

ESG in Construction - A View from the Market

Insights from the CMS hosted Roundtable:

The impact of ESG considerations on the construction industry

A rapidly evolving arena

In June 2022, CMS hosted a Roundtable event on “The impact of Environmental, Social and Governance (ESG) considerations on the construction industry” with senior representatives from stakeholders in UK and overseas construction projects. The discussion centred on how rapid developments in the ESG space are impacting corporations and the projects they are engaged on.

A number of key themes emerged from the discussion: **Data; Contractual Risk, Funding and IP**. Before we address these in detail, it is worth pausing to note the context in which this Roundtable took place.

Construction is widely regarded as one of the sectors most exposed to ESG considerations. This is most obvious in terms of Modern Slavery, health and safety protections, Anti-Bribery & Corruption legislation, and CO2 emissions. However, in recent years there has been a greater focus on employee diversity and gender pay parity, as well as the social impact of projects.

Governments play a role in disincentivising less desirable ESG behaviours by way of legislation, taxation and fines. ESG reporting obligations are becoming stricter meaning that businesses are required to benchmark and monitor their performance in all aspects of ESG through robust and credible data.

Mark Carney, when Governor of the Bank of England, sagely predicted that *“In the future,*

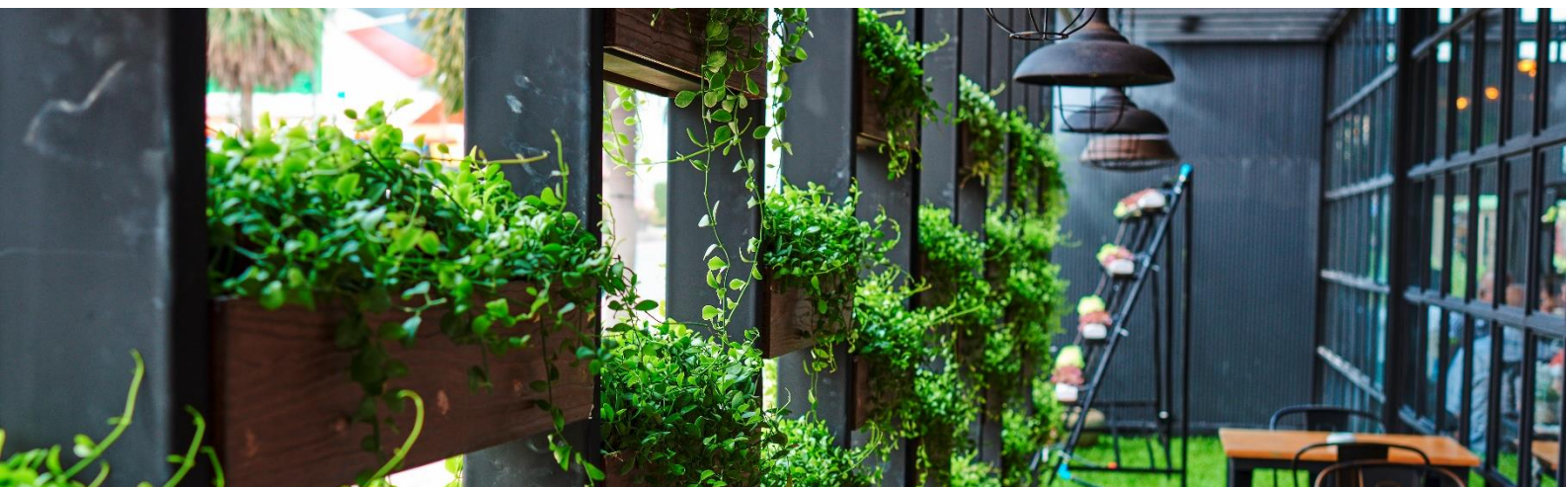
climate and ESG considerations will likely be at the heart of mainstream investing.” Funders and investors are indeed now actively establishing their own ESG criteria to ensure that their investments are resilient and sustainable in the long-term. For the same reason, ESG criteria is an important part of procurement decision-making in the public and private sectors.

Shareholder, employee and customer activism is also on the rise, meaning businesses are exposed to increased scrutiny and resulting reputational damage if perceived not to be doing enough, or indeed over-reporting or “greenwashing”. Businesses with strong ESG scores are regarded as more strategically resilient and able to anticipate and adapt to risks and opportunities.



In the future, climate and ESG considerations will likely be at the heart of mainstream investing.

Mark Carney, former Governor of the Bank of England



Data

For all of the Roundtable participants, data collection, interpretation and measurement were a key concern. Recognising that the 3 pillars of ESG encompass a diverse range of issues, all participants agreed that it was important to gain an understanding of what “good” looks like and consensus on what should be considered, measured and tracked.

Measurement

A particular issue facing stakeholders is that there is no standard or consistent method for measuring carbon emissions or the progress of companies towards their net-zero targets. For example, achieving net zero as a result of offsetting carbon, as opposed to net zero without carbon offset, are two different concepts but are not always distinguished in the media or company reporting. This raises the issue of working out how to effectively collect data which is credible, comparable and quantifiable.

Collection

As matters stand, much is left to individual businesses to collate their own data and there is no consistent methodology or even a standard list of areas to report against. However, developers are now creating their own checklists and industry-recognised software is emerging which can help to rationalise the position. One example in the real estate sector is the NABERS UK scheme for rating the operational energy efficiency of UK offices, which was launched in 2020.

Interpretation

The international nature of construction supply chains brings specific challenges in relation to reporting and disclosure. While companies

themselves may have, and be hitting, ambitious ESG targets, there can be less transparency further down the supply chain. Different regulatory frameworks, clients and market practices across the globe make for even further inconsistency in the approach to ESG measurements.

