Navigating Regulatory Rapids of the ESG Landscape

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Now, more than ever, the resilience and growth of businesses depend on the proactive actions taken by their leadership to address ESG risks and seize opportunities arising from them. However, a key challenge that they face is understanding and navigating the constantly evolving regulatory landscape.

Introduction

The global business landscape is undergoing a transformative shift as legal and regulatory frameworks increasingly prioritise Environmental, Social, and Governance (ESG) considerations. This trend extends to India, where ESG and supply chain risks have become prominent concerns in boardroom discussions. As a major global hub for international supply chains, India faces a multitude of ESG-related risks that have implications beyond local entities. Compliance with regulations such as the Corporate Sustainability Reporting Directive (CSRD), Corporate Sustainability Due Diligence Directive (CSDDD), and Carbon Border Adjustment Mechanism (CBAM) is crucial for Indian businesses operating with the European Union (EU) or the United States (US) counterparts.

However, understanding and navigating the evolving regulatory landscape poses significant challenges for businesses. This article explores the impact of regulations like CBAM, CSDDD, and CSRD on Indian businesses. Real-world case studies illustrate proactive actions taken by companies to address ESG risks and leverage opportunities arising from regulatory changes. By prioritising ESG considerations, businesses can enhance their resilience and long-term success in an increasingly interconnected and sustainability-focused business environment.

Global Climate-related Legal Obligations

The issue of climate change transcends geographical boundaries, and regulatory obligations related to climate action are no exception. In today's interconnected world, climate-related obligations are increasingly crossing continents, affecting companies operating in multiple jurisdictions, including Indian businesses and foreign businesses operating in India. The legal and regulatory landscape is expanding beyond national borders, as exemplified by the reach of certain EU laws and regulations that can impact companies around the globe. We look at some examples of regulations that not only demonstrate the global momentum of climate action for companies but also illustrate the urgency for being prepared.

CBAM

In the traditional view of pollution control, there has often been an opportunity for companies to engage in arbitrage by shifting production to India, taking advantage of weaker pollution control measures. However, the introduction of the CBAM eliminates this arbitrage opportunity for companies seeking to move their production out of the EU or compete with EU-based producers. The CBAM ensures that there is a symmetric taxation of carbon intensity for Indian firms operating within the EU or elsewhere. On the other hand, Indian companies aiming to enhance their competitiveness in the EU market can reap significant benefits by reducing pollution, regardless of the location of production.

What is CBAM?

The CBAM is a tax imposed at the EU border on imported goods, which takes into account the carbon emissions associated with their production. The tax is calculated based on the market price of carbon emissions within the EU, ensuring that firms face a similar cost for pollution regardless of whether they produce within Europe or elsewhere.

Relevant Timelines:

Starting from October 1, 2023, companies exporting steel and aluminium to the EU will be required to establish systems for measuring the carbon intensity of their production processes and provide corresponding statements. (a few other industries such as cement, fertilisers, and electricity are also covered under the CBAM).

Beginning January 1, 2026, exporters to the EU will need to purchase CBAM certificates to bridge the gap between the carbon price paid in the country of production and the price of carbon allowances in the EU Emissions Trading Scheme. These measures are aimed at ensuring a level playing field by factoring in the carbon intensity of imported goods, contributing to the EU's efforts to reduce carbon emissions and promote sustainable practices.

While the scope of this regulation is limited—with industries like steel and aluminium being at the cutting edge—it is likely that CBAM will only expand in its scope and it and all businesses from India engaging in export should keep abreast of these developments.

Next steps:

Indian exporters operating in the EU will be required to thoroughly assess the carbon emissions associated with their production processes and supply chains. They must actively seek ways to minimise carbon intensity, which can be achieved through several approaches: (a) enhancing energy efficiency measures, (b) prioritising renewable energy sources for energy procurement while maintaining the current production location, (c) relocating production to areas with readily available and affordable renewable energy, or (d) implementing carbon capture and sequestration technologies. These pathways offer viable strategies for Indian exporters to navigate the changing landscape and ensure compliance with carbon-related regulations.

Corporate Sustainability Due Diligence Directive (CSDDD)

What is CSDDD?

