THE CONFERENCE BOARD

Beware the 80/20 Governance Trap: Focus on the "G" in ESG

Lessons from the PG&E Bankruptcy Filing

by Gilbert S. Hedstrom

Judging by the praise lauded on Pacific Gas & Electric by external environmental, social and governance (ESG) rating agencies, the California utility was best among peers. Sustainalytics (a leading provider of ESG and corporate governance research, ratings, and analysis—used by Bloomberg and others) named PG&E an "outperformer"—ranked in the 82nd percentile on governance and the 88th percentile on environment. PG&E was rated the No. 1 utility in *Corporate Responsibility* magazine's 100 Best Corporate Citizens and by *Newsweek* Green Rankings. *Newsweek* also listed the company No. 4 overall.

Then, in what *The Wall Street Journal* called "the first major corporate casualty of climate change," PG&E filed for Chapter 11 bankruptcy protection on January 29, 2019. But wait a minute; shouldn't the ESG ratings have caught that? Not likely. External ESG ratings fail the 80/20 rule. They may be able to measure 80 percent of environmental and social impacts. However, they barely capture 20 percent of governance. And governance is by far the most important of the "E-S-G."

This *Sustainability Matters* analyzes the PG&E climate-change related bankruptcy as an example of how external ESG ratings fail to fully measure the governance element of ESG. The author makes the point that external ESG ratings only capture a very small portion of the "G" in ESG, something the author calls the "80/20 ESG governance trap."

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The sign entering the London Underground famously warns pedestrians to "Mind the Gap"—exercise caution when stepping between the platform and the train. Likewise C-suite members, board members, investors and other stakeholders should exercise extreme caution when viewing a company's external ESG ratings.

PG&E is an American investor-owned utility based in San Francisco, serving the northern two-thirds of California. Founded in 1905, the company has a long track record of impressive environmental accomplishments. Over the past several years, PG&E has been quite transparent about its environmental issues. For example:

- The company's *2017 Annual Report* discussed the wildfire issue in detail on over a dozen pages.
- The 187-page *2018 Corporate Responsibility and Sustainability Report* "checks all the boxes."
- The company has sustainability explicitly in the company mission; a materiality assessment; financial incentive plan that addresses ESG; an outside Sustainability Advisory Council; a history of ESG disclosure; bold goals to cut greenhouse gas emissions; and more.
- PG&E reports a very significant $34.5B worth of renewable energy contracts.
- The company reports a record of early delivery on rigid California compliance standards.

Then, on January 14, 2019, PG&E gave a warning about filing for bankruptcy protection, noting wildfire liabilities estimated at $30 billion and a market value of about $9 billion. Ten days later, California fire investigators said PG&E did not cause the deadliest (Tubbs fire) of 2017 state wildfires. There was a bump in the stock price. But that did not change the company's liability estimate. Two weeks later, the utility filed for bankruptcy protection. Bloomberg reported PG&E declared it had $51.7 billion in total debt with assets of $71.4 billion; the move was a defensive maneuver that sets the stage for a major restructuring.[1]

"…a business milestone: the first major corporate casualty of climate change"

The Wall Street Journal
January 18, 2019

How can reputable mainstream investor ESG ratings agencies give the company top grades on ESG, and then have the company file for bankruptcy protection (arguably for governance and environmental reasons)? Were they looking at the wrong things?

Public companies globally are engaged in an almost relentless pursuit of strong ESG ratings, viewing them as necessary—as reported in depth by The Conference Board in its 2018 report "ESG Rating and Ranking Initiatives—A Necessary Evil?"[2] Various stakeholders take comfort in high ratings from MSCI ESG, Sustainalytics (data provider to Bloomberg, Yahoo Finance and others), Dow Jones Sustainability Index (DJSI) and many others.

When the PG&E bankruptcy filing occurred, the author started wondering what's going on here. He knew a fair bit about how over 100 of the Fortune 500 companies manage ESG issues internally—from 10 years working as program director of ESG-related executive councils for The Conference Board. Each council meets under the Chatham House Rule, which allows members to confidentially share information without attribution.

The author was also sitting on recent data from over 60 global companies (many as members of the councils noted above). The company self-assessment data measures performance on a Stage 1-Stage 4 maturity scale. Executives rate their company's status on about 150 key sustainability indicators (KSIs) in four areas: governance and leadership, strategy and execution, environment stewardship, and social responsibility. The rating criteria in the Corporate Sustainability Scorecard™ are public—published in late 2018 in *Sustainability: What It Is and How to Measure It*.[3] (See the appendix for additional information.)

