

Water Scarcity and PepsiCo: A Concern for Shareholders?

Introduction

Real Assets Investment Management Inc. and Trillium Asset Management Corporation request your support for a shareholder proposal calling on PepsiCo to report on the business risks it faces from rapidly occurring developments related to global water scarcity around the globe. (A copy of the resolution is attached.)

This backgrounder provides an explanation of the issue, an elaboration of the business risks emerging water scarcity poses to PepsiCo, an assessment of PepsiCo's inadequate response to those risks to date, and some benchmarks provided by PepsiCo's competitor Coca-Cola.

The Emerging Issue of Global Water Scarcity

Many investors probably think of water scarcity as a local issue, and often a temporary one that stems from a particular drought. Increasingly, experts are recognizing that population growth and burgeoning industrial and agricultural demands for water are leading to a state of chronic water scarcity in many regions around the globe. According to the United Nations:

About one-third of the world's population lives in countries with moderate to high water stress. The problems are most acute in Africa and West Asia but *lack of water is already a major constraint to industrial and socio-economic growth in many other areas, including China, India and Indonesia*. If present consumption patterns continue, two out of every three persons on Earth will live in water-stressed conditions by the year 2025. The declining state of the world's freshwater resources, in terms of quantity and quality, may prove to be the dominant issue on the environment and development agenda of the coming century. (Emphasis added).

This issue poses great challenges for businesses across a range of sectors that rely on water as a key input, from agribusiness to manufacturing. As examples:

- In November 2002, a United Nations committee declared drinking water a human right and asserted that water should not be viewed "primarily as an economic good."
- Controversies over bottling plants' water withdrawals are cropping up around the world, from Michigan to India to El Salvador, and these bottling operations are facing new community opposition, legal challenges, and government scrutiny.
- Activists and the media are increasingly airing criticism of businesses water use. *Business Week* gave a devoted space in August 2002 to a largely positive review of the book "Blue Gold: The Fight to Stop the Corporate Theft of the World's Water." Writing in the more liberal publication, *The Nation*, Blue Gold's author asserted "The bottled-water industry is one of the fastest-growing and least regulated industries in the world, expanding at an annual rate of 20 percent. Last year close to 90 billion liters of bottled water were sold around the world-most of it in non-reusable plastic containers, bringing in profits of \$22 billion to this highly polluting industry. Bottled-water companies like Nestle, Coca-Cola and Pepsi are engaged in a constant search for new

water supplies to feed the insatiable appetite of this business. In rural communities all over the world, corporate interests are buying up farmlands, indigenous lands, wilderness tracts and whole water systems, then moving on when sources are depleted.” (*The Nation*, Sept. 3, 2002).

- Perhaps of greatest concern for those thinking about the bottom line, Peter Gleick, one of the world’s pre-eminent researchers on fresh water issues reports, “In the last decade, the idea that fresh water should be increasingly subject to the rules and power of markets, prices, and international trading regimes have been put in practice in dozens of ways in hundreds of places, affecting millions of people. *Prices have been set for water previously provided for free.*”

Business Risks to PepsiCo

Water is critically important to PepsiCo’s long-term business success. Water is obviously a crucial ingredient in its soft-drink lines – especially its fast growing bottled water brands – and is used extensively in its snack foods divisions as a process input.

The issue of water scarcity poses three significant kinds of risk for PepsiCo: higher costs, barriers to expansion, and brand/reputation risk:

- 1. Higher costs:** Experts agree that water is generally under-priced under current water management regimes. Viable policy options for meeting the emerging challenge of global water scarcity may involve significantly higher costs on end users of water resources. In some markets around the world, water prices have doubled or even tripled over the past several years. It is therefore very possible that the future holds cost increases of a material nature for a key input across PepsiCo’s product lines, which will vary geographically depending on local water conditions, the level of economic development in different markets, and local political context. Investors require greater disclosure from the company on its water uses and impacts in order to assess these business risks.
- 2. Barriers to Expansion:** PepsiCo’s long-term growth will require increasing access to high quality freshwater resources at appropriate quantities and prices. (Investors should note that bottled water itself is the company’s fastest-growing product segment.) PepsiCo’s prospects for future earnings growth may be seriously jeopardized if concerns over growing global water scarcity causes local regulatory and political actors to: withhold permits for new production facilities; impose limits on water use at existing production facilities; introduce increasingly onerous permitting requirements; or raise barriers to entry into new potentially lucrative markets on environmental grounds. Overcoming these barriers and maintaining a reputation as a responsible business partner that communities welcome will require companies like PepsiCo to demonstrate the highest levels of corporate commitment to the issue of water scarcity.
- 3. Brand/Reputation Risk:** As illustrated in the previous section, environmental groups and independent experts have increasingly argued that water scarcity is one of the most important social and environmental challenges of the 21st century. Activists have already targeted soft-drinks manufacturers in the context of local disputes over water resources. For companies such as PepsiCo that derive a significant portion of shareholder value from brand equity, there are very real costs involved if a well-publicized consumer campaign and associated negative press reports were to materialize. The anti-sweatshop campaigns of the 1990s targeting footwear and apparel manufacturers and global retailers

