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Strategy and sustainability: a strategic logic for engagement with the environment

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ABSTRACT While many firms today routinely publish sustainability reports, work to increase their energy efficiency and market some part of their products or services to customers who are in some way interested in their environmental performance, there still appears to be a general lack of engagement on the issue of the environment from Chief Executive Officers and members of Boards of Directors. Despite years of effort and thousands of scholarly articles, academia has yet to develop a compelling framework with which to engage Senior Management. The article proposes such a framework based on an idea called *environmental sensibility* and the degree of compliance a firm chooses to pursue.

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Introduction

A little more than 50 years after the publication of Rachel Carson's Silent Spring, concern for our natural environment has become widespread, gained legitimacy in civil society, been written into government regulation, and become standard business practice in the United States, Europe, Japan, and other regions.

A segment of consumers think about the environmental impact of what they do: routinely recycle glass, plastics, and paper and pay attention to the environmental reputation of the companies with which they do business. In the West, we also take for granted landmark legislation largely enacted in the 1960s and 1970s that protects air and water quality and regulates a number of aspects of the way business interacts with the natural environment.

With the rise of environmental activity by business, the academic community has become keenly interested. Linnenluecke and Griffiths (2012), for example, reviewed more than 3,000 peer reviewed papers in the area of Corporate Sustainability. Amini and Bienstock (2014) also undertook an extensive review of the literature and established a framework classifying firms at one of four levels of "sophistication" echoing the levels of "maturity" developed by Baumgartner and Ebner (2010). What is common in these reviews and much of the literature in the field is a clear bias that more engagement with the environment is inherently better and right for firms.

From a very different perspective, Baron (2012) calls out environmental sustainability and climate change in a long list of issues that firms might need to incorporate into their non-market strategy. What is most compelling about Baron's framework is that it makes dealing with sustainability a fiduciary issue, not a moral obligation.

My approach is to take Baron as a starting point and side step the moralistic posturing found in much of the literature and focus instead on the strategic challenges which arise as a result of environmental sustainability. I will then offer a practical framework to deal with those challenges which is framed in a way to engage with Senior Management.

Strategic issues. Many firms publish sustainability reports, take steps to increase their energy efficiency and market some of their products or services with environmental messaging. Despite the activity, however, it seems that only a limited number of firms have an environmental committee as part of its governance structure (Walls *et al.*, 2012) and I see a general lack of engagement on the issue by many Chief Executive Officers and members of Boards of Directors. Often the issue of environmental sustainability has been delegated to a Chief Sustainability Officer or left to Corporate Communications, Operations, Marketing, R&D, Corporate Affairs and Legal.

Strategic issues are those that have a material impact on either the medium- or long-term viability of the firm and/or its basic size and scope in terms of geographies and market segments. I have identified five such issues connected with environmental sustainability as follows:

- a firm's social license to operate;
- potential catastrophic risks that might affect a firm's survival;
- the degree to which the firm's customers value its approach to the environment;
- the way new technology can change the situation;
- the way that globalization plays out in this area for example by bringing a firm's performance around the world to the attention of interest groups and consumers in its core markets.

Sensibility and compliance. By combining what I call *Environmental Sensibility* with a firm's *Level of Compliance*, it is possible to articulate six clear and distinct strategic approaches to environmental sustainability that have the potential to fully engage Senior Management and members of the board in a constructive discussion of strategy.

Environmental Sensibility has to do with the relationship that the people involved with the firm have with the natural environment. A number of factors can potentially add up to produce deferent levels of *Environmental Sensibility* including:

- the firm's industry since some sectors such as energy, mining, etc. have much greater impact than others;
- the level of environmental commitment of the firm's shareholders;
- the existence of external pressure from government, special interests, and the news media;
- the level of interest of a firm's employees and customers in environmental issues.

Level of Compliance has to do with the approach a firm chooses to take with respect to the myriad regulations which affect it in different countries and territories. Reinhard (1999) and Shimshack (2007) argue that there are specific reasons to go beyond compliance including increasing differentiation, cost reduction, hedging against risks, and also to attempt to mollify public opinion and thus forestall the development of more stringent regulations.

Strategic options

Combining the concepts discussed above creates a two dimensional map in which a firm's strategy can be shown. Six generic approaches are shown graphically in Fig. 1 in an illustrative way along the two axes from less to more *Environmental Sensibility* and *Level of Compliance* and further developed below. For this article no attempt has been made to quantify or operationalize these concepts as that would require drilling down to a specific industry and geographic location and this idea is left for further research.

