Corporate purpose: implications for Italian utilities

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Recent years have seen growing social, political and market pressures on business leaders to go beyond simply creating short-term value for shareholders. The notion that businesses exist primarily for their shareholders (‘shareholder primacy’) has been openly challenged, while concepts such as ‘responsible capitalism’, ‘stakeholderism’ and ‘sustainable business models’ have become increasingly prevalent.

The drivers of this change in mindset are diverse—from a recognition of the need to protect the environment, mistrust in big corporations following the financial crisis, concerns around equality and fair treatment of consumers and workers, and changing attitudes to work. International commitments to addressing the climate crisis have focused minds, including the 2015 Paris Agreement, the United Nations Sustainable Development Goals (SDGs) and the European Green Deal. The COVID-19 pandemic has also led firms, investors and the general population to question what a greener, fairer and sustainable recovery would look like.

Changing investor expectations, new corporate code requirements, and the evolution of reporting approaches—in particular, environmental, social, and governance (ESG) reporting and integrated reporting (IR)—have intertwined to put pressure on companies to consider their underlying purpose and their wider impacts. This is about how a firm makes its profits rather than how they are spent.

The benefits of a purposeful business model

There is increasing recognition that to be profitable in the longer term, a firm must maintain and enhance its various sources of capital. Put another way, effective management of a company’s various capitals can result in:

- increased value creation;
- improved risk management;
- improved decision-making;
- engaged stakeholders;
- more effective communication.

Consumers increasingly switch away from brands associated with firms that have a poor environmental record. Studies show that firms employing a more diverse workforce enhance their human capital and make more profits. Employees want to work for and stay with firms with a good social and environmental record. There is also evidence that firms adopting ESG or IR reporting make higher returns, although there are also critiques of these analyses. Investors are acutely aware of these trends.

However, for a company to realise these kinds of benefits, it must do so in a way that is genuine and credible—as opposed to greenwashing.

We explore a variety of examples internationally where companies have adopted a purpose. In Italy, the Benefit Corporation model has been adopted by a number of companies since 2016 as a means of embedding a broader purpose into the business, in addition to B-Corp accreditation.

An obvious question follows: how can a company seek to measure and monitor its progress in delivering its purpose? The critical challenge is understanding the impact that the company is having on the world at large, rather than just on shareholder value.

The six capitals model

While ESG is one framework for addressing this challenge, another more recent initiative is for companies to state a purpose and to measure delivery against this purpose using the six capitals framework. In this vein, to survive in the long run, firms must maintain not only their physical and financial capital—but also their natural, human, social, material and intellectual capital. This model can help to frame how companies make decisions, measure performance and assess their impact on society.

We explore examples from around the world in which companies had stated a purpose. Alternative reporting measures exist, including ESG, IR and monetisation of impacts (impact-adjusted profits). ESG (sustainability) reporting is commonplace, while companies adopting the six capitals framework increasingly use IR. There is also a push from some in academia for companies to go further, and to publish impact-weighted accounts, with adjusted-EBITDA figures in the company's bottom line.

Arguably, the 'gold standard' would involve:

- stating clearly the corporate purpose and establishing the six capitals framework;
- establishing monetisation of impacts in an ex ante appraisal framework;
- measuring ex post impacts in monetised (and non-monetised) form;
- linking ex post performance to management remuneration.

We have not uncovered in our research an example that meets all of these conditions, particularly in relation to comprehensive ex ante and ex post monetisation of wider impacts.

The special case of utilities

Utilities are a special case: they provide an essential service, contain a naturally monopolistic element, and there is the problem of information asymmetry that necessitates economic regulation.

Therefore, while providing a continuous service to society while minimising adverse environmental impacts is in the DNA of water, energy and municipal waste companies, market failures may arise as consumers cannot monitor firm behaviour perfectly and cannot switch. In turn, firms' interests may not be completely aligned with that of wider society or the environment.

There are, however, a variety of correction mechanisms that could be employed, including: ownership and governance changes, industry and global initiatives, investment community pressure and regulatory measures. These differ in the degree to which they are adopted by the firms or are imposed on them. They also differ in terms of their severity. We outline some lessons from the England and Wales water sector.

Sustainability and Italian utilities

We explored with Utilitalia members how they approach sustainability and the kinds of issues discussed above. We spoke with a variety of different companies involved in water supply, wastewater treatment, energy, and municipal waste. These companies varied with respect to:

- whether they were publicly owned (by municipalities), privately owned, or a mixture of the two;
- whether they were large-scale multi-utilities or smaller scale with a single focus;
- their evolution along the path of ESG and other initiatives.

One strong message that came from these discussions was that the very nature of the activities that they undertake—that of providing essential services crucial to the wellbeing of society and the environment—means that purposefulness is in many ways within their DNA.

The model of ownership was also cited as making a difference, but no one model dominated in delivering outcomes. Municipalities are public-sector bodies and as shareholders want a good service for their citizens, employment and training opportunities, and stewardship of the environment. Public-listed companies said that equity investors were increasingly looking to companies that could demonstrate their sustainability and diversity credentials, as were the debt (bond) markets. Some companies had a mixture of public-sector and private-sector (publicly listed) ownership—and thus a mixture of these motivations.

Depending on the specific company, changing the articles of association or equivalent could be difficult as there were legal constraints around this, although we did speak to one company that had done so. Nonetheless, in practice, companies undertook other initiatives within their company structure, corporate governance, codes, initiatives and reporting. Larger listed companies are required to disclose on information environmental, social and diversity matters under the EU NFRD and under Italian law.

Companies have sustainability plans of various forms in which the concept of the circular economy was emphasised. Many of the companies have initiatives aimed at improving gender diversity in science. And many had procurement policies in place where only sustainable and accredited suppliers would be invited to tender.

Most companies targeted KPIs linked to ESG goals of one form or another, although some were at a very early stage of this process whereas others had fully embedded ESG. One company we spoke to had embodied the creating shared value concept within its operations, whereby a number of sustainability KPIs are reported on wider value created each year, including reporting of sustainability-adjusted profits. Most companies linked management renumeration to these KPIs.

Barriers to achieving societal outcomes were identified. Culture could be difficult to change overnight, and communication within an organisation was often an enabler of change. Regulation did not always remunerate additional activities, such as the additional costs of waste collection that companies have incurred during the COVID-19 pandemic. Downstream supply chain issues were also beyond the control of some companies. While some assets are not, and cannot be, totally decarbonised at present, future technologies may enable this.

All of these issues highlight that alignment is important for achieving purposefulness.

Looking to the future?

Much progress has been made in Italian utilities, in particular in relation to SDG and ESG. In our view, and thinking of the 'gold standard' discussed above, there is further opportunity for Italian utilities to focus on their public purposes.

- At present, companies tend to operate within a ESG framework, as opposed to the more recent six capitals framework.
- In addition, most companies adopt KPIs around sustainability, but these are not (with some exceptions) monetised in terms of public value.
- Finally, monetisation of public value impacts has not as yet been incorporated into the ex ante investment decision frameworks of companies. Rather, impacts are taken into account ex post through the KPI framework.

Such initiatives will have practical implications, but are nonetheless worth considering.

1 Introduction

In this report, we consider how there is an increasing need for businesses to demonstrate that the way in which they do business has positive wider impacts.

- Globally, there is a drive for firms to have a clear stated purpose beyond just profit or ‘the bottom line’, and to monitor their performance against that purpose.
- Purpose is about how profits are made rather than how they are spent.
- A purposeful business that maintains and enhances the different sources of capital it draws on, and contributes to, in undertaking its activities (the ‘six capitals’) is increasingly seen by consumers, investors and others as a resilient and sustainable business.
- There are different schools of thought regarding how the purposeful framework (including the six capitals) should be implemented, and how performance should be measured and monitored.

In this summary document, we study examples from around the world in terms of adopting a purpose and in reporting performance. We consider the special case of utilities, whose business model is to provide an essential public service. We explore in particular current practice in the Italian utilities sector and we set out some implications for the sector going forward.

The report is a discussion paper to encourage further debate.

1.1 Report structure

In the following sections, we discuss:

- what is driving the shift from profits to purpose (section 2);
- the benefits of adopting a purposeful business model (section 3);
- what corporate purpose is exactly (section 4);
- how performance against a corporate purpose can be measured according to the six capitals framework (section 5);
- why the six capitals framework is of particular relevance to the utilities sector in embedding and communicating its ‘public value’ (section 6);
- how this framework is being applied in the Italian utilities sector, and what more could be done (section 7).

2 What is driving the shift from 'profits' to 'purpose'?

Attitudes to business change over time. Since the 1970s, the idea that the role of a business is to generate profits for its owners has been central to how (many) corporations have acted, organised themselves, measured performance, and rewarded their employees.[1] The result is that the successes, failures and (hence) value of businesses have often been assessed through the narrow lens of financial performance.

In recent years, however, there have been increasing social, political and market pressures on business leaders to go beyond simply creating short-term value for shareholders. The notion that businesses exist primarily for their shareholders ('shareholder primacy') has been openly challenged, while concepts such as 'responsible capitalism', 'stakeholderism' and 'sustainable business models' have become increasingly prevalent.[2]

The drivers of this change in mindset are diverse—from a recognition of the need to protect the environment, mistrust in big corporations following the financial crisis, concerns around equality and the fair treatment of consumers and workers, and changing attitudes to work.

Global commitments have also played a role. The 2015 Paris Agreement committed countries to further carbon reduction to tackle the climate crisis. Also in 2015, the United Nations (UN) set out a global framework for the achievement of a greater balance between economic, social and environmental impacts:[3]

> The Sustainable Development Goals (SDGs), also known as the Global Goals, were adopted by all United Nations Member States in 2015 as a universal call to action to end poverty, protect the planet and ensure that all people enjoy peace and prosperity by 2030. The 17 SDGs are integrated—that is, they recognize that action in one area will affect outcomes in others, and that development must balance social, economic and environmental sustainability.

Under the European Green Deal, the EU aims to be climate neutral by 2050 (i.e. to have an economy with net-zero greenhouse gas emissions), and has adopted an intermediate target of reducing net greenhouse gas emissions by at least 55% (compared to 1990 levels) by 2030. In July 2021, this commitment was enshrined in the European Climate Law.[4]

Beyond public institutions, investors have increasingly looked to see how large companies have mapped these SDGs in their governance and reporting. Most recently, the COVID-19 pandemic has led firms, investors and the general

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[1] US economist Milton Friedman wrote that: 'there is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say engages in open and free competition without deception and fraud'. Friedman, M. (1970), 'A Friedman doctrine—The Social Responsibility of Business Is to Increase Its Profits', *The New York Times*, 13 September.

[2] Most notably, in August 2019, the (US) Business Roundtable announced a new Statement on the Purpose of a Corporation (signed by 181 CEOs) outlining a 'a modern standard for corporate responsibility' with a commitment to all stakeholders. From 1997 onwards, each version of the Principles of Corporate Governance adopted by the Business Roundtable had endorsed the principles of shareholder primary—i.e. that corporations exist principally to serve shareholders. Business Roundtable (2019), 'Business Roundtable Redefines the Purpose of a Corporation to Promote 'An Economy That Serves All Americans', 19 August.

[3] See: https://www.undp.org/content/undp/en/home/sustainable-development-goals.html (last accessed 10 September 2021).

[4] European Commission (2021), 'Regulation (EU) 2021/1119 of the European Parliament and of the Council of 30 June 2021 establishing the framework for achieving climate neutrality and amending Regulations (EC) No 401/2009 and (EU) 2018/1999 ("European Climate Law")', July, available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32021R1119 (last accessed 13 September 2021).

population to question what form of business is sustainable and resilient—and what a greener, fairer and sustainable recovery would look like.

2.1 Changing investor expectations

These trends are reinforced by changing investor sentiment as evidenced by the growth in environmental, social, and governance (ESG) investing. By the end of 2020, European sustainable funds covered over €1.1tn of assets.[5] Larry Fink, CEO of Blackrock, has outlined what investors now expect to see from companies:[6]

> Companies must ask themselves: What role do we play in the community? How are we managing our impact on the environment? Are we working to create a diverse workforce? Are we adapting to technological change? Are we providing the retraining and opportunities that our employees and our business will need to adjust to an increasingly automated world? Are we using behavioural finance and other tools to prepare workers for retirement, so that they invest in a way that will help them achieve their goals?

While the traditional financial framework focuses on investment in manufactured capital in order to reward the provision of financial capital by shareholders, the ESG framework focuses, in addition, on whether firms have governance measures in place to mitigate negative social and environmental impacts (and promote positive impacts).