had very real financial consequences in terms of lost sales, the costs of rebuilding tarnished brands, and the distractions created for senior managers. The parallels between these events and emerging activist concerns over water scarcity should not be lost on PepsiCo...or its investors.

A prudent concern for long-term shareholder value requires a rigorous evaluation of water-related business risks, careful forecasting, and appropriate business planning to avoid negative consequences through PepsiCo's cost structure, slower-than-expected growth, or lost sales. Unfortunately, as discussed in greater detail below, PepsiCo has failed to demonstrate in its public disclosure documents, in conversations with the proponents regarding this shareholder resolution, in its proxy materials, or in its environmental reporting that Management is cognizant of these long-term business risks or that it is addressing them appropriately.

PepsiCo's Response

In its proxy materials, PepsiCo states "water is basic to our business, and it always has been". It acknowledges risks associated with fluctuations in water supply and price, but argues that a report on business risks associated with water use is unlikely to improve the management of these risks. Instead, the company argues that its water conservation efforts and attempts to find alternative water sources are adequate to meeting the business risks associated with water.

While PepsiCo's divisions are to be commended for the steps taken toward responsible water management, isolated and ad hoc water conservation efforts are not an adequate corporate response to the emerging issue of global water scarcity. Moreover, risk management systems that are oriented toward short-term fluctuations in water supply and water prices are unlikely to detect – much less respond to – the long-term, strategic issue of global water scarcity. Indeed, one of the solutions mentioned in PepsiCo's proxy materials – seeking alternative sources of supply – is likely to exacerbate the long-term challenges posed by water scarcity in PepsiCo's areas of operation.

From the beginning, PepsiCo has demonstrated a lack of understanding of the issues raised in this shareholder resolution. In conversations with shareholders, PepsiCo has argued repeatedly that the selective reporting on water conservation efforts contained in its November 2002 Environmental Commitment Report amounted to adequate disclosure for investors on the business risks associated with global water scarcity. PepsiCo also sought to deny shareholders the opportunity to vote on this issue by applying to the U.S. Securities and Exchange Commission for permission to omit the proposal, arguing that it had already "substantially implemented" its objectives. The SEC rightly disagreed.

PepsiCo's short-term and negative response to the issue of the emerging business risks associated with water scarcity raised by this shareholder proposal is indicative of a company that lacks a coherent, strategic, systematic, and corporate-wide approach to water use issues. Better policies and practices would enable our company to adapt to the changing business landscape caused by an increasingly water-scarce world, and to withstand growing public scrutiny in the future.

A Point of Comparison: The Coca-Cola Company

In considering this proposal shareholders should be made aware that The Coca-Cola Company; one of PepsiCo's strongest global competitors, has taken a very different approach to the issue of water scarcity, and to a very similar shareholder proposal filed (and subsequently withdrawn) by Real Assets Investment Management, Inc.

In conversations with shareholders, The Coca-Cola Company frankly acknowledged the business challenges it faces relating to water. Representatives of The Coca-Cola Company demonstrated an impressive knowledge of the substantive issues related to water scarcity derived from internal research and consultations with noted fresh water experts such as Peter Gleick. The Company signaled its commitment to this issue by candidly discussing the existence of corporate-level plans, training materials, and internal operational targets that will lead to a reduction of business risks associated with water scarcity. Moreover, the Company has begun working collaboratively with suppliers and bottlers to facilitate responsible water-use throughout the company's supply chain. The Coca-Cola Company also indicated that it plans to release a report later this year that will incorporate a specific discussion of water-related business risks as well as information on key performance indicators and goals.

Several Coca-Cola bottling operations face community concerns, and more will likely face more concerns in the future. However, we believe that The Coca-Cola Company itself has demonstrated a commitment to understanding how the emerging issue of water scarcity is changing the business risks and opportunities the Company faces and we believe the company is developing proactive strategies to reduce risks and maximize opportunities.

