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With markets in flux, Infospectrum's **Clare-Marie Dobing** explores how the maritime and bunkering sectors are responding to the evolving drivers of ESG compliance, disclosure and commercial opportunities

Shipping industry market participants are showing an increasing appetite for insights, knowledge and guidance in understanding the connection between Environmental, Social, Governance (ESG) topics, and long-term enterprise risk and opportunity. However, with regulations in flux, voluntary ESG disclosure mechanisms taking market players in different directions, and divisions stretched further because of stakeholder activism and broader geopolitical trends, the task of selecting the right approach to ESG is a difficult one. Equally challenging is defining the risks and opportunities associated with each approach, and whether a chosen strategy will be effective in achieving long-term strategic goals.

Although market feedback suggests businesses are currently 'putting their houses in order' from an ESG perspective, many market players and commentators have expressed their belief that collaboration and innovation lie at the heart of the ESG paradigm, particularly when it comes to meeting the sector's decarbonisation targets. This approach demands high levels of trust, fostered by openness and transparency among participants. At the same time, the significant investment and operational restructuring required to meet shipping's ESG goals warrant a robust counterparty appraisal system that evaluates newer ESG-specialised entrants while also reassessing established counterparties as they undertake new risks to address the evolving markets.

COMMON THEMES, DIVERGING APPROACHES

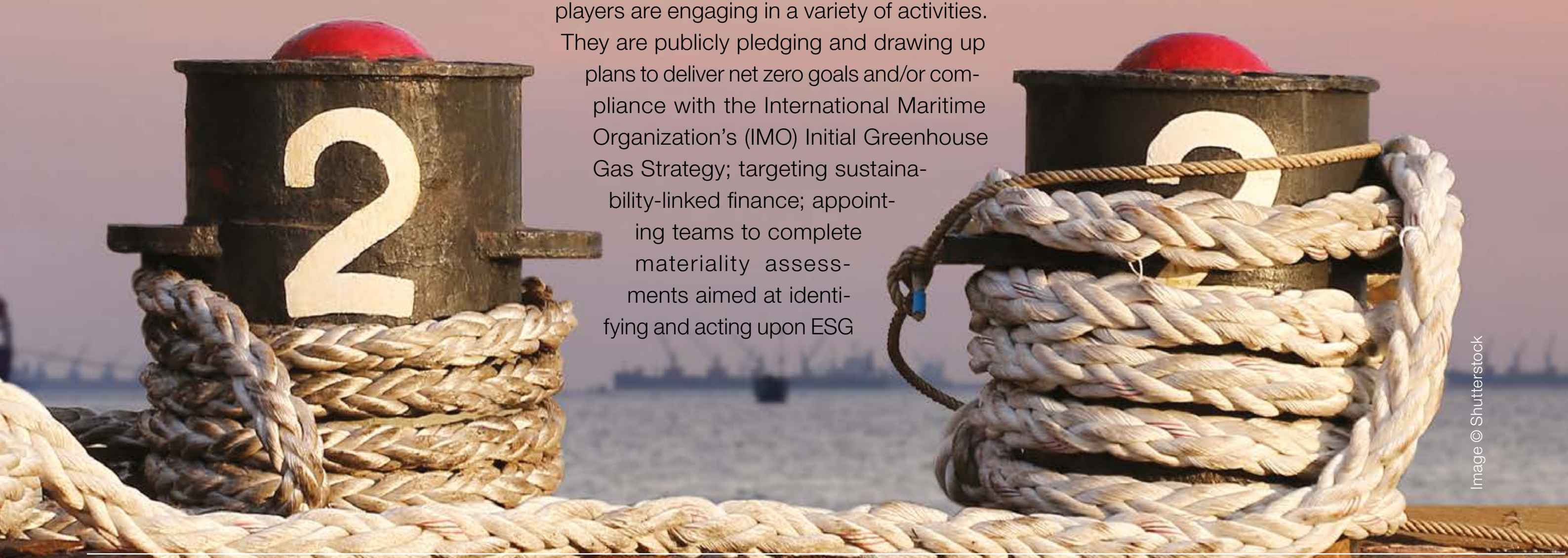
Despite market players moving in many directions to shape and refine their approach to ESG, there are certain topics that offer a degree of commonality among businesses. These include: climate action (including regulations and voluntary contributions); sanctions risk; tackling bribery and anti-corruption; screening for human rights violations; and health and safety, particularly regarding seafarers, but also shore-based staff. However, an entity's approach to these topics, among others, is likely to be influenced by numerous factors. These include their level of exposure (the closer to end-consumers, the more significant the calls for environmental action, for instance), their understanding of ESG, its evolving risk and opportunities, cultural context, and their ability and willingness to dedicate resources (both financial and human) at a time when regulations and technologies are evolving and early adopters may find themselves underwriting the benefits that economies of scale are likely to bring as the market matures.

To deliver their ESG aspirations, market players are engaging in a variety of activities. They are publicly pledging and drawing up plans to deliver net zero goals and/or compliance with the International Maritime Organization's (IMO) Initial Greenhouse Gas Strategy; targeting sustainability-linked finance; appointing teams to complete materiality assessments aimed at identifying and acting upon ESG topics regarded as material to their stakeholders and participating in voluntary initiatives aiming to catalyse progress in key areas.

INCREASED REPORTING, BUT GOVERNANCE LAGS BEHIND

Organisations taking a proactive approach to ESG are increasingly opting to disclose their progress on an annual basis as part of an ESG report (also commonly known as a Sustainability or Non-Financial Report), which is typically presented as a standalone document or a dedicated section within an existing annual report framework. Contributors to reports are often multidisciplinary, which could reflect the necessity to disclose information relevant to stakeholders with different priorities.

