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Policy Brief

ENABLING PRAGMATIC POLICIES: LEVERAGING ESG FRAMEWORKS TOWARDS A JUST TRANSITION

Task Force 7

International Finance and Economic Recovery

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Abstract

A just energy transition[1] is essential in achieving global decarbonisation ambitions under the Paris Agreement. Environment, social and governance (ESG) frameworks can potentially influence investors and, in turn, markets on an international scale. Developed economies, already out of their carbon-intensive stage of development, are well-positioned to initiate domestic ESG frameworks. In contrast, developing countries struggle with hard-to-abate sectors, putting them at a structural disadvantage. Common but differentiated commitments are a hallmark of the Paris Agreement, and the ESG frameworks should embody this theme. Through technology, facilitating transparency in ESG frameworks will help build trust in stakeholders and investors, enabling progress towards a sustainable future.

[1] "A Just Transition involves maximising the social and economic opportunities of climate action, while minimising and carefully managing any challenges – including through effective social dialogue among all groups impacted, and respect for fundamental labour principles and rights" (International Labour Organisation, 2022).

Challenge

Global stakeholders in the sustainable energy transition are increasingly focusing on policies and regulatory frameworks to attract the massive investments required to meet the energy transition needs. Achieving net-zero targets requires critical investment decisions on key mitigation technologies and enabling conditions, including conducive policies and regulatory environmental, financial and logistical infrastructure, and business environments. Environment, social and governance (ESG) frameworks can help policymakers make decisions that ensure a just and inclusive energy transition. However, current ESG metrics incentivise investments that generate a return in the short term over the long term. Investments in climate-associated technologies and related research and development innovations are longer-term and need to be insulated from the volatility of market returns to be provided with an opportunity to scale, mature and evolve to either fail or succeed. Using such short-term-focused ESG metrics or similar market-directed ratings to make investment decisions focused on the future could be detrimental to the progress of the energy transition as it will inhibit risk-taking and investments in new technologies.

Developing and least-developed countries require financial support and investments to transition into greener energy infrastructure. A one-size-fits-all approach for the energy transition globally will be doomed to policy missteps, squandered opportunities and misallocated precious resources, especially time. In addition, social reactions to such one-size-fits-all policies could further derail ambitions towards a net-zero future. Therefore, as the world moves towards carbon neutrality, stakeholders in the energy transition are increasingly focusing on ensuring greater acceptability and increased attraction for investments to flow into the new technologies and innovations required to help support the evolution and development of the process.

A just and comprehensive reporting scheme for all countries is a critical first step in securing a global net-zero effort. Such a scheme is essential to creating an enabling environment for financing this effort, specifically, efficient resource allocation, constructive oversight and rewarding performance. Such comprehensive reporting, in turn, necessitates a global structure that collects and disseminates data at the granular level. Such a granular approach would also increase transparency and accountability. The circular carbon economy (CCE) framework highlights multiple paths to a broad transition; adaptation, abatement, mitigation, energy efficiency, innovation and technology development appear to be more viable strategies than focusing on narrower sector, industry or country-specific approaches.

Our proposals construct a policy environment where ESG and the CCE framework overlap and ensure that the legacy fossil fuel-based infrastructure is repurposed and optimised for a just

energy transition that is fair and equitable to all stakeholders globally. We highlight the need to promote global data collection and reporting mechanisms that integrate carbon management processes. Establishing international reporting standards will surely bring about debates among interested parties. Towards this end, regional governance mechanisms should focus on market creation and dispute resolution and support the development of financial markets to securitise and monetise carbon capture, utilisation and sequestration. We believe these initiatives can create an enabling environment for a sustainable and inclusive energy transition.

Proposal

"Because for prosperity to be sustained, it must be shared"

- G20 Seoul Summit, Annex I

Proposal 1:

Incorporate the CCE approach into the ESG framework. Establishing a digital register to integrate carbon-management processes (reuse, reduce, recycle and remove) into the financial streams will help bring in the much-needed transparency and help build trust amongst stakeholders. A convergence of reporting standards and reconciliation of disclosure requirements backed by transparent and auditable carbon data would help reduce compliance costs, increasing stakeholder acceptability to build investor confidence.