What does data from eight other utilities and 60 major companies tell us about the PG&E situation? The data paints a starkly different picture than the one external ESG raters painted of PG&E (and also paint of many other companies in every industry sector). The data show that a wide cross-section of industry rates their internal ESG risk management processes as being *not particularly robust*, *not very mature*, and *not well-integrated with the business*.

The 80/20 ESG governance trap

This dramatically different assessment of ESG governance between outside ESG raters and internal company executives is what the author calls "the 80/20 ESG Governance Trap." He captured this idea in blogs posted by The Conference Board[4] and the National Association of Corporate Directors (NACD).[5]

As *The New York Times* reported on March 19, 2019, "there is a climate change component to (the PG&E bankruptcy) . . . but there's also a failure of management." External ESG ratings may be able to capture some important data ("the 20 percent"); however, another tool is needed to assess the internal management of those risks ("the 80 percent"). This is especially interesting since 91 percent of investment firms say governance has the greatest impact on investment decisions (among ESG factors), according to a Russell Investments 2018 ESG Survey.[6]

The 80/20 ESG governance trap is becoming more acute by the day.

> **Red Flags (9 of 10 risks).** Sometimes companies do not act on the red flags that are staring them in the face. The World Economic Forum has consistently listed various aspects of climate change as the top risk globally. In both 2018 and 2019, nine of the 10 risks in the Global Risk Review (defined as high impact; high probability) were related to climate change.[7] Thus, no CEO or board member can be surprised if major business disruptions are increasingly caused by climate change. Climate risks impact virtually every industry sector. While fire risk was the issue for PG&E, for other companies the key issue might be stranded assets, product deselection, or supply chain disruptions. The list goes on.

Investor Pressure. Financial markets will continue to ratchet up the ESG focus. On February 28, 2019, *The Wall Street Journal* reported that, "Companies are under more pressure than ever to disclose their exposure to climate-change risks. In the (2019) annual-meeting season, companies are projected to face a record of 75 or more climate-related shareholder proposals, up from 17 in 2013."[8] A month earlier, in his annual letter to CEOs, BlackRock CEO Larry Fink again called on companies to *demonstrate* their value to society.[9] In 2017, BlackRock stated it would vote out directors of companies that fail to address the risks posed to their businesses by climate change, framing climate change as a "systemic issue."[10]

This situation should send warning sirens across corporate boardrooms and C-suites—not just among utilities but across all industry sectors. PG&E may be the first "casualty of climate change." It certainly will not be the last, especially considering how climate issues are deeply interwoven with core business issues. The underlying issues triggering the bankruptcy filing were mostly operational and maintenance ones (e.g., vegetation management, equipment maintenance; etc.).

It's hard to hear the sirens in the distance—the sounds of ice melting, historic flooding from Mozambique to Missouri, and a growing number of "climate refugees" on the move. The issue for C-suites and boards of directors is whether the company has strong risk management systems in place. Does the company still operate with a compliance ("check the boxes") mentality? Or are executives aware of—and acting on—the powerful changes sweeping across the business landscape? It is all about governance.

What constitutes robust sustainability governance?

The widespread misconceptions and confusion around governance—and the inability of ESG rating agencies to actually measure "the G in ESG"—is the real story of the PG&E failure.

Mention the term "governance" and you are often met with blank faces. To some, it refers to all things related to the board of directors. To others, "governance" is vaguely about CEO and C-suite roles. The author has examined sustainability governance for 30 years—from the boardroom to the shop floor. He sees governance as the company DNA—the structure, processes, and culture in place in an organization that impact how key business decisions are made. How does the capital budget get allocated? Which among many important projects get funded? How are long-term risks balanced with short-term business performance needs? Who sits at the table when strategic plans are finalized and key business decisions are made?

What governance factors do ESG raters ask about?

External ESG rating agencies ideally want everything in an Excel file. The problem is that while a lot of the "E" and "S" performance lends itself to data in an Excel file; governance processes do not. ESG ratings thrive on environmental and social impact data: (e.g., energy use, greenhouse gas emissions, water use, waste, personal safety, health and wellness, diversity, human rights, etc.).