The contents and metrics enclosed in these reporting documents are subject to debate, both in the shipping industry and further afield. This is likely reflective of the current absence of strong governance in this area, which lacks a comprehensive regulatory regime, a formalised auditing process and an overarching global standard (although all may be on the horizon). Maritime lawyers have also flagged potential liabilities that could result from over or under-reporting of ESG, while others have emphasised the role cultural norms could play in influencing the extent and style in which ESG actions are publicly disclosed within



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the shipping industry (a lack of disclosure may not necessarily point to a lack of action).

REGULATORY DRIVERS AND EVOLVING CUSTOMER NEEDS, BUT MARKET REACTION UNCLEAR

At the top end of the market, ESG proactive players are motivated to go beyond regulatory compliance, driven by a combination of stakeholder activism, increased commercial opportunities, perceived moral imperatives and increasingly vociferous demands from financiers looking to de-risk their portfolios from a climate change perspective. For other market players, the focus is primarily on regulations, the changing needs and expectations of customers (and their customers) as well as capitalising on commercial opportunities. When it comes to regulations, ship owners have an eye on the incoming carbon intensity indicator (CII), which comes into effect on 1 January 2023, with the first ratings expected in March 2024. However, uncertainty remains regarding the extent to which the regulation will translate into action. For instance, there are currently no direct penalties for failing to comply for the first three years (2023-2026). Furthermore, while IMO encouraged CII improvements in a June 2021 press briefing (saying that 'administrations, port authorities and other stakeholders, as appropriate, are encouraged to provide incentives to ships rated as A or B'), the extent to which stakeholders will engage with the spirit of this clause, and the financial impact on the market, remain unclear. Environmental improvements could also be instigated by voluntary screening that filters ships with a poor CII rating out of the chartering chain. However, market feedback provides only isolated instances of this future consideration, with definitive action likely to be reserved until 2024 when the first ratings are available.

In the bunkering sector, players have asserted that one of the key ESG priorities of the shipping sector, namely the transition to low carbon and zero carbon fuels, is being driven by regulations as well as charterers and shippers with an eye on Scope 3 emissions reporting and reduction.

This will require systemic transformation, introducing uncertainty and risks to strategic, operational and financial plans across the value chain. Given the longer gestation of such a transformation and the quantum of investment required, some companies might find this transition beyond their immediate capabilities.

Certain bunker suppliers see the voluntary carbon market (VCM), and the sale of carbon credits to customers looking to offset emissions from their fuel choice, as an immediate opportunity to turn environmental pressure into a potentially revenue-generating opportunity. An upcoming Infospectrum whitepaper finds that interest in the VCM also extends to ship owners, both as buyers of credits to offset voyage emissions and as sellers, who can apply for vessels/fleets with one or more energy efficiency measures to become carbon credit generating projects. This could enable eligible ship owners to extract commercial value from the sale of carbon credits in addition to the cost reductions these fuel-saving innovations bring, this being particularly important in today's fuel inflationary context. Before embarking on a project to produce and sell carbon credits, ship owners should be aware of the financial and managerial commitments involved. They should also consider whether their ship's ability to generate carbon credits could be impacted by future regulations.

> 'The humanitarian, food, energy and security crisis created by the war in Ukraine also poses deeper questions about the ultimate aims and success of the ESG agenda'

Overarchingly, voluntary offsetting remains a contested approach. Among the plethora of open issues are high market fragmentation, a lack of regulatory oversight and pricing transparency, as well as concerns over integrity including the lack of a common definition of a high-quality carbon credit. Efforts are underway at an international level to address these areas, but the complex network of stakeholders engaged in this market may lengthen the time it takes to achieve meaningful progress and clarity.

There are early signs that heightened fuel costs could trigger a spur in energy efficiency technology installation, with CII ratings also improved as a result. Indeed, market feedback suggests that raised prices are already triggering an increase in enquiries about premium hull coatings, which reduce fuel usage and costs by cutting frictional resistance as a vessel sails. Technological innovation will be integral to achieving the sector's overall decarbonisation ambitions. However, solutions require robust verification so the veracity of an entity's environmental claims, financial position and future prospects can be validated. Moving forward, market feedback and a robust commercial evaluation on the performance of the product/service may also offer a valuable component of due diligence that supports confident and informed decision-making. Similarly, providers of ESG services entering the maritime sector would also benefit from assessing the risk profile of their counterparties, given the unique operating and payment characteristics of the shipping and chartering sectors.

DYNAMIC MATERIALITY

This is just a snapshot of some of the ESG considerations present in the maritime industry today. One of the most challenging elements of the ESG agenda is the need to monitor and act upon so-called 'dynamic materiality'; the idea that ESG topics can become material – either gradually or very quickly. The most recent example of this is the outbreak of the war in Ukraine, which has created multiple new E, S and G considerations. These include heightened sanctions risk for many as well as serious operational, financial and safety issues for owners and crew of vessels reported to have become trapped around Ukrainian ports currently blockaded and mined. The humanitarian, food, energy and security crisis created by the war in Ukraine also poses deeper questions about the ultimate aims and success of the ESG agenda, and whether its goals can be achieved amid growing challenges in balancing E, S and G considerations faced with competing demands and limited resources.

Ultimately, the maritime industry is likely to operate at two speeds. On the one hand, typically larger and well-resourced counterparties, with the financial and operational wherewithal to absorb the risks associated with being first movers, will have the capability to drive a broad based ESG agenda forward. On the other, the large number of small to mid-scale businesses will need clarity in complexity, to deliver positive ESG returns incrementally, consistently and cautiously.

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