Rationale:

Despite its global acceptance, the implementation of the ESG framework worldwide is nonstandard and employs inconsistent scoring metrics defined by multiple agencies. The Organisation for Economic Cooperation and Development (OECD) notes that ESG investing has become a leading form of sustainable finance but has raised concerns that data inconsistencies and a general lack of transparency may hinder progress towards climate goals (OECD, 2021). There is an urgent need to codify and mainstream a cohesive and inclusive mechanism to measure ESG effectively and equitably from a data-driven perspective. A first step in enhancing the transparency would be establishing a digital register to integrate carbon-management processes (reuse, reduce, recycle and remove) and create verifiable/auditable data for stakeholders across the carbon value chain. This proposed digital register could play a key role in helping reform emissions reporting under the Greenhous Gas (GHG) Protocol[2].

Developed economies like the European Union, the United Kingdom and the United States have traditionally been thought leaders on environmental issues and already have stringent ESG reporting requirements. In the US, the Securities and Exchange Commission (SEC), the

[2] Greenhouse Gas Protocol (https://ghgprotocol.org/)

governmental body that regulates securities, has signaled that corporations will be required to disclose information on GHG emissions and environmental risks across all sectors of the economy (Giavelli, 2022). While some corporations have independently placed ESG as a part of their strategy, the SEC shifts the voluntary approach to a federal requirement to report on ESG issues.

The regulatory pathway observed across multiple markets consists of various ESG reporting frameworks requiring varied disclosure requirements and new challenges (Ganapathi, 2021). A lack of global alignment indicates that goalposts are shifting rapidly (Deloitte, 2021). With the often cross-jurisdictional reach of some provisions, ESG reporting poses challenges, increases hesitancy and abets confusion, leading to more transactional costs (RBS International Institutional Banking, 2021).

Many approaches based on the inconsistent rating of ESG scores enable inaccuracies in reporting (Kotsantonis & Serafeim, 2019). A level playing field is required to ensure a holistic view of an organisation's ESG practices and reduce the "greenwashing and virtue signaling" some corporations use to hide questionable ESG practices (IFC Review, 2022). Consumers and investors have called for more transparency on climate implications and associated risks (Hamlin, 2022). The International Organization of Securities Commissions has made similar recommendations to the international community to create "building blocks" for more transparent and auditable ESG frameworks (Board of the International Organisation of Securities Commissions, 2021). The ad hoc and generic reporting have led to confusion and uncertainty about which companies are making the best investments to enable a transition (Edmans, 2020). Many companies have played a leadership role in promoting a transition from generic reporting to auditable and transparent ESG disclosures. Reporting regimes have included feedback from innovators across different industries.

With the currently accepted practice, policymakers, investors and consumers get no insights on which spending will be the most ESG-friendly when deciding between products and services. Large corporations have no real incentive to invest in lower carbon inputs when they can continue to use generic data. Similarly, consumers remain sceptical that claims of good corporate citizenship are valid. Stakeholders have called for transparency tools to ensure that ESG reporting meets high analytical standards, which signifies a departure from the questionable reporting of the past (Cacioli, 2021) (S&P Global, 2020). Though the GHG Protocol has provided regulators feedback on achieving a level and transparent playing field across industries and geographical borders, much more need to be done to refine this approach. Today, companies can base ESG reporting on "best-guess," which does not incentivise good corporate stewardship and equity across industries and geographical

boundaries (Pucker, 2021). Companies that report on Scope 3[3] (the emissions that a company does not directly control) emissions can rely on data from competitors' reports in the simplest terms. That competitor may have made significant investments to become environmentally friendly in some cases. This acceptance of generalised reporting, or "borrowing" data from competitors or general industry data, gets us no further to achieving Paris Agreement goals and muddies the water for all stakeholders (Kaplan & Ramanna, 2022).

A digital data registry would enable a holistic view of activity across the entire value chain, enabling third-party reviewers, verifiers, certifiers, customers and vendors to view the full ESG impact transparently. It would allow for allocating different carbon abatement and capturing contributions from each country/manufacturing process in the product value chain to its carbon footprint. Such a data registry would also help reduce compliance costs for participants, thus ensuring high-quality disclosures. This would generate buy-in from stakeholders and ensure that market participants can value and measure longer-term impacts, enabling them to make informed decisions about their investments.

Companies are under increasing pressure to be transparent and auditable regarding their ESG exposures. Negative ESG ratings could increase the possibility of financial impacts on their market performance, inhibiting their ability to invest in new and innovative technologies needed to sustain the energy transition. To be ESG investible and ESG compliant across their corporate portfolios, organisations often now require their suppliers, partners, and collaborators to adhere to a shared sustainability practice (Villena & Gioia, 2020). A digital data registry would enable a level playing field for small and medium enterprises, technology start-ups, and other stakeholders to comply with fast-changing regulations.

