



## A green world through ESG compliance

### **This is a critical time for environmental, social, and governance (ESG) factors.**

The threatening impacts of climate change are forcing businesses across the globe to hit the reset button. Based on the latest Intergovernmental Panel on Climate Change (IPCC) report, action needs to be taken now to keep changes in climate to below 2.0 degrees Celsius.<sup>1</sup> And like never before, investors are holding companies accountable.

### **What this means**

Climate change reveals a global threat that is real to our economies and way of life—requiring businesses and consumers to face this challenge head on through measurable and verifiable actions. However, it's also an opportunity for innovation and growth that can help drive decarbonization, create new products and services, and enhance customer satisfaction.

Creating long-term value goes beyond tackling climate change challenges. Diversity,

equity, and inclusion (DEI) is also driving business strategies—from employment decisions to companies' social license to operate. DEI is also impacting supply chain decisions across businesses with detailed compliance reporting requirements at the state and federal levels.<sup>2</sup>

In what is fast becoming a critical decade, **embedding ESG strategies into business has risen in importance.** Increasingly, shareholders, community interest groups, general consumers, the ecosystem of suppliers, and employees are attaching

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value to ESG. They demand businesses introduce changes in their standard corporate operating conditions to drive relevant ESG outcomes. Navigating these conflicting priorities is not normally easy. But stakeholders reward the organizations that create sustained outcomes for the environment and the society through effective ESG frameworks.

**What's the first step?** Organizations should become aware of the trends driving stakeholders' decision-making and determine how they will respond. Organizations should, in some way, consider and respond to these challenges. Many of these challenges are also impacted by significant policy changes with implications in the United States, including the newly proposed disclosure rules put forth by the Securities and Exchange Commission (SEC) regulations,<sup>3</sup> recommendations of the Financial Stability Oversight Council (FSOC),<sup>4</sup> and the Infrastructure Investment and Jobs Act.<sup>5</sup>

## Why ESG is the key to unlocking a better world

Environmental and climate change challenges, combined with greater social awareness, have created the demand for integration of ESG factors into business strategy with dedicated governance oversight. For many organizations, this will require them to reimagine their approach to ESG, which can help drive the global impact on the issues facing the world today.

However, ESG as a concept is evolving—often depending on a particular focus or issue that an organization or sector prioritizes. Yet ESG as an industry-agnostic principle goes beyond the typical investor-focused view to define a responsibility to society. The ESG framework includes a variety of topics that span three specific areas: 1) climate and natural resource preservation; 2) equity, inclusion, and opportunity; and 3) transparency and accountability.

Each letter in **ESG** represents specific organizational agendas and stakeholder priorities:



**Environmental:** Climate and decarbonization; circular economy; sustainable finance; sustainable supply chain



**Social:** DEI; social impact; community support and involvement; privacy and security; employee opportunity and development; human capital management; workforce transformation



**Governance:** Ethical conduct; fiduciary responsibility; reporting transparency; corporate governance; governance structure; leadership and board accountability

Within these broad areas are some specific examples for the power and utilities sector:



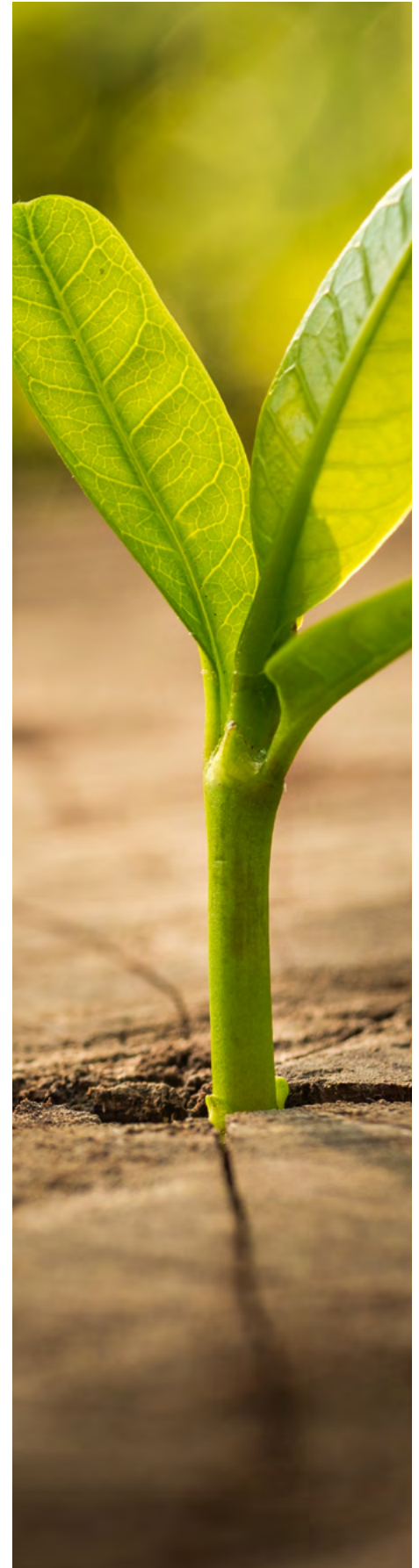
**Environmental:** Decarbonization through “responsibly sourced gas”



**Social:** Formally-adopted goals based on targeted location to enhance supplier diversity and address social inequality



**Governance:** Focus on the strength and rigor of corporate compliance programs, including “E” and “S” components and the emergence of dedicated sustainability functions



## From now to the future: taking ESG goals forward

Reporting on components of ESG is not new, but there is a growing trend in increasing the amounts of information about companies' strategies toward decarbonization, DEI, and governance goals—information often provided in organizations' sustainability reports.

The publication of sustainability reports started in the late 1980s, with the first reports published in the chemicals industry as a response to a reputation crisis. Since then, the release of sustainability reports has grown from about 12% of publicly traded companies in the 1990s to close to 80% of companies globally publishing today.<sup>6</sup>

As stakeholders are starting to seek increased transparency and information about ESG, there are broader sustainability reports and, in some cases, specific reports addressing climate and water. Current sustainability reports generally cover an organization's emissions (scope 1 and 2 emissions, and lately scope 3 emissions), water management, DEI, community involvement, health and safety, and governance. In addition, sustainability reports also highlight compliance against the various voluntary initiatives they report against, such as the Task Force on Climate-related Financial Disclosures, SASB Standards, and Global Reporting Initiative.

Sustainability reports provide value to the companies that publish them. The clear and transparent information allows stakeholders to easily understand and potentially compare companies to assess their ESG path and compliance with obligations.

Moreover, the growing focus on ESG reporting and compliance provides signals to stakeholders, including investors, customers, employees, and the broader community. Some examples include:

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**Investor value:** Transparent and robust ESG reporting, clear implementable goals, and measurable action can increase access to capital.



**Customer value:** Customers are using their purchasing power to drive outcomes that align with their individual priorities.



**Employee value:** When corporate values align with personal values, it is often easier to attract and retain employees.



**Community value:** A strong focus on ESG and its impact on communities can bolster social license to operate now and in the future.

## A green world through ESG compliance

ESG is driving a focus throughout the C-suite for two reasons:

- 1 It touches on many aspects of an organization.
- 2 It is required to be embedded throughout the lion's share of company levels.

Some factors driving this significant transformational change across companies, industries, and the economy are:



**Regulatory obligations:** Both in the US and globally, governments are grappling with Greenhouse Gas Emissions Regulatory Reporting and are in the process of developing regulatory obligations.



**Voluntary initiatives:** The expectations of the market are still evolving, and reporting against numerous initiatives is still expected.



**Low-carbon strategies:** Having a strategy is not enough for companies to obtain value from stakeholders. Rather, it is necessary to establish what actions are taken now and will be taken in the future—thus meeting the expectations of the investment community and regulators.