In the governance area, ESG raters focus is much more limited:

> **Data**—Facts about board and executive diversity; compensation practices; major ESG risks; level of top corporate officer overseeing sustainability; etc.
>
> **Yes/No/Describe**—The existence of certain structures and processes (yes/no or check the box questions). They ask if you have conducted a materiality assessment; if your board provides oversight; if ESG material issues are linked to your company's enterprise risk processes. They might ask you to describe your climate impacts.

Every external ESG rating agency wants very much to get a handle on the company's management of ESG risks. But that is simply not possible. From outside a company, it is typically not possible to truly understand "*the way things really work around here*."

The bottom line is that for most companies, it is actually pretty easy to look good on the governance portion of external ESG rating criteria.

What governance information did PG&E disclose?

PG&E disclosed a significant amount of ESG information—not only in its comprehensive sustainability report. In addition, its 2017 annual report included:

- In the CEO's letter, six of the first eight paragraphs address ESG and the wildfire issue;
- Wildfire costs are included in the financial highlights; and
- Item 1A: Risk Factors starts with four pages of detailed information on risks related to wildfires.

The company's *2018 Corporate Responsibility and Sustainability Report* further highlights governance information, including:

- Sustainability embedded in the company vision and mission;
- CEO commitment;
- Ethics; and
- Materiality and risk management processes.

The reader learns a lot from these reports but does not gain insight into the core processes in place to run the company.

How can companies measure the sustainability governance?

Unfortunately, companies tend to build robust governance *after* problems occur. This has been the author's experience participating in meetings with boards of directors at major global companies over 60 times.

What the author learned in all of those meetings is that, at best, a small fraction of what constitutes robust governance is how it looks on paper. The vast majority of robust governance can be thought of as "the soft stuff"—about "the way things really work around here." He has studied best governance practices at companies, developing a scorecard that measures this "soft stuff." (This scorecard was the basis of a 2015 *Director Notes*, "Navigating the Sustainability Transformation,"[11] published by The Conference Board.)

Figure 1 highlights the 80/20 governance trap in greater detail. It clearly illustrates that a typical external ESG rating agency (in this case Sustainalytics) only addresses a small fraction of the governance structures, programs and processes companies actually have in place to manage ESG risks and opportunities. The structure of governance illustrated in Figure 1 was developed over 20 years by assessing the many elements leading companies across virtually every industry sector have put in place to manage ESG issues. Thus, each of the boxes in Figure 1 represents a key element of sustainability governance and strategy in place at leading companies.

While the structure depicted in Figure 1 was developed independently from The Conference Board, it largely aligns with "The Seven Pillars of Sustainability Leadership"—a 2016 report by The Conference Board that outlines the key business practices that define leadership in corporate sustainability.

Figure 1

Corporate Sustainability Scorecard™

Governance and strategy KSIs* addressed by Sustainalytics

Vision, mission, values	CEO leadership	Board leadership	Goals and metrics	Culture and organization	Disclosure and reporting	Strategic planning
CEO's view—role of company in society	Speeches by CEO and C-suite	Board oversight of "S"	★ Materiality assessment	Executive committee ESG focus	Posture re ESG materiality	Corporate "S" positioning
"S" in vision and mission	CEO messages to shareholders	Board's "S" commitment	Philosophy re "S" goals	"S" in executive compensation	Disclosure of ESG impacts	Strategy re ESG cost reduction
"S" in core values and policies	C-suite meetings with customers	Board's "S" expertise	Stakeholder input to goals	Communication to employees	"S" in annual report	★ Strategy re ESG risk reduction
Support of international "S" charters	CEO messages to employees	Board's "S" advisors	Long-term (5–15-year) goals	Reward and recognition	Sustainability report	Strategy re "S" revenue
Long-term viability of core businesses	CEO's sources of "S" learning	★ Board ESG review of key business decisions	Ultimate (e.g., 2050) "S" goals	★ "Unwritten rules of the game"	Data verification/ assurance	Strategy re ESG impacts on brand
Key business decisions tied to ESG	Board agendas	★ Reporting most material ESG issues	Magnitude of footprint cuts	C-suite role, re "S"	Outreach posture	★ ESG and enterprise risk
"S" ratings and rankings	C-suite roles re sustainability	★ Assurance letter or equivalent	Revenue from "S" products	CSO reporting level	Public policy alignment with "S"	★ Scenario planning
Ethics and trust ratings	Executive "S" council	★ Time spent in board meetings	★ Accounting for material risks	"S" risks in goals and job descriptions	Marketing and advertising	"S" impact of CapEx
		Board sources of "S" learning				