Doing less than required by law, or what I refer to as *Break the Law,* is not recommended or condoned. In a business with low environmental impact and little *environmental sensibility* on the part of customers, employees, shareholders, and other stakeholders, what might make sense however is to simply comply with regulation and I call this approach *Take the Low Road*.

The four other choices represent increasing levels of both compliance and *environmental sensibility*. While Fig. 1 is only illustrative, the six approaches are explored in sequence as the capabilities (Teece *et al.*,1997) that need to be developed

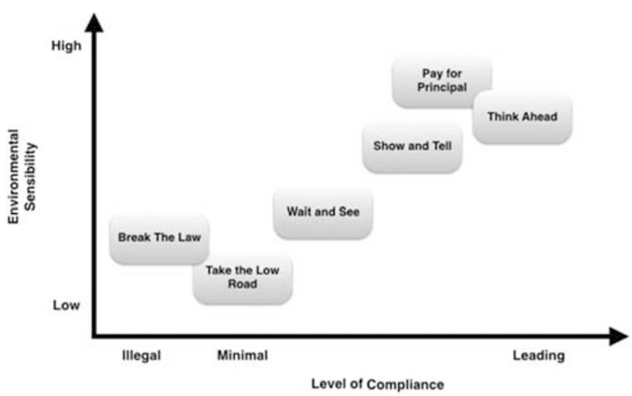

Figure 1 | Strategic Options.

are cumulative. Thus a firm can move from one option to another by developing its capabilities.

Take the low road. *Take the Low Road* is about minimizing the cost of compliance due to the understanding by the CEO and the Board that environmental issues are of little strategic importance to the firm. While many ecologists would say that all firms have a significant environmental impact, the fact is that some have a much greater impact than others.

The owner of an American fast food chain with just over 100 franchise outlets, for example, has adopted a positioning based on taste, value, and fun. In this case, neither the management team, nor the franchise owners, employees, or customers have any specific identification with environmental issues. The firm's approach is to comply with state health and safety laws, dispose of used cooking oil in a responsible way, and leave it at that. This firm, for example, chooses not to have outlets in California due to the state's strict regulations.

With thousands of units in the United States, McDonalds is in a very different situation. In November 1990, faced with an increasing numbers of cities banning styrofoam and under pressure from its customers, McDonalds worked with the Environmental Defence Fund and abandoned its tradition "clamshell" box for hamburgers and replaced it with paper and cardboard. The new packaging had 90 per cent less bulk and represented total cost savings for the company but the driver to change was public perception and pressure according to McDonalds.

The difference between McDonalds and the much smaller chain of restaurants mentioned above is its public profile and *environmental sensibility*.

In businesses with low environmental impact and little or no legislation affecting it, the *environmental sensibility* of Senior Management, employees, and customers may, in fact, be quite low making a *Low Road* approach a realistic option.

If a firm does choose the *Low Road* approach what is very important is to make that choice explicit and carefully communicate it to the unit managers around the company who could misinterpret a *Low Road a*pproach for implicit permission to cut corners and take risks with respect to compliance.

Break the law. When the cost of compliance is high and the perception that there is little downside to non-compliance, there is a temptation for firms to do less than the law demands or put simply to *Break the Law*. The perception that the downside is low can be a combination of there being little or no penalties associated with discovery, a low probability of that discovery or both.

The strategy of *Break the Law* should not be confused with a firm which opts for the *Taking the Low Road* and unwittingly goes over the line. In that case, Senior Management will take steps to correct a problem as soon as it is detected. In *Break the Law*, there is either deliberate avoidance of specific regulations or internal processes which lead to infractions occurring at statistically incredulous frequency.

The legal risks associated with *Break the Law* are significant as governments are increasingly prosecuting deliberate or even unintentional damage to the environment in the criminal courts in many countries around the world.

There are also strategic risks to pursuing *Break the Law* that may outweigh any legal issues associated with the strategy. These have to do with the possibility of being found out by environmental interest groups who might jump on the issue of non-compliance to attack the company and put its social license to operate at risk.

The last issue associated with *Break the Law* is that if Senior Management either directs its employees to disregard rules and regulations or sets up a system which encourages them to do so, then it is condoning its own people to behave in an unethical manner. This begs the question that if a manager is encouraged or allowed to break certain laws, then what is to stop him or her from breaking others such as misreporting financial figures or committing other types of fraud?

