ESG: FIVE THINGS TO LOOK OUT FOR IN 2023

15 DECEMBER 2022 • ARTICLE

"ESG is set to remain as a key risk management tool in 2023."

In the second half of 2022, ESG continued to polarise. Many still classed it as an imperative, in particular during the period surrounding COP27 in Egypt, whilst others argued that it is a harmful diversion from the purpose of companies to make a profit, with several US states leading the way on the latter perspective.

Either way, it is still top of the agenda in many boardrooms and ESG is set to remain as a key risk management tool in 2023, with potentially mixed messages around the concept of ESG as an opportunity for growing value. So, what are the main areas to look out for in 2023?

FULL LIFECYCLE FUNDING

At COP 27, the assembled governments decided 'in principle' to establish new funding arrangements, as well as a dedicated fund, to assist developing countries respond to loss and damage. This demonstrates an acknowledgment that significant funding is needed to mitigate the effects of climate change. It appears also to be an acceptance that states who benefitted from the activities which fuelled climate change should also be responsible for the "clean up" efforts. However, there is both a risk that these efforts will be curtailed by the current economic climate and that monies diverted to mitigation efforts could be diverted away from decarbonisation efforts

"Some economists argue that the price of raw materials should start to factor in their full lifecycle costs."

That aside, an extension of this economic theory, combined with the existing drive towards a fully circular economy for finite resources, is also being more closely considered in respect of many corporate activities.

Some economists argue that the price of raw materials should start to factor in their full lifecycle costs, which includes:

- either the waste disposal costs or the costs of reclaiming them from end-of life products and making them available for use in new products; and

- the costs of restoration of habitats and communities around extractive sites (for example mines) following the end of production.

Where that is not done, the economic costs of later lifecycle effects fall disproportionately on states and future generations, thereby perpetuating the current issues where both mitigation costs and transition costs need to be funded at the same time and in turn creating a continuing economic deficit.

In 2023, we will likely see a growth in discussion around (1) legislation in relation to pricing of raw materials to take account of the full lifecycle costs (whether through taxation or mandating that a “sinking fund” is maintained for future costs) and (2) financial products which allocate a percentage of proceeds to a trust, escrow or other community schemes, designed to avoid end-of-life or mitigation costs falling onto wider society.

CONSOLIDATION OF SUPPLY CHAINS

> "Companies will be carefully considering whether to continue to rely on complex and convoluted supply chains."

There is already some degree of nervousness around the real meaning and effect of European Union legislation on ESG-related issues (consider, for example, the meaning of “do no significant harm” within the obligations on Article 8 and Article 9 funds) and whether current structures, including due diligence, contractual obligations, audits and other assurance are sufficient to discharge duties. That nervousness is only likely to increase as the provisions on legislation banning imports of goods made with forced labour bed in – the German Supply Chain Act comes into force and the Corporate Sustainability Due Diligence Directive continues on its path through the legislative process.

This legislative tightening will coincide with several pieces of litigation in the UK and elsewhere which seek to hold brands and retailers liable for issues in their supply chain having their first outing in the courts. As a result, companies will be carefully considering whether to continue to rely on complex and convoluted supply chains or simply to cut out the middle man and take control of critical sources of raw material and manufacturing processes in order to avoid the need to rely on third party audits and other blunt tools to enforce increasingly onerous social and environmental standards.

> "Don’t make claims which are open to interpretation, or which you are unable to substantiate with credible metrics based on verifiable facts."

INCREASED PRAGMATISM

As 2030 net zero target deadlines loom ever closer, certain industries will need to grapple with the fact that there simply is not sufficient capacity to allow the entirety of global business and supply chains to run on renewable energy. A choice will need to be made as to which industries should be prioritised for decarbonisation and which may need to continue on a slower trajectory in order to facilitate the overall switch, including those needed to extract and transport critical minerals.

In light of the significant proportion of critical minerals necessary for the green transition being under the control of China, geopolitics could also force other countries to look to exploit deposits closer to home. This in turn could accelerate trends towards more sustainable practices and whole life-cycle economics in the extraction and exploitation of resources but would also mean at least a short-term increase in the immediate costs of transition critical materials.

GREATER CARE IN EXTERNAL STATEMENTS

2022 has seen several high-profile attacks on advertising relating to sustainability claims. 2023 may see some initial decisions in court cases, notably in the Netherlands, but the message is already out; don't make claims which are open to interpretation, or which you are unable to substantiate with credible metrics based on verifiable facts.

"There is a growing attractiveness to engaging in early settlement discussions, and agreeing a package of measures to address ongoing ESG issues."

Linked with the trend towards "green-hushing" experienced in the second half of 2022, this awareness of the risks associated with promoting sustainability and ESG claims, together with the polarising effects of ESG in some jurisdictions (notably in the US) will likely see discussions around "ESG opportunities" contract (at least from within businesses), whilst discussion of "ESG risks" will continue to take centre stage internally within corporates and funders, particularly at board level.

MORE LITIGATION, AND MORE SETTLEMENTS

As mentioned in our outlook for the second half of 2022, there are several pre-action claims which could come before the courts for the first time in 2023. However, this may not be the beginning of an ESG litigation explosion. There is a growing understanding of the effects of the issues underlying these claims on business that, coupled with a wish to get one's house in order in preparation for incoming regulation and the other risks to supply chains which have materialised in 2022 as a result of the geopolitical landscape, may lead to an increasing desire to avoid or settle such claims. Add in the growing sophistication of settlements (which often now take into account forward looking elements as well as financial redress and therefore offer the potential to make significantly more impact than a court award) and it all means that there is a growing attractiveness to engaging in early settlement discussions, and agreeing a package of measures to address ongoing ESG issues.

KEY CONTACTS

SARAH ELLINGTON
PARTNER • LONDON

T: +44 20 3314 6317

SEllington@wfw.com

DISCLAIMER

Watson Farley & Williams is a sector specialist international law firm with a focus on the energy, infrastructure and transport sectors. With offices in Athens, Bangkok, Dubai, Dusseldorf, Frankfurt, Hamburg, Hanoi, Hong Kong, London, Madrid, Milan, Munich, New York, Paris, Rome, Seoul, Singapore, Sydney and Tokyo our 700+ lawyers work as integrated teams to provide practical, commercially focussed advice to our clients around the world.

All references to 'Watson Farley & Williams', 'WFW' and 'the firm' in this document mean Watson Farley & Williams LLP and/or its affiliated entities. Any reference to a 'partner' means a member of Watson Farley & Williams LLP, or a member, partner, employee or consultant with equivalent standing and qualification in WFW Affiliated Entities. A list of members of Watson Farley & Williams LLP and their professional qualifications is open to inspection on request.

Watson Farley & Williams LLP is a limited liability partnership registered in England and Wales with registered number OC312252. It is authorised and regulated by the Solicitors Regulation Authority and its members are solicitors or registered foreign lawyers.

The information provided in this publication (the "Information") is for general and illustrative purposes only and it is not intended to provide advice whether that advice is financial, legal, accounting, tax or any other type of advice, and should not be relied upon in that regard. While every reasonable effort is made to ensure that the Information provided is accurate at the time of publication, no representation or warranty, express or implied, is made as to the accuracy, timeliness, completeness, validity or currency of the Information and WFW assume no responsibility to you or any third party for the consequences of any errors or omissions. To the maximum extent permitted by law, WFW shall not be liable for indirect or consequential loss or damage, including without limitation any loss or damage whatsoever arising from any use of this publication or the Information.

This publication constitutes attorney advertising.