



SMALL, SCATTERED, MESSY AND POLLUTING

How China's environmental enforcement is disrupting supply chains

In 2015, the newly installed Chinese Minister of Environmental Protection Chen Jining said environmental enforcement in China lacked teeth. But with new powers and the political backing of the Chinese leadership, Chen committed the Ministry of Environmental Protection (MEP) to take action to protect the environment and it's a promise that Chen (who was recently promoted to Beijing mayor) has executed vigorously; the MEP has proven its bite can be as fierce as its bark.

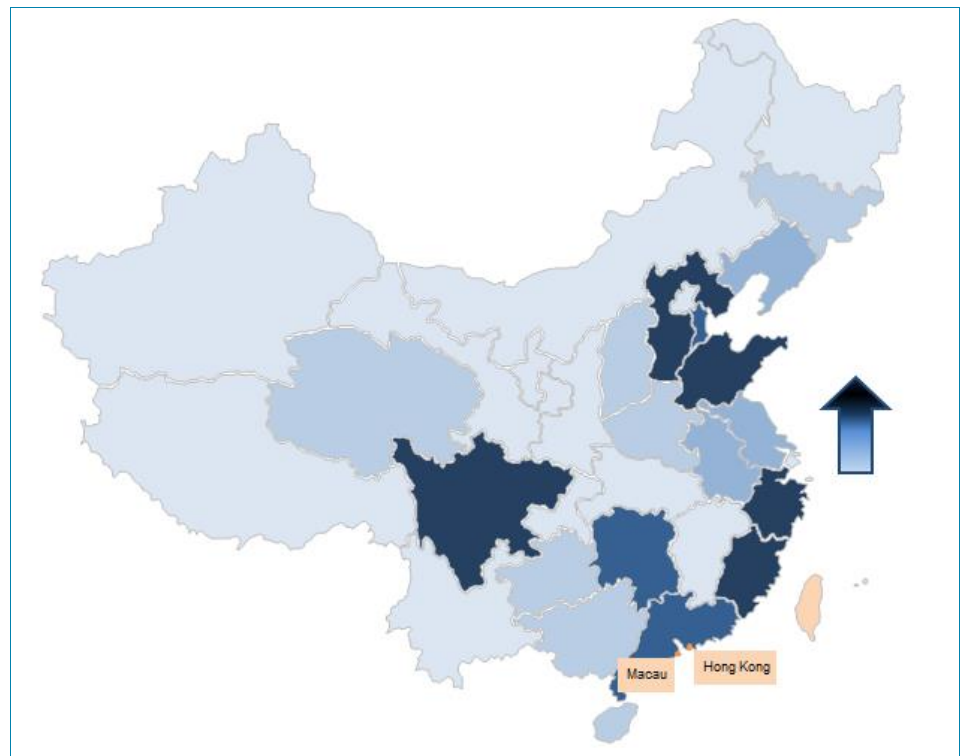
With reports of as many as 30,000 companies – primarily Chinese – being shut down in just one Shandong industrial hub, closures and suspensions during the latest two rounds of the central government-led environmental enforcement campaign have reached unprecedented levels. This has led to – in some cases public and high profile – calls for help from multinational companies that have had their supply chains suddenly disrupted or their own factories shut down for months at a time.

The environmental new normal – regular shut downs

Authorities so far have been unsympathetic. In the past two years, the MEP has repeatedly warned of poor compliance and of intensifying enforcement. A tougher Environmental Protection Law, in force since 2015, has significantly increased fines and enabled both officials and environmental NGOs to pursue legal action against companies in violation of environmental rules, including through public interest lawsuits against major multinationals.

A new environmental tax – in force from January 2018 – and changing reporting structures for environmental authorities all herald further tightening of environmental rules and more routine scrutiny of corporate environmental performance.

China's intensifying environmental enforcement



Based on number of enterprises ordered to rectify in the 2016-2017 central government environmental campaign.

The environmental crackdown must therefore be understood as part of the new normal. And just as the anti-corruption campaign significantly affected how multinationals operate compliantly in the market, environmental enforcement is set to shake up supply chain management, compliance and reporting as the next big operational hurdle.

