What matters in ESG?

Practical steps to consider in 2023

#FromTalkToAction

As we enter a new financial year, the KPMG Sustainable Futures team has considered and articulated the top 10 themes which they expect will most impact the corporate ESG landscape across Ireland in 2023.

While our overall theme for 2022 saw corporates moving from talk to action, we expect 2023 will be the year of accountability, with increased focus on supporting ESG claims, ensuring information & data integrity and avoiding the risk of greenwashing accusations.

01. The year where CSRD preparation begins in earnest.

Following the approval of the European Council, the Corporate Sustainability Reporting Directive (CSRD) begins a new era in non-financial reporting. A new corporate reporting landscape is forming, and Irish businesses will have to align with mandatory and regulated sustainability reporting as soon as 2024.

At present, it is estimated that c. 11,000 companies across Europe are covered by the Non-Financial Reporting Directive (NFRD), however, the CSRD will expand the scope of requirements to include 50,000 companies across Europe. In fact, CSRD introduces a whole new set of accounting standards that will profoundly impact corporate reporting requirements. Entities may have up to 30 new standards to report on, with quantitative metrics, and qualitative disclosure reporting requirements – all of which will be subjected to mandatory assurance.

Ireland-based companies are not fully prepared for the CSRD. In 2022, a KPMG survey found Irish companies were lagging on independent assurance, with only 37% of Ireland's largest 100 companies (N100) being assured by third parties, in comparison to the global average of 47%. Similarly, only 58% of Ireland's N100 companies issued Ireland-specific sustainability reports. This is in line with KPMG research showing that the vast majority of firms will not be ready for the new directive, and it is clear that many entities are underestimating the scale of change coming in the CSRD. The volume of information required by the new directive is broad ranging and, in most instances, will cover areas that companies have never reported on before, let alone measured.

As such, Irish businesses in 2023 are recommended to get familiar with the proposed reporting requirements of CSRD. Identify what would their specific business be required to report - for example by undertaking exercises to map out ESG matters material to that business. And Prepare disclosure maturity before having to publicly disclose on a statutory basis.

02. Driven by success at COP15, biodiversity will materially grow across the Irish corporate agenda

In mid-December, governments from around the world met in Montreal (COP15) to agree on a new set of global goals and targets to halt and reverse nature loss. One of the key outcomes was an agreement to protect 30% of nature on Earth by 2030 – a commitment praised by environmental groups and ministers.

Happening almost in parallel with these global negotiations was The Citizens' Assembly on Biodiversity Loss in Ireland. Reassuringly, this sample of Irish citizens voted overwhelmingly to recommend a referendum to amend the Constitution to better address biodiversity protection. The proposed constitutional change would recognise nature as a holder of legal rights, comparable to companies or people.

How does this translate in relevance to companies in Ireland in 2023?

1. National adoption and implementation of the Kunming-Montreal Global Biodiversity Framework will begin in 2023. This means that the global goals and targets on biodiversity will be translated into national level goals and targets for agreement and action. Companies will have the opportunity to engage in this dialogue and development of national plans.
2. The need to close the 'biodiversity finance gap' and scale up investment in biodiversity conservation and restoration is becoming more understood across the public and private sectors. Meanwhile, the emerging TNFD framework will provide a guide for corporates and financial institutions to assess, disclose and manage their nature-related risks and opportunities. KPMG had the pleasure of helping a number of Irish corporates in 2022 become the first in Ireland to utilise the draft TNFD framework to assess the risk and opportunities that biodiversity brings to their business, and we expect this will increase dramatically in 2023.
3. The interdependence of climate and biodiversity is a recurring theme - net zero will not be possible without becoming nature positive. Understanding this interaction at a sector and company level will make it easier for organisations to respond more meaningfully and strategically to stakeholder and regulatory expectations on the full ESG spectrum.

03. The relentless march of new EU ESG regulations shows no signs of abating in 2023

The EU continues with the rapid revision of existing, and introduction of new laws to help achieve its goal of reducing GHG emissions by at least 55% by 2030. In July 2021 the 'Fit for 55' package, which encompasses 14 legislative proposals, was presented by the European Commission for further discussion and agreement. In December 2022, a provisional political agreement was reached on the introduction of the world's first Carbon Border Adjustment Mechanism (CBAM), the revision and extension of the current EU Emissions Trading System (ETS) and the establishment of a Social Climate Fund (SCF).

