GREY PAPER
insights

ESG: OPPORTUNITIES AND RISKS

Pilko & Associates Grey Paper

Concise summaries of key Operations/EHS and Transaction Risk challenges and how to unlock value for your project, assets and enterprise.

Pilko & Associates is the Trusted Operational and Environmental, Health, and Safety Risk advisory firm — working with clients in 78 countries and advising on M&A deals worth more than $600 billion.

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INTRODUCTION

Concerns over issues such as climate change, greenhouse gas emissions, stress on water supply and the circular economy have escalated to the board room. The confluence of these concerns with the demands for corporate responsibility, transparency, diversity and inclusion has fueled the Environmental, Social and Governance (ESG) movement. While this movement has been developing over many years, its pace has accelerated due, in part, to investor activism. Bold commitments from energy companies towards investments in renewables speaks to how seriously the issue is being viewed.

This Grey Paper highlights key considerations of an effective ESG strategy, recognizing the steady drum beat of stakeholders for greater transparency and increased regulatory control around disclosures. Businesses have progressed their Sustainable Development programs but the journey isn't over. As discussed below, ESG asks that we do more and this presents new challenges.

I have benefited by my engagement on all aspects of sustainability and ESG, ranging from programs in their infancy to maturing ones, including those facing regulatory and litigation pressures and risks. Throughout my work, I have found it important to ask how Sustainability is relevant to a company and its business. No one approach works for every company.

While minimizing the impact on future generations is important, Operational Excellence and Environmental, Health and Safety (EHS) performance must be viewed as "table stakes" for having a credible ESG strategy. A good reputation takes years to build yet can be lost in a moment when a catastrophic incident occurs. On the ESG journey, an organization must not lose focus on the importance of operational safety and the marketing of products that can be used and disposed safely. Operational Excellence is foundational to ESG.

WHAT MORE DOES ESG ASK?

Much of ESG is familiar yet the lens through which these issues are viewed has changed. The movement rests on three pillars: Environmental, Social and Governance. While similar in intent to Sustainable Development, the element of *Governance* is new and anticipates a greater level of transparency of business ESG risks and leadership oversight. It reflects a strengthened retail and institutional investor sentiment that ESG issues can and will impact future financial return.

Environmental Pillar. This component includes air toxics, water pollution, waste minimization, and recycling, but goes much further to address environmental impacts, including vulnerability of communities to climate change, carbon emissions, responsible water usage, circularity of raw materials and products, biodiversity impacts, and end of life product management.

Social Pillar. Often considered by many in manufacturing as community relations, it now includes a much broader array of societal issues, such as human capital development, diversity and inclusion, health and safety, product stewardship, supply chain responsibility, human rights, labor standards, compliance, and raw material sourcing. In the United States, environmental justice is also included here.

Governance Pillar. This pillar includes Enterprise Risk Management (ERM), business ethics and compliance, leadership engagement, board engagement, diversity and competency, policy, assurance, data reporting and integrity.

Global connectivity is inherent to ESG. In 2015, the UN set out 17 Sustainable Development Goals (SDGs) for 2030 (Figure 1). These broad global issues are intended to be addressed by countries, the business community and civil society. Improvements will be made locally but measured globally.

FIGURE 1: 17 Sustainable Development Goals

Additional information on UN SDGs can be found at https://sdgs.un.org/goals

By way of example, SDG #13 includes climate change; SDG #11 would include plant siting and environmental justice; SDG #1 would include the extent that a company directly or indirectly supports employment; and SDG #14 would focus on marine pollution, e.g., plastic waste. Criteria provided by the Sustainability Accounting Standards Board (SASB) is also helpful and is supplemented by other resources such as sector specific guidance published by API, IPIECA and IOGP. Ultimately, the individual business must work through what aspects of sustainability are relevant to their company.

Businesses should anticipate that evolving regulatory changes will create increased standardization of requirements for sustainability disclosures, a redefining of "materiality" in the context of ESG disclosures and a higher level of comparability between organizations in the same sector. The World Economic Forum (WEF) is one of several organizations that has issued recommended reporting metrics. WEF's core and expanded metrics are grounded in and map to the UN SDGs and are intended to promote consistent reporting on sustainability, including demonstrating how SDGs are being met.