Major overlap ★ A core ESG risk management KSI

Partial overlap

Little or no overlap

* Each box represents a KSI that is part of the Corporate Sustainability Scorecard™

Source: Hedstrom Associates

In Figure 1 the darkest shading represents indicators of governance that Sustainalytics explicitly includes in its criteria for companies (notably utilities). The medium shaded indicators are ones that Sustainalytics partially addresses. All the other items are "the soft stuff"—aspects of how companies manage their ESG risks and opportunities that do not lend themselves to being assessed by external raters. Sustainalytics is used in Figure 1 to illustrate the 80/20 ESG governance trap; however, an analysis of how six other ESG raters compare shows a similar picture.[12]

The question then becomes: if Sustainalytics and other external raters are only able to assess about 20 percent of ESG governance and strategy, can companies actually rate themselves on those things?

The good news is that companies can (confidentially) measure how their company stacks up on the softer aspects of ESG governance and strategy. There are several tools available to companies to help with this exercise. Here are some of the most common:

- *The Corporate Sustainability Scorecard*™: Initially developed in 1997, this tool has been shaped and vetted by over 80 major global companies. With the publication of *Sustainability: What It Is and How to Measure It*, the rating criteria are publicly available. Companies simply request log-in credentials and then begin a free trial. The tool has about 150 rating criteria, including ~55 on governance and ~35 on strategy for each of the four stages of maturity. A brief description of the Corporate Sustainability Scorecard™ is provided in the appendix.
- *Ceres 2020 Roadmap for Sustainability*: Launched in 2010, the Roadmap presents 20 expectations companies should meet by 2020 in order to capture the competitive advantage sustainable business offers. The tool has 20 key expectations, covering governance, stakeholder engagement, disclosure and performance.[13]
- *Future-Fit Business Benchmark*: The free tool provides Action Guides for each of 23 cause-no-harm goals aligned to transform business into "future fitness." All goals are founded on best-available environmental and social science. The tool does not specifically focus on governance; rather, it is built around attributes of a fit-for-the-future business (e.g., zero waste, optimizing resources, etc.).
- *Sustainable Brands Transformation Roadmap*: The tool, available only to members, addresses five characteristics (purpose beyond profit, system-wide brand influence, regenerative operations, net positive products and services, transparent and proactive governance) on a Level 1 to Level 5 rating scale. Each level has just three or four rating criteria for governance.[14]

How do 60 global companies rate themselves on the "G" in ESG?

Let's circle back to the PG&E situation. While the author only had information about the utility that was reported in the news or included in company disclosures, he does have data on how eight peer utilities rated themselves using the Corporate Sustainability Scorecard™.

In 2018, 60 major global companies (including eight utilities) participated in a comprehensive benchmarking exercise using the Corporate Sustainability Scorecard™. Most of the companies were members of one of The Conference Board's executive sustainability councils.

Companies rated themselves on about 150 KSIs. Of those, about 90 align with the basic governance and strategy activities. A subset of those governance criteria are 10 KSIs that relate specifically to ESG risk management and the PG&E situation. These are noted by the 10 red stars in Figure 1.

Figure 2 further analyzes these 10 core ESG risk management questions, which are directly applicable to the PG&E situation—and to every company. How do companies rate themselves on these core questions? The data from 60 major companies—many of whom are widely recognized industry leaders—tells a starkly different story than the governance ratings of PG&E. The 60 major companies are basically saying: "We have a long way to go to fully embed ESG risk management into the core business processes and achieve best in class. In fact, we are not even at Stage 2."