The EU ETS, which currently applies to limited energy-intensive, high emitting industries, is a cap-and-trade system that sets an annual cap on the amount of greenhouse gases that companies in covered sectors may emit. It covers over 100 installations in Ireland and c.29% of Irish emissions. The revised EU ETS provisional agreement looks to increase the ambition of emissions reduction in ETS sectors from the original 40% to 62%, by 2030 compared to 2005 levels. Moreover, the provisional agreement seeks to extend the ETS sector coverage to include the maritime sector. An additional new ETS ('ETS II') has been provisionally agreed upon, to be established by 2027 which deals separately with the buildings and road transport sectors and fuels for certain industrial sectors (such as manufacturing).

The CBAM, which is a supplementary measure to, and mirrors, the EU ETS, targets imports of products in carbon-intensive industries and will begin to operate from October 2023 onwards. The objective of CBAM is to prevent that the greenhouse gas emissions reduction efforts of the EU are offset by increasing emissions outside its borders through relocation of production to non-EU countries. The CBAM operates by imposing a charge on the embedded carbon content of certain imported products that is equal to the charge imposed on the production in Europe of such goods under the ETS. The CBAM will, over time, replace the free ETS allowances currently granted to EU producers assessed to be at high risk of carbon leakage. For Ireland's manufacturing and aviation sector, already hard to abate sectors, this steep reduction and eventual removal of free allowances will make reducing emissions and meeting targets even more challenging as the cost of carbon subsequently increases. Furthermore, the practical implementation of a CBAM in Ireland could prove challenging due to significant trading relationships with non-EU partners such as the US and UK. A CBAM could pose potential political, economic, and regulatory challenges for trade flows when considering the unique situation of the Northern Ireland Protocol.

To address the social impacts that arise from the revision and extension of the ETS to other sectors, and to assist those most affected by energy and mobility poverty to cope with the increased costs of the energy transition, the SCF will be established. The SCF will provide funding to Member States to support measures and investments in increased energy efficiency of buildings, decarbonisation of heating and cooling of buildings, including the integration of energy from renewable sources, and granting improved access to zero- and low-emission mobility and transport. These measures and investments need to principally benefit vulnerable households, micro-enterprises or transport users.

04. The Climate Action Plan 2023 will make its presence felt across the sectors

The newly released CAP 2023 provides Ireland with a broad platform for serious climate action. It ranges from legal requirements to carbon budgets to sectoral emissions ceilings and now the first statutory action plan. However, accountability for its delivery and determination to implement the plan and reduce emissions in 2023 is critical. The Climate Change Advisory Council, in both its 2021 and 2022 annual reports, warned of significant gaps between the government's ambitions for climate action and the implementation of those actions in practice.

The sectoral emissions ceilings (SECs) agreed upon in July 2022 put in place targets for each sector to enable Ireland to halve emissions by 2030 and achieve net zero by 2050. Depending on the sector, this will mean a large-scale switch to renewables; a dramatic change to the transport system; ambitious home and business retrofitting and climate-based construction, and new innovative systems that will protect and support our family farms to diversify their income streams. It is worth noting however that while these SECs are now in place and underpinned by the Climate Action and Low Carbon Development (Amendment) Act 2021, there is no direct link to, or compulsion for individual corporates to stay within such a ceiling. This means success in meeting the SECs will come down to additional legislative, social or economic incentives to ensure participants in the sector support in the sector's decarbonisation journey.

The difference with CAP 2023 is that it has a greater focus on system change. "Climate Action Plan 2023 recognises that it is important that the systems that shape where we live or how we build, how we work or get around, how we shop or produce food do the heavy lifting. We need local government to change; we need the public sector to change; we need industries and key economic sectors to change." (CAP 2023)

The actions outlined within CAP 2023 support this thinking and will require a new level of collaboration and leadership. There is no business in Ireland that won't be impacted by, or find opportunity, within the actions and ambitions set out in CAP 2023. However, in order to realise these opportunities, it requires business to take a proactive and collaborative approach to making transformational changes that will reap longer term benefits.

