

# Promoting Local Development by Benefit Sharing in the Hydropower Sector

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## 1. Introduction

The search for “social justice” and “equitable distribution” of development opportunities appear central in the concept of benefit sharing (IEA, 2000 and WCD, 2000). One key question that emerges then is how sharing benefits to enhance local development can be justified from the perspective of the firm (or project promoter). Is it so that enhancing local development does imply sacrificing financial performance and if so, what is the economic rationale or the motives behind it? This paper looks at this matter from two different angles. First, it looks at enhancing development benefits as part of a risk management strategy. Related to this it is considered relevant to review the relationship between the concept of benefit sharing to enhance local development and the efforts by hydropower companies in the sphere of social responsibility. Second, the paper looks at enhancing development benefits from the perspective of three groups of stakeholders: the local communities, the project promoter, and the country.

## 2. Enhancing benefits to local communities: a Risk Management Strategy

### a. Managing social risk

The importance of managing social risk is becoming increasingly well understood by the proponents, authorities and financiers of large projects. Social risks arise among other reasons from the dissatisfaction and grievances of external community and non-governmental stakeholders (EAP, 2008). Failure to manage these issues can have enormous financial costs, significantly damage the reputation of organizations involved and even put entire investments at risk. Usually, from the perspective of ministries of finance and/or the project developers there is concern regarding the potential costs of delays in the construction phases and/or from interruption of the operations in generation facilities due to conflicts with neighboring communities. For instance, it is reported that cases been raised to the Inspection Panel in the World Bank, can in average delay projects one year and add 1 million USD to project costs. Together with these concerns there is often - either explicitly or implicitly - the question about the returns or benefits one can expect from investing in local development-enhancing initiatives.

Some of the common social risks that can impact on project outcomes are:

- Project delays or abandonment
- Reputational damage
- Lack of user acceptance
- Decreased operational revenues

- Consumer boycotts
- Major modifications due to stakeholder pressure
- Exposure to legal action
- Security problems

Socially sensitive issues in hydropower include:

- livelihoods
- resettlement
- indigeneous peoples
- cultural heritage

**b. Social license to operate**

While it is universally accepted that legal permits or license is required from the relevant government agencies, project proponents are also acknowledging the importance of obtaining a *social license to operate* (SLO). The concept of SLO has been described as addressing the demands and expectations that emerge from neighborhoods, environmental groups and community members, and other elements of the surrounding civil society. Failure to properly understand these expectations can generate a diversity of risks (reputational damage, project delays or abandonment, security problems, etc.).

The following Table shows short and long-term social risks typical of hydropower projects. For each type of social risk, the last column reports a general assessment about the potential commercial consequences; e.g. Local-level economic risks and National-level economic risks. Usually, benefit enhancing initiatives aim at reducing these risks. As can be seen in the Table, both risks score “High” for their potential Commercial Consequences. In other words, social investments may have a (positive) “rate of return” since they reduce the risks for negative commercial consequences.

Table 1. Social risk issues in hydropower and their associated consequences

| Risk issue  | Short term                              |                                   | Long term   |                        | Commercial consequences |
|---|---|-----------------------------------|---|------------------------|-------------------------|
|   | Risk to construction schedule and costs | Risk to operation and maintenance | Risk to reduced access to in-country growth opportunities | Global reputation risk |                         |
| <b>Local-level economic risks</b> – Unfulfilled expectations of local communities to realise employment opportunities; ‘boomtown’ effects; local community jealousy of migrant workers, and intra and inter-community jealousies and rivalry, with potential for violence; construction wage levels in excess of market norms (eg in agriculture) leading to ‘labour drain; adverse effects of employee/sub-contractor retrenchment post construction | ✓                                       | ✓                                 |   |                        | High                    |
| <b>National-level economic risks</b> – Lack of transparency and accountability in payment of revenues to central and provincial government; production revenues fail to return to region of operations in a way that provides visible economic benefits to local population; national and provincial suppliers unable to access opportunities on project owing to economic barriers to market entry   |   |                                   | ✓   |                        | High                    |

Source: ODI, 2005.