Figure 2

How companies rated themselves

On average, from stage 1 to stage 4

Risk management		Core ESG risk management questions	Average rating	STAGE 1 2 3 4
IDENTIFY	1	**Materiality assessment** Have we identified our major ESG risks?	2.1	
	2	**Accounting for impacts** Have we assessed the magnitude and scale, costs and liabilities of major ESG risks?	1.5	
MANAGE	3	**Enterprise risk management** How are ESG risks incorporated?	1.9	
	4	**Scenario planning** How well are we tracking the rapidly changing landscape and impact on business?	1.5	
	5	**Strategic planning** How thoroughly are ESG issues incorporated into our strategic and business plans?	2.0	
ACT	6	**C-suite ownership** Do business leaders personally own the major ESG risks?	1.5	
	7	**Culture** Do the "unwritten rules of the game" drive the "right" decisions?	2.2	
OVERSEE	8	**Board time** Does our board spend sufficient time on ESG risks?	1.4	
	9	**Board agendas** Does the board fully address material ESG risks?	1.6	
	10	**Key business decisions** Are material ESG risks factored into "key business decisions"?	1.5	

Source: Hedstrom Associates

On the KSIs aligned with these 10 questions, 60 large global companies rated themselves on average at about Stage 1.7 on a stage 1-4 maturity scale. The ratings by eight large utilities (not including PG&E) were virtually identical—average of Stage 1.7 on these core ESG risk management questions. In the appendix, we provide additional information about the Corporate Sustainability Scorecard™.

The results are not surprising to any chief sustainability officer (CSO) or director; however, they might be surprising to C-Suite executives, board members, investors, NGOs, and other stakeholders that tend to take comfort in external ESG ratings.

A Call to Action: Pause—Rethink—Rebuild

The PG&E story shines a spotlight on what should be obvious: managing climate risk (or any environmental or social risk) is predominantly about governance. The problem with governance is that few people seem to understand it. Raters cannot truly measure it. NGOs largely ignore it. Every function inside companies touches it but nobody seems to own it. It is time to collectively hit the "pause" button and rethink the way ESG has been managed over the past 20 years.

In 1997, climate risk and governance issues hit the front-page business news. BP's then CEO John Browne broke ranks with his oil company peers, noting in a Stanford University speech that "…there is now an effective consensus among the world's leading scientists and well informed people outside the scientific community that there is a discernible human influence on the climate, and a link between the concentration of carbon dioxide and the increase in temperature."[15] Later that year, the Kyoto Protocol (a climate treaty that the United States did not ratify) triggered intense debate. That same year, the Global Reporting Initiative (GRI) was launched.

Fast forward 20 years. Despite some impressive incremental ESG improvements, we do not seem to be heading in the right direction as a global society. Collectively, investors, CEOs, sustainability executives, NGOs and external ESG rating agencies need to ask: "Are we better off today than we were in 1998?"

Swedish teenager Greta Thunborg answered this question in front of world leaders and captains of industry in Davos in early 2019. She has become the voice of a generation and inspired 1.4 million students at over 2,000 schools in 125 countries on all continents to walk out of class in solidarity. Her message about the global risk of climate change is simple: "You are not mature enough to tell it like it is."

We are at an inflection point. The honest assessment of the current situation is that whatever we have done the past 20 years to address climate risk is not remotely close to what's needed the next decade. Let's take a hard look at the current situation.

- **Investors:** Unfortunately, there is no free lunch when it comes to evaluating company ESG performance. The current approach of ESG raters on governance topics is not quite like measuring deck chairs on the Titanic—but it is close. Measuring board diversity, CEO compensation (as a multiple of average worker pay), and the existence of certain organizational positions or committees may be interesting, but it does not provide any meaningful insight into the company.

  The opportunity for investors is to sharpen the focus on sustainability governance as the market for sustainable investments explodes. Bloomberg reports that global socially responsible investments grew by 34 percent to $30.7 trillion over just the past two years. Money managers around the globe said that climate change became the leading issue for investors this year. And, investors who integrate ESG principles into their portfolios now represent about $17.5 trillion, up 69 percent since 2016.[16] Serious money is at stake. Investors owe it to their customers to significantly upgrade their focus on governance.

- **CEOs and C-suite Executives.** CEOs globally view ESG as a future driver of growth. This was once again confirmed in The Conference Board's 2019 annual C-Suite Challenge Survey.[17] Growth is about managing risk and opportunity—but it starts with managing risk. Business leaders love being "on the list" of top sustainable companies—but the 80/20 ESG governance trap suggests that a company can have great ESG ratings with lousy internal risk management processes.

  We know from a decade of feedback during council meetings held by The Conference Board that leading companies have long looked outside their industry associations for insight and trend tracking. However, part of the problem is that too many companies take false comfort among their industry association peers. How can companies be sensitive to the world around them as they engage with industry sector peers? Let's face it: on issues that may represent major threats, industry associations tend to do the least possible to reflect the lowest common denominator of their members.