**Transparency:** Shareholders are becoming more sophisticated and their expectations around ESG are increasing. With this comes an expectation that ESG data is robust and transparent and follows leading practices.

The ESG landscape is still shifting with the wide range of actions that government agencies and regulators are taking. Companies are, therefore, required to continually assess ways they can increase value out of reporting and ESG actions (through direct investments and acquisition of offsets or shifts in business models).

## Driving the climate change imperative

Globally and in the United States, governments are focusing on climate change and its negative impacts on society and the economy. In the United States, the Financial Stability Oversight Council—Treasury Department (FSOC) identified climate change as an emerging and increasing threat to US financial stability.<sup>7</sup> The FSOC’s findings are not surprising, but they could result in more significant data and reporting requirements for entities that are regulated by FSOC members. The FSOC views that by working together, members can accelerate their understanding of climate-related financial risks and take actions to help ensure resilience of the financial system.

A global effort of governments and regulators toward evaluating the policies and regulatory requirements is a proactive step.

The FSOC recommendations cover four core areas:

- 1 Build capacity:** Member agencies to build capacity to address climate-related financial risks through increased internal experience and understanding adverse impacts on financially vulnerable populations.
- 2 Address data gaps:** Address climate-related data gaps, develop consistent data standards, and engage in climate-related data sharing with other members.
- 3 Enhance disclosure:** Enhance public climate-related disclosure, standardize data formats to facilitate comparability, and specifically consider disclosure of GHG emissions.
- 4 Assess and mitigate:** Understand and address climate-related risks, including through collaboration among members and international counterparts, that could threaten the stability of the financial system.

**Now, what’s the way forward?** A global effort of governments and regulators toward evaluating the policies and regulatory requirements is a proactive step. That should reinforce the commitment to ESG investments and assess and mitigate the climate-related risks—risks that will impact financial sectors and economies globally. However, the increased number of voluntary initiatives and the global focus on reporting, data collection, and disclosures will continue to evolve and will impact the way the industry mitigates risks.

## Tackling challenges, tapping opportunities

The growing focus on ESG and climate change threats presents challenges for many organizations; however, the nature of these challenges varies by industry and the direction of their sustainability journey. Some specific challenges include:



**Convergence:** There are some calls for convergence of reporting requirements. Currently, the data and reporting requirements can vary by the initiative, framework, and geography. For some organizations, convergence may be seen as an opportunity, especially where they are already ahead of the curve. For others, convergence may highlight laggards in the market.



**Mindset:** Mindset refers to the way that individuals consider ESG. There are two main ways of thinking—the first is as an opportunity that can be leveraged for innovation and growth. The second sees ESG as a burden that gets in the way or competes with the core business. Changing the second viewpoint is necessary to really embed ESG into business as usual.



**Environmental justice:** A predominant issue in ESG is environmental justice. This means looking at the impact on the broader society from industry activity. For new legislation or regulations, this will mean that a more significant portion of the benefit may need to be directed to either communities that have been negatively impacted by climate change or to those areas of society that are less likely to have the ability and capital to make change.



**Access to capital:** Organizations are facing pressure from investors to not only report on the current state of their operations and their aspirations but also take real action to reach those goals. Organizations that fall short of market expectations may find it more difficult to access capital or find that it is more expensive than their counterparts who are leading in ESG and low-carbon actions.



The power and utilities sector faces some rare challenges, thanks to its diverse nature and structure:



**Essential service:** Electricity and gas are often considered essential services. Therefore, the requirements, regulations, and societal obligations placed on the power and utilities sector can be higher than for other industries.



**Regulated rates:** Utilities are often subject to jurisdictional or federal rate-setting processes. This may present a challenge in balancing the revenue required to efficiently operate a utility with the revenue required to advance ESG initiatives. This creates the need for a certain balancing to be completed with respect to pursuing ESG initiatives and the approved rates charged to customers.



