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# ESG Lab: The Catch-22 of the Just Transition

**It's the fundamental challenge that society faces as we decarbonise the global economy: how can we transition away from fossil fuels and carbon-intensive activities without creating unmanageable social impacts?** Many millions of people around the world work in industries that will have to disappear if we are to prevent catastrophic climate change. How are we to ensure they, their families and their communities do not bear the brunt of the transition to net zero? How can we ensure that the economic benefits of the new clean industries, in energy, transport and buildings, flow to those who stand to lose from the move away from fossil fuels?

The challenge to ensure a so-called 'just transition' is, primarily, one of policy. But it also has profound implications for business and investors. For businesses and their shareholders, a failure to prepare their workforce for the future brings social risk. For investors, a disruptive and unequal transition risks macroeconomic underperformance and lower overall returns for their investments. For both, a successful transition creates opportunity.

To explore these issues, PAI Partners dedicated the last ESG Lab of its 2021 Climate series to the subject of the Just Transition. More than 40 attendees from LPs, GPs and corporates participated in a discussion on the topic, led by the following experts:

- **James Bond:** emerging markets finance and public policy expert, and veteran of the World Bank Group

- **Borja Gomez Rojo:** Senior Adviser, Fair Transition Group, a leading consultancy specialising in the Just Transition agenda

- **Philippe Maillard:** CEO of Apave Group, a PAI portfolio company

- **Niels Planel:** Founder, Fair Transition Group

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## Understanding the Just Transition

The concept of the Just Transition was introduced in the mid-1990s, in response to concerns that, as society mobilised to address environmental challenges, workers would lose out [1]. More recently, the concept has been applied to issues around mitigating the social impacts of phasing out coal and other fossil fuels in the context of climate change. The International Labour Organization (ILO) summarises the challenge: "A just transition for all towards an environmentally sustainable economy … needs to be well managed and contribute to the goals of decent workflow, social inclusion and the eradication of poverty."

This offers a more holistic alternative to a narrow focus on industrial restructuring, said Niels Planel, offering a definition from the Principles for Responsible Investment, which sees the Just Transition as "a forward-looking, action-oriented framework that identifies opportunities for public and private investment in economic development that is both sustainable and inclusive". Niels added that the Just Transition should be understood as "one of the most important imperatives of this century, for societies to achieve decarbonisation while equitably redistributing opportunities among their populations. It means moving from high energy-intensity economies to low energy-intensity ones without exacerbating their Gini coefficient [2]."

Of course, the net-zero transition is only the latest in a series of profound transitions affecting the global economy since the Industrial Revolution in the 19th Century, observed James Bond. Indeed, during the post-Soviet transition in Eastern Europe, the World Bank helped close down polluting, inefficient coal mines in Romania and Bulgaria, and redeploy 750,000 miners into healthier, more productive jobs, he noted.

## Risk and opportunity

The risks of an 'unjust transition' are largely social and macroeconomic. Increased poverty and unemployment lead to political instability and macroeconomic underperformance. 'Left-behind communities' can feed political extremism, require disproportionately high social and health spending, and lead to migration and internal displacement of populations. Poorly executed transition policies can trigger opposition, leading to political instability and higher government expenditure; for example, higher diesel taxes in France triggered the Gilets Jaunes protests in France, which in turn resulted in policy reversal and €17bn in additional government spending to calm the unrest [3].

Risks can also manifest themselves at the corporate level. A failure by companies to support workers whose skills become redundant can poison labour relations, harm corporate reputations and threaten companies' social licence to operate. Meanwhile, companies that do not anticipate the need for new skills could find themselves constrained by a lack of human capital. For investors, financing assets that do not support a just transition could leave their portfolios vulnerable to political risk events.

But a just transition also creates opportunity. At the macroeconomic level, it is increasingly accepted that the net-zero transition will be a net contributor to employment, says Borja Gomez Rojo; a 2018 study by the ILO estimated that energy-related policies to hold warming to less than 2°C would create a net additional 18 million jobs globally in energy, transport and construction. If that transition was combined with a deliberate effort to train and upskills workers in, for example, renewable energy, electric vehicles and building energy efficiency, many of its negative social impacts could be avoided.