05. ESG Reporting in Ireland will expand beyond the largest corporates down into medium and smaller enterprises

Through European Union regulations, ESG is becoming codified in law across Ireland. In 2023, the ESG agenda will transcend the optional realm and will increasingly become something that corporates must take into serious consideration. Regulatory changes, investor pressure, and market maturity have created a strong incentive for Irish Corporates to improve the quality of their ESG performance disclosures. This is reflected in an increase in ESG reporting as 95% of Ireland's N100 companies published stand-alone sustainability reports in 2022, compared to 78% in 2020. Similarly, 74% of Ireland's N100 companies have integrated sustainability/ESG information in their annual reports for 2022, compared to 56% in 2020.

While these largest corporates have embraced ESG reporting, 2023 will see significant growth in smaller businesses adopting ESG reporting, driven partly by the lower thresholds under CSRD than the previous Non-Financial Reporting Directive (NFRD). The previous threshold with NFRD applied to listed companies with more than 500 employees (approximately 11,700 EU companies), however, as mentioned before, the CSRD lowers the threshold by including all EU companies, listed or not, that meet at least two out of these three criteria: more than 250 employees, a net turnover that exceeds EUR 40 million and, assets that exceed EUR 20 million (approximately, 50,000 EU companies). Overall, with 4x more companies affected by CSRD, as well as corporate customer pressure, or increasing requirements under public and private tenders, smaller businesses have strong incentives to adopt ESG reporting in 2023.

This increase in reporting, and ESG activity generally, will drive ongoing ESG talent acquisition by corporates, as they seek to develop in-house ESG expertise. According to the global recruiter Robert Walters, in 2021, an estimated 1,600 new jobs were created in the fields of sustainability and ESG in Ireland. ESG professionals are in high demand and are expected to remain as such in 2023 and beyond.

06. The ESG Data Journey is Intensifying for the financial sector

In 2023, many financial companies will be subject to the next wave of disclosure requirements. For example, Sustainable Finance Disclosure Regulation ("SFDR") aims at preventing greenwashing and ensuring data comparability through enhanced standardized transparency on sustainability within the financial markets. It is designed to drive convergence in how funds describe themselves with respect to sustainability and in turn reduce confusion in the market. SFDR requires that fund managers provide information about the ESG performance across 14 mandatory Principal Adverse Impact ("PAI") data points and 2 optional metrics. Above anything else, the SFDR will raise the bar for investment products, particularly those seeking to promote ESG characteristics and objectives, by setting a strict minimum-disclosure standard for Article 8 and Article 9 funds. Investment funds, not able to avail themselves from exemption, will be required to report PAI's in June of this year. With PAI data points across E, S & G factors, those running funds with a particular focus in a single factor have found themselves in a rush to obtain additional data with many market participants intensely searching for comprehensive data coverage.

07. Anti-Greenwashing Campaigns are Intensifying

Three European Supervisory Authorities (EBA, EIOPA and ESMA - "ESAs") published a Call for Evidence on greenwashing on November 15th 2022. The call seeks to gather input from stakeholders on how to understand the key features, drivers and risks associated with greenwashing and to collect examples of potential greenwashing practices. Obtaining a more granular understanding of greenwashing will help inform policy makers and ultimately help foster the reliability of sustainability-related claims. All interested parties are welcome to contribute to the survey, including financial institutions under the remit of the three ESAs and other stakeholders ranging from retail investors and consumers' associations to NGOs and academia. Respondents could submit their responses by 10 January 2023. In lock step with the ESAs, the Central Bank of Ireland (CBI) has announced a thematic review with respect to funds domiciled in Ireland. The CBI has made it known that the focus of their review will be to identify greenwashing activities. Notably this will include the classification of Article 6 funds versus Article 8 funds to identify misrepresentations. This review is expected to be undertaken in the first quarter of 2023.

The practice of greenwashing has been under mounting scrutiny over the past years, and 2023 is expected to be no different. With the growing demand for sustainability-related offerings, coupled with the rapidly evolving regulatory landscape, corporate greenwashing scrutiny is expected to be at an all-time high. All businesses are susceptible to the risk of being held accountable for greenwashing, and may face regulatory probes, civil claims, and public backlash on the basis of alleged greenwashing. Such greenwashing allegations may include presenting an activity as sustainable without scientific basis, setting an ambitious climate-related target without outlining clear and effective steps to achieve it, or failing to disclose the financial impacts of transitioning to a low-carbon economy. As society develops an increasingly sophisticated understanding of climate-related issues, businesses must rise to the challenge of making well-founded sustainability statements against the backdrop of a fast-changing regulatory landscape.