### c. Financial Performance and CSR

Most definitions of CSR tend to coincide with two basic conceptual features. First, CSR manifests itself in some observable and measurable output/behavior, i.e. Corporate Social or Environmental Performance; this behavior usually reflects some degree of sacrificing financial performance in the social interest (Elhauge, 2005). Second, with CSR social or environmental performance of firms exceed levels set by obligatory regulations or standards enforced by laws (Kitzmueller, 2008).

There is, however, disagreement in the literature about the motivation for firms to engage in socially responsible behavior. The CSR- financial performance relationship has been investigated previously without substantial agreement about its nature. While CSR has traditionally been defined as a strategic 'process', empirical studies to date have been almost exclusively cross-sectional in nature, (i.e. several cases analyzed at some point in time) studying the immediate or short-term effects of CSR on firm performance. Many authors argue thus, that the CSR-financial performance relationship should be studied over time. In a recent study, time series data is used instead to empirically analyze the cumulative effects of CSR on the firm’s financial performance (Peters and Mullen, 2009). While cross-sectional analyses of CSR have produced ambiguous results, this analysis provide evidence that time-based, cumulative effects of CSR on firm financial performance are positive and strengthen over time. The results provide support for the ideal that long term socially responsible behavior (e.g. benefit sharing initiatives) is positive for a firm's stockholders as well as other stakeholders.

## 1. Cost-benefit considerations: a stakeholder's perspective

Cost-benefit considerations of benefit sharing mechanisms from the perspective of three different stakeholders: i. communities, ii. proponents, and iii. the country are presented in this section.

### a. The communities: balancing risks and local development opportunities

Local communities in hydropower project's influence area either directly or indirectly affected by the project works or activities during construction or operation phases usually face a diversity of risks. Their legitimate claim is not to become worst off as a consequence of the new project. In principle, the mitigation and compensation measures aim at this. In many circumstances, unfortunately, traditional communities do not get their user rights for natural resources recognized and are simply excluded from the use of the resource with no or insufficient compensation (Baland and Platteau, 1996). The right way to face this challenge is through improved dialogue and participation of the affected parties, so that mitigation and compensation packages are able to achieve the "no worst off" scenario. Enhancing local development opportunities through benefit sharing mechanisms may often be a cost-effective way of facilitating project implementation, as long as local communities perceive these mechanisms contribute positively to improve their baseline conditions. Local communities can enhance their development opportunities if supported by project promoters; either alone or in collaboration with other stakeholders – public or private. The eventual improvement of local communities' baseline conditions can be expressed and monitored by indicators such as: per capita incomes, improvement of living standards (housing, communications, and access to social infrastructure/services), measures of economic activity (agricultural/livestock productivity, market access, etc). Local communities must therefore search for a balance between the risks of living in the project influence area with the opportunities it may carry. Whereas project promoters must understand that as higher the risks placed on these communities, the higher the challenge to support local development opportunities.

### b. The promoter: balancing sustainable growth and financial performance

From the project promoters' point of view there are at least two arguments to justify profit sharing initiatives in socially beneficial projects. The first argument (regarding the time perspective) claims that actions aiming to improve social and environmental performance may have effects on profitability that differ *in the short versus the long term*. Higher levels of social responsibility may generate unrecoverable costs. It is thus easy to understand that enhancing local development initiatives – beyond to what is required by a legal framework – entail costs for the project promoters from which some of its benefits are only visible in the long run as well as being difficult to measure. In addition, voluntary social investment may be hindered because the costs related to not having a responsible corporate behavior are often hidden or unrecognized, while the savings from cutting corners seem obvious and may be considered as apparent benefits (Testa, 2008).

Benefit sharing measures may induce short-term decrease in profits which are followed by a more-than-compensatory increase in long-term profits. Under this vision, CSR/Benefit Sharing is about taking a long-term perspective to maximizing (intertemporal) profits. This suggests that socially

responsible investors should position themselves as long-term investors who monitor management and exert voice to correct short-termism (Bénabou and Tirole, 2009).