WHERE DO WE GO FROM HERE?

Build Upon What You Already Do

The governance component is associated with appropriate oversight of overall risk management in the organization and setting business strategy.

We have found contemporary Enterprise Risk Management frameworks fall short of fully understanding Operational Risks and even risks associated with the organizational culture.

An important step is identifying how to best incorporate ESG considerations into existing processes and management systems. An initial self-assessment and potential gap analysis should be considered, focusing on a data driven analysis that identifies key issues ***and opportunities***, business strategy and leadership engagement.

Are your processes and project approval procedures consistent with the SD goals that you set? Do your capital projects and planned expansions factor in alternative and future costs of carbon?

Consider what steps you need to make more robust disclosures, including assuring the integrity and completeness of data currently relied upon. A higher level of scrutiny from an increasingly sophisticated audience should be anticipated. In the United States, businesses should understand emerging pressures on environmental justice and their potential impact on future air permitting.

Bottom line, reassess where you are and then identify any blind spots and areas for improvement.

Make It Relevant

Sustainability and ESG can look vastly different between two companies. If the United Nations SDG goals represent the blueprint for needed international progress, from the lens of your business (or industry) which ones are most relevant? Understand your stakeholders and the few key material issues that are important to them.

What issues are relevant to your company but may be best progressed through a trade association or coalition? May some issues, in fact, represent a business opportunity if viewed through a global lens?

You should first align with a few of the most relevant SDGs, then develop concrete plans and timetables to meet these specific goals. While progressing sustainability goals, a critical focus is to manage existing core assets as the organization adjusts to incorporating sustainability goals.

Anticipate Local Changes to Impact Global Landscape

Rapidly changing expectations in different countries or regions of the world can impact businesses. Regulatory differences have and will surface and require coordinated responses. In 2022, expect to see decisions in Europe that will call for standardization of performance reporting and new requirements for businesses that operate in Europe to assess and manage on an ongoing basis, environmental, social and governance risks in their operations and supply chains. Clearly, U.S. businesses that operate globally will face the question of how to best implement these programs.

Prepare for Expanded Disclosures

This area is rapidly evolving: the demand for greater, more transparent disclosures; the changing landscape for governing disclosures; and the growing importance of well-timed, appropriate disclosures. ESG disclosures are now being linked to likely future profitability and the "investability" of the Enterprise. Failure to properly manage the content and scope of disclosures may limit future access to capital for projects and acquisitions. While most large public companies do well with polished annual reports on Sustainable Development, businesses would do well to prepare for uniform approaches to disclosure and to assure consistency in approach throughout the year and at all levels in the organization, with consideration to company, sector specific and common metrics, such as WEF's metrics, against which it may be judged.

Communication Strategy

Community and stakeholder outreach processes should be revisited to identify any needed changes given trends in the external environment. While some stakeholders are entrenched in their beliefs, a large number are open to dialog and want additional data and information. Increasingly, rating systems are relied upon by stakeholders; but such systems often use different criteria, can be problematic in their application, and can lead to different conclusions. You want to make certain that company actions and ESG initiatives or projects are important and meaningful and not merely activities to "check the box."

Sustainability claims will increasingly be subject to scrutiny and potential liability under the Federal Trade Commission and similar legislation around the world. The consequence could be increased regulation, penalties and reputational harm.

We expect to see some standardization of rating schemes to improve credibility of grades that are published. Ultimately, the ESG strategy pursued by an organization should be tailored to its business and reflect its unique footprint, supply chain, policies and ESG vulnerabilities.

M&A Transactional Impacts

Pilko is seeing ESG and climate change as relevant and elements of targeted inquiry during due diligence projects. Current and future carbon tax risk, integrity of reported data, governance effectiveness and product lifecycle are increasingly important topics that are viewed as potential impacts on valuation. ESG health assessments of prospective asset purchases are more commonly being requested.

Key questions by potential buyers can involve whether a target organization has too many ESG vulnerabilities, lacks sufficient mitigation strategies, or whether the entire organization is aligned and working effectively toward common goals.