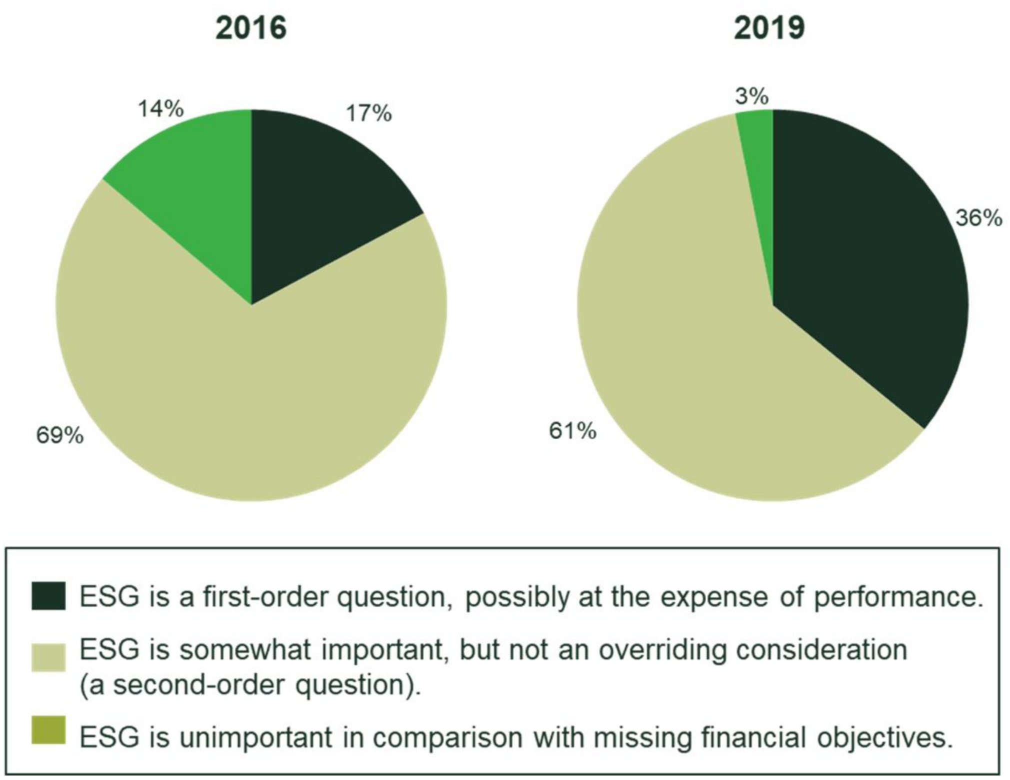
A predecessor to ESG was the concept of *corporate social responsibility* (CSR). CSR focuses on making a business accountable for its wider impacts. However, a limitation is that CSR is largely qualitative in nature. It does not provide a framework for quantification of the impacts of the business. In contrast, ESG provides a criteria-based framework for measuring social and environmental impacts, as well as for scoring governance arrangements, and accordingly enables investors to vet businesses in a more objective manner. However, there remain different standards around the world.

ESG has been used by some firms as a means of incorporating the UN SDGs into their governance and reporting. In addition, in 2017, the UN set out its Principles for Responsible Investment (UNPRI or PRI). Aimed at institutional investors, this sought to accelerate the adoption of ESG. Six principles were set out, including a commitment to incorporating ESG issues into decision-making and seeking disclosure on ESG issues by the entities invested in.

In EDHEC Business School's 2019 Global Infrastructure Investor Survey,[7] institutional investors were asked about their stance on the social and environmental impact of their infrastructure investments. As shown in Figure 2.1, between the surveys completed in 2016 and 2019, there was a shift in sentiment towards the valuing of ESG objectives, even if this is at the expense of financial performance.

[5] Losavio, E. (2021), 'ESG demand prompts more than 250 European funds to change tack', *Financial Times*, 16 February.
[6] Fink, L. (2018), 'A sense of purpose', available at, https://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter (last accessed 13 September 2021).
[7] See EDHEC Business School (2019), 'EDHEC*infra* Paper: 2019 Global Infrastructure Investor Survey – Benchmarking and Best Practices', April, available at: https://edhec.infrastructure.institute/paper/2019-global-infrastructure-investor-survey-benchmarking-trends-and-best-practices/ (last accessed 13 September 2021).

Figure 2.1 2019 Global Infrastructure Investor Survey



Source: EDHEC Business School (2019), 'EDHEC*infra* Paper: 2019 Global Infrastructure Investor Survey – Benchmarking and Best Practices', April, available at: https://edhec.infrastructure.institute/paper/2019-global-infrastructure-investor-survey-benchmarking-trends-and-best-practices/ (last accessed 13 September 2021).

There is also growing evidence that, rather than there being a trade-off between profits and sustainability considerations, in the longer term ESG factors and financial performance are positively linked (see section 3).

The most recent emerging trend that embraces this positive relationship is for companies to define their corporate purpose—beyond delivering profit in the short term—and their measurement of performance against this purpose. Measurement takes place within a six capitals approach, which means understanding the effects of a given company's actions not just in terms of financial performance, but also with respect to five other sources of capital (human, social, natural, manufactured and intellectual) on which the company draws. Integrated reporting (IR) is one way of doing this, although it is not the only approach available (see below).

In effect, there have been changes in both corporate governance and corporate reporting. We discuss these in turn below.

2.2 Changing corporate codes

In certain instances, the call for purpose-driven businesses has been underpinned by changes to corporate governance codes.

For example, the UK corporate governance code, which applies to listed companies, has evolved from solving the agency problem between investors and managers to upholding a corporate purpose. The revised code states that the board should establish the company's purpose, values and strategy, and satisfy cultural alignment; and that it should ensure that the necessary resources are in place for the company to meet its objectives and measure performance against them. Figure 2.2 sets out some of the key provisions in more detail.[8]

Figure 2.2 UK corporate governance code (revised 2018)

A. A successful company is led by an effective and entrepreneurial board, the role of which is to promote the **long-term sustainable success** of the company, generating value for shareholders and contributing to wider society.

B. The board should establish the **company's purpose, values and strategy**, and satisfy itself that these and its culture are aligned. All directors must act with integrity, lead by example and promote the desired culture.

C. The board should ensure that the necessary resources are in place for the company to **meet its objectives and measure performance** against them. The board should also establish a framework of prudent and effective controls, which enable risk to be assessed and managed.

D. In order for the company to meet its responsibilities to shareholders and stakeholders, the board should ensure **effective engagement** with, and encourage participation from, these parties.

E. The board should ensure that **workforce policies and practices** are consistent with the company's values and support its long-term sustainable success. The workforce should be able to raise any matters of concern.

Source: Financial Reporting Council (2018), 'The UK corporate governance code', July.

The UK Code is not prescriptive and, for example, does not specify whether an ESG or IR approach should be followed for reporting.

In France, the Civil Code and Corporate Code have been amended such that companies must now be managed in the 'corporate interest' (rather than in the interests of particular persons), and such that companies must now take account of the 'social and environmental impacts' of their strategies and activities.

In Italy, the January 2020 Corporate Governance Code, which applies to companies listed on Borsa Italiana, requires companies to pursue 'sustainable success', defined as:[9]

> […] the objective that guides the actions of the board of directors and that consists of creating long-term value for the benefit of the shareholders, taking into account the interests of other stakeholders relevant to the company.

While diversity (including gender) is mentioned in the Code, there is no discussion of social or environmental issues.

The degree to which companies are compelled to take into account their wider impacts as corporations therefore varies by jurisdiction, as does the specificity of the requirements.[10] However, companies do not need to wait for EU or national corporate governance codes to become more explicit in their response to sustainability issues. Increasingly, companies are changing their governance practices proactively or as a consequence of reporting requirements becoming more stringent (see below).

[8] Financial Reporting Council (2018), 'The UK corporate governance code', July.
[9] See Italian Corporate Governance Committee (2020), 'Corporate Governance Code', January, p. 4, available at: https://www.borsaitaliana.it/comitato-corporate-governance/codice/2020-eng.en.pdf (last accessed 13 September 2021).
[10] Further information of the codes is contained in Appendix A1.

2.3 Changing reporting approaches

In addition to governance arrangements that align managerial objectives with corporate purpose, reporting is a key tool for holding management to account for delivery.

The above discussion highlights three types of annual reporting activity (all stemming from corporate purpose):

- financial reporting;
- sustainability (ESG) reporting;
- integrated reporting (IR).

While reporting the annual accounts is a legal requirement, for many sectors and companies ESG reporting and IR are voluntary initiatives. However, the adoption of some companies of ESR and IR has created pressure for others to follow. In addition, as discussed below, at the EU level non-financial reporting is mandatory for certain companies. Figure 2.3 compares the three approaches.

Figure 2.3 Alternative reporting models

Source: Oxera, based on various classifications set out in the literature.

As shown on the left-hand side of Figure 2.3, traditionally, firms have reported their financial situation and investments made in their annual accounts. These are prepared on behalf of shareholders and other investors.

As shown on the right-hand side of the figure, in recent years, some firms have incorporated annual sustainability reporting within (or alongside) their accounts, using the ESG model. This sets out metrics on issues such as how companies impact on the environment, mitigate climate change, invest in their skills base, increase diversity and inclusion, and build links with the communities within which they operate.

However, it is the six capitals model that seeks to integrate the five capitals captured within the traditional and ESG framework, while also adding intellectual capital. A number of companies now report their annual performance against the six capitals using an IR framework. We describe this in more detail in section 5.

As discussed above, the 2015 UN SDGs framework provided an impetus for large companies to report on their wider impacts, with a number of companies adopting ESG reporting.

At the EU level, through the 2014 Non-Financial Reporting Directive (NFRD), certain large ‘public-interest entities’ (including listed companies, banks and insurers) are required to disclose on information environmental, social and diversity matters.[11] Most recently, in April 2021 the European Commission set out, among other sustainability measures, plans to revise and strengthen the NFRD. The proposed Corporate Sustainability Reporting Directive (CSRD) aims to make sustainability reporting by companies more consistent, so that firms, investors and the public can use comparable and reliable sustainability information.[12] It means that nearly 50,000 companies in the EU (including listed SMEs) will need to follow detailed EU sustainability reporting standards, an increase from the 11,000 companies that are currently subject to the NFRD.[13] To help ensure that reported information is reliable, the proposed CSRD would also introduce a general EU-wide audit (‘assurance’) requirement for reported sustainability information—starting with a ‘limited’ assurance requirement.[14]

It is likely that, in the future, audit firms will increasingly scrutinise companies’ ESG performance, as well as their financial accounts. We also discuss in section 5 how impact-adjusted financial reporting, through monetising impacts, goes beyond IR.

[11] European Commission (2014), ‘DIRECTIVE 2014/95/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups’, 22 October.
[12] European Commission (2021), ‘COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE REGIONS, EU Taxonomy, Corporate Sustainability Reporting, Sustainability Preferences and Fiduciary Duties: Directing finance towards the European Green Deal’, Brussels, 21.4.2021 COM(2021) 188 final, 21 April.
[13] European Commission (2021) ‘Press release: Sustainable Finance and EU Taxonomy: Commission takes further steps to channel money towards sustainable activities’, Brussels, 21 April.
[14] European Commission (2021), ‘Questions and Answers: Corporate Sustainability Reporting Directive proposal’.

3 What are the benefits of adopting a purposeful business model?

Regardless of the specific requirements in any given jurisdiction, there is a growing consensus among business leaders, academics, and policymakers on the *benefits* to businesses of defining a purpose, establishing governance processes around this purpose, and defining instruments for measuring and monitoring sustainability performance. There are several organisations leading the way in this area across various jurisdictions.

3.1 Market failures confronted

In economic terminology, a failure by a firm to maintain and enhance its various forms of capital can be regarded as a 'market failure'—this arises when the firm does not take into account itself (or 'internalise') these wider impacts in its decision-making, and the normal processes of competition do not punish or correct this.

Such market failures include the following.

- **Externalities**—a firm may cut costs by cutting corners in a way that harms the environment, or it may fail to train its workforce, if it does not face these wider costs through adjustments to its profits.
- **Monopolies**—a firm with significant market power may behave in a way that ignores the public perception of such environmental and social issues as consumers are captive and cannot switch.
- **Behavioural failures**—the culture of the firm may be difficult to change, and a firm may be short-sighted ('myopic') and pay insufficient regard to the long-term consequences of its decisions.

However, there is a limit. While in adopting undesirable behaviours the bad can drive out the good in the short term, such behaviours are not sustainable in the long term. Put another way, businesses can benefit in a number of ways over the long term from defining their purpose and measuring performance against this. This is reflected in the growth of ESG sustainability reporting and—more recently—the trend towards integrated reporting (IR), where non-financial information is integrated with financial data to tell a richer story about an organisation, challenging traditional reporting models (in section 5, we also discuss the more recent concept of impact-weighted financial accounts, which goes further than IR and monetises wider impacts in profitability terms).

By taking the six capitals into consideration in the business decision-making process and subsequent reporting on performance, a company takes into account and provides a fuller picture of the way in which it creates value, providing a method for communicating with stakeholders about how they measure their six capitals.[15]

In the traditional approach, the firm's objective would be to maximise profits, subject to various legal and wider constraints—a form of constrained optimisation. In contrast, the purposeful business has at its heart and within its objective function the maintenance and enhancement of its six capitals. In essence, it credibly commits itself to a path that promotes the long-term

[15] EY (2018), 'Why more companies are measuring their natural and human capital', 3 May, available at: https://www.ey.com/en_gl/assurance/why-more-companies-are-measuring-their-natural-and-human-capital (last accessed 13 September 2021).

benefits to wider society as opposed to ceding to short-term exploitative behaviours.

There is a debate as to whether market power hinders or actually assists the adoption of a purposeful model, taking into account CSR, ESG or the six capitals. Based on a review of the evidence, Roe (2021) states 'highly profitable firms—often in weakly competitive markets—do better for their stakeholders than those in highly competitive markets'.[16] The reason is that, if corporate purpose costs are large, firms in very competitive product markets have insufficient funds to invest in corporate purpose activity while remaining competitive on price and service. In contrast, firms with market power in 'weakly competitive' markets generate rents, which in turn can be spent on CSR and ESG measures.