  In the author's experience, the most important action a CEO and team can take is to engage the board of directors in conversation about ESG risks. Too often, this happens after a major incident. According to the latest NACD annual survey, boards of directors want to learn more about ESG and disruptive risks. They also have little confidence in management's ability to manage climate risk.[18] Most companies limit the board ESG time to small, carefully scripted slots reviewing data. In a recent poll by The Conference Board, 69 percent of companies responded that their board committee (or full board) typically spends two to four hours per year on sustainability/environmental, health and safety (EHS) issues.[19]

  This standard, highly-orchestrated board reporting practice stands in stark contrast to best practices. Several years ago, a major North America utility invited the author to speak to the full board and to participate in a three-hour scenario planning exercise. The scenarios were built around climate risk and opportunity. At the end of the meeting, the board chair said it was the best half-day the board had ever spent. The board added a half-day to the next meeting to continue the deliberations.

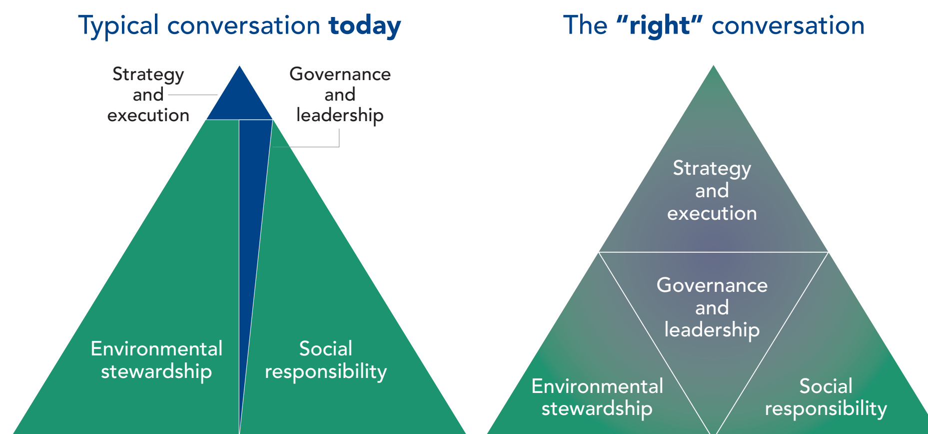
- **Chief Sustainability Officers (CSO).** Who owns sustainability governance? It is easy to think that someone else inside your company (e.g., the general counsel, corporate secretary, CEO, C-suite) owns governance. But CEOs look to the most senior full-time head of sustainability at the company to personally own sustainability governance. This may be the vice president of EHS, a director of sustainability, or a chief sustainability officer.

  It is time for sustainability executives to step up and own sustainability governance. This requires changing the conversation.

As Figure 3 depicts, the conversation about sustainability has long focused predominantly on environmental and social impacts. Governance gets precious little attention, as do ESG-related issues associated with strategy. For the past 20 years, the CSO's world has looked like the left side of Figure 3. To be successful the next decade, CSOs need to shape the role and conversation around the right side of Figure 3.

Figure 3

Change in the sustainability conversation



Source: Hedstrom Associates

A good way to start changing the conversation is to measure your company's performance on ESG governance and strategy. Conduct a detailed company self-assessment—with a sharp focus on risk management (the 10 core questions in Figure 2). Such a self-assessment can be easy and confidential, using tools such as those noted above. See how you stack up compared with peers in your industry sector and across sectors.

- **NGOs:** For the past 20 years, NGOs have pushed for disclosure—and have arguably won the (ESG disclosure) battle. But we collectively are losing the (climate change impacts on society) war. NGOs have piled demands on companies to report hundreds of metrics and data points, often calling those data points "material." By "forcing" companies to assess environmental and social impacts that are important to any stakeholder, NGOs have lost the forest for the trees.

  It's time for NGOs to focus on materiality the way investors do. Every company has only a very small number (normally three to four) of ESG issues that are truly material. An excellent starting point for identifying these issues is the German Environment Ministry's SD KPI report.[20] A sharper focus on (financially) material issues also suggests that it is time to kill the corporate sustainability report and to pursue integrated reporting.[21] If ESG issues are material, the data and discussion of those issues belongs in the annual report and associated financial disclosures.