A final aspect of *Break the Law*, which is shown graphically in Fig. 1, is that it actually requires a higher *environmental sensibility* than simply taking the *Low Road*. This idea, which may appear counterintuitive, is that to deliberately avoid compliance one must first understand the cost of that compliance and then perform some sort of cost–benefit analysis to determine that it is better not to comply. In contrast, a company pursuing the *Low Road* need not actually know its cost of compliance as a separate line item in its profit and loss accounts.

Wait and see. Moving up the diagonal of Fig. 1, the next strategic option is to do more than the minimum in terms of compliance and to take a more proactive stance in terms of monitoring environmental impacts. The strategic logic of *Wait and See* is to be ready to adjust the firms practices, products and services, and communications policies if and when it is determined that it makes sense to do so. At least four capabilities are key to making *Wait and See* work.

The first key capability is to develop a process to know what the legal requirements are for each operating unit and to track their compliance with hard data. The second key function is to also understand and track the firm's portfolio of products and services in terms of their environmental footprint both in production and in their usage again in order to know what the current status is.

The third key function is to actively monitor legislation, consumer response, and the activities of environmental interest groups and social media in order to be able to spot emerging trends. The last key capability is to prepare different levels of management in advance for the possibility that the company may need to react at some time in the future as changing a firm's managerial culture can take years to accomplish.

In *Wait and See* there is an implicit assumption that environmental issues will increase in importance over time and thus it makes more sense to develop internal capabilities and to make the process of knowing the firm's current situation continuous and build such knowledge into its management systems. *Environmental sensibility* will increase as collecting the requisite data will raise the awareness of the management team.

What is also important for a firm which chooses *Wait and See* is to take great care with its external communications as the main objective of the strategy is to control the cost of compliance and avoid taking action until it can be shown to be in the medium- and long-term interest of the firm. While this basic idea can be compelling for business leaders, it might be perceived as cynical and can open the company up for criticism and attacks.

Show and tell. Although many companies publish annual sustainability reports and may have dedicated teams working on the issue, what distinguishes *Show and Tell* is the incorporation of a firm's environmental performance in its internal and external communications such that it becomes part of the culture and brand identity.

The strategic rationale for choosing a *Show and Tell* strategy will most likely come from a conviction that the firm's customers, employees, or other critical stakeholders, such as impact investors, value the firm's commitment to environmental sustainability.

In terms of compliance, choosing *Show and Tell* requires a firm to apply relatively high standards in all countries and territories in which it does business as the higher the public profile, the more scrutiny will be directed by interests groups and regulators.

The danger is that if serious problems are uncovered or even unfounded accusations are made, the entire effort can be written off as greenwashing by activists and potential damage can be done to the firm's reputation. One approach is to adopt the environmental standards of a firm's home market as its global code of conduct.

Critical capabilities for pursuing a *Show and Tell* approach include having accurate and real time data concerning its environmental performance, the internal controls and culture in place to assure compliance, a strong communications team, and robust financial models in place to track the of costs of the effort. Additionally, Senior Management itself ought to be fully fluent in the concepts dealing with environmental sustainability such that it can not only consider issues and choices at the highest level but also communicate its approach in a compelling way to the press, shareholders, and other constituencies.

As compared to *Taking the Low Road* and *Wait and See*, choosing *Show and Tell* will potentially add costs to the business. The main source of added costs will be to develop functional capabilities which will, most likely, require some number of dedicated people and these costs need to be balanced against a clear understanding of the benefits of improving a firm's environmental performance and reputation.

If the business case for *Show and Tell* is not forthcoming, then its adoption should be considered very carefully because once a firm begins to proactively and systematically share its environmental performance, stopping at some later date might prove costly in terms of reputation.

Pay for principle. Over the last 10–20 years, a number of entrepreneurs, venture capitalists, and public officials have found themselves in agreement with the goals of the environmental movement. Due to their convictions, these people have pushed their companies to take a leading role to either minimize their firm's environmental impact or offset whatever impact they do have regardless of whether or not there is a compelling business case. I call that strategic approach *Pay for Principle*.

Typically, such people hold deep beliefs about the importance of reducing air and water pollution, protecting the natural landscape, or slowing climate change. What is critical is that this strategic option is made explicit so that other shareholders can freely choose to be a part of the effort or sell their holdings.

