by Johan de Villiers | Enspire Consulting

Johan balances the demands of corporate life with outdoor adventure and as a result has summited Kilimanjaro, met mountain gorillas in Rwanda and has overlanded through Africa. Johan is also a qualified helicopter pilot.

Johan has been in the IT, marketing and corporate game for 20 years. He has featured in CEO Magazine, SA Millionaire, Brainstorm and ITWeb, has been a speaker for companies such as Capestorm, Vox Telecoms and BDO, and he has contributed to a range of business publications. He currently consults on business development and marketing to a range of corporate and SME clients.

His next adventure will be trekking to Everest Base Camp in 2010. Visit www.enspireconsulting.co.za or write to johan@enspireconsulting.co.za for more information.

PLANNING FOR CLIMATE CHANGE

On a daily basis, companies are talking about going green, but few are actually planning for a change in our planet's climate. Executives should visualise their companies in 30 years' time to imagine how climate change will impact on their profitability and corporate survival. Unfortunately, most of them do not look so far ahead, with the focus very much short term on the next quarter's earnings to please shareholders. The thinking that permeates is always that the next CEO or his successor can fret about the long-term climate strategy.

First, some background: at an elevation of 1 000 metres in the Spanish Pyrenees, a wine farmer by the name of Miguel Torres invested in his company's future by planting 104 hectares of a Pinot Noir cultivar 10 years ago. At the time, common knowledge dictated that grapes would not do well that high above sea level, owing to the cold temperature. However, Torres, being the head of one of the largest wine families in Spain, had access to scientific data that showed that the current Rioja wine region would be non-viable for growing grapes within 40 to 70 years, owing to climate change.

The actual wine belt of Europe would move north by as much as 40 kilometres per decade; so much so, that some farmers are considering planting grapes in the south of England and even as far north as Scandinavia. Should this happen, Miguel had effectively mitigated his company's risk by planting this vineyard in the Pyrenees as a hedge to future climate change.

The question begs, however, what are companies currently doing to prepare or plan for downside scenarios when it comes to climate change?

Planning for more hurricanes or rising sea levels owing to climate change might be an important issue for a coastal property developer, but it is very difficult to justify spending a lot of shareholders' money on mitigating risk X if the company could actually be blindsided by risk Y instead.

The evidence thus suggests that the corporate sector is doing very little other than reducing carbon emissions and perhaps improving on environmental sustainability. Some have taken the more pessimistic approach of adaptation. The problem with an adaptation strategy is, of course, that it has very little PR value for a company. Nobody is trying to save the planet for future generations … it is all about trying to remain profitable when the Earth starts falling apart. No streetwise company is going to publicise that kind of thinking.

New regulations in the USA from the Security and Exchange Commission will force companies to reveal any material risk that they may suffer from climate change. This will allow investors to adapt their strategies according to the way that companies view climate risk.

Climate change can, however, be viewed by companies as more than an ominous reality but perhaps even as a business opportunity. In places like Brazil, state-owned banks such as BNDES and Banco do Brasil are evaluating whether investing in projects makes sense if the sustainability does not exceed 20 or 30 years. Agricultural giants such as Monsanto are developing genetically engineered crops that can withstand drought better and some global shipping firms are using satellite imagery to plot more fuel-efficient transportation lines through a partial ice-free Arctic passage. In the American West, power companies such as TransAlta has put future power plants on hold, seeing that water rights for the project life duration could not be ensured.

Dan Ariely, a behaviour economist that penned the book Predictably Irrational, is quoted as saying, "Climate change is a problem that is perfectly designed to make people do nothing: it happens far in the future; its effects will be felt most greatly by other people; and the efforts of any one individual are minuscule."

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The problem with climate change is that the time horizon spans over decades and most corporate companies work on a business plan of typically five to seven years at a time. Investing massive amounts of money in a project where the potential return could reflect in only 20 or 30 years might be difficult to swallow for most shareholders and executives, especially if the future probability is difficult to predict.

Take the example of an electronic manufacturer that relies on silicone supplies from Bolivia for its semi-conductors. If your climate change model predicts massive upheaval in that country's economy, leading to possible political unrest and a massive increase in the price of silicone, do you start stockpiling now?

This is a serious potential risk to the company, but there is very little that you could do about it from a hedging point of view, as silicone is not a futures-traded commodity. The company might as well disclose the risk in its SEC filings and continue doing business as before.

Another hedging strategy would be to buy insurance against potential climate change. Already the majority of reinsurance companies are pricing risk according to their climate change models. Companies are, however, experiencing a false sense of security thinking that their risks are hedged.

Insurance policies are valid for only 12 or 24 months at a time, thereafter an organisation needs to renew on a yearly basis. Should the insurer's climate change risk model predict a catastrophe in 20 years' time, there is no need to increase premiums now. But nothing prevents them from refusing cover in 15 years as the effects of climate change slowly unfold or increasing the premiums at an unaffordable rate when it suits them.

Think back to the Bhopal chemical disaster in India in 1984. After the event, pollution liability insurance went off the market for a time. When the reinsurance companies offered it again, the cost was 10 times higher than before the event.

Thus, insurance does not work very well as an adaption strategy to climate change either, as rising insurance cost is inherently difficult to protect a company against.

In conclusion, even if the effects of climate change are foreseeable, they can be impossible to hedge. The lesson here is that identifying a risk is not the same thing as being able to negate it.