The CSDDD aims to establish a responsible and sustainable framework for global value chains, recognizing the role of companies in building a sustainable society and economy. It places the onus on companies to take responsibility for their environmental and social impacts, as well as those of their suppliers.

Who is it applicable to:

- EU companies with over 250 employees and approximately $43 million in revenue.
- Companies with parent companies exceeding 500 employees or global revenue of at least $161 million are also subject to compliance.
- **Non-EU companies** must comply if they generate revenue of $43 million within the EU or if their parent companies have revenue of at least $161 million, with a minimum of $43 million generated in the EU.

Next steps:

The CSDDD mandates companies to conduct due diligence of their operations and supply chains to assess potential environmental and human rights impacts. It requires companies to mitigate risks, develop policies and procedures to address identified risks, publicly report their efforts to address environmental and human rights risks, evaluate the effectiveness of due diligence procedures at least once every 12 months, and establish grievance mechanisms to facilitate concerns raised by employees and stakeholders.

Corporate Sustainability Reporting Directive (CSRD)

What is CSRD?

The purpose of the CSRD is to improve transparency and accountability around corporate ESG performance. CSRD focuses on sustainability disclosures from a "double materiality" perspective. This means that companies are required to provide third-party audited reports that describe how sustainability issues affect their business and how their business impacts people and the environment.

Who is it applicable to?

- Listed companies;
- Large companies that meet two of these criteria: More than 250 employees, net turnover of more than EUR 40 million, or total assets exceeding EUR 20 million; and
- **Non-EU companies** with at least one subsidiary in the EU and a net turnover of more than EUR 150 million.

Next Steps:

Under the CSRD, companies must disclose information on "sustainability matters" that affect the company, including the resilience of their business model and strategy to sustainability risks. They should also outline plans that align with the 1.5-degree Celsius global warming target under the Paris Agreement.

United States

The Securities Exchange Commission (SEC) plans to enhance and standardise climate-related disclosures for stakeholders, as part of a growing awareness of the importance of ESG issues among public companies.

The new disclosure rules would require listed companies to not only disclose risks that are "reasonably likely to have a material impact on their business, results of operations, or financial condition," but also "to disclose information about its direct greenhouse gas (GHG) emissions (Scope 1) and indirect emissions from purchased electricity or other forms of energy (Scope 2)," as well as certain types of GHG emissions "from upstream and downstream activities in its value chain (Scope 3)."

Given the current regulatory climate and India's position as a global supply chain hub, it is safe to assume that many of these regulations may require Indian corporates to create robust ESG-related policies and data sets.

Case Studies

As regulatory frameworks surrounding ESG issues continue to evolve and expand globally, companies are proactively adapting their strategies and operations to comply with the changing landscape. This section explores a series of case studies that shed light on the steps taken by companies to prepare for upcoming regulatory changes in various jurisdictions. These case studies provide valuable insights into the practical measures and initiatives implemented by businesses to address ESG risks, enhance sustainability practices, and align their operations with emerging legal requirements. By examining real-world examples, we can gain a deeper understanding of the proactive actions undertaken by companies to navigate the evolving ESG regulatory landscape and position themselves for long-term success.

- *Switching to renewables*: Indian steel and aluminium companies have been well aware of the impending CBAM since its proposal in 2021, and they have already begun taking proactive steps to address its implications. JSW Steel Ltd. has set a target to fulfill up to 60% of its electricity requirements from renewable sources by 2030. Similarly, Tata Steel Ltd. has committed to sourcing 100% of its electricity needs from renewable energy by 2030. Both companies are actively investing in captive solar and wind power projects and entering into power purchase agreements with private renewable energy producers. Their efforts have gained recognition, as both firms were included in the Climate Disclosure Project's list of climate change leaders in 2022.
- *Reducing emissions through renewable energy*: ArcelorMittal SA is currently developing a large-scale 989-MW wind-solar hybrid renewable energy project in Andhra Pradesh. This project will supply power to the group's steel plant in Hazira, Gujarat, leading to an *estimated annual reduction of 1.5 million tonnes of carbon emissions*.
- *Sustainable supply chain*: Tata Steel has implemented various sustainability practices and measures to ensure a responsible supply chain. The company conducts sustainability assessments of its key vendors and has adopted a comprehensive "responsible supply chain policy" that emphasises sustainability considerations, including monitoring greenhouse gas

(GHG) emissions. In line with its commitment to low-emission steel production, Tata Steel has obtained certification from Responsible Steel, an independent verifier specialising in certifying steel production sites with low emissions.