This is analogous to the innovation literature—while small firms are more nimble and have more incentive to innovate to remain competitive in a market and grow, they may lack the means to do so, through retained profits or external finance; in contrast, larger firms with more market power have accumulated profits, and easier access to external finance, to fund research and development (R&D).[17]

The debate in the innovation literature is ongoing. In practice, which effect dominates depends on the specific context. This is likely also to apply in the case of sustainability reporting.

Nonetheless, extensive research has been carried out to explore the benefits that arise from adopting a purposeful business model, whether based on the six capitals approach per se or its forerunner ESG. Effective management of a company's various capitals can result in:

- increased value creation;
- improved risk management;
- improved decision-making;
- engaged stakeholders;
- more effective communication.

These are explored below in turn.

3.2 Increased value creation

As suggested above, adopting a purpose makes for a sustainable business, whereas the opposite is true for a business that is not purposeful.

In what follows, we cover a broad range of industry contexts, but focus on sectors in which private-sector companies operate in a competitive environment. Even under these conditions, companies placing sustainability at their heart can be more profitable. We discuss later in this report whether the same conditions apply to regulated monopoly utility businesses (including those operating in the public sector).

[16] Roe, M.J. (2021) 'Corporate Purpose and Corporate Competition', European Corporate Governance Institute, Law Working Paper No. 601/2021, August.
[17] For a discussion, see section 2.3.4, 'Characteristics of the firm: firm size and stage in the life cycle', in Oxera (2005), 'Innovation market failures and state aid: developing criteria', prepared for the European Commission (Directorate-General for Enterprise and Industry), pp. 20–1.

Adopting a purposeful business model has the potential to increase value creation. The concept of value itself is broadening, reflecting that value is created by leveraging different capitals over different time horizons and for different stakeholders. The majority of market value, at a global level, is now defined as 'intangible value'.[18] Maximising one capital while disregarding another will likely limit value creation. For example, the maximisation of financial capital (e.g. profit) at the expense of human capital (e.g. through inappropriate human resource policies and practices) is unlikely to maximise value for the organisation in the longer term.[19]

Value is also generated for businesses that adopt a purposeful business model through increased investor demand, demonstrated by the move towards sustainable investments. There is an increasing shift in investor priorities, with investors wanting to understand the impact of their investments. This is reflected in the growth in investment in thematic and impact investments funds. Research by BlackRock found that investors plan to double their ESG assets under management by 2025, with growth in sustainable assets being most pronounced in the UK and Europe.[20] It also found that 20% of survey respondents said that the pandemic would actually accelerate their sustainable investing allocations.

Consumers and employees are increasingly punishing companies that deplete social and environmental resources. The six capitals and ESG approaches provide a monitoring framework, with evidence increasingly showing that a firm that does not take adequate account of its impact on its wider capitals will not be resilient in the longer term. The failure of companies to take broader factors into account increasingly has an impact on wider public and stakeholder perceptions—consumers may not want to buy the products; people do not want to work for the company; and investors do not want to be linked or exposed to such firms. Social media means that small-scale dissenting voices can rapidly become global campaigns.

A study by Kantar UK found that 77% of UK grocery shoppers have switched, avoided or boycotted buying certain products, or would consider doing so in future, based on a brand's environmental policies.[21] This trend can be seen across a range of sectors. A study conducted in France by CSA Institute and Havas Sports & Entertainment shows the changing expectations that sports fans have regarding brands and events in terms of their ecological commitments, with two-thirds of French fans stating that they would boycott an event with no environmental commitments.[22]

A purposeful business will invest in its employees. Indeed, it is a standard principle in labour economics that firms need to do so in order to enhance the stock of intangible human capital. While coming at a cost in the short-term, this will help the firm to produce better products or services, and become more productive and competitive over the longer term. In addition, offering employee

[18] Ocean Tomo (2015), 'Annual Study of Intangible Asset Market Value'.
[19] Integrated reporting (2021), 'INTERNATIONAL <IR> FRAMEWORK', January, available at: https://integratedreporting.org/wp-content/uploads/2021/01/InternationalIntegratedReportingFramework.pdf (last accessed 13 September 2021).
[20] BlackRock (2020), 'BlackRock Survey Shows Acceleration of Sustainable Investing', 3 December.
[21] Talking retail (2019), 'Consumers boycotting brand over environmental policies, Kantar reveals', December, available at: https://bit.ly/3tyYh8k (last accessed 13 September 2021).
[22] Euractiv (2021), 'Two-thirds of French sports fans ready to boycott non-eco-friendly events', 24 February, available at: https://www.euractiv.com/section/health-consumers/news/two-thirds-of-french-sports-fans-ready-to-boycott-non-eco-friendly-events/ (last accessed 13 September 2021).

growth prospects is beneficial to employee engagement (the enthusiasm and commitment workers feel towards their job and organisation).

However, purpose-driven organisations will also focus on broader issues around their human capital, including around diversity and inclusion. This assists in recruiting, retaining and motivating the best people, and in generating a greater variety of ideas and practices throughout the business. A number of studies show that businesses with greater gender and ethnic diversity generate higher profit performance.[23]

Employees also care about the wider impacts of a firm on society and the environment. In 2016 a survey of Millennials[24] in the USA (approximately 50% of the workforce by 2020) found the following.[25]

- 64% of Millennials consider a company's social and environmental commitments when deciding where to work.
- 64% will not take a job if a company lacks strong CSR values.
- 83% would be more loyal to a company that helps them to contribute to social and environmental issues.

The Millennial (and Gen Z) generations place more emphasis on environmental and social concerns than previous generations, and are a rapidly growing proportion of the workforce—making social and environmental considerations ever more important to firms in attracting and enhancing human capital.

Brands that promote sustainability are generating value by attracting customers. For example, Unilever's 28 'sustainable living' brands, which focus on reducing Unilever's environmental footprint and increasing social impact, delivered 75% of the company's growth and grew 69% faster on average than the rest of its businesses in 2018.[26]

The case study in Box 3.1 demonstrates the benefits to businesses that arise from taking this purposeful perspective into account, showing that companies that disclose more than just financial information outperform those that do not.

Box 3.1 Case study: Asia Pacific and South Africa

Asia Pacific

A study by KPMG applied the framework of IR and sustainability reporting (SR) to a group of 80 firms in the Asia Pacific (40 treatment and 40 control firms). The report demonstrates that this framework helps firms focus on aspects that materially affect their long-term ability to create value. The two main findings were as follows.

1. **Share price returns for firms that adopt IR or SR are consistently higher**. By comparing the two portfolios, KPMG found that share price performance of firms that adopted IR and SR practices surpassed the control group from mid-2010 onwards. Further analysis showed that the differences between the two portfolios were significant

[23] For discussion, see McKinsey & Company (2020), 'Diversity wins: How inclusion matters', May, available at https://www.mckinsey.com/featured-insights/diversity-and-inclusion/diversity-wins-how-inclusion-matters; Deloitte (2017), 'Diversity and inclusion: The reality gap. 2017 Global Human Capital Trends', February, available at https://www2.deloitte.com/us/en/insights/focus/human-capital-trends/2017/diversity-and-inclusion-at-the-workplace.html; and MarketWatch (2020), Opinion: The numbers don't lie: Diverse workforces make businesses more money', August, available at https://www.marketwatch.com/story/the-numbers-dont-lie-diverse-workforces-make-companies-more-money-2020-07-30 (all accessed 3 November 2021).
[24] The Millennial generation definition adopted in the survey refers to people born between 1981 and 1996.
[25] Cone Communications (2016), '2016 Millennial Employee Engagement Study', November.
[26] Unilever (2019), 'Brands with purpose grow—and here's the proof', 11 June, press release.

and confirmed that a portfolio consisting of IR and SR firms tended to yield a much higher return over time for a given level of risk.

2. **Firms that adopted IR or with higher IR scores have significantly higher Price to Book ratios (P/B) and lower Weighted Average Costs of Capital (WACCs)**. Firms were scored based on the extent to which they applied the Framework by using the scoring methodology in accordance with the NUS Disclosure Guidance (2014). These scores were then regressed against their P/B ratio and WACC as proxies for value creation and risk. Their findings suggest that firms with higher scores generally exhibit higher P/B ratios and lower WACCs. This correlation suggests that these firms are viewed more favourably by investors and lenders alike.

The study illustrates that markets are likely to reward firms that adopt the IR framework.

South Africa

Research carried out by the Nanyang Business School examines the association between IR and corporate valuation using 100 South African companies listed on the Johannesburg Stock Exchange (JSE) for the period 2009–12.[1] A score was constructed based on the level of disclosure and the market valuation of equity, with findings showing that firms with a higher score have a higher market valuation.

They find a significant positive association between IR score and market valuation, after controlling for various firm characteristics that affect equity valuation (such as firm size, sales growth, capital expenditure intensity, operating profitability, liquidity, industry membership and time trends).

As IR was a mandatory implementation from 2010 for South African listed firms on the Johannesburg Stock Exchange (JSE), they also examined the effect of IR implementation on the change in the company's market valuation. Here they find a positive and statistically significant association between the change in IR score and the change in market valuation from 2009 to 2012.

Overall, the results provide evidence that equity investors value IR.

Note: [1] All JSE Listed Companies have to adhere to the King III Code of Governance to adopt IR on a 'Comply or Explain' Basis for all financial years ending on or after 1 March 2010.

Source: KPMG (2015), 'Towards better business reporting', November; Yeo, G., Wai, G. and Thiruneeran, L.K. (2014), 'Integrated Reporting and Corporate Valuation'; the Singapore Accountancy Commission and the Institute of Singapore Chartered Accountants.

3.3 Improved risk management

The ability of a business to be resilient ultimately depends on its longer-term purpose and how it maintains and enhances its various capitals. Put another way, a purposeful firm seeks to maintain and enhance its stock of various capitals, and is thereby sustainable and resilient:[27]

> Corporate purpose identifies how the company assists people, organisations, societies and nations to address the challenges they face, while at the same time avoiding or minimising problems companies might cause and **making them more resilient in the process**.

Research by EY indicates that investors frequently consider wider information, such as environmental, social and governance issues, when determining the risk and holding period of prospective investments, evaluating industry dynamics, and examining the regulatory environment.[28]

3.4 Improved decision-making

Using a wider set of information plugs gaps in knowledge and enables a better understanding of the drivers of performance and value creation. A more

[27] British Academy (2019), 'Principles for purposeful business: how to deliver the framework for the future of the corporation', p. 8.
[28] EY (2018), op cit.

detailed picture of a company's role in the world also highlights commercial opportunities that may otherwise be obscured.

Studies have found evidence of support for long-term investment among mainstream investors such as pension funds. A 2014 survey among 180 senior executives in major pension organisations around the world found a 'broad consensus […] that conceptually and aspirationally, long-horizon investing is a valuable activity for both society, and for their own fund'.[29]

Research by EY found that 59% of businesses surveyed view reporting on broader areas of value creation as essential to investment decisions, as it gives them vital insight into business strategy, performance, governance and prospects, supporting better investment decisions.[30]

3.5 Engaged stakeholders and more effective communication

Greater insight into an organisation's business model from adopting IR as a tool to communicate their impacts results in an improved understanding of shared value creation and depletion, improves effective communication, and may strengthen relationships with stakeholders.

Studies show that firms that adopt IR have more dedicated, long-term investors and fewer transient investors, likely attributed to IR providing investors with information more relevant to decisions over the longer term—as opposed to quarterly snapshots of financial data that encourage investor churn.[31] Further, a multidimensional overview of the company gives stakeholders valuable information on the overall explanation of the business model, how the company generates cash, how the company creates value, a well-articulated strategy, and anticipated future opportunities and vulnerabilities.

It is therefore in the long-term interest of firms to maintain and enhance its six capitals.

3.6 A word of caution?

Evidently, the way in which a firm implements a sustainability strategy will determine whether it experiences the above benefits in practice.

In the environmental sphere an attempt by a firm to deliberately overstate its green credentials to consumers in its marketing material is commonly known as 'greenwashing'. For example, if a company claims to be reducing its carbon emissions by examining selective measures, when in fact its emissions are increasing, then consumers may be misled. Milder forms of greenwashing may be inadvertent rather than deliberate in nature.

Similarly, greenwashing should be avoided in undertaking ESG or other reporting. Establishing a meaningful purpose and culture with sound reporting should help to avoid such a scenario. However, it is important that any such strategy is implemented in a meaningful rather than through a more cosmetic way that is aimed at 'ticking the boxes'. The metrics should provide a complete picture as opposed to a selective one. Regulatory requirements may also be set out that demand this.

[29] Ambachtsheer K. and McLaughlin J. (2015), 'How effective is pension fund governance today? And do pension funds invest for the long-term? Findings from a new survey'.
[30] EY (2018), op cit.
[31] Stubbs, W., Higgins, C., Milne, M.J. and Hems, L. (2014), 'Financial capital providers' perceptions of Integrated Reporting', SSRN 2473426, available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2473426 (last accessed 13 September 2021).