The Just Transition is also a source of enormous investment, noted Borja. For example, the European Union has earmarked €72.5bn over 2025-32 to its Social Climate Fund, which is aimed at mitigating the social impacts of its climate policies. This is in addition to a €17.5bn Just Transition Fund to support the phasing out of coal in the EU. Internationally, the Climate Investment Funds, managed by the World Bank, and the European Bank for Reconstruction and Development's Just Transition Initiative are both set to channel billions to support just transitions in middle- and low-income countries. As Borja said, "the smart money is already on the Just Transition."

**The Just Transition is one of the most important imperatives of this century, to achieve decarbonisation while equitably redistributing opportunities.**

1. The term was first used in 1995 by Les Leopold of the Labor Institute and Brian Kohler, a labour leader from the Communications. Energy, and Paperworkers Union of Canada, in a presentation to the International Joint Commission on Great Lakes Water Quality

2. The Gini coefficient is a measure of the distribution of wealth or income across a population, where 0 represents perfect equality (with everyone earning the same income) and 100 perfect inequality (where one person earns all the income, and the rest earn none).

3. "French social security deficit signals budget squeeze," Victor Mallet, Financial Times, 11 June 2019

## A central role for the financial sector

While it will be the role of government policy to guide the Just Transition, prior experience shows that the financial sector has a more important role to play with regards to how the transition unfolds, asserted Bond. He noted that the incremental annual cost of the net-zero transition has been estimated at some $1.5-2trn – compared with annual investment in infrastructure of around $5trn, or about 3.5% of global GNI of $150trn, and global financial assets of around $300trn.

“The money is there,” he said, and is already being deployed, moving from carbon-intensive sectors such as coal, oil and gas. Responsible investors are responding to mitigate some of the downside risks of social disruption as well as identifying opportunities to invest in emerging industries which offer better returns than legacy industries. “How investors act will determine the social part of this transition,” Bond said.

## Finding the right metrics

A key challenge for investors is understanding the associated risks and measuring impact. While there are often clear indicators for environmental issues, such as carbon dioxide emissions to measure climate impacts, social factors are more difficult to capture systematically, particularly given the varying contexts in which companies operate, said Borja. For example, a just transition in a Scandinavian country would include an important role for the welfare state, in contrast to the United States, where social welfare is often regarded with suspicion.

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This is also a challenge for portfolio companies themselves, says Philippe Maillard of Apave Group. Observing the many dozens of metrics under development to track social impacts, Philippe stressed the need for standardisation to ensure that claims and pledges are rigorous and broadly accepted.

Niels at the Fair Transition Group cited the OECD’s Inclusive Growth Framework, the UNDP Human Development Index, and metrics tracking cumulative adversity, which considers the structural and cultural impediments to development [4]. “The key is to merge the approach taken by these indexes with a green growth-based approach,” he adds.

Some standardisation is also underway, with regulatory interventions such as the EU’s Taxonomy for sustainable activities providing a framework for aligning investment with policy objectives, focused thus far on climate mitigation and adaption. James noted the challenges that the Taxonomy is facing in winning support from the market but welcomed its role in a “two-pronged approach”, whereby the finance sector feeds into the design of regulation from the bottom up, which is then formalised from the top down to ensure industry-wide adoption.

## The corporate view

From the company perspective, the net-zero transition will, while shutting down carbon-intensive business models, create new opportunities. “There are so many opportunities for us to create services to help our customers better manage the transition,” says Philippe, whose company helps its clients manage risks. “Every transition creates new economic activities and these new activities are often associated with risk,” he said.

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He cited work his company is doing with firms installing electric vehicle charging systems, and training battery specialists to maintain electric vehicles. While these new industries create economic opportunities, they also present risks to be managed.

In addition, a growing number of companies will find their employees are keen to play their part in the net-zero transition. However, while a motivated workforce is clearly an asset in responding to new opportunities, it can present a problem if companies are not responding fast enough, notes Philippe. “Employees want to contribute to the transition, and they want to be sure that their company will be contributing. They are more demanding in that respect,” he says.

**Critically, successfully navigating a just transition will require governments, businesses and investors to come together. While the business community can create employment in the clean industries of the future, it is important for business to work with government – especially employment ministries and agencies – in helping to direct labour towards those opportunities. And, of course, it will be vital for investors to recognise the risk and opportunity presented by the Just Transition in their investment decisions, and to use their role as owners of companies to ensure management recognise them as well, so that no-one is left behind in the transition to net zero.**

4. For more information, see OECD (2018), Opportunities for All: A Framework for Policy Action on Inclusive Growth, the UNDP’s webpage on the Human Development Index, and Harvard’s Project on Race, Class & Cumulative Adversity