changing world*. Ashridge and IBLF.

Complexity – Deep Awareness of systemic interdependencies and being able to thrive in conditions of ambiguity, uncertainty and low agreement

- Sensing and acting on emerging processes in markets and societies
- Creating short term and medium term feed back and learning loops

- Skills and capabilities: Emotional Intelligence
  Combining analysis and intuition
  Flexibility and Responsiveness

Systems thinking and mindful action

Connectedness: a leader's role in leading change in wider society

A number of the interviewees also identified an important change in the scope of their work. More and more they now see it as their role to lead beyond the traditional boundaries of their organisation, proactively leading change in consumer and supplier behaviour, industry norms and government policy, for the mutual benefit of their organisations and wider society. Some are leading collaboratively with industry competitors, NGOs and government where challenges need to be tackled and only collective, systemic solutions will do.

This new horizon to their role has required leaders to develop skill in areas that historically have not been a conventional part of the business leader's repertoire: contributing to public debate with an informed point of view, proactively leading change in consumer and supplier behaviour, industry norms and government policy, relating well with multiple constituencies, engaging in dialogue to understand and empathise with groups and communities with perspectives contrary to one's own, and engaging in multi-stakeholder collaboration with unconventional partners.

John Brock, Chairman and CEO of Coca Cola Enterprises talked about the change like this:

> Senior executives we surveyed[14] told us that leaders at their level must be able to:
>
> - Identify key stakeholders that have an influence on the organization (73%)
> - Understand how the organization has impact on these stakeholders, both positively and negatively (74%)
> - Engage in effective dialogue (75%)
> - Build partnerships with internal and external stakeholders (80%)
> - Wngage in and contribute to public policy (60%)

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[14] Gitsham, M. & Lenssen, G. et al. (2009) *Developing the Global Leader of Tomorrow.* Ashridge and ABIS for the UN Principles for Responsible Management Education.

> I think the role of a business leader today is much more challenging because you've got so many other constituencies out there that you didn't have before. Certainly the hierarchical approach – let's just lead from the top and if other people don't like it, that's their problem – that does not work anymore. You've got to engage with these multiple constituencies and make decisions in a more consensual way. And that requires a real skill. As the leading drinks manufacturer in several countries, and as a major player in the industry itself, we believe we have an important leadership role to try to figure out how to bring government, NGOs, and industry all along. We as a company will invest a huge amount of time. And not just me, our whole leadership team.[15]

Connectedness – Understanding and engaging with multiple actors in the wider economic, political and societal landscape and build effective networks

- Share a personal sense of connection with diverse social networks and communities
- Build partnerships with internal and external stakeholders
- Engage and contribute to public policy
- Skills and capabilities: Dialogue
  Self-awareness and authenticity
  Boundary spanning

Generating legitimacy and trust

What Does It Mean for Talent Management and Executive Education?

Getting this new leadership role right has become key to whether an organisation (and wider society for that matter) survives and thrives in today's turbulent, uncertain and volatile times. But the extent to which organisations have ended up with leaders that can do this well (or not) has to date been more to do with good (or bad) luck, rather than by design. As Paul Polman notes, few of today's generation of business leaders have been trained for this:

> I don't think our fiduciary duty is to put shareholders first. I say the opposite. What we firmly believe is that if we focus our company on improving the lives of the world's citizens and come up with genuine sustainable solutions, we are more in synch with consumers and society and ultimately this will result in good shareholder returns… It is an enormous learning curve as no one has been trained for this.[16]

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[15] Gitsham, M. (2012). The Changing Role of Global Leaders. *Harvard Business Review Insight Center*. February 14. http://blogs.hbr.org/2012/02/what-it-takes-now-to-lead-a-bu/

[16] Confino, J. (2012) Unilever's Paul Polman: Challenging the status quo. Guardian Sustainable Business. 24 April. http://www.theguardian.com/sustainable-business/paul-polman-unilever-sustainable-living-plan

As a result, this same new generation of business leaders has started to recognise that their organisations need to start taking a more systematic approach to the selection and development of the groups of executives handed the responsibility of senior decision-making roles. Their organisations need to deliberately build the right kind of leadership capability and cultural norms to be able to survive and thrive in this new context.

Clearly, today's business leaders need a much more thorough literacy in global issues and their business implications, as well as the motivation and commitment to put acting on this at the heart of their work, and a different level of relational skill to lead change inside and beyond their organisations. But how do you achieve this? How come some business leaders get it and others don't?

We asked some of these leaders for their perspectives on how it was that they and some of their peers had grasped the need to lead in this kind of way while many of their other contemporaries were still operating from an out-of-date leadership blueprint.

While each individual's story was unique, the clear theme was that certain key experiences had been crucial in influencing and shifting perspectives. For some it was formative experiences around upbringing, university and business school study. For others it was influential mentors or first-hand experiences like engaging with people living in poverty, personal experience of challenges like water stress or the impacts of climate change, or personal first-hand experiences of the changing interests of key stakeholders.

For Neville Isdell, the former CEO of The Coca Cola Company, an influential sociology professor, student activism and training as a social worker in Cape Town's Cape Flats shanty towns in the polarised atmosphere of 1960s South Africa was a potent combination that shaped the positions he took once CEO on issues like human rights, climate change and water scarcity. "I majored in sociology at university in South Africa and I qualified as a social worker. I was also involved in student politics and I stood for the Student Council on an anti-apartheid ticket. So I started out with a frame of reference which was a little different from your average business leader."[17]

Mark Foster talked about the influence on him of Accenture's International Chair, Vernon Ellis. "I became interested in these topics by being exposed to others who were fairly passionate about it. They made you think about things you hadn't previously thought about."[18]

Paul Walsh talked about the powerful impact of being exposed to the realities of people's lives in water-stressed parts of the world where Diageo does business. "I remember opening a borehole project in Lagos, in one of the terrible slum areas, and seeing these children flick water at each other. It was almost as if they were playing with a Christmas gift. It was incredible. Just flicking it in each other's face and giggling."[19]

[17] Gitsham, M. et al. (2012) *Leadership in a rapidly changing world*. Ashridge and IBLF.