**Physical climate risks:** Physical climate risks (e.g., wildfires) caused by changing climate and the increasingly complex nature of the electricity grid because of increased renewable generation and the removal of synchronous generation pose a significant challenge. Tackling this challenge requires numerous trade-offs in pursuit of cleaner energy while ensuring the system remains operational and affordable.



**Social license to operate:** Communities are more aware of who is operating in their area and want corporate values to align with the communities. This will be a key consideration as future generations interact with the power and utilities sector.<sup>8</sup>



**System requirements:** Operating utilities in a safe and secure manner is a regulatory and compliance requirement. However, meeting this requirement can become more difficult and requires additional investment as the share of renewable generation keeps increasing.

## How the power and utilities sector can lead the ESG revolution

How can the power and utilities sector move forward with a clear ESG framework, a tailored approach, and measurable goals?

ESG reporting requirements are indeed evolving. The COVID-19 pandemic has also acted as a trigger, reinforcing the importance of developing a strong ESG framework in light of the shifting ways of how companies work, where they work, and what they work on. These shifts related to the future of work, spurred by COVID-19-related controls, have contributed to changes to what companies do in terms of bringing their ESG frameworks to life because supply chains have changed, where production takes place has changed, and the associated ESG commitments have had

to evolve, too. What steps can companies take now to navigate the new reporting requirements and market standards? And what approach will they need to follow to achieve long-term business resilience?

**To start with, it is important that organizations understand the data—data is required now and will be required in the future—which can enable ease of reporting regardless of the regulatory or voluntary requirements.** To accelerate the journey, organizations should introduce and leverage flexible technology, processes, and protocols.

**Organizations also need to understand what matters to stakeholders and be accountable through reporting and key performance indicators (KPIs)—** helping to ensure that the message is clear, transparent, and easily understood by

stakeholders. ESG, reporting, and corporate action need to be considered collectively to mitigate risk, drive compliance, and derive value. This is especially important for the power and utilities sector where numerous regulatory requirements are in play.

**Taking visible actions with a clearly articulated vision to drive the ESG strategy forward can help enhance value.** To do that, organizations should leverage diversified technologies and processes with an understanding of short-, medium-, and long-term actions.

The power and utilities sector can greatly benefit from taking a proactive approach to ESG and compliance. Meeting its own requirements and those of regulatory bodies now and in the future enables it to remain in the driver's seat rather than being in reactive mode and letting business decisions be driven by its stakeholders.

## Ready to lead the ESG revolution?

As ESG gains traction as an important strategy, the power and utilities sector should play its role in decarbonizing the world. It should leverage its strength to drive meaningful change. Some actions to consider are:

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**The role of renewable generation:** Widespread decarbonization will require significant new low-carbon generation. Given the timing associated with construction and connection, proactive planning and development by businesses may be warranted.



**Innovative ways to address reliability:** Given the increased role of renewable generation, finding innovative ways to decarbonize synchronous generation and providing network services to maintain a reliable system will likely grow in importance. Doing so will help the sector meet regulatory and stakeholder obligations.



**Drive differentiation to meet customer needs:** Not all customers are the same, and not all have the same ability or willingness to pay. However, differentiated products that allow customers to direct their spending to products that align with their values or provide a benefit to society may create value.



**Balance regulations and ESG requirements:** The power and utilities sector should seek an appropriate balance in terms of meeting the regulatory requirements associated with the sector and the growing requirements related to ESG reporting and compliance. This will involve careful consideration and a holistic approach to embedding ESG into the business.





## The bottom line

A lot of focus is often on the “E” or “S” elements of ESG. But organizations that put in place strong governance and controls may be better positioned to deliver on their goals and comply with reporting and regulatory requirements. A governance and compliance framework should support effective decision-making and track against corporate and regulatory obligations. Without strong governance, it is difficult to manage noncompliance risks, leading to reputational, regulatory, and financial risks.

The challenges and opportunities that ESG presents are not always certain. But they will continue to be at the forefront of how the power and utilities sector operates and evolves. As new regulatory and compliance obligations emerge, the need to embed ESG factors into business will continue to become necessary beyond corporate responsibilities.