These points led to a broader discussion on Scope 3 emissions and the difficulties in identifying, let alone tracking, a company’s indirect emissions occurring throughout its value chain. It appears that much of the responsibility is being left in the hands of companies to calculate their emissions on an individual basis, meaning there is no standard baseline for projects as a whole. Consultancies such as the Carbon Trust are developing increasingly sophisticated tools to support corporations in measuring and reporting on carbon emissions throughout their value chain.

What was apparent was that, when developing industry methodologies, there is a balance to be struck between ensuring that data inputs and outputs are sufficiently accurate and avoiding labour intensive processes aimed at forensically capturing all the minutiae. In other words, there needs to be an acceptance that there will be some degree of approximation whilst also making sure any grey areas are not exploited and greenwashing is curbed.

In relation to the “S” of ESG, there is also the challenge that much of the data is inherently subjective, leaving “accurate” reporting exposed to criticism.

Contractual Risk

New entrants into the market, new operation and delivery models and new technologies and materials are all driving the construction industry to develop and innovate rapidly. Traditional practices have been disrupted as businesses invest in R&D to stay ahead of the curve. With change comes uncertainty and, inevitably, risk.

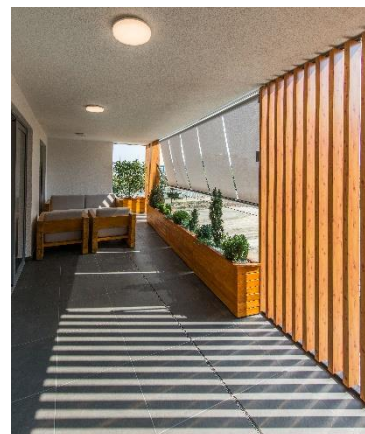
Contracting for ESG risk and liability in construction contracts is a source of considerable debate. There is no settled industry practice on how such risks should be identified and allocated. There was a general consensus at the Roundtable that in the majority of cases traditional standard form contracts do not accommodate for these new risks. Some industry bodies are recognising the benefit in tackling the issue head on and are developing their own standard form clauses (such as NEC's new X29 clause). However, there was a consensus that the industry needs a more sophisticated approach than simply looking to shift the full burden of reducing carbon emissions down the supply chain. Such a traditional approach to risk allocation fails to recognise the degree of investment required to develop cutting edge technologies and ways of working that reduce carbon emissions.

Indeed, the traditional approach of seeking to assign as much risk as possible to contractors may be stifling innovation in the industry, given the tight margins that companies are working within. Even where there is R&D funding, the sentiment in the room was that this is often short-term, with near-term financial goals being prioritised over long-term, sustainable growth and improvement in the sector.

A crucial challenge is how to shift clients' perspectives from a focus on the short-term, bottom-line, year-on-year, to an understanding that the immediate spend will bring savings or other benefits over the life cycle of the built asset. Such forward-looking approach will empower change in the industry.

From a legal perspective, it was clear that legal and other advisers need to grasp the impact of ESG clauses being proposed. When relying on traditional forms of contract, to be cognisant of the effects their provisions might have on the supply chain and its ability to absorb the types of risks it is being asked to assume, particularly with new and innovative technologies.

Ideas such as "soft landings", collaborative contracting, extended warranties, and a whole lifecycle approach were all raised along with a move towards shared responsibility and accountability. It may be that a more



collaborative, risk-share approach would be more conducive to achieving the desired end-result; there is already precedent for that in the use of BIM and alliancing contracting. It

was thought that a degree of consistency and standardisation would be helpful going forward but only if all parties have a clear understanding of the implications of the contract requirements. There was a unanimous call for lawyers to educate and encourage clients, and other stakeholders, to move away from the traditional employer/contractor risk allocation and towards more innovative procurement methods and risk allocation.

Funding

Another important issue discussed was how to develop financeable structures in the face of first-of-a-kind risk.

The RICS' *Sustainability and ESG in commercial property valuation and strategic advice* highlights the financial impact on projects of not adhering to ESG developments. Similarly, the UK Emissions Trading Standards demonstrate the effect that simply offsetting rather than reducing emissions will have on companies and projects.

From a funding perspective, the perception was that there is a contradiction whereby funders are often risk averse when it comes to new technologies, projects and materials, but are also increasingly taking into account the risk of stranded assets. They are therefore looking to fund based on good ESG performance which, in relation to carbon footprint in particular, necessarily requires innovation.

In the funding arena, the position is as yet unsettled with no standard models available. Bespoke arrangements are therefore being set up on a case by case basis. As with the contracting models, it was thought that some degree of consistency and standardisation would be helpful.

IP

A number of our Roundtable guests also noted challenges around IP rights.

They cited examples of employers wanting contractors to bring innovative solutions and then seeking to take ownership of the IP developed to do so; however, the reality was that they had no further use for that IP. Rather than bolstering the drive for change, this works as a clear disincentive for contractors to innovate, creating practical barriers to further progressing these ideas.

Change does appear to be afoot however, with a Government (DFT) paper soon to be released which aims to tackle the issue of IP, changing the approach so that those best placed to exploit the IP own it.

Collaboration and the future

The main takeaway from the Roundtable was the need for:

- a greater level of understanding as to what is to be measured and tracked – standardisation and consistency
- greater collaboration in the industry and a shift away from a CAPEX driven approach to projects where the focus is on achieving practical completion
- development of funding models for first of a kind risk and innovation, and
- development of suitable contractual structures.



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Other Resources:



[The CMS guide to ESG: Ten steps to success for construction companies](#)

If you are interested in attending future ESG in Construction events, [please register your interest here](#).