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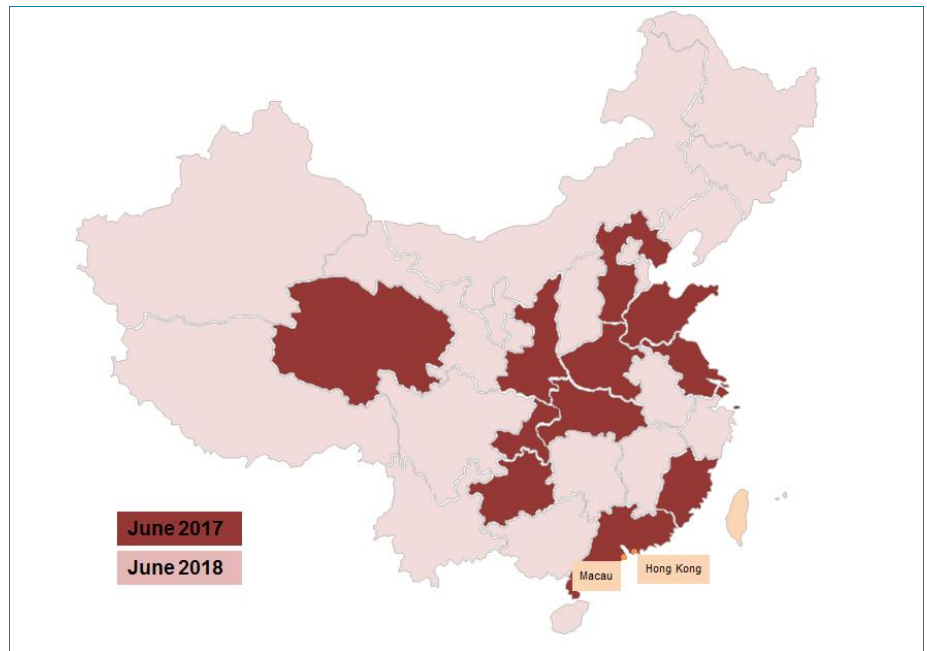
More than environmental

But the latest enforcement has extended beyond environmental issues. Inspections have been conducted not just by environmental authorities, but local industry regulators as well. Companies shut down generally fell into the categories of 小, 散, 乱, and 污 (xiao – small, san – scattered, luan – messy, and wu - polluting). Numerous companies compliant with emission rules were shut down if their business licence, certificates or other documents were not in order.

China's senior leadership is merging environmental goals with wider industry goals, particularly with regards to cutting overcapacity and upgrading industries. Smaller, inefficient operators will not be allowed to reopen. The government views this as an essential part of upgrading China's economy. This can also be seen in the intensifying relocations for manufacturing companies in recent years.

To make sure this happens, the responsibilities of authorities are shifting. Environmental authorities are being freed from potential conflicts of interest, by introducing vertical reporting structures (where each environmental agency reports to a more senior environmental agency, rather than their local government heads). Local mayors in those jurisdictions, and the rest of the country, have seen their influence on environmental issues erode. They can no longer overrule environmental restrictions or penalties.

Deadline for changing environmental authorities' reporting structures



How to respond

All these changes position authorities to more extensively and more frequently monitor and inspect for environmental compliance.

- **UNDERSTAND:** To respond effectively to these changes, companies need to understand the drivers and the timing of wider enforcement, to stay ahead of local government and sector-specific trends as well as one-off investigation and shut-down triggers such as industrial accidents or seasonal pollution.
- **ENGAGE:** The changes also require companies to renew and intensify their communication on environmental issues with all regulators. Going forward, companies' narrative around their environmental performance and their environmental contribution will become much more essential, not just when dealing with environmental inspections, but for all regulatory approvals.
- **INVESTIGATE:** Finally, the latest inspections serve as a good reminder that companies need to know their entire supply chain, and ensure they too are environmentally compliant. This is not just about environmental audits – as seen in the latest inspections. It's about conducting thorough due diligence on business partners and identifying any compliance red flags that indicate there are current or likely future environmental or business issues.