The second argument claims that CSR can be explained by a new class of sociological and psychological ideas that have recently entered microeconomic theory in general and the individuals' agent utility function in particular; as such CSR can be perfectly compatible with profit maximization behavior (Reinhardt et al., 2008). Standard motivational assumptions have been expanded and a literature on intrinsic (non-pecuniary, including social) aspects of motivation has emerged. In this literature, it is assumed that agents have preferences not only for money, but also for other social/public goods and reputation. The related departure from the neoclassical firm paradigm is closely linked to the extension of traditional individual choice theory towards a broader set of attitudes, preferences and calculations (Kitzmueller, 2008).

This approach is illustrated by the efforts known as Triple Bottom Line and represented by Sustainability Reports and/or by Social Reports where "wider values" determining social and economic values for all stakeholders, through the progressive expansion of social responsibility are taken into account (Testa M., 2008). For instance, ISAGEN, the Colombian utility does report annually their contribution to social development with a "triple bottom line approach" (ISAGEN, 2010).

### **The country: balancing economic growth and equity**

For the country as a whole benefit sharing initiatives may have a positive impact on income distribution. Since nearby (rural) communities usually face higher levels of poverty on average, the benefits from enhancing development opportunities supported by monetary or non-monetary mechanisms can make a significant contribution.

Local development-enhancing initiatives promoted by monetary and non-monetary mechanisms may improve equity in income distribution, increase demand for local goods and labor triggering local multiplier effects (Bhatia et al., 2003). Induced demand for goods, services, and labor from realizing existing local opportunities (through multiplier effects: income and employment linkages) will generate additional economic growth in other economic activity. This will contribute to optimal resource allocation from country/society point of view.

In addition, for the country/national society, successful benefit sharing initiatives will also lead to improved relations between the project promoter (or investors in general) and the neighboring communities (or civil society in general) as well as a lower degree of conflict. The improvement of relationships between project owners and local communities will directly or indirectly contribute to a sound investment climate for the country.

### **Concluding Remarks**

#### Enhancing benefits from hydropower investments: as a risk management strategy

Some degree of opposition and conflicts are common risks faced by hydropower projects. Social risks arise because the expectations of external stakeholders are broader or different than those defined

by legislation, regulatory approvals and/or the conditions of project financing (ODI, 2005). In the hydropower sector, as in other major industry sectors (e.g. mining) additional complications arise when the affected populations simultaneously claim for mitigation /compensation measures due to the external negative effects of these projects; in addition to participation in the project benefits; or at least development-enhancing initiatives from these projects.

Enhancing benefits to local communities and promoting good relations between project promoters and a wide set of stakeholders (affected communities, local authorities, customers, own workers, etc.) is more than risk management strategy. It is part of a trend for better corporate governance and accountability which has focused attention on the responsibilities an organization has not only towards its shareholders but also to the environment and society in which it operates (Testa , 2008).

#### Financial performance can be positive – with proactive CSR policies

Voluntary social investments aiming at enhancing local development opportunities do actually contribute positively to social returns. But in addition to that, there is also some recent evidence that positive returns can be achieved not only on the “triple bottom line” – but in the more traditional “narrow” financial performance indicators.

#### Multiplier effects: income and labor linkages

Overall gains or benefits from hydropower projects can in occasions be low among the local communities – due to weak “backward linkages” between the hydropower investment and the local economy; and thus, require positive action to exploit synergies and activate local potentials. Multiplier effects can be triggered – increasing the economic growth potential – when local opportunities are identified and realized through benefit enhancing initiatives. These initiatives can then bring benefits to: i. the local communities in the form of improved living conditions; ii. the investors in the form of long-term business potential, reduced reputation risks and goodwill from their neighbors; and iii. the country, in the form of optimized use of scarce resources (capital), improved investment climate and through stronger multiplier effects, increased GDP growth.

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