- *Internal carbon prices*: Several Indian companies, including Tata Steel, JSW Steel, Sanyo Special Steel Manufacturing India Pvt., and Hindalco Industries Ltd., have taken the initiative to calculate and disclose their "internal carbon prices." This voluntary practice assigns a monetary value to each metric ton of carbon emitted by the company. Tata Steel, for example, incorporates internal carbon prices into its decision-making process, ensuring that the internal rates of return for projects exceed a predetermined internal carbon price-adjusted hurdle rate. Although formal carbon pricing mechanisms are not yet in place in India, the calculation of hypothetical internal carbon prices will allow these companies to fulfil the reporting requirements of the CBAM and assess the potential risks associated with their carbon emissions on their business operations, anticipating the implementation of CBAM regulations in the future.
- *Net Neutrality*: More than twelve companies, including Reliance Industries Ltd, Vedanta Ltd, ITC Limited, JSW Energy, and HDFC Bank, have committed to achieving carbon neutrality in the coming decades. These companies are actively reevaluating their business strategies and making necessary adjustments to meet net-zero emissions targets.

Privately held companies in India are showing significant interest in aligning with international ESG standards to attract foreign investors who prioritise sustainable investments. For instance:

- ITC Limited, a prominent tobacco and consumer goods manufacturer and hotel operator, has made a commitment to obtain certification for all its factories and hotels operating in water-stressed areas according to the International Water Stewardship Standard, a recognized global benchmark for responsible water management.
- Indian companies like Tech Mahindra, Infosys, and Wipro are included in the Dow Jones Sustainability Index, which evaluates the ESG performance of companies worldwide, showcasing their commitment to sustainability practices.
- Leading fast-moving consumer goods giants such as Nestlé India and Procter & Gamble India have set sustainability goals to reduce energy and resource consumption in their manufacturing facilities. They are actively exploring methods to recycle or reuse their entire packaging within the next decade, demonstrating their dedication to sustainable practices.

These case studies provide a glimpse into the actions taken by Indian companies to navigate the changing regulatory landscape and embrace sustainability practices. They demonstrate that companies across various sectors are proactively addressing ESG risks and leveraging opportunities.

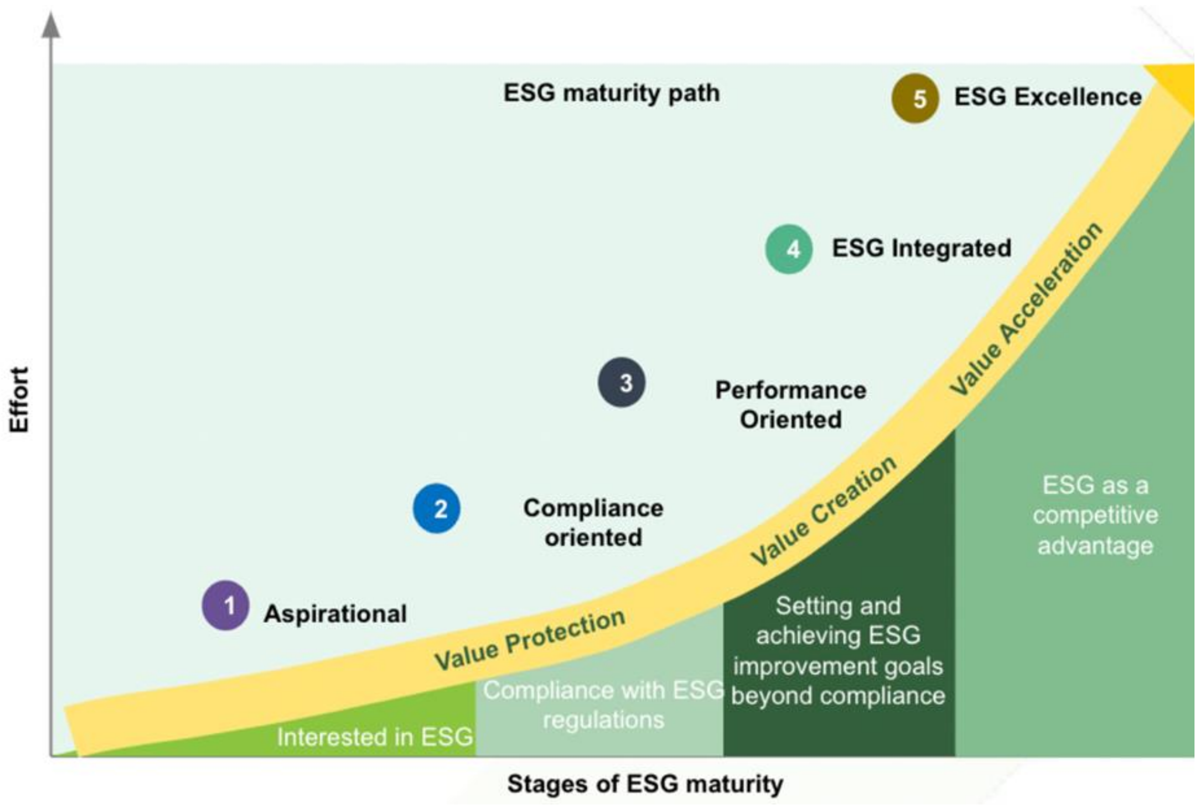
Prioritising and embracing ESG practices and complying with regulatory frameworks is a strategic business decision and requires organisations to engage in an integrated strategy approach. It can enhance reputation, drive operational efficiency, foster innovation, attract investment, and mitigate risks. By prioritising ESG considerations, companies can position themselves for long-term success in a rapidly changing business landscape.

