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# The climate challenge faces the energy crisis

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As we emerge from 2022, the geopolitical and economic environment doesn't look promising for stronger environmental measures; moreover, latent social tensions were further accentuated. Are compliance with the Paris Agreement and meeting Net Zero targets still realistic, given how unfavourable the current context seems to be to the environmental cause?

## A COP in a tense international context

COP27 ended with mixed feelings. Some commitments to reducing greenhouse gas emissions and to exiting fossil fuels were stepped up, but debate focused more on the issue of losses and damage. As developing countries are the most exposed to the consequences of global warming, and developed countries are the most responsible for it, participants ultimately approved the creation of a new fund to assist the hardest-hit countries. As it was based on a 30-year-old observation, this decision is no small matter and sends out a strong signal. Until now, little or no investment had been earmarked for managing the repercussions of climate change. Assisting the most affected countries is justified, but this shuffling of priorities reveals that we are now trying to mitigate the effects of climate change as much as acting on its causes and sheds new light on the economic and social consequences of climate change.

## How did we get to this point?

The outbreak of the Russian-Ukrainian conflict has bogged Europe down in an unprecedented energy crisis, which has been exacerbated by the shutdown of half of France's nuclear power plants, the main alternative to fossil-fuel-fired plants. In reaction to skyrocketing natural gas and electricity prices and their economic and social risks, policy-makers have rather naturally decided to place national interests ahead of global ones, thus relegating the climate issue to the back-burner. Most of all, the current situation has shed light on some countries' very heavy dependence on a limited number of fossil-fuel producers, as well as the lack of diversity in the European energy mix. With no other alternative, the most carbon-intensive substitutes have generally been chosen as a stopgap. Fossil fuels thus made a comeback in 2022, led by coal, emissions of which rose by 1.2% year-on-year in 2022[(1)]. Meanwhile, demand for natural gas rose in order to top off inventories, which had been at lows in the run-up to winter, and to keep the energy crisis from morphing into a social crisis.

(1) IEA, Coal 2022 – Analysis and forecast to 2025, Dexember 2022.

## Is the Paris Agreement a dead letter?

The energy crisis is a perfect illustration of the issue of timing and the trade-off between short- and long-term interests. This same question is continually being asked of financial sector actors. While the current situation has favoured the short term, pre-existing commitments, including the coal exit calendar and the downward trajectory on emissions and investments have neither been reviewed nor eliminated. On the contrary, in some cases they have been stepped up. Moreover, a crisis forces innovation and may accelerate decision-making. For example, in the US, the 1970s oil crisis pushed policy-makers to seek out alternative sources in order to ensure its energy independence. Moreover, according to the International Energy Agency (IEA), renewable energies are currently the most cost-efficient. While their use is still very limited, they provide a cushion in a tense energy context. According to the IEA, given the current high prices for natural gas and electricity and thanks to ongoing investments, renewables' production capacity could make it the main source of electricity by 2030. Between now and then, the energy situation is likely to remain shaky, as tensions contribute to prolonging the transition process, without jeopardising the initial objective..

## High ambitions on a global scale

In Europe, the new RePowerEU[2] programme, estimated at 210 billion euros, is targeting 45% renewable energy supplies by 2030, as well as 13% energy savings (vs. 9% currently) and has recently been strengthened by a carbon tax mechanism at the EU's borders. In the US, the Inflation Reduction Act of 2022 approved last June (nearly 400 billion dollars over 10 years) is meant to support the greenhouse gas reduction target of 50% to 52% by 2030 from 2005 levels; it mainly involves tax credits to promote "made in USA" renewable energy generation. The US's manifest determination to cast off dependence on China through ultra-protectionist measures nonetheless constitutes a source of tensions for its European partners, who, once again, have suffered collateral damage from trade war, which is dragging on even though Donald Trump has left office. Speaking of China, the Party is targeting a reduction of carbon intensity by more than 65% vs. 2005 levels and an increase in non-fossil fuels' share of energy consumption to 25% (from 15.3% at end-2019). There is still the matter of timing, but these announcements serve notice of the ambition of a government that wants to position itself as a leader in renewable energies and generally has the wherewithal to achieve its objectives.