Related to this is the scepticism in some quarters of 'stakeholderism'—where (broadly speaking) corporations are required to serve the interests of stakeholders, including employees, customers, suppliers, and the environment, and not only their shareholders. An analysis of the incentives facing corporate leaders has been provided by Bebchuk and Tallarita (2020). They explore whether these leaders have in the past used discretion to protect stakeholders, and find that commitments to stakeholderism have been 'mostly for show'. Their conclusion is that commitments to stakeholderism do not produce material benefits for stakeholders, and that such a model may actually reduce shareholder scrutiny. Legislation and regulation are seen as more effective mechanisms.[32]

Mayer (2021) critiques Bebchuk and Tallarita's paper, noting that 'in presenting their argument, all that [the authors] demonstrate is that shareholder interests prevail in a country like the USA in which superiority of shareholder value is presumed'. Furthermore, the paper fails 'to provide any evidence on the potential for change and the fact that there are alternative systems around the world that promote different types of corporate conduct and balances of interest in companies'. This is a 'systems issue'. Rather than focusing on the past, there needs to be a 'focus on what needs to be, can and should be done about it'.[33]

We set out above a number of ways in which adopting a sustainable business model benefits firms. However, there are differing views as to whether ESG investing delivers outperformance in the long term to investors. In recent research conducted by index provider Scientific Beta, the performance of 24 ESG strategies between 2008 and 2020 was analysed. The majority outperformed by up to 3% per annum, but the authors state that most of this was driven by 'quality' (high profitability and low investment). In addition, many investments were biased towards technology stocks, which meant strong returns. Recent performance of ESG strategies could also be linked to an increase in investor attention. According to Scientific Beta, it is these factors (or risk adjustments), as opposed to ESG *per se*, that had driven performance.[34]

The implication of these critiques is that measures to embed a corporate purpose need to be authentic and transparent. For success, there needs to be consistency at a systems level between policy, law, regulation, ownership and governance (see Figure 4.1 in the next section). In this regard, regulation may be a complement to—rather than a substitute for—adopting a stakeholder-based governance model.

[32] Bebchuk, L. and Tallarita, T. (2020), 'The Illusory Promise of Stakeholder Governance', *Cornell Law Review*, **106**:91, December.
[33] See: https://corpgov.law.harvard.edu/2021/02/17/shareholderism-versus-stakeholderism-a-misconceived-contradiction-a-comment-on-the-illusory-promise-of-stakeholder-governance-by-lucian-bebchuk-and-roberto-tallarita/ (last accessed 10 September 2021).
[34] Scientific Beta (2021), '"Honey, I Shrunk the ESG Alpha": Risk-Adjusting ESG Portfolio Returns', April.

4 Drilling down into corporate purpose

It is worth elaborating on what precisely we mean by a 'corporate purpose' and a 'purposeful business', and drawing upon concrete examples.

4.1 Embedding a purpose

A corporate purpose is an articulation of why a business exists, how its core activity is intended to make a positive contribution to society, and therefore what would be lost to society if that business were no longer to exist. The purpose should explain the role the business plays (or aspires to play) in helping people, institutions, or wider society to address problems.[35]

There are a number of important things to note about the formulation of a corporate purpose.

- First, the corporate purpose should aim to **create value for a broader set of stakeholders** than just the firm's owners (e.g. employees, customers, society). The purpose provides a means for the company to consider the impact that it currently has (and wants to have) on the world, including the external impacts on the environment and on society.
- Second, pursuing a corporate purpose that takes account of the needs of all stakeholders should not be seen as incompatible with the generation of profits. The important distinction is that **profits should be a by-product of successfully delivering the purpose, rather than being the purpose itself**.
- Third, purpose is about the core business activities—i.e. the primary means by which the business makes its money—rather than, for example, targeted corporate social responsibility initiatives or 'philanthropy'. A purpose-driven business may still seek to engage in such initiatives—for example, by donating a proportion of its profits to charitable causes. However, the central question of purpose is concerned with ***how* the company makes its money** and whether this has societal value, as opposed to how it chooses to allocate the profits that it makes.

There is, of course, a risk that companies adopt corporate purpose at a superficial level, such that it becomes little more than a 'slogan' or sales exercise (akin to greenwashing, as noted in section 3). This is unlikely to create meaningful change.[36] For a purpose to have a positive impact, it needs to be **embedded throughout the organisation** and evident in the actions it takes. It should flow down through the company's strategy, culture, values, behaviours and processes. It should be something that employees throughout the organisation understand, recognise and associate with. For this reason, some proponents of corporate purpose (such as Professor Colin Mayer) have argued that the purpose should be enshrined in the company's articles of association.

[35] British Academy (2019), 'Principles for purposeful business', p. 16.
[36] Indeed, Alan Jope, the CEO of Unilever, has argued that companies using purpose messaging without backing it up with actions (which he termed 'woke-washing') poses a risk in terms of potentially further destroying trust in corporations. See Davies, R. (2019), 'Unilever boss says brands using 'woke-washing' destroy trust', *The Guardian*, 19 June.

4.2 Case studies

There are a growing number of examples of companies that have chosen to define and communicate a corporate purpose (see Box 4.1). In some instances, these companies have sought external certification or accreditations based on meeting set standards, such as B Corporation (or B Corp) status.[37] However, while a potential avenue, this is not a necessary condition for being a purpose-driven business.

Box 4.1 Case studies of corporate purpose

Ben & Jerry's (USA)

Ben & Jerry's is a B Corporation that operates with a view to creating 'linked prosperity for everyone that's connected to [its] business: suppliers, employees, farmers, franchisees, customers, and neighbours alike'. The three-parts of its purpose are:

- to make, distribute and sell the finest quality products with a commitment to promoting business practices that respect the Earth and the Environment ('the product mission');
- to operate the company in a way that actively recognises the central role that business plays in society by initiating innovative ways to improve the quality of life locally, nationally and internationally ('the social mission');
- to be financially sustainable ('the economic mission').

Patagonia (USA)

Patagonia, the US clothing company, is often cited as a leader in terms of embedding and pursuing a defined corporate purpose. For many years, Patagonia's stated mission was to 'build the best product, cause no unnecessary harm, [and] use business to inspire and implement solutions to the environmental crisis'. In 2018, this was changed to: 'Patagonia is in business to save our home planet'. This purpose is intended to shape the culture of the organisation, and to drive decision-making and behaviours at all levels of the business.

For example, it has led to a company-wide commitment to be fossil fuel-free by 2025, but also to a new HR policy of, all else being equal, hiring the person who shows the greatest commitment to saving the planet.

Patagonia has been a certified B Corporation since December 2011.

Crown Estate (UK)

The Crown Estate is one of the largest property managers in the UK, with activities spanning commercial development, residential property, infrastructure, mining and agriculture. Its stated purpose has evolved over time. In its 2018/19 integrated annual report the company stated:

> In everything we do, we are driven by a clear purpose: brilliant places through conscious commercialism. This means taking a long-term view, considering what we do from every perspective, and working in partnership with customers, communities, partners and our supply chain to deliver positive outcomes for all.

In its 2020/21 report the company restated its purpose, as follows:

[37] B Corporation certification is issued to for-profit companies that achieve at least a minimum score against a set of social, environmental, public transparency and legal accountability standards. Certifications are awarded by B Lab, a global non-profit organisation that has been in operation since 2007.

> Our purpose: To create lasting and shared prosperity for the nation. Our purpose sets out our primary reason for existence and guides the evolution of our strategy at the intersection between what society needs and where we can specifically and uniquely contribute…

The company believes it can be ‘creators of financial, environmental and social value’. It ‘will innovate and work with [its] customers and stakeholders to deliver long-term financial performance through creating social and environmental value’.

The Crown Estate employs IR based on a six capitals framework (see section 5).

Sources: Ben & Jerry’s, ‘Our values & mission: we believe that ice cream an change the world’, last accessed 22 September. Patagonia, ‘The climate crisis’, last accessed 22 September. The Crown Estate (2019), ‘Integrated annual report and accounts 2018/19’; The Crown Estate (2021), ‘Integrated annual report and accounts 2020/21’.

B Corp is an international certification process, undertaken by the non-profit entity B Lab since 2008. In contrast, a Benefit Corporation is a legal structure that a for-profit business might wish to adopt, which legally empowers it to pursue positive wider impacts beyond profit.

In 2016, Italy became the first country outside the USA to introduce a law that established Benefit Corporations as distinct legal entities (‘Società Benefit’). Operationally such companies must balance the objectives of making profits with achieving transparency and sustainability. They also need to consider a range of stakeholders (communities, employees and the environment).

In Italy, companies can adopt the Società Benefit model as a step towards attaining B Corp certification (and vice versa). For example, two major Italian pharmaceutical companies, Chiesi Group S.p.A.[38] and Aboca S.p.A.,[39] are both Benefit Corporations and B Corps. These companies have arguably led the way in adopting the Benefit Corporation model. Each year they publish an impact report setting out the company’s purpose, values and behaviours, the reporting framework (linked to SDG), and an analysis of impacts.

More widely, however, the Benefit Corporation model in Italy is still in its infancy and there is considerable variation in implementing the model. Mion and Adaui (2020) review a number of Italian Benefit Corporations’ purpose declarations.[40] The authors find that this stated purpose can be vague even if it technically complies with the law. In addition, while Italian Benefit Corporations are obliged to publish an annual impact report, Mion (2020) notes that there is a low degree of compliance. Where reports have been published, there exists a wide variation in impact reporting quality—although this is higher for larger companies. In the analysis, the adoption by a company of an external reporting standard was found to be a much more important determinant of reporting quality than B-Corp certification.[41]

B Corp status is one way of embedding a purpose. In section 6, we discuss more specifically the role of purpose in utilities sectors—including water and wastewater, energy and waste management. In this regard, there are examples of purpose statements in the UK water sector, as shown in Box 4.2. Note that Anglian Water has amended its articles of association to align with its

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[38] See https://www.chiesi.uk.com/we-are-a-b-corp; and https://www.chiesi.com/en/about-us/b-corp-and-benefit-corporation/ (each last accessed 1 November 2021).
[39] See https://www.aboca.com/news/aboca-achieves-b-corp-certificationcompany/for-the-common-good/ (last accessed 1 November 2021).
[40] Mion, G. and Adaui, C. (2020), ‘Understanding the purpose of benefit corporations: an empirical study on the Italian case’, *International Journal of Corporate Social Responsibility*, **5**:1, December, pp. 1–15.
[41] Mion, G. (2020), ‘Organizations with impact? A study on Italian Benefit Corporations reporting practices and reporting quality’, *Sustainability*, vol. **12**:21, October, pp. 1–21.

stated purpose (in section 7 we also discuss Hera, an Italian utility that has also amended its articles of association to embed the company's purpose).

Box 4.2 Purpose statements: UK water companies

Anglian Water

'To bring environmental and social prosperity to the region we serve through our commitment to Love Every Drop.'

Dwr Cymru

'To provide high quality and better value drinking water and environmental services, so as to enhance the well-being of our customer and the communities we serve, both now and for generations to come.'

Severn Trent

'To serve our communities and build a lasting water legacy. This drives our vision to be the most trusted water company by 2020, delivering an outstanding customer experience, best value service and environmental leadership.'

Source: Purpose Union and Impact Institute (2020), 'Public Value in the Water Sector', June, pp. 27–8.

4.3 Principles of purposeful business

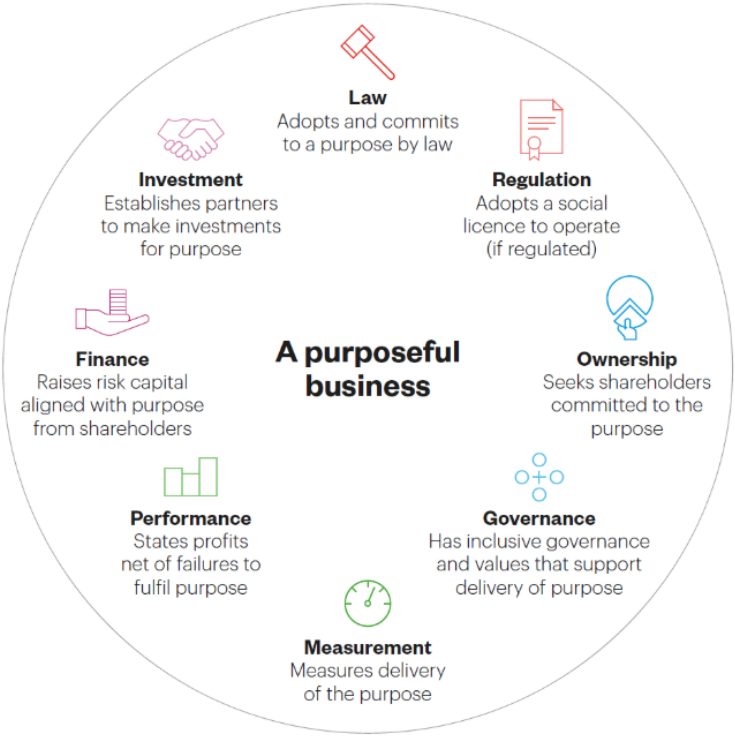
The British Academy, led by Professor Colin Mayer FBA, has been conducting a major research and engagement programme examining the purpose of business and its role in society. Its 'Future of the Corporation' review provides a framework for reshaping business policy and practice. According to the British Academy:[42]

> A purposeful business will organise itself on all levels according to its purpose. We propose eight principles for business leaders and policymakers. They do not prescribe specific actions, but set out the features of an operating environment that will enable the delivery of those purposes, while remaining flexible to a diversity of business models, cultures and jurisdictions.