- **ESG Raters and Rankers.** External ESG rating agencies play a vital role, growing in importance. Major financial institutions continue to invest heavily in building the methodology and algorithms to assess company ESG performance. However, as noted above, there are critical aspects of how companies manage their operations that are extremely difficult—if not impossible—to assess from outside the company. That will not change anytime soon.

  Truth be told, a company can look good to external ESG raters if it has some basic building blocks in place: a materiality assessment; some linkage between that assessment and enterprise risk management; a basic governance structure in place (board committee; executive sustainability council; etc.); executive compensation tied, in part, to long-term performance; strong environmental and social goals and metrics; and a track-record of performance.

  The challenge and opportunity for ESG raters is twofold:

  - As a service to investors, significantly ramp-up the focus on governance. Learn from the nearly 100 KSIs that represent leading practices across industry sectors.
  - Candidly share the limitations of what an external body can "see" about the "softer parts" of governance and strategy. If you can only evaluate about 20 percent of what constitutes robust governance, say so.

Conclusion

Without getting governance "right," it is difficult for a company to get anything else right. This is true in creating successful products and services, creating robust brands, delivering consistent and strong financial results, and earning a reputation as a good company to work for. It is also true of sustainability.

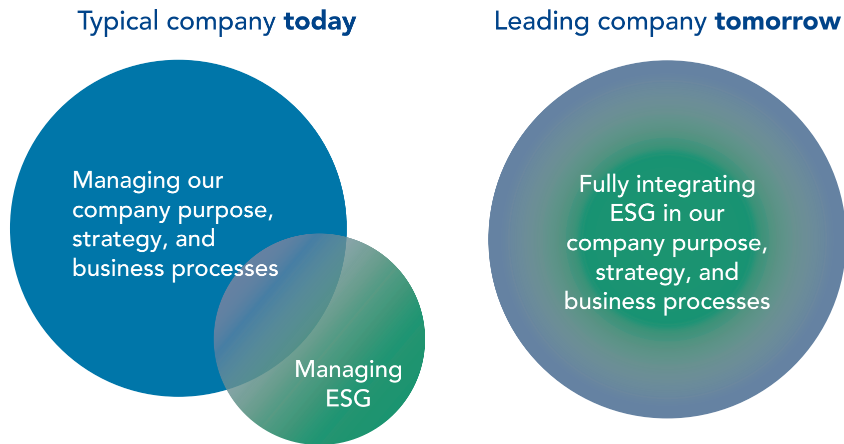
Peter Senge[22] has said that "sustainability is not a problem to be solved; it is a future to be created." PG&E has been helping to create that future, viewing ESG as a growth driver. The company has a striking $34 billion of renewable energy contracts. But look what happened. The PG&E situation is not an anomaly. Look back at Figure 2 where 60 major companies—including eight major utilities and a wide cross-section of industry sectors rated themselves.[23] The 60 companies essentially say their internal ESG risk management processes are not particularly robust, not very mature, and not well-integrated with the business.

The Feb. 21, 2019 edition of *The Economist* notes that "corporate-risk managers … are rotten at assessing their exposure to changing climate." The article further notes that: "The risk of severe climate change is thus rising, posing physical threats to many firms. Most remain blind to these, often willfully so. They should start worrying about them."[24]

Climate change is not a single risk; it is a complex set of interrelated factors that can impact companies in widely different ways. Many companies have off-balance-sheet risks related to ESG factors (including climate risk). Fire risk for PG&E might show up as drought or flooding in the agriculture sectors, stranded assets for oil and gas (and coal) companies; supply chain disruptions for every sector from apparel to food to consumer products; and product deselection across virtually every sector (plastic straws are just the beginning).

Figure 4

How companies manage ESG



Source: Hedstrom Associates

Almost all companies today manage ESG at the periphery (Figure 4). They treat ESG as serious stuff, assign C-suite oversight, publish sustainability reports, invest time with ESG raters, discuss the stuff at the board, and lots more. But ESG is still managed at the fringe—not fully integrated into the core business structures and processes to run the company. This needs to change fast.

The PG&E bankruptcy situation raises the volume on climate risk warning sirens. Investors, CEOs, CSOs, NGOs and ESG raters all should heed this wake-up call.