Evolving your organisation's ESG Maturity Journey

ESG maturity refers to the progression of companies in integrating Environmental, Social, and Governance considerations into their business practices. It encompasses the evolution from basic compliance to strategic integration and leadership in sustainable business practices. Understanding the stages of ESG maturity can help companies assess their current position and identify areas for improvement.

Key questions to address under the environmental pillar at this stage include:

- Has your organisation assessed the current needs and material metrics to be tracked to make ESG related decisions and setting up processes?
- Has your organisation set up verifiable processes to collect and report environmental and climate-related metrics?
- Has your organisation set a long-term emission reduction goal or has a decarbonization strategy?
- How is your organisation learning, tracking, and preparing for new climate regulations, particularly for multinational firms that may have different regulations impacting the business?
- Does your board/leadership have climate expertise or formal climate oversight in alignment with peer practice?



In the context of a rapidly changing environment and regulatory focus, an organisation's ability to transition towards strong compliance as well as higher levels of ESG maturity will have a lasting impact on their short and long-term sustenance in the market. Riding this wave of opportunity can also enable organisations to generate financial, economic, social, and reputational value.

Conclusion

The evolving global legal and regulatory landscape surrounding ESG issues presents both challenges and opportunities for businesses. To ensure resilience and growth, companies must proactively take steps to navigate these changes effectively.

The introduction of regulations such as the CBAM, CSDDD, and CSRD demonstrates the increasing importance of ESG considerations in the business world. Companies operating in multiple jurisdictions, including Indian businesses and foreign companies operating in India, must be prepared to comply with these evolving regulations.

It is crucial for companies to start taking proactive measures to understand and adapt to the evolving ESG legal and regulatory landscape. This includes assessing their carbon emissions, implementing sustainable practices, and enhancing transparency and accountability throughout their operations and supply chains.

By being prepared and proactive, companies can position themselves for long-term success, maintain competitiveness in international markets, attract investment, and mitigate risks associated with non-compliance. Embracing ESG practices not only aligns with global sustainability goals but also demonstrates a commitment to responsible business practices.

Sattva can enable corporates to transition along this maturity path, to know more about our offering and further details on our analysis please reach out to esg@sattva.co.in.

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Sattva has been working with various non-profits and social organisations as well as corporate clients to help them define their social impact goals. Our focus is to solve critical problems and find scalable solutions. We assist organisations in formulating their long-term impact strategy by aligning with business objectives and providing meaningful solutions to social issues.

If you have any such stories or ideas to share, please write to us: esg@sattva.co.in