The eight principles are summarised in Figure 4.1. This shows that merely stating a purpose is not enough—there are a number of interdependent initiatives that the company must engage in for it to be purposeful. Arguably, this distinguishes between marketing activity by a company to publicise its sustainability credentials from genuine embedded activity *in practice.*

[42] British Academy (2019), 'Principles for Purposeful Business. How to deliver the framework for the Future of the Corporation: An agenda for business in the 2020s and beyond', November.

Figure 4.1 British Academy principles for purposeful business



Source: British Academy (2019), 'Principles for Purposeful Business. How to deliver the framework for the Future of the Corporation: An agenda for business in the 2020s and beyond', November.

While the British Academy's 2019 'Future of the Corporation' report does not formally propose that companies adopt the six capitals framework to measure and monitor performance (see below), its message is nonetheless consistent with the notion that a company that depletes its capitals will not be sustainable in the longer term. To be profitable the company must be attentive to all its various capitals.

Building on the principles set out in the 2019 report, the final report of the British Academy, published in September 2021, describes the business practices and public policies required to deliver purposeful business. A necessary (but not sufficient) condition for systematic reform is to have a supportive legal, regulatory, governance and reporting framework in place. However, two further mechanisms are set out that, in the authors' view, are required to deliver the necessary reform:[43]

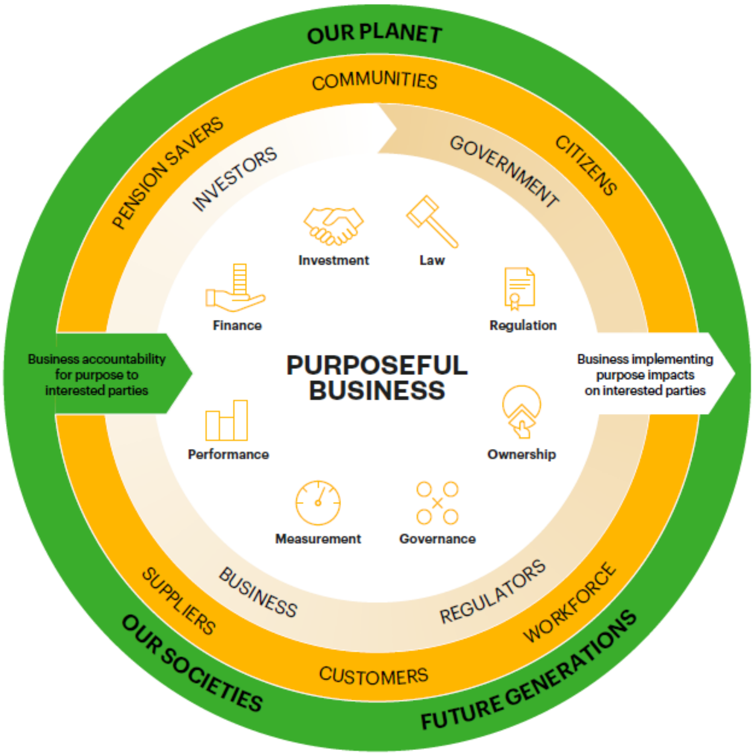
- **accountability**—using the legal, regulatory, governance and reporting framework to hold companies to account for complying with corporate purposes of profitably solving problems of people and planet and not profiting from creating them;
- **implementation**—ownership, measurement, finance, innovation and investment through which people harness the potential of markets to deliver profitable solutions which benefit customers, the workforce, investors, communities, society and the environment.

Governments, regulators, companies, investors and non-governmental organisations all have a role to play in delivery. This is illustrated in Figure 4.2,

[43] British Academy (2021), 'Policy & Practice for Purposeful Business. The final report of the Future of the Corporation programme', September.

below. However, the authors identify various deficiencies in the UK business ecosystem—in implementation as well as accountability—that inhibit the achievement of purposeful business. The report therefore focuses on various reforms, around the eight principles, to drive change.

Figure 4.2 Purpose: Accountability and implementation mechanisms



British Academy (2021), 'Policy & Practice for Purposeful Business. The final report of the Future of the Corporation programme', September.

On the issue of measurement of performance against the purpose, the British Academy notes the limited consistency or comparability between different ESG measures. As we discuss in section 5, the British Academy report encourages governments, regulators and standard setters to take the lead on standards, and for companies to measure and report how they link their purpose to their wider impacts.

5 The six capitals framework

An obvious question follows: how can a company seek to measure and monitor its progress in delivering its purpose? The critical challenge is understanding the impact that the company is having on the world at large, rather than just on shareholder value.

5.1 Measurement issues

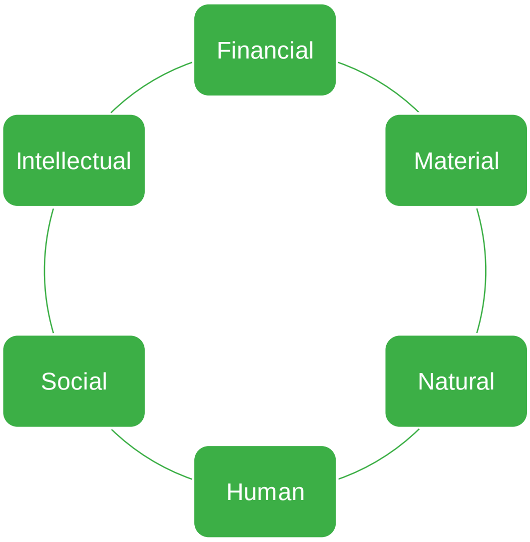
While ESG is one framework for addressing this challenge, another more recent initiative is the six capitals framework. The framework was originally developed by Forum for the Future to help organisations promote sustainable development through maximising the value of different forms of capital, and to contribute to thinking about how to manage them in the long term.[44]

The framework allows companies to recognise the different sources of capital they draw on and contribute to in undertaking their activities, and therefore to better understand the overall economic, social and environmental effects resulting from their actions. Professor Mayer notes:[45]

> What such enlightened corporations do is to deliver on their stated purpose by balancing and integrating the six different components of capital that constitute business and economic activity—human capital (employees and producers), intellectual capital (our knowledge and understanding), material capital (our buildings and machinery), natural capital (our environment, land and nature), social capital (our public goods and social infrastructure) and financial capital (equity and debt).

Mayer argues that, to survive in the long run, firms must maintain not only their physical and financial capital—but also their natural, human, social, material and intellectual capital. This model can help to frame how companies make decisions, measure performance and assess their impact on society. The six capitals are summarised in Figure 5.1.

Figure 5.1 The six capitals model



Source: Oxera.

[44] Forum for the Future (2019), 'The Five Capitals', available at: https://www.forumforthefuture.org/the-five-capitals (last accessed 13 September 2021). The six capitals framework is an extension of the original five capitals approach, and includes intellectual capital.
[45] Mayer, C. (2015), 'Reinventing the Corporation', Sir John Cass's Foundation Lecture read 3 March 2015, *Journal of the British Academy*, **4**:53–51, March.

Within the framework, a company needs to embrace within its stated purpose the six capitals and measure its performance against them. This is to embed a culture and to hold companies to account to their stated objectives. Arguably, this is not a question of 'maximising profits subject to five constraints'; rather all are within the objective function of the firm. It internalises the market failures at source.

Over the past 20 years, there have been attempts by various bodies to introduce environmental audit standards, including through the ESG approach. These track companies' exposure to and impact on the environment including climate change. Management remuneration can then be linked to these metrics. However, there is as of yet no commonly agreed system, with various different metrics being developed around the world. There have been recent initiatives to standardise ERG reporting, including the metrics used.[46]

In its final 'Future of the Corporation' report, published in 2021, the issues around measurement of firm performance are discussed. In particular:[47]

> Despite recent progress, there remains little consistency, comparability or correlation between different ESG measures. There is little data assurance, verifiability or auditing of information, and there is therefore concern about its reliability or relevance to delivery of better outcomes. There is also considerable confusion between ESG and measurement of purpose.

Similar questions regarding measurement also apply to the emerging six capital framework. This can be done through:

- **integrated reporting**—in which performance against the capitals is reported using financial and non-financial KPI metrics alongside the normal financial metrics presented in the annual accounts. The Crown Estate (discussed in Box 4.1) reports in this way, and we discuss below how this has been adopted elsewhere;[48]
- **corporate accounting**—for example, Professor Mayer's view is that profits should not be recorded until it can be shown that these have been earned in a way that does not compromise the wider capitals. This does not require valuing these wider capitals, but rather the cost of maintaining the wider capitals (remediation) should be subtracted from profits as a maintenance charge;
- **impact assessment**—various approaches can be used to monetise the positive and negative impacts of a business on the six capitals. This can be used as part of ex ante project appraisal and/or in ex post impact assessment. Yorkshire Water has started to adopt this approach, as shown in Box 5.1.

[46] See: https://www.journalofaccountancy.com/news/2020/sep/global-effort-unified-sustainability-corporate-reporting.html (last accessed 10 September 2021).
[47] British Academy (2021), 'Policy & Practice for Purposeful Business. The final report of the Future of the Corporation programme', September.
[48] See, for example, the Crown Estate (2018), 'Integrated annual report and accounts 2017/18'; 'Performance against our capitals 2017/18'.

Box 5.1 Impact assessment: UK water

Yorkshire Water, an English water and sewage company, has undertaken work in this area. Ex ante, it has been integrating the six capitals framework into its Decision-Making Framework (DMF), in which a range of projects have had the impacts on the capitals monetised through cost-benefit analysis (CBA). Ex post, the company has been reporting on its impacts of its activities on the six capitals through its Total Impact and Value Assessment (TIVA) approach.

Source: https://www.yorkshirewater.com/about-us/capitals/ (last accessed 10 September 2021).

The three approaches have both similarities and differences. IR involves setting criteria out in advance and measuring performance ex post, but not necessarily in a monetised way (it uses various KPIs). Arguably, the corporate accounting approach is purely ex post. It seeks to include impact-adjusted profits within the accounts, based on a notional monetised maintenance charge.

The impact assessment approach can be applied ex ante and ex post. This monetises the costs and benefits of corporate policies and investments on the six capitals. This goes beyond both the IR and maintenance charge approach, in terms of the attention given to monetisation.

Serafeim et al. (2019) are part of the Impact-Weighted Accounts Project (IWAP) at Harvard Business School. The authors propose that large listed companies should go beyond ESG and IR—and that they should present impact-weighted financial accounts:[49]

> Impact-weighted accounts are line items on a financial statement, such as an income statement or a balance sheet, which are added to supplement the statement of financial health and performance by reflecting a company's positive and negative impacts on employees, customers, the environment and the broader society.

In July 2020, the IWAP published the environmental impacts of 1,800 companies in the form of adjusted-EBITDA figures. The plan is for this in due course to be expanded to other impacts.[50] The initiative is seen as a means of countering greenwashing (see section 3) since, by focusing on outcomes, the framework delivers transparency and has a balanced view.[51]

As we discuss in section 7, in Italy, Gruppo Hera has (in addition to publishing KPIs) monetised its wider impacts and expressed its profits in an impact-adjusted way.

In any of the above approaches, management remuneration, using short- and long-term incentive plans, can be linked to performance with respect to the six capitals—for example, against the financial and non-financial KPIs adopted using IR.

The 2021 final 'Future of the Corporation' paper sets out some specific recommendations around measurement, performance and remuneration, to enable investors (and other stakeholders) to evaluate and account for the performance of the company in implementing its corporate purpose, as shown

[49] Serafeim, G., Zochowski, T.R. and Downing, J. (2019), 'Impact-Weighted Financial Accounts: The Missing Piece for an Impact Economy', Harvard Business School, available at: https://www.hbs.edu/impact-weighted-accounts/Documents/Impact-Weighted-Accounts-Report-2019.pdf (last accessed 13 September 2021).
[50] Cohen, R. and Serafeim, G. (2020), 'How to measure a company's real impact', *Harvard Business Review*, 3 September, available at: https://hbr.org/2020/09/how-to-measure-a-companys-real-impact (last accessed 13 September 2021).
[51] See: https://www.icaew.com/insights/viewpoints-on-the-news/2020/nov-2020/people-and-planet-in-the-accounts-impactweighted-accounts-facilitating-a-race-to-the-top (last accessed 10 September 2021).

in Box 5.2. While the six capitals approach is not mentioned explicitly in the report, the work by the IWAP and the IR approach are both highlighted.

Box 5.2 British Academy recommendations 2021

The 2021 British Academy final report covers a wide range of issues around the eight principles it defines: company law, regulation, ownership, governance, measurement, performance, finance and investment.

On measurement and performance, various existing initiatives in the UK, EU and internationally to develop reporting standards are discussed, as well as developments around company reporting and remuneration. The authors' recommended measures include the following.