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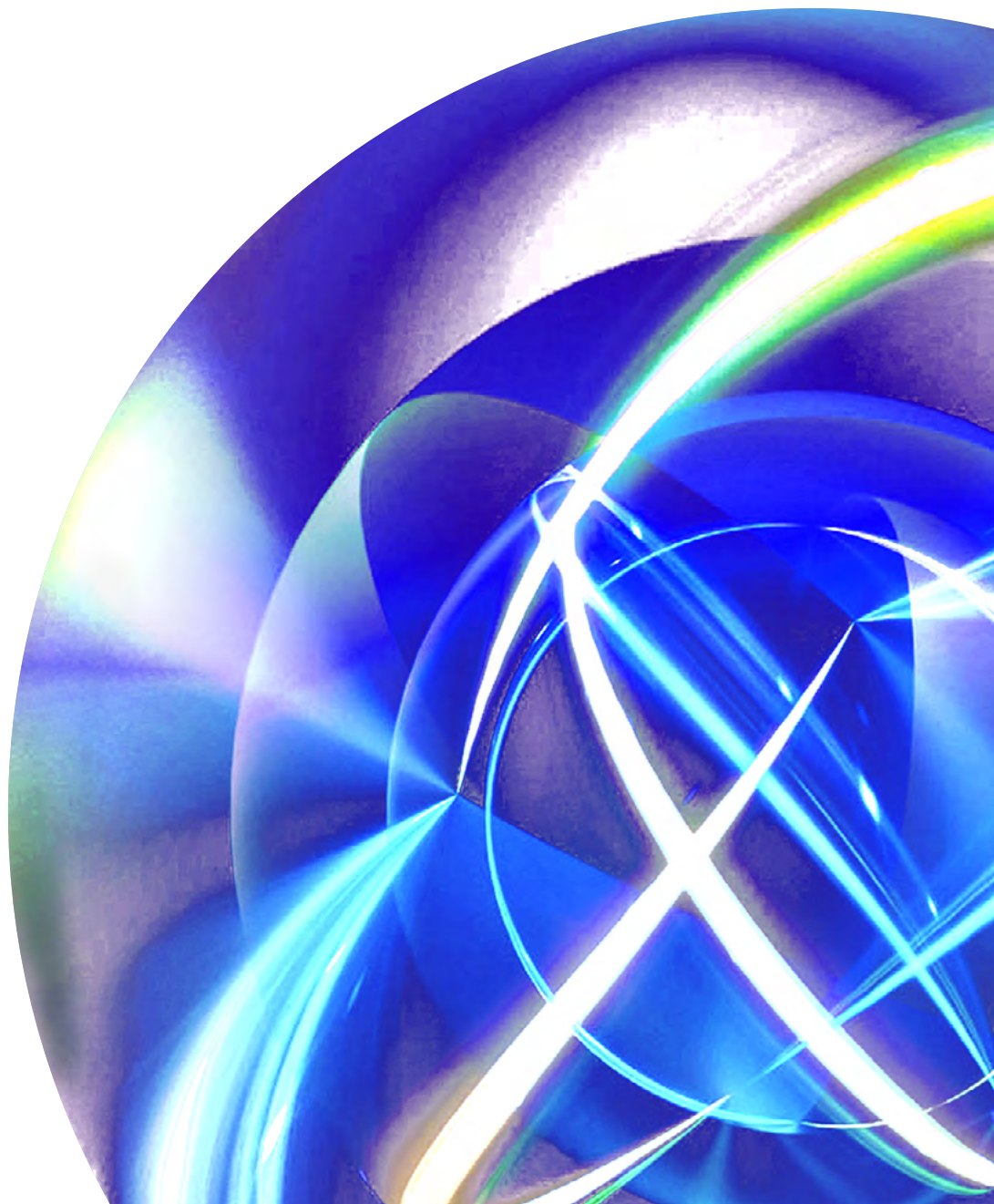
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# Endnotes

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