In the view of Real Assets Investment Management and Trillium Asset Management, the fact that the PepsiCo's main competitor is investing substantial resources in addressing the water issue serves to establish the significance of water-related risks in PepsiCo's industry.

Potential Objections:

1. This Resolution Concerns a Non-Business Issue:

The Resolution identifies water scarcity as an emerging business risk and requests the preparation of a report detailing PepsiCo's exposure to this business risk. It does not promote a social, political, or special interest issue. Instead, it addresses how shareholders can ensure the best possible return on their investment, given the potential for global water scarcity to negatively impact PepsiCo's cost structure, growth prospects, competitive position (*vis-à-vis* Coca-Cola), or reputation.

2. The Report Requested Is Duplicative or Redundant

PepsiCo sought to deny shareholders the opportunity to vote on this proposal. In its submission to the Securities and Exchange Commission, PepsiCo argued that the essential objectives of the proposal had already been implemented when the company published its 2002 Environmental Statement Report (which contained anecdotal information concerning ad hoc water conservation efforts). The Proponents argued at the SEC that the report requested would not be duplicative, since it sought greater transparency on the *business risks* associated with water use not information on water conservation projects *per se*. The SEC refused to concur with the Company that the Proposal had already been substantially implemented, indicating that it did not view the requested report as duplicative or redundant.

3. The Report Requested Would Costly to Prepare:

Much of the information requested is likely to be already available to Management, given that in its proxy materials PepsiCo maintains that 'for both economic and environmental

reasons, our operating divisions are sensitive to the quality and quantity of the water they use as well as to the water they release as a manufacturing by-product”. The Proponents have acknowledged that a *separate* water report would not be necessary to fulfill the essential objectives of this proposal. Therefore, the costs of greater transparency are likely to be negligible, especially when compared to its value for current and prospective investors.

Conclusion

The Proposal requests that the Company’s Board of Directors prepare a report to shareholders evaluating the business risks linked to water uses and impacts. Investors currently have insufficient evidence to ensure that the Company has undertaken a strategic or systematic assessment of the significant new business risks and challenges arising from growing global water scarcity. Greater disclosure as requested in this proposal would help assure investors that a potentially significant source of risk to shareholder value is being effectively managed. Such a report would also demonstrate to communities, the public, environmental groups, and other influential stakeholders that PepsiCo has policies in place to ensure its responsible stewardship of a resource that faces increasing and competing demands.

Given rapidly evolving public concerns over water-related issues, the evidence offered above that water-related risks to the Company are growing, and the fact that these risks are particularly germane to the PepsiCo’s current and future profitability due to its unique product mix, the Proponents contend that this issue is critically important to investors, and that shareholders should support this Proposal on its merits.

For further information please contact:

Kai Alderson, VP Social Research
Real Assets Investment Management, Inc.
(604) 636-5860
kaialderson@realassets.ca

Steven Lippman, Senior Social Research Analyst
Trillium Asset Management Corporation
(415) 392-4806
slippman@trilliuminvest.com

Whereas,

The business case for developing long-term corporate water use strategies has never been stronger (GEMI, 2002):

- Total water costs are increasing in unexpected ways;
- Risks of business disruption due to water-related issues are increasing;
- Customer expectations relating to water use and impacts are evolving; and,
- Businesses' "license to operate" and ability to expand are increasingly tied to water-related performance

Scientists predict that water use for households, industry, and agriculture will increase by at least 50% over the next twenty years, leading to greater competition for water resources and, potentially, higher water prices (IFPRI & IWMI, 2002).

Industrial water users are likely to face changes in water-related regulatory regimes that may lead either to price increases or supply constraints or both. Currently more than 1 billion people around the world do not have access to a safe water supply. World leaders agreed at the World Summit on Sustainable Development in Johannesburg to cut in half the number of people without access to clean water by 2015 (WSSD, 2002).

The bottled water industry is particularly exposed to reputation risks when disputes with local communities arise over water use. Competitors, such as Nestle Waters North America, are engaged in court proceedings with a local citizens' group over a proposed bottling operation in Michigan (Business Week, 2002).

Bottled water makes up a small but fast-growing component of our company's product portfolio, further compounding the potential for brand risk if conflicts with local communities over water use issues were to increase.

Therefore Be It Resolved, that the Board prepare a report to shareholders (at reasonable cost and omitting proprietary information) by September 2003 evaluating the business risks linked to water-uses and impacts throughout our company's supply chain, including subsidiaries and bottling partners, with special reference to our company's current policies and procedures for mitigating the impact of operations on local communities in areas of water scarcity.