Investing in the most efficient aircraft and flying slightly slower flight plans, can, for example, reduce the carbon footprint of air travel. Richard Branson's company, Virgin Atlantic, is committed to reducing its carbon emissions per mile by 30 per cent between 2007 and 2020 taking these and other measures and it is unclear to what extent this policy is driven by the opportunity to reduce fuel prices, a perception at Virgin that its customers value the company's commitment in this area, or the passion that Sir Richard brings to the issue.

What potentially confuses things is that, in some cases, these entrepreneurs have enjoyed significant market success and naturally find causality in their approach to life and business and their later success. While clearly there is a link between believing in what one does and being successful, what also appears to have occurred in cases such as Patagonia and Whole Foods Market is that people like Yvon Chouinard and John Mackey managed to create customer segments which identifies with their sustainable positioning. The business case, in other words, emerged after an initial *Pay for principle* approach.

What is key therefore for pursuing *Pay for Principle* is clarity of thinking on the part of the CEO to explicitly separate those aspects of the strategy that already make sense in terms of clear business criteria and which are a function of conviction and principle. In *Pay for Principle* communication with the public, shareholders, and regulators will be even more critical as sustainability becomes a central part of the firm's positioning and message.

Think ahead. A different reason for taking a leading position could be the conviction that the level of consumer interest and regulation in the future will be higher than it is at present. This could lead Senior Management to make commitments today based on their understanding of the most likely scenario for tomorrow. This approach is referred to as *Think Ahead*.

Going back to the example of Virgin Atlantic, Branson and his colleagues may feel that an airline's carbon footprint will be a competitive issue in the airline industry after 2025. Since modernizing a fleet of more than 40 airplanes takes years, perhaps they made the decision to begin renewing the fleet today in order to be ready for tomorrow.

The argument for *Think Ahead* is that if society's attitude about certain industrial practices does shift and require a more environmentally friendly approach, they may shift quite quickly and business leaders could be caught off guard. The question then becomes if a firm can react quickly enough to respond to changing circumstances or is it necessary to begin such development years in advance on the chance that such a shift might come to pass.

Changing the structure of fixed assets, market position, or the corporate culture of a firm takes time and from a risk management point of view, the issue is to avoid putting a firm's legal or social license to operate in doubt if its current practices fall afoul of changing norms. If such change was expected in a specific industry, then it might turn out to be strategically critical for a firm to *Think Ahead*.

One of the key capabilities that are needed for *Think Ahead* is an ability to reflect on trends and imagine the future using scenario planning (Wack, 1985). Another key capability is a very well developed change management process such that it is possible to predict how long it will take to bring about changes in a firm's products, processes, or culture in the case it decides to do so.

While the development of scenarios and the technical work involved can be delegated to specialists, only Senior Management has the ability to drive such an effort. In the event that the firm makes the wrong bet on the future it is critical that Senior Management be deeply involved in the process so that it can take full responsibility whatever the result.

The downside of a *Think Ahead* strategy is the risk of doing too much too soon and finding oneself having higher investment levels or higher operating cost relative to competitors who did not make the investments or change their processes.

On the other side, however, is the possibility of sudden shifts in the way the general public, consumers, regulators, and other interested parties, such as investors and financial institutions see specific issues and the time it may take a firm to react. Being in the right place at the right time could bring significant competitive advantage or even guarantee a firm's survival.

Conclusion

Environmental sustainability has become an important issue in the minds of the public as well as political and religious leaders in many parts of the world. As such, dealing with the issue has become part of the fiduciary responsibility of the men and women who make up the Senior Management of firms and can not be simply delegated or outsourced.

Each firm, however, is different and thus I reject the idea that all firms should do all they can all the time. Although it is often imperfect, the role of government in civil society is to set the minimum standards for behaviour for members of that society including business and I suggest that firms which fully comply with the law are good corporate citizens.

I do suggest, however, that there may be reasons to do more and urge each firm's Senior Management to agree on a high level approach to environmental sustainability which is right for them, their customers, shareholders and other stakeholders. By framing such an approach in strategic, rather than operational, technical or moral terms, I believe it is possible to fully engage Senior Management with the issue.

While governance models are different around the world, most large firms have some kind of Board of Directors that looks out for the medium and long-term health of the firm or institution. This body should become deeply involved in choosing the overall approach as only it can truly balance potential tensions between short-term gain and long-term risks and opportunities.

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Additional Information

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