## The energy transition and economic and social challenges

Despite the determination being shown by governments, the current situation shows that an about-face in energy strategy is not viable. It would require in particular taking into account labour impacts (professional reconversion, support and guidance, training, etc.) along with territorial consequences (offshoring, overconcentration, etc.). To be sustainable a new model must not recreate or exacerbate the imbalances inherent in previous models. Moreover, the need to diversify the European energy mix, notably *via* public incentives, has long been an issue but lack of organisation in implementation is likely to have a considerable impact on price stability and, ultimately on people themselves. For, according to ECB models, in Europe, an orderly transition would cause energy prices to rise by about 3.5% annually from a base scenario. This scenario would lead to average annual inflation of 0.10% and a slightly negative, short-term impact on euro zone GDP. However, a disorderly climate transition would come with an 13.5% average annual increase in energy prices and would be inflationary (+0.5% on annual average vs. a standard scenario) and would undermine short- and medium-term growth. Meanwhile, these scenarios are now facing the current crisis, which is tending to exacerbate the inflationary effects of the energy component.

## Is the inflationary environment undermining the transition?

Already stoked by the global pandemic, inflation has skyrocketed in many regions of the world, driven by a combination of the energy crisis and commodity shortages. In reaction, the main central banks have begun a monetary tightening cycle on a scale not seen in more than a decade. Against the backdrop of rising debt servicing costs, is it therefore realistic to hope that companies will commit to investment plans in favour of the transition? This new context does not necessarily undermine their capacity to invest. The highly favourable rate environment in which we had lived over the past decade allowed most of them, and energy companies in particular, to shore up their balance sheets. Meanwhile, most regulatory changes have had the effect of promoting investment in sustainable solutions. From the financial viewpoint, we also see that sustainability criteria influence risk premiums, due to the additional guarantees they offer to investors. Transparency and clarity of investments will therefore be key for companies wishing to finance their transition and and that this decision contributes to strengthening their valuation. It will be up to investors to select those companies that are committed and the best placed to benefit from this upside potential.

(2) Renewable energies

## Net Zero: utopian?

More than 80% of the world's economy is currently committed to achieving the Net Zero objective[3]. While the pace differs, the momentum is clearly there. However, the credibility of these commitments will require setting various target dates and transition plans organised with clearly identified resources. Achieving some standardisation in commitments (integrated into the company's strategy, with capital allocated and monitoring of a $CO_2$ budget) is essential, as is taking scope 3[4] into consideration, despite this factor's inherent complexity. Creating a supervisory authority to encourage transparency and limit greenwashing will inevitably contribute to the emergence of best practices and a market standard. Regulations are taking this path, and both investors and companies are in favour of implementing initiatives such as taxonomy, which offers a legal and unified framework. Meanwhile, beyond fossil fuels and their alternatives (hydrogen, nuclear fusion, etc.), issues of energy efficiency and technological innovation will be crucial in coming years. Apart from pure energy companies, the heaviest emitting sectors (industry, utilities, commodities, chemicals, etc.) will therefore have a fundamental role to play in favour of the transition.

## Our transitionapproach in this context

The current context reinforces our confidence in the approach we have taken to transition and in our Net Zero strategies. Despite the urgency and the determination of the highest political bodies, some sectors can simply not be instantaneously transformed from top to bottom, especially when they are connected to heavy industries or provide large numbers of jobs. Doing so requires anticipation and investments that are commensurate with ambitions. Investing in such sectors, notably the main emitters of greenhouse gases, does not mean negating a process of transition, as long as commitments are made in exchange. Active management, with a careful stock-picking, makes perfect sense here. Knowing the companies and being able to assess the credibility of their objectives, relying on well-regarded service providers, and long-term monitoring of transition plans are essential aspects of our approach. This process is unlikely to be linear. Some turbulence, such as the current crisis, will continue to emerge. These periods of tensions will help identify those companies able to stay the course of a structural change, even during a turbulent period. We are fully committed to this, regardless of the environment, and will adjust our positioning in order to encourage the major sector transformations already in progress and to come.

(3) University of Oxford, november 2021
(4) Indirect carbon emissions related to the various stages of a product's life cycle.

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