08. ESG Due Diligence will become an integral part of the due diligence process

82% of respondents to KPMG's 2022 EMA ESG Due Diligence Study said that ESG considerations are on their mergers and acquisitions (M&A) agenda and an even greater share, 95%, are planning to include ESG in their M&A activity in the future. This aligns with our team's perception of increasing number of request and queries on ESG due diligence (ESG DD) from a range of Irish businesses. We expect this interest to further grow in 2023 due to the following three reasons:

- **ESG is increasingly linked to value creation:** Investors and corporates associate high-levels of ESG maturity of a target organisation with long-term positive business practices and financial returns. In fact, KPMG's study identified that 68% of respondents would pay a premium for a target with high level of ESG maturity. On the other hand, a target with immature ESG approach may lead to financial and reputational risks, potential liabilities and compliance issues or other hidden emerging risks, such as human rights or modern slavery. ESG due diligence is designed to shed light on specifically these issues.
- **ESG is becoming more regulated:** the EU's Green Taxonomy, Sustainable Financial Disclosures Regulation (SFDR), Corporate Sustainability Reporting Directive (CSRD) and the upcoming Directive on corporate sustainability due diligence are designed to enhance transparency and accountability on the operations of organisations and their wider impact. ESG DD will help investors and corporates ensure that their current operations and future investments align with such regulations. 47% of respondents in KPMG's study mentioned that conducting ESG DD makes them better able to respond to regulatory requirements.
- **There is low level of knowledge on incorporating ESG considerations into deals:** The queries we are receiving shows that while corporates and investors are becoming aware of the importance of ESG and the need to act on it, they are not sure how. KPMG's study shows that about half of all respondents agree on 3 key challenges: defining the scope of ESG, lack of data or written policies around ESG and the quantification of findings. These are all areas of ESG that we, at KPMG Sustainable Futures, have been developing with KPMG's broader, cross-structural teams in the past three years and are well suited to help our clients or future clients in addressing.

09. The energy crisis is accelerating the shift to renewables with corporates looking to hedge prices through Corporate PPAs, while governments look to reduce import dependency.

2022's energy crisis has affected practically every aspect of the economy. Such is the scale of the impact that governments, corporates and consumers have responded with ambitious initiatives to accelerate the roll out of renewables, reduce demand and to protect consumers from record high prices through supports and market reforms.

Historically, the availability of plentiful and cheap fossil fuels meant most corporates were fairly reluctant, outside of CSR tokenism, to invest in renewable energy, or consider long-term renewable corporate power supply agreements. While Ireland's market structure and legislative environment makes corporate PPAs more difficult than in neighbouring jurisdictions, record high electricity prices along with security of supply concerns have put corporate PPAs and self generation projects top of many corporates' agenda. With attention now turning to energy prices for winter 2023 and beyond, we are seeing a sustained appetite by corporates to enter into long-term, fixed priced renewable Corporate PPA, both for electricity, and increasingly for biomethane gas to displace natural gas.

To unlock the full potential of corporate PPAs in Ireland, a review of the direct wire legislation is required in 2023. This will enable developers and corporates to connect local renewable generation to nearby customers by private wire and minimise the use of the grid.

10. Supply chain & ESG

While regulation remains an important driver of corporate adoption of ESG, within Ireland, the single biggest driver in 2023 will come from the supply chain – typically a larger corporate customer putting pressure on their suppliers to show support for the customer's corporate ESG objectives.

This is particularly relevant in the context of a corporate's scope 3 emission targets, which for some sectors, account for over 85% of the overall carbon emissions.

For many organisations, a responsible supply chain questionnaire from a customer is their first exposure to ESG information provision. In our experience, this has led to hastily gathered and incomplete data and can reflect badly in their scoring, impacting future relationships or tenders with their customer. There is a real opportunity for companies to develop internal processes to gather accurate emissions data and to develop polices and targets that will enhance their customer engagement, increased market exposure, reduce emissions and ultimately grow the business.

Contact Us

If you are ready to move from talk to action or want to accelerate your sustainability progress please get in touch with Russell Smyth, Head of Sustainable Futures. We'd be delighted to hear from you.

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