Buyers want to know if representations are valid and supported by meaningful governance, and whether a target organization's ESG program is sufficiently developed and internally supported at the operating/plant level to deliver on corporate level goals.

Our approach is holistic and clarifies the most important material risks that exist, including the organizational capacity to sustainably manage Operational Risk and ESG goals.

HOW PILKO CAN HELP

Pilko believes that ESG is advancing more broadly at a pace not previously seen and should be discussed at the Executive level of organizations, if this discourse is not already taking place. Short-term and long-term milestones will likely be appropriate for most organizations depending on their perceived vulnerability.

We hold ourselves out to our clients in the global Energy, Chemical and related industries as an Advisor who is ready to support our client's journey to Operational Excellence and improved EHS performance. Our services include supporting M&A work (buy and sell side), including assessment of the ESG profile of target company. Understanding the balance of ESG type risks with operational risks in the proposed acquisition is important. We continue to provide risk management advice to existing operations, including cold eyes reviews where we seek to identify areas that could potentially blind-side an organization. We have helped position facilities for startups and organizational transitions.

We have clearly seen an acceleration in the attention given to those activities that are now encompassed within ESG. Our business and operational consultation approaches support the ESG challenge and can assist companies in meeting ESG demands. Services such as organizational risk assessments can be tailored appropriately to provide insights into an organization's ESG positioning today and progress towards a future goal. We are prepared to assist our clients work through today's most important ESG issues and possible next steps.

Importantly, we believe achieving and sustaining excellent Operational/EHS performance is table stakes for ESG. We remain committed to share our experience and expertise with organizations that wish to make a step change in Operational Excellence and/or ESG.

About the Author:

Donna Petrone has extensive experience in the chemical and petroleum industries. She began supporting sustainability and the evolving issues of corporate citizenship, environmental disclosures, emissions reduction targets, metrics and annual reporting 14 years ago. In addition to this, she has also worked to address human rights supply chain issues, including conflict minerals, forced labor, sustainability platforms, ESG issues, UN SDGs and circular economy.

Donna also has experience in advising on life cycle assessments, evaluating new sustainable product and joint venture opportunities, as well as sustainability marketing claims. She helped develop advocacy approaches, strategies for NGO engagement and participation in sustainability-focused activist groups.

As an executive legal counsel, Donna was the recognized legal expert on product stewardship in the company. She supported "Fortune 500" business lines on all aspects of product stewardship, including country product restrictions, customer and brand owner deselection bans and strategies to address the complex and rapidly changing regulatory landscape. Her work enabled global sales of specialty and commodity chemicals into a broad range of consumer-focused end applications. Some of which included medical, pharmaceuticals, food, food packaging and agricultural applications.

After graduating with a Master's in Environmental Health, Donna spent her early career in corporate and plant assignments as an industrial hygienist (C.I.H.) with Gulf Oil before transitioning her career to ARCO, where she served as the refinery-based Safety Supervisor. Donna's first role at ExxonMobil was as a chemical plant Environmental Coordinator. There, she was responsible for handling air, water and waste permitting.

After completing her law degree, Donna served as managing counsel on complex environmental and chemical injury lawsuits for ExxonMobil. Following this role, she became a chemical company business lawyer for transactional work that included joint ventures, mergers and acquisitions, and divestures. Donna was then assigned to support chemical and refinery operations on health and safety issues, process safety, emergency response, remediation, and community outreach.

ABOUT PILKO & ASSOCIATES

We are the Trusted Advisor to corporate officers and boards on mitigating Operational/EHS Risks and unlocking value in the global Energy, Chemical and related industries.

Since 1980, we have served energy and chemical clients in more than 78 countries, advising on over $600 billion in transactions and ongoing operations. In addition, we have developed an excellent reputation advising on Governance of Operational/EHS Risks at existing as well as planned operations. Our global experience, combined with extensive knowledge and capabilities, is invaluable to firms in mitigating their most significant Operational/EHS Risks and liabilities, thereby maximizing value and optimizing business performance.

For more information about our services and capabilities, please visit us at www.pilko.com.