Companies must be more resilient in this energy transition. They need to position themselves to innovate and evolve as the regulatory environment changes, and there is a more significant push for climate disclosures potentially impacting consumer preferences. The data registry, enabled by digital technology, would also help sustain real-time adjustments as new regulations and climate-disclosure protocols are developed, trialed and implemented. The registry would help provide granular data regarding the effectiveness of policymaking and enable insights to be generated for improvements in the process. ESG and net-zero are long-term concepts, leading decades into the future. While longer-term commitments to net-zero are being made, it is crucial to report the interim progress towards the goal or detect deviation. The reported progress towards achieving the climate ambitions towards net-zero can help

[3] To understand more about Scope 3, please visit:
https://ghgprotocol.org/sites/default/files/standards_supporting/FAQ.pdf

companies create new sources of value, which can be monetised. These could be around creating a carbon market based on adaptation and mitigation using the CCE framework. The registry would help make data granular and enable attention to be focused on specific areas needing additional investments or research and development support.

Proposal 2:

Enhance regional governance frameworks with existing organisations.

Rationale:

The establishment of regional organisations like the Organization of American States, the African Union, the EU, the Gulf Cooperation Council (GCC), and others after the launch of the United Nations was an acknowledgment of the role of regional cooperation in achieving economic, social and political goals. These regional entities can play a role in spearheading initiatives to create consistent data across geographical boundaries. Political and economic alliances have historically been a hallmark of regional organisations. Still, a natural expansion would be to leverage existing expertise in these organisations. Regional knowledge and expertise within the organisations can be harnessed to develop data-sharing platforms and regional markets for carbon offsets. Dispute-resolution mechanisms accessible to all players along the value chain can be accomplished soon. Establishing regional governance mechanisms would allow all stakeholders to be heard, an essential but overlooked constituent of a dispute-resolution process. Each regional organisation can focus on capacity building and develop subject matter expertise and human capacity to advance generally accepted standards and disseminate technical knowledge towards regional carbon accounting aligned with global goals.

Using regional organisations to play a more vital role in creating transparency in ESG reporting could help leverage the regional "know-how" of experts with bountiful knowledge. Organisations like the Association of Southeast Asian Nations (ASEAN) and GCC could be forums that enable such initiatives. Sharing regional contextual knowledge helps avoid the "one size fits all" approach to ESG benchmarks. The root causes of inequality have some global commonalities, but the solution set may differ considerably between countries with vastly different stages of development, culture and environmental conditions. Regional organisations have differing capacities to provide leadership under the proposed ESG policy proposals in Proposal 1. Still, housing this work under existing organisations helps reinforce the existing expertise while demonstrating the value within the international community for solid regional alliances to work cohesively to solve global problems.

Proposal 3:

Prioritise social and governance scores alongside the environmental to ensure a just transition.

Rationale:

To meet the goals of the Paris Agreement, the transition towards sustainable energy systems needs to accelerate. However, there are social challenges associated with going green. A just transition means greening the economy fairly and socially inclusively, creating decent work opportunities, and ensuring no one is left behind. Such a shift cannot be handled by business as usual. We need innovative and collaborative approaches that advance the transition to sustainable energy systems and foster a just transition. One such environmental justice focus can be seen in the Justice 40 Initiative in the US, which focuses on finding ways to invest in energy and environmental justice initiatives in communities that have historically been overlooked (US Department of Energy, 2021). Innovative programmess must include skill development, enabling new sustainability-focused green businesses, social protection and dialogue. The reality of the international aspect of the "just energy transition" is that not all countries have the luxury of choosing an equitable energy transition pathway without developmental assistance and international cooperation. An economically weak and developing country facing international pressure to decarbonise away from fossil fuels will not have the freedom to make energy choices between a legacy fossil fuel-based economy or one based on green and renewable resources. For such countries, ensuring energy costs and increasing energy access for their populations will be more critical than managing GHG emissions. As we emphasise collaborative efforts to drive sustainable outcomes, it becomes crucial to focus on ensuring the development of a financial market to ensure securitisation of carbon capture, mitigation and abatement for developing and least-developed countries. Digital infrastructure to help support such a market creation would enable the innovation and development of digital financial products to promote CCE locally, driven by entrepreneurial opportunities. Financial institutions' role and enabling frameworks that help support the transition to a low-carbon economy are critical. Investments would need to be inclusive and flow to poor and rural communities. Increasing transparency and helping deepen markets will ensure that the funds are available across the energy transition space and assuring adherence to UN Sustainable Development Goals (SDGs). Sustainable financial frameworks should focus on mobilising capital towards companies and projects that create solutions to address social and environmental challenges to contribute to a more resilient, inclusive and just transition.

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