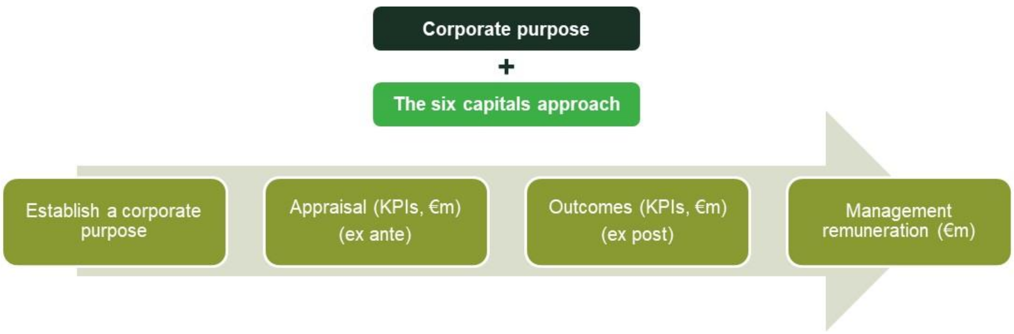
- **Standards-setting**—international standard setters should define baseline metrics that apply universally to all companies, allowing for additional company-specific metrics. In addition, while significant progress has been made in the UK and globally in relation to sustainability reporting and ESG indices, more weight needs to be given to the 'S' or 'social' aspect in ESG reporting.
- **Company accounting and reporting—**IWAP is making progress in transparently capturing external impacts. IR should directly link purpose to financial as well as social, environmental and other external impacts. On non-financial reporting generally, there is a need for a methodology of impact reporting that is consistent, practical, allows comparisons between companies, and can be externally audited. An interim requirement could be for boards of firms above a certain size to choose and adopt such a system, alongside existing requirements.
- **Reward structure—**a company board should ensures that the company's incentives and remuneration are based on fulfilment of its purpose. Executive pay remains an issue that undermines trust. More is needed in relation to disclosures on pay, reward and staff satisfaction. Linking executive reward (remuneration and promotion) to the above accounting and measurement systems could help restore trust in the link between pay and delivering value to society. More should also be done to involve employees in the reporting process, which could include evidence on employee satisfaction and staff turnover.

Source: British Academy (2021), 'Policy & Practice for Purposeful Business. The final report of the Future of the Corporation programme', September.

5.2 A gold standard?

The above discussion highlights that there has been much discussion of the appropriate framework to establish and measure performance against a company's purpose, including through the six-capitals approach and other approaches. The 'gold standard' that might be adopted in an ideal world, is set out in Figure 5.2 below.

Figure 5.2 An ideal-world six capitals approach?



Source: Oxera.

This involves:

- stating clearly the corporate purpose and establishing the six capitals framework;
- establishing monetisation of impacts in an ex ante appraisal framework;
- measuring ex post impacts in monetised (and non-monetised) form;
- linking ex post performance to management remuneration.

We have not uncovered in our research an example that meets all of these conditions, in particular in relation to comprehensive ex ante and ex post monetisation of wider impacts. However, there are practical implications of seeking to move towards this model. Each company will face a different situation and will be at a different stage of evolution. In addition, the legal and regulatory framework that the firm is subject to, as well as its corporate structure and supply chain, need to be aligned to the model. This is particularly the case for regulated network utilities.

6 What are the implications for utilities?

6.1 Markets and market failures revisited

Utility firms—and particularly those with a substantive network element—are a special case of firms in the wider economy, in that three conditions hold.

1. **Utilities provide an essential service**—water, electricity, gas and municipal waste services are all essential to life. The priority is to keep water running, energy flowing, and the streets clean.

2. **Utilities involve a naturally monopolistic characteristic**—due to the costs of duplication, within a region it makes sense only to have one water network, one electricity distribution network, and (depending on the size of region) one municipal waste provider.

3. **Information asymmetry**—in normal-functioning markets, consumers observe firms' behaviours; in network utilities a regulator is often appointed to monitor, seek information from and incentivise firms on behalf of consumers.

The first trait—the essential service—can help in ensuring that a company behaves in a responsible way. In a sense, the provision of essential services is in the company's DNA. A water company by its very nature is tasked with investing in physical capital (the network), in a way that delivers a reliable service to society, alongside environmental improvements.

In addition, the ownership and governance of a company can make a difference to how it behaves in relation to its essential service remit. A publicly owned company might internalise the issue of delivering 'public value'—the degree to which it maintains and enhances its wider capitals—in that it is held to account by a public stakeholders (taxpayers, municipalities, etc). However, private companies (such as public listed companies) can also internalise the delivery of public value if they are held to account by their investors on public value issues (more discussion on this follows below). In this sense, public ownership is not essential to delivering public value—and indeed, this is the emphasis of initiatives such as the Future of the Corporation (discussed in section 4).

There is nonetheless a limit to which an organisation may be held to account by its owners (regardless of the nature of its ownership). The second trait—natural monopoly characteristics—means that normal market forces do not activate to punish the firm should it neglect its duties: as discussed above, consumer boycotts serve as a constraint on firms behaviour in most markets. However, in the case of utility networks end-consumers cannot switch network provider.

The market power that stems from the natural monopoly characteristics—the second trait—may then combine with information asymmetry—the third trait—in a way that leads to the exploitation of one or more of the capitals in an unsustainable way.

For example, a large monopoly firm that is also short-sighted might seek to exploit the environment while undertraining its employees—in the knowledge that this may go undetected for a number of years. Consumers cannot switch and the environment and labour force may suffer.

To avoid this, the company needs to be regulated in an effective way, including through reporting to the regulator and to the markets on its long-term strategy and its annual performance.

6.2 Correction mechanisms

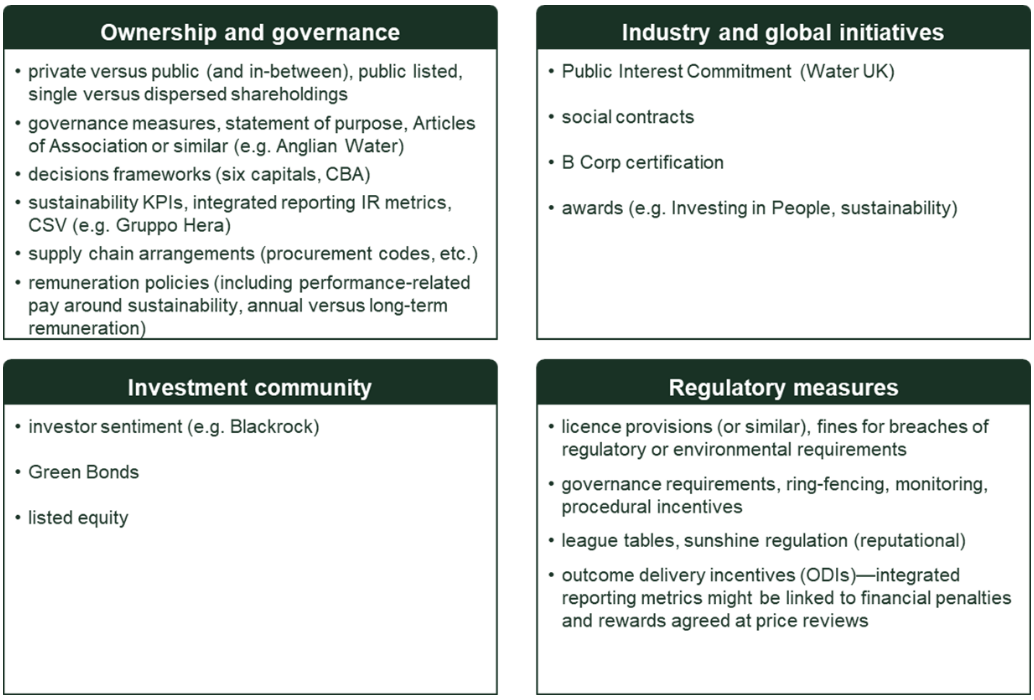
Indeed, there are a variety of correction mechanisms available that can be used to align the utility to creating public value, while constraining behaviours that deplete the six capitals. All of these measures would take account of developments in law and corporate governance requirements (such as the EU NFRD and proposed CSRD, discussed in section 2).

The measures include:

- ownership and governance;
- industry and global initiatives;
- investment community;
- regulatory measures.

These are highlighted in Figure 6.1 below.

Figure 6.1 Alternatives to align utility companies with public value



Source: Oxera.

The above measures differ in the degree to which they are adopted by the firms or are imposed on them. They also differ in terms of their severity.

Sector regulators play an important role. In Italy, the Regulatory Authority for Energy, Networks and Environment (ARERA) is the national regulator of electricity, natural gas, water services, waste cycle and district heating services. As regards regulatory aims, the Authority notes:[52]

[52] See https://www.arera.it/it/inglese/about/presentazione.htm (accessed 2 November 2021).

> The Authority's work focuses on ensuring the promotion of competition and efficiency in the energy sectors, as well as ensuring uniform availability and distribution of the services, for all regulated sectors and throughout the country. The Authority also establishes adequate levels of quality for services, certain and transparent tariff schemes based on predefined criteria, while promoting user and consumer protection. These functions are performed by harmonising the economic and financial goals of the operators with more comprehensive objectives, with a focus on social issues, environmental protection and efficient use of resources.

Therefore, the way in which ARERA regulates the sector in balancing these aims, and the way in which companies respond, will have an important impact on sustainability outcomes.

6.3 Case study: UK water sector

In the privatised England and Wales water sector, Ofwat (the sector regulator) has discussed a number of initiatives that companies are undertaking on public value, and the challenges and possibilities for the future.

As illustrated in Box 6.1, various approaches have been adopted including governance, decision-making, stakeholder engagement and reporting. Ofwat's view is that enablers to creating public value need to be reinforced, that initiatives emerging from this need to be authentic, but that a completely standardised approach across the sector would be undesirable.

Box 6.1 Ofwat on public value in England and Wales water

In December 2020, Ofwat—the England and Wales water sector regulator—published a discussion paper on public value in the water sector. This drew upon the findings of a study by Purpose Union that Ofwat had commissioned as well as discussions with companies. Ofwat noted:

> Whilst public value is inherent in the core services water and wastewater companies deliver, we consider, and companies recognise, that they need to continue to challenge themselves to consider how they can create *more* public value, by delivering their core services differently.

There had already been a step change in activity in recent years, including through the water resource and environmental programme planning processes, and the Public Interest Commitment issued by the industry to net zero emissions by 2030.[53] In addition, the outcomes framework of the regulatory review (PR19) had a key role in ensuring delivery.

Ofwat set out four key enablers of increasing public value that companies had highlighted in discussions with Ofwat:

- governance and leadership (articles of association, social contracts, licence conditions, B-Corp, sharing mechanisms);
- decision-making tools and frameworks (six capitals, CBA);
- customer, community and stakeholder engagement (PR19, PR24+);
- reporting tools and frameworks (ESG, TCFD).

[53] Water UK (2019), 'Public Interest Commitment', 25 April, available at: https://www.water.org.uk/wp-content/uploads/2019/04/Public-Interest-Commitment-2.pdf (last accessed 13 September 2021).

Going forward, in terms of developing its own approach, Ofwat considered that it was important that companies 'walk the talk': activity should be authentic, transparent and translate into tangible outcomes. The regulator noted that targeting public value would not necessarily increase company costs (or raise affordability concerns), as more innovative solutions can be more efficient.

Ofwat noted that enabling culture was a precursor to delivering public value outcomes: a culture that ensures that 'every part of the business and every business decision is seen as an opportunity to add value to society'. However, from the regulator's perspective, it was unclear whether a unified or standardised framework for public value across the industry, encompassing both the culture and outcomes dimensions, was necessary or desirable. There remained a question as to which elements could be standardised.

Sharing best practice, promoting common enablers and modified PR24+ incentives were seen as key activities moving forward.

Source: Ofwat (2020), 'A discussion paper on public value in the water sector', December.

In part, Ofwat's discussion paper drew from desk-based research undertaken by Purpose Union, which set out to explore current practice across the sector. As shown in Box 6.2, while most companies state a purpose, there is inconsistency across the sector.

Box 6.2 Purpose Union on public value in England and Wales water

Purpose Union (and the Impact Institute) submitted a report to Ofwat on public value across the England and Wales water sector in June 2020. This compared the sector against initiatives in other sectors. The study was based on desk research only (the authors did not speak to the companies).

The study found that most companies articulate a purpose, but that the practice around this is uneven, anecdotal, and not communicated well. The authors take the view that:

> [A] company's purpose describes why a business exists. This should articulate how the core activity of a business intends to make a positive contribution to society (hence the use of the phrase social purpose), which in the water industry is often framed around meeting the needs of the community that the provider serves. This should also be compatible with being financially successful.

Given various uses of terminology, the study equates societal value (their preferred term) to public or social value used by others.

Purpose Union finds that, within the sector, more emphasis is placed on environmental issues than on social issues in approaches and reporting, as the nature of the industry means it prioritises natural capitals (including the risk that the climate crisis poses). However, there is less on creating social value in the communities companies operate in (e.g., through social mobility initiatives or targeting pay inequality).

A number of enablers for change are identified by the authors, including the following.

- Companies should clearly state their purpose, ensure the board has a clear line of sight on purpose, and instil a culture around the purpose.
- Companies should be transparent, reporting mistakes as well as successes, and provide voice to contentious societal issues (even given the possibility of a backlash).
- Companies should tackle problems at a system-wide level through coalitions (rather than in isolation through traditional bilateral charity-corporate relationships).

In the report, the authors state that a purposeful company's impact is its contribution to societal wellbeing, as measured through the impacts it has on the six capitals (as defined by the IIRC). A framework is then set out to measure these (positive and negative) impacts.