[18] Gitsham, M. et al. (2012) *Leadership in a rapidly changing world*. Ashridge and IBLF.

[19] Gitsham, M. et al. (2012) *Leadership in a rapidly changing world*. Ashridge and IBLF.

Selecting and Developing Today's and Tomorrow's Senior Executives

These stories have important implications for how organisations think about talent management and executive education. They suggest that more is required than just briefings and lectures on global trends and their commercial implications – relationships and first hand experiences are at the heart of what it takes for business leaders to build the emotional connection and commitment to put this agenda front and centre of their work. Therefore to foster the right kind of leadership capability in their organisations, HR, Learning and Development, and Organisation Development teams need to do more of the following:

1. **Value these kinds of life experiences when making decisions about recruitment, career development and succession planning, and make sure they are embedded in the HR processes that underpin these.**

   If personal, first-hand experience like engaging with people living in poverty, personal experience of challenges like water stress or the impacts of climate change, or personal first-hand experiences of the changing interests of key stakeholders are key in stimulating the required kind of business leadership for the current era, then these kinds of experiences need to be deliberately encouraged, valued and sought after in recruitment, career development planning, the identification of high potentials and succession planning. Not because they are 'nice-to-haves' that demonstrate a rounded individual, but because of the crucial contribution they make to developing a worldview, relational ability and organisational culture now essential for organisations to survive and thrive.

   This will require being mindful about deliberately looking for something different in the moment of making these decisions about recruitment, career development planning, high potentials and succession planning, and perhaps challenging a tendency to recruit in your own image by hiring based on what worked in the past. It will also require reassessing and, where necessary, reformulating the kinds of HR processes and indicators that supply the management information sometimes used when making these decisions.
2. **Embed the opportunities to have these kinds of experiences in leadership development and executive education.**

Our research with organisations like IBM, HSBC, Lend Lease, IMC Group and others[20] suggests that more and more organisations are structuring their leadership development activities to create opportunities for their current and future senior leader to have precisely these kinds of personal, first-hand experiences. To achieve this, they are employing powerful experiential learning that:

[20] Gitsham, M. et al. (2013) *Building Leadership Capability for a Rapidly Changing World.* Ashridge.

- Give senior executives the chance to develop relationships with people experiencing some of the world's most pressing challenges, and also with people working to help address these challenges.
- Give them a chance to engage with new ideas to help make sense of the demands of this new business context like ecology, complexity, systems thinking and social constructionism, and how these link with business language through new concepts like 'shared value', 'brand substance', 'closed loop manufacturing' and 'integrated reporting'.
- Support them to make their own sense of these experiences and relate them to their organisational roles through action learning, business challenge strategic projects and exposure to individuals in their own organisations already modelling this way of leading.
- Help them develop and articulate their own authentically held view on the purpose of their work, and the value it creates for wider society.

Take Dutch multinational Philips for example. In their leadership development work in partnership with Ashridge Business School, between residential modules participants engage in strategic projects to develop new commercial propositions which help contribute to achieving the goal of the organisation's strategy: to improve the lives of three billion people a year by 2025.

One recent learning project challenged participants to develop proposals for serving rural communities in India with good business case potential and the ability to scale up. After spending time engaging first-hand with women in rural Indian communities and health professionals and NGOs, the team developed an idea to use mobile communications technology to support remote diagnosis.

The result has become a thriving public-private partnership involving Philips, government and NGO partners. Health professionals now travel among rural communities with portable ultrasound, X-Ray and ECG testing equipment and send test results electronically to specialists in distant hospitals using mobile technology, who then liaise with the health professionals to discuss diagnosis via video-conference.

Singapore-based shipping conglomerate IMC Group is another example. Working with partners from the Global Institute for Tomorrow, the IMC Integrated Leadership Programme for high potentials in the organisation involves a week of classroom-based learning exploring socio-political and environmental trends, sustainable development and business, followed by a week of experiential immersion learning, tasking participants to develop a strategy that embraces the principles of sustainable development for a specific part of the business. The 2010 cohort developed a strategic plan – embracing sustainability – for the IMC Palm Oil Plantations business in Kalimantan, Indonesia after spending a week on the plantation, engaging with local management, local workers, families in local communities and ecologists. Their plan was presented to the IMC Group Senior Management Team on the final day of the programme.

Similar approaches combining awareness raising with powerful first hand experiences and opportunities to form relationships with key stakeholder groups have

been taken by numerous organisations. As part of their leadership development programme, senior executives from British broadcaster Sky had to complete a business challenge on sustainable livelihoods in the Brazilian Amazon, involving first hand engagement with local government officials, NGOs and indigenous communities. Senior executives at IBM work on strategic projects in emerging markets partnering with NGOs, local government and local communities as part of the IBM Corporate Service Corps leadership development programme. At HSBC, senior executives have worked side by side with climate scientists at forest research stations to build awareness, emotional connection and commitment to engaging with climate change in their work.

Numerous case studies now abound in fostering the kind of leadership capability and cultural norms to create shared value, stimulated through leadership development employing powerful experiential learning.

"You can't call yourself a successful business leader in a failing world"

So said Feike Sijbesma, CEO of Dutch multi-national DSM at the UN Global Compact Leaders Summit during the 2013 UN General Assembly.

The role of business leaders has changed. So must how we select and develop them.