APPENDIX

The Corporate Sustainability Scorecard™

The structure and rating criteria embedded in the Corporate Sustainability Scorecard™ have been shaped and vetted by over 80 companies across many industry sectors. Over the past two decades, the scorecard has been developed in collaboration with The Conference Board. Over 90 percent of the companies involved in shaping the tool are currently—or have been—members of a sustainability council of The Conference Board.

Measures the "G" in ESG. The Corporate Sustainability Scorecard™ is designed to allow companies to confidentially measure the "softer" aspects of how the company manages ESG issues. It is extraordinarily difficult to measure board effectiveness or executive engagement with sustainability. However, the Scorecard includes ~55 key sustainability indicators (KSIs) that measure governance and another ~35 that measure strategy. The criteria have been shaped by a decade of ESG council meetings with The Conference Board, where corporate sustainability leaders shared stories and polled members about (for example) time spent presenting ESG at board meetings, integration of ESG into strategic planning, and the like.

By Industry—For Industry. The framework has been built by analyzing the best practices and stated ambitions of companies at the leading edge of the sustainability transformation.[25] The key sustainability indicators defining each stage were built by analyzing companies from 3M to Marks & Spencer; Cisco to Waste Management; Ashland to Patagonia, Campbell Soup to Ingersoll Rand, Ecolab to Maersk, Exxon to Unilever, Ford to Nestlé and several hundred others.

Tough Rating Scale. The rating tool has a tough scale from Stage 1 (initially engaging with sustainability) to Stage 4 (truly transforming your company fully aligned with sustainability principles).[26] (See Figure A.)

Figure A

Corporate sustainability position

Most companies are currently between Stage 1 and Stage 2

Stage 1 **ENGAGING**	Stage 2 **ACCELERATING**	Stage 3 **LEADING**	Stage 4 **TRANSFORMING**
Fold sustainability into traditional environment, health & safety, and philanthropy efforts **Take "no regrets" actions (e.g., reducing energy use)** **Sustainability not truly integrated into business strategy**	**Sustainability efforts often are CEO/ C-suite driven** **Take a lead role on key business issue(s)** **No sustainability-driven changes to business model or portfolio** **"Bolted on," not "woven in"**	**Sustainability represents a core platform for growth** **ESG drivers at the core of business strategy** **Weave sustainability into critical business processes** **Incentives in place to drive ESG leadership**	**Company purpose and values hard-wired to future generations** **Sustainability fully integrated into business processes** **Sustainability fully aligned with circular economy principles (closed-loop, 100% renewables, etc.)**

Source: Hedstrom Associates

The author estimates that nearly half of all companies in the developed world are between Stage 1 and Stage 2—with the top of the bell curve being at about Stage 1.5. Data from 60 (many leading) companies supports this. The peak of the bell curve for those 60 companies is Stage 1.75. While it is convenient to express a company as being "in Stage 1" or "a Stage 2 company," in reality, most companies exhibit a range of attributes that fall across several stages of maturity on this scorecard.

The rating criteria have been used and refined by about 80 companies over nearly 20 years. They are not perfect—never will be—but they represent the input of dozens of corporate leaders across many sectors.

Endnotes

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Gilbert (Gib) Hedstrom is president of Hedstrom Associates, an advisory firm specializing in business consulting and executive counsel on sustainability strategy. Schooled in finance at GE, Hedstrom spent 20 years at Arthur D. Little where he was vice president and managing director. He has over 25 years of experience advising CEOs and board members about how to handle difficult environmental and business challenges, and has reported directly to boards of directors of Fortune 500 companies on over 60 occasions. Hedstrom has had a long association with The Conference Board. From 2009 to 2018, Gib was program director of three member-only councils addressing issues of sustainability: Sustainability Council I: Strategy and Implementation; Sustainability Council II: Innovation and Growth; and the Chief Environment, Health and Safety Officers' Council. In 2017, he published *Sustainability—A Guide for Boards and C-Suites*. His latest book, *Sustainability: What It Is and How to Measure It* was published by De|G PRESS in late 2018. The book includes Gib's Corporate Sustainability Scorecard C-Suite rating system—also available to registered users on https://thesustainabilityscorecard.com/. Gib was recently named a to the faculty of the National Association of Corporate Directors. In this role, Gib will continue to advise boards of directors on ESG. He earned his MBA (Corporate Strategy) and MS (Natural Resource Management) from the University of Michigan and a BA in Economics and Geology from Hamilton College.

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