The report notes that there are differing views on certain issues. On the issue of whether companies should change their articles of association or seek B Corp accreditation, the authors are sceptical as cultural change is viewed as being more important than formalised changes. It was also noted that, while larger companies have more internal resources to develop a robust public value reporting system, smaller companies may find it easier to build a culture where purpose guides decision-making.

Source: Purpose Union and Impact Institute (2020), 'Public Value in the Water Sector', June.

Box 6.2 shows that, while most of the water companies examined undertake environmental reporting, few undertake social reporting. Purpose Union recommends the adoption of the six capitals framework and notes that, while larger firms have more resources to undertake public value reporting, smaller firms may be more agile in changing their culture. Purpose Union regards achieving this culture change as being more important than modifying a company's articles of association.

While Ofwat acknowledges the existence of the six capitals framework, it wants to adopt a somewhat narrower approach in terms of how it sees its role. As set out in its July 2021 principles paper, Ofwat considers that its own focus should be on social and environmental value, stating:[54]

> Companies should seek to create further social and environmental value in the course of delivering their core services, beyond the minimum required to meet statutory obligations.

The rationale is as follows:[55]

> In response to our discussion paper, companies agreed that public value approaches should be firmly rooted in the delivery of core services to minimise the risk of a loss of focus. Water customers cannot be expected to fund activities that are not related to a water company's statutory functions. We consider it is therefore right that as a regulator our focus should also remain on public value delivered in the course of carrying out those functions.

Ofwat regards its work on board leadership, governance and transparency as capturing some of the human and intellectual capital issues.

Ofwat notes that a clear purpose and ESG strategy are important components in demonstrating public value. However, there was a general view in the industry that Ofwat should not use standardised reporting for public value since there is not yet a common approach to reporting public value, and many companies are still experimenting with new models.

The above discussion illustrates that the focus of the sector regulator, in monitoring public value outcomes for its own specific purposes, may be on certain issues (environmental and social). However, this does not rule out the introduction by water companies of a six capitals (or other) framework for their own strategy, governance and monitoring purposes.

[54] Ofwat (2021), 'Public value in the water sector: A supporting set of principles', July.
[55] Ofwat (2021), op cit.

7 Corporate purpose in Italian utilities

As part of our research, we spoke with a number of Italian utilities that are members of Utilitalia. Our research reveals that there is a lot of practical progress on issues around sustainability, social and environmental impacts, and diversity.

7.1 Key findings

We spoke with a variety of different companies involved in water supply, wastewater treatment, energy and municipal waste. These companies varied with respect to:

- whether they were publicly owned (by municipalities), privately owned, or a mixture of the two;
- whether they were large-scale multi-utilities or smaller scale companies with a single focus;
- their evolution along the path of ESG and other initiatives.

One strong message that came from the discussions was that the very nature of the activities that they undertake—that of providing essential services crucial to the wellbeing of society and the environment—means that purposefulness is in many ways within their DNA.

The model of ownership was also cited as making a difference, but no one model dominated in delivering outcomes. Municipalities are public-sector bodies and as shareholders want a good service for their citizens, employment and training opportunities, and stewardship of the environment. Public-listed companies said that equity investors were increasingly looking to companies that could demonstrate their sustainability and diversity credentials, as were the debt (bond) markets. Some companies had a mixture of public sector and private sector (including publicly listed) ownership—and thus a mixture of these motivations.

Depending on the specific company, changing the articles of association or equivalent could be difficult as there were legal constraints around this, although we did speak to one company that had done so. Nonetheless, in practice companies undertook other initiatives within their company structure, corporate governance, codes, initiatives and reporting. Larger listed companies are required to disclose on information environmental, social and diversity matters under the EU NFRD and under Italian law (as discussed in section 2, the NFRD will be superseded by the CSRD).

Companies had sustainability plans of various forms in which the concept of the circular economy was emphasised. Many of the companies had initiatives aimed at improving gender diversity in science. And many had procurement policies in place where only sustainable and accredited suppliers would be invited to tender. Stakeholder engagement is seen as an important way of empowering customers, citizens and others.

Most companies targeted KPIs linked to ESG goals in one form or another, although some were at a very early stage of this process whereas others had fully embedded ESG. One company we spoke to had embodied the creating shared value concept within its operations, whereby a number of sustainability KPIs are reported on wider value created each year, including reporting of sustainability-adjusted profits. Most companies linked management renumeration to these KPIs.

Barriers to achieving societal outcomes were identified. It could be difficult to change a culture overnight, and communication within an organisation was often an enabler for change. Regulation did not always remunerate additional activities, such as the additional costs of waste collection that companies have incurred during the COVID-19 pandemic. Downstream supply chain issues were also beyond the control of some companies: for example, while the company took efforts to separate waste materials at source for recycling, it was not in control of what might happen to the material further down the value chain. In the future, there is the possibility that some rule is put in place that will not allow a large company to generate profits unless it invests in totally sustainable assets. While some assets are not, and cannot be, totally decarbonised at present, future technologies may enable this.

All of these issues highlight that alignment is important for achieving purposefulness.

Much progress has been made in Italian utilities, in particular in relation to SDG and ESG. In our view, and thinking of the 'gold standard' in Figure 5.2, there is a further opportunity for Italian utilities to focus on their public purposes.

- At present, companies tend to be operate within a ESG framework, as opposed to the more recent IR and six capitals framework.
- In addition, most companies adopt KPIs around sustainability, but these are not (with some exceptions) monetised in terms of public value.
- Finally, monetisation of public value impacts has not as yet been incorporated into the ex ante investment decision frameworks of companies. Rather, impacts are taken into account ex post through the KPI framework.

Such initiatives will have practical implications, but are nonetheless worth considering.

7.2 Case studies

We spoke with a number of companies about whether they had a corporate purpose, the frameworks that they employ, measurement of performance and the link to management remuneration. We also explored public-domain information on their websites.

For example, we spoke with A2A, which refers to itself as a Life Company, since in dealing with energy, water and the environment, and through the circular use of natural resources, A2A provides services necessary for life and the quality of life. Box 7.1 provides further details.

Box 7.1 A2A

A2A S.p.A. is based in the North of Italy and is a multi-utility: it generates, distributes, and markets renewable energy, electricity, gas, integrated water supply, and waste management services. The company description is of a 'Life Company' rather than a multi-utility—as everything it does is to support peoples' lives.

With a ten-year strategic plan, and a workforce of over 13,000, A2A promotes Italy's sustainable growth. A2A's new strategy foresees investments totalling €16bn earmarked for development of the circular economy and the energy transition. By 2030, the Life Company wants to make a solid contribution to the attainment of 11 of the 17 United Nations 2030 Agenda Sustainable Development Goals. A2A uses its key skills and advanced technologies to improve the quality of life and lead the ecological transition, to make the best use of energy while minimising the impact on the environment.

In terms of corporate governance, while the bylaws do not permit embedding a wider purpose within the articles of association of the company, in practice this may not make much of a difference—as A2A is already undertaking several initiatives via its Board. Inside the Board of Directors is a Sustainability Committee. One of the functions of this is to ensure that the strategic and operational plans of the company are in line with the growth of the sustainability context, involving internal stakeholders, employees, gender diversity, etc. The Remuneration Committee has requested for part of the remuneration of the senior and middle managers to be linked to sustainability. In addition, the company is developing a bond programme linked to sustainability targets.

The company has a ten-year strategic business plan (see above), complemented by a sustainability plan. While the plan does not seek to monetise sustainability impacts it does have targets. A2A had an observatory with the municipalities of Brescia and Milan, in which the company engaged the stakeholders in an open conversation. The company showed them the plan and asked for advice, suggestions, actions, priorities, feedback, and anything else to help improve it. Discussions centred, in particular, on the circular economy, energy transition and social mobility.

Only qualitied suppliers can provide A2A with services, and more than 90% of what the company buys is rated and approved—with sustainability is one of the elements of the rating.

The COVID-19 pandemic has had an impact in particular on employees and younger people. The business has needed to adapt to keep its workers safe, and is reaching out through initiatives to help the young.

Source: Discussions with A2A; https://www.a2a.eu (last accessed 10 September 2021).

ACEA is a multi-utility business operating mainly in the water sector and has both public and private shareholders. The company is listed. The Ethics and Sustainability Committee monitors and promotes all aspects connected to ESG. It has recently issued green bonds, which are related to sustainable investments. In the Business Plan, around 45% of total investments relate to specific sustainability targets (protection of water resources, electricity service quality, smart cities, the circular economy, green energy and growth in GDP and employment). Management remuneration is linked to sustainability targets. Further details are provided in Box 7.2 below.

Box 7.2 ACEA

ACEA is a leading Italian multi-utility operating in the water, energy (distribution and production) and environmental sectors. The company shareholders include the Municipality of Rome (the public controlling entity), a private investor, a large international utility and other institutional investors. From a corporate governance point of view ESG is captured by:

- the Ethics and Sustainability Committee, the main purpose of which is to monitor and promote all aspects connected to ESG;
- a dedicated Investor Relations & Sustainability department, tasked with integrating the ESG strategy and performance in the company's equity offering and promoting visibility on sustainable finance topics (e.g. Task Force on Climate-related Financial Disclosures, TCFD);
- financial projects, under the CFO, including via green bonds issued recently.

The main business of the company is the water sector—serving customers in large areas in the regions of Lazio (including Rome), Tuscany, Umbria, Molise and Campania—in which the integrated water cycle is and must be sustainable. The company is also dealing with the waste transition nationwide.

ACEA has a 2020–24 Business Plan, which is integrated with the Sustainability Plan. In the Business Plan, of total investments amounting to €4.7bn, €2.1bn relates to specific sustainability targets. In particular, the targets concern: protection of water resources, via network interventions to reduce leaks; electricity service quality, for improved resilience of the mains grid; smart cities, with the installation of charging stations and digital meters; the circular economy, via waste management and valorisation; and green energy, with the generation of electricity from photovoltaic plants.

The 2020 Sustainability Report was drawn up in compliance with Global Reporting Initiative (GRI) Standards (the most widely used sustainability reporting guidelines at international level), and in accordance with Legislative Decree no. 254/2016 (which implemented EU Directive 95/2014 on the disclosure of non-financial information).

In terms of the linkage to remuneration, in the short-term incentive plan (MBO) and the long-term incentive plan (LTIP), a composite sustainability indicator has been included, with a weight of 10%, covering all business areas. Both incentive plans are designed with three thresholds (minimum, target and maximum) and the vesting period of the LTIP is three years.

The business promotes stakeholder engagement activities across its territories. Suppliers will not make it onto the company's procurement list if they do not have the right requirements.

ACEA views the sectors within which it operates as naturally assisting the sustainability agenda. It also views its listed status as being important, as the financial markets are looking for innovative and sustainable companies who embed sustainability in their business plans. In addition, having public stakeholders provides the company with the ability to promote the strategy to other stakeholders.

Source: Discussions with ACEA; https://www.gruppo.acea.it/ (last accessed 10 September 2021).

Gori is a small water company. In its view, what matters is the way in which the company carries out its purpose. For example, one of the common problems is network losses (leakage), which it is addressing through investment. In addition, as shown in Box 7.3, is has undertaken collective initiatives in the Campania region to tackle pollution in the Sarno River.

Box 7.3 GORI

GORI Acqua is a water utility serving the Sarnese-Vesuviano District of Campania. The mission of the company is to make the management of water resources efficient, effective and economical in compliance with national legislation (D.Lgs 152/2006). This essential service is subject to two regulators: the national regulator—Arera—and the local regulator—EIC.

GORI aims to guarantee to end-users the supply of drinking water, the quality of which is ensured by continuous monitoring, and adequate service for the conveyance and the treatment of wastewater considering environmental quality standards of the final water bodies (the Gulf of Naples and the Sarno River).

For this purpose, GORI is engaged in planning and managing investments for the improvement of the hydraulic infrastructure. The investments are supported by water service rates and by national and regional funds.

At present, apart from routine maintenance costs, the main purpose of the investment is to reduce physical water losses in the networks, which it addresses in a unique way, and to complete the works necessary to mitigate pollution of the Sarno River. Day-to-day activity is also aimed at technological innovation and the protection of the aquatic environment.

At same time, GORI is carrying out a series of social and cultural initiatives, together with the Campania region, and has created an association that includes mayors of the municipalities of the Sarnese-Vesuviano area. Citizens are invited to participate actively in these initiatives and to provide feedback and new ideas to the company.

GORI tracks KPIs related to financial and network performance and these affect management remuneration. To date, the KPIs do not include all the sustainability parameters. The company has recently presented its first Sustainability Report, and has plans to update the report in the coming years.

Source: Discussions with Gori; https://www.goriacqua.com (last accessed 10 September 2021).

Gruppo CAP is an organisation that is 100% public-owned by the municipality shareholders. As shown in Box 7.4, the company noted that it was difficult to formally change its statute but that its ownership structure provided it with a public purpose. The company has a long-term sustainability plan, with performance against this published annually, including through ESG metrics. The latter affect management remuneration. The company also employs programmes to increase gender diversity.

Box 7.4 Gruppo CAP

Gruppo CAP is the main water service company in the territory of the Metropolitan City of Milan. The company also provides water services to some municipalities in the provinces of Monza, Brianza, Pavia, Varese and Como. Almost all of CAP's shareholders are municipalities (195 municipalities and two counties in total, each with a low percentage share). Purpose and ESG criteria are set out in the company's statute. Its shareholders look not just at financial performance but at the quality of life of their citizens and the quality of service provided.

The company has a 2033 sustainability plan. Annual sustainability reports are assessed against three pillars: sensitivity (affordability); resilience (helping the environment, reducing CO_2 emissions, purchasing green energy); and innovation. The annual reports include ESG metrics in the non-financial statements. Managers have ESG strategies with KPIs linked to remuneration. Long-term incentives (LTIs) apply every three years, which managers receive only if they achieve the objectives (in 2022 managers will not receive a reward if they achieve less than seven out of the nine objectives). Other incentives also apply at the office and company level.

The company's financial plan is connected to the sustainability plan and the industrial plan. It adopts rules to binds it to sustainability systems. For example, the company will not work with banks who do not match its sustainability criteria. There is also an operational document with tools through which the business makes strategic decisions. The company has a procedure for ESG monitoring of investments.

On diversity, the business has a specific programme to support women, given the cultural legacy in Italy relating to women at work and particularly women's roles in science. It supports projects in the municipalities and schools, such that when they join CAP they can more quickly become managers. CAP is one of a few companies promoting a project called 'Valore D', where D stands for Donna (Woman). Cultural change is seen as an important step before formal KPIs are adopted in this area.

Source: Discussions with CAP; https://www.gruppocap.it (last accessed 1 November 2021).

One company that has been on a sustainability journey for some time is Hera, a municipalised multi-utility listed on the Italian stock exchange. As discussed in Box 7.5, in 2016, Hera began to move from a CSR-type model to one of creating shared value (CSV). This latter model involves adopting as a company mission the purpose of attaining CSV. Performance is published annually in the sustainability report (which contains various KPIs), and in the shared value report (which monetises the CSV impact as an adjustment to profits). This is arguably a fairly advanced form of ESG reporting, coupled with monetisation of wider business impacts through CSV. See also section 5 for a general discussion of impact-adjusted accounts, and section 6 for a discussion of 'public value' in the England and Wales water sector (where, similar to CSV, Ofwat focuses on societal and economic value).

Box 7.5 Hera

Hera is now one of the largest national multi-utility companies in Italy, and is listed on the Borsa Italiana since 2003. Its operations cover waste management and treatment, water and wastewater, energy distribution and sales, public lighting and telecommunications.

Hera is one of the first companies in Italy to introduce the concept of 'Purpose' within its articles of association, with a focus on 'Creating Shared Value' (CSV). In particular, Hera has included a further paragraph in Article 3 to clarify its corporate purpose (i.e. the objectives that it aims to achieve in the conduct of its business), thus reaffirming a commitment to sustainability adopted since its inception.

In 2016, Hera adopted its CSV mission:

> Creating shared value is the new perspective that integrates our strategic approach to corporate social responsibility (CSR) and sustainability. It stems from a path started in 2016 and is our way of generating economic value for the company and, at the same time, producing a positive impact on society and the environment taking into account global priorities.

In 2019 Hera incorporated the CSV concept into its Code of Ethics (which is reviewed and updated every three years).

Hera's CSV mission took account of the drivers behind the UN 2030 Global Agenda on Sustainable Development. Hera started through an internal bottom-up process to identify the sustainable development goals (SDGs) it should pursue. In order to achieve the goal of CSV, SDG objectives were mapped across three areas updated in 2020:

- **Energy**—pursuing carbon neutrality (energy efficiency, renewables, biomass, carbon reduction);
- **Environment**—regenerating resources and expanding the circular concept of the waste economy to other resources—starting with water;
- **Local area (and Business)**—enabling resilience and innovating (wealth created in the territory, investment, smart cities).

Across these areas, nineteen CSV KPIs are reported each year in the company's annual sustainability report, including: reduction in CO_2 emissions compared to 2019 with SBTi calculation method (percentage of total), plastic recycled by Aliplast (thousands of tonnes), renewable electricity sold (percentage of total), natural gas sold with CO_2 offsetting (percentage of total), biomethane produced by FORSU (million mc), and women holding roles of responsibility (percentage of total).

Hera also publishes a shared value sustainability report each year as part of its, which monetises the CSR impact as an adjustment to profits. For example, in 2020 the company stated:

> CSV EBITDA for 2020 amounted to €420.0m (37.4% of the Group’s total EBITDA), a 7.2% increase compared to 2019 CSV EBITDA. This result is in line with the 2020-2024 business plan, created so that approximately 50% of 2024 EBITDA will derive from business activities that respond to the priorities of the ‘Global Agenda’ for sustainability. A roughly 7% increase in ‘shared value’ EBITDA is recorded against a 3.5% increase in the Group's overall EBITDA (equal to €1,132.0m) compared to the previous year. 74% of the growth in the Group’s overall EBITDA regards CSV areas.

The main contribution to CSV EBITDA in 2020 was from activities or projects related to the Environment driver (regenerating resources and closing the loop, €239.8m), followed by those related to the Energy driver (pursuing carbon neutrality, approximately €136.6m), followed by those related to the Local Area (and Business) driver (enabling resilience and innovation, €74.5m).

Incentives also depend on sustainability. In 2020, 35% of the variable remuneration of Group managers and middle managers was linked to sustainability target projects (improvement of quality, environmental impact, image, personnel involvement, professional development and involvement of stakeholders), with target projects aimed at CSV accounting for 23%.

Source: Discussions with HERA; https://www.gruppohera.it (last accessed 10 September 2021). Includes CSV figures from Grupo Hera (2020), ‘2020 Sustainability report—Shared value creation and stakeholder involvement: the story of a company committed to leave its mark–but not its footprint’, Consolidated non-financial reporting drawn up pursuant to Articles 3 and 4 of Italian Legislative Decree No. 254/2016.

IREN is a listed multi-utility that has adopted a number of sustainability initiatives over the years. It highlighted, in particular, the financial benefits of being a company focussed on sustainability—in terms of both bond market and equity investor sentiment. The company has an independent CSR department that ensures sustainability is promoted through the business. It has worked with other companies to promote gender diversity and inclusion. Box 7.6 provides more details.

Box 7.6 IREN

Iren is one of the largest multi-utilities in Italy, providing electricity, gas, district heating, waste and water/wastewater services. The company, formed through the merger of predecessor entities, is listed on the Borsa Italiana. It has outlined a manifesto that includes focusing on the company's environment, its communities, and its people. The company sets out its objectives further in its mission, vision and values.

Sustainability is one of the key pillars in the company's latest business plan. This includes a commitment to protect the environment and fight climate changes through the circular economy, minimising resource consumption, decarbonisation and the creation of increasingly resilient cities.

Being listed, the company is obliged to publish a non-financial report under the European regulation. Having 20 years of experience in sustainability reports, the company publishes much broader information than is mandatory, and it accounts for the medium-term objectives and the level of milestones to achieve the objectives. The sustainability report is published annually (with KPIs) together with the annual financial report. Management remuneration is linked to published and internal KPIs. The fact that the CSR department is separate from the others is important because it also brings to the Board the logic of a third party. The choice of the most significant KPIs, in relation to the metrics most used internationally, are identified by the CSR department and applied to the other business units.

IREN only buys from companies with the same sustainability targets as itself, and it has strengthened these requirements. Ethics is embedded in Iren's strategy, and it has a well-written policy. The business has accelerated its diversity and inclusion policies, defining a target for the female presence in management, and hiring more females in technical roles (e.g. engineers). As part of this IREN has developed a multi-year project with 'Valore D', an association of companies that have come together in Italy to work on gender-related issues.

On the issue of communicating the benefits of being a sustainable company, Iren noted that this was becoming easier because it was increasingly understood that being more sustainable is directly connected to being more resilient (and the COVID pandemic had made this evident). The company has €3.7bn of investment, of which about 65% is directly linked to sustainability. As regards the investment community, the company has issued green bonds that have secured market appetite at low cost. As a public-listed company, being greener was looked on favourably by equity investors. This was the general direction of travel—to be in the market you need to be sustainable.

Source: Discussions with IREN; https://www.gruppoiren.it (last accessed 10 September 2021).

A1 Corporate codes and purpose

This section provides examples of corporate codes and purposes already in existence, showing the variation in the ways in which this has been carried out in different countries. While the UK and France are leading in this arena, we still observe that companies in these countries are playing catch-up.

UK

- **UK corporate governance code (2018)**: there has been a recent shift in the UK corporate governance framework from solving the agency problem between investors and managers to upholding a corporate purpose. As set out in section 2, the Board should establish the company's purpose, values and strategy, and satisfy cultural alignment; and should ensure that the necessary resources are in place for it to meet its objectives and measure performance against them. Chapter 5 of the code outlines the way in which **remuneration** can be used as a tool to align board behaviour to core principles.[56]
- Remuneration policies and practices should be designed to support strategy and promote long-term sustainable success. Executive remuneration should be aligned to company purpose and values, and be clearly linked to the successful delivery of the company's long-term strategy.
- A formal and transparent procedure for developing policy on executive remuneration and determining director and senior management remuneration should be established. No director should be involved in deciding their own remuneration outcome.
- Directors should exercise independent judgement and discretion when authorising remuneration outcomes, taking account both of company and individual performance, and of wider circumstances.
- **The British Academy**: Corporate law should place purpose at the heart of the corporation. Measurement should recognise impacts and investment by companies in their workers, societies and natural assets within and outside the firm.

France PACTE statute (2019)

- The **1833 French Civil Code**: every company must have a 'lawful corporate purpose' and be constituted in the 'common interests of its partners'. However, nothing further required beyond this.
- The **PACTE** amends the Civil Code (and the Corporate Code): the process began in October 2017 and was implemented April 2019. Companies must now be managed in the 'corporate interest' (rather than in the interests of particular persons). It also stipulates that companies must now take account of the 'social and environmental impacts' of their strategies and activities. A company can also now pursue an entrepreneurial project that is in the collective interest of its employees. Further, a monitoring body, where employees are represented, will be responsible for checking adherence to the corporate purpose.[57]

[56] Financial Reporting Council (2018), 'The UK corporate governance code', July.
[57] French Government (2019), 'Le Plan d'Action pour la Croissance et la Transformation des Entreprises', January.

Italy

- **The Civil Code (*Codice Civile*)** applies to any type of Italian company.
- **The Corporate Governance Code (*Codice di Autodisciplina*)**, last revised in January 2020 applies to companies listed on Borsa Italiana. This is issued by the Italian Corporate Governance Committee, which is comprised of Borsa Italiana and others. The 2020 Code (which closely follows the 2018 version of the Code) follows a self-regulation approach: Compliance with the Code is on a 'comply or explain' basis, and companies adopting the Code must publish annual statements regarding the extent of their compliance. The Code requires companies to pursue 'sustainable success', defined as: '[…] the objective that guides the actions of the board of directors and that consists of creating long-term value for the benefit of the shareholders, taking into account the interests of other stakeholders relevant to the company'.[58] While diversity criteria (including gender, added in 2018) are mentioned in the Code, there is no discussion of social or environmental issues.
- **Rulings (*Regolamenti*)** have been issued by the National Commission for Companies and the Stock Exchange (*Commissione Nazionale per le Società e la Borsa*) (CONSOB).
- **Decree 254/2016** (for companies with more than 500 employees) governs the content of (non-mandatory) non-financial statements, as implemented by CONSOB (resolution 20267) information to be disclosed includes: environmental matters, use of energy and water resources, greenhouse gas and pollutant emissions, potential impact of risks on the environment, and health and safety requires information about the undertaking's diversity policy.
- Hermes investor reaction to (the 2018 version) of the Italian Corporate Governance Code was as follows:[59]

> We welcome the adoption and publication of the Italian Corporate Governance Code, updated in July 2018 […] and generally support its recommendations and suggestions […]. However, the guidelines set by the Code do not sufficiently cover all the issues we regard as important.
>
> […] Companies should effectively manage environmental and social factors that are relevant to their business, with a view to enhancing long-term sustainability. They should also disclose to shareholders on a regular basis how they identify and manage the relevant risks and provide evidence that these processes are effective […].
>
> […] In addition, companies should clearly define board and senior management responsibilities for environmental and social issues. We believe that directors of companies are accountable to shareholders for the management of social, ethical and environmental risks and opportunities in the same way that they are accountable for the company's financial performance.

[58] See Italian Corporate Governance Committee (2020), 'Corporate Governance Code', January, p. 4, available at: https://www.borsaitaliana.it/comitato-corporate-governance/codice/2020-eng.en.pdf (last accessed 13 September 2021).
[59] Hermes Investment Management (2018), 'Corporate Governance Principles: Italy', December.

A2 Interviews

Table A2.1 Interview questions

#	Theme	Example questions
1	Incorporating public value in purpose	Does the firm have a stated purpose?
2		To what extent does the purpose recognise public value and trade-offs between different capitals and stakeholders?
3	Embedding purpose	Is the purpose embedded via their articles of association and/or changes in their licences?
4		To what extent has the purpose been embedded in the culture of the firm?
5	Monitoring performance against purpose	Have companies have set KPIs to measure performance against the capitals?
6		Do the KPIs encompass the whole range of impacts that the firm has on the capitals?
7	Governance and renumeration	Is executive remuneration linked to sustainability targets and other non-financial KPIs?
8		To what extent would executive remuneration be affected if sustainability KPIs changed materially?

Source: Oxera.

www.oxera.com