RETHINKING THE FUTURE ENERGY TRANSITION



OVERVIEW ON CURRENT EVENTS

Current geopolitical events will have long-term implications for global oil and gas prices, which will in turn cascade through to impact not only home energy bills and forecourt prices but existing expectations and strategies around the planned energy transition to transform the global energy sector.

COP26 last autumn saw a reaffirmation of commitments to embrace a Net Zero future. Whilst timelines and transition plans vary by country, there is a broad consensus for a "just transition" and the phase-down of coal between 2040 and 2060. A key focus for bodies such as the COP26 Energy Transition Council has been the need for integrated energy planning, utility scale renewables, and investment to support coal and fossil fuel transition.

In preparation for the phase-down, many countries had started to put in place transition plans for bridging the energy gap that will inevitably arise. National policymakers had set out a path forward whilst simultaneously seeking alignment across wider membership blocks such as the European Union. Transition plans were looking to reconcile regional differences in economic factors and energy mix, the reaction to energy transition from different groups of consumers with varied preferences, and the geopolitical consequences of redrawing the energy map.

These transition plans have not been without controversy. The European Commission has come under fire for bowing to pressure from pro-nuclear and pro-gas member states to label the two technologies as 'green' label within an initial draft of its updated Green Taxonomy. Equally, the UK's Hydrogen Strategy is not without its critics, with blue hydrogen in particular singled out over its potential to generate millions of tonnes of carbon emissions every year. However, the unfolding events in Ukraine, and the magnitude of the attendant response around the world, mean such transition plans are now fraying, and many will require significant revision.

As recently as January, for example, German ministers wrote to the EU requesting an easing of restrictions on fossil gas,¹ calling on the European Commission to delete requirements aimed at promoting a shift to low-carbon gases such as biomethane or hydrogen in the transition to green energy. Germany's investment in the Nord Stream 2 pipeline highlighted its intention to use fossil gas as a bridging fuel during its rapid phase out of coal. A little over a month later and the landscape had changed completely with the European Council's Versailles Declaration and the European Commission's REPowerEU commitments, and the shelving of Nord Stream 2.

The EU has moved surprisingly quickly to address member states' energy concerns arising from the recent turmoil. In summary, this response centres on a short-term rekindling of its relationship with coal and nuclear power, with a parallel commitment to turbo-charge the continent's renewable power generation capacities to make green energy dominant across the Union in the medium to long-term.

The UK, for its part, has been making its own arrangements to secure oil and gas imports, a pre-emptive approach – mirrored by governments and leaders more widely – intended to front run anticipated knock-on effects on global supplies of these commodities. How this plays out remains to be seen, but there may be implications for renewables if existing priorities are reassessed to ensure fuel security – perhaps contrary to the EU acceleration agenda.

1. https://www.bmwi.de/Redaktion/DE/Downloads/S-T/stellungnahme-bundesregierung-taxonomie.html

One scenario that may further complicate energy provision and security is the stance and role that China chooses to adopt, given its 'One Hundred Year Marathon' strategy to become the dominant global superpower and the tension between its rising internal energy demands and its COP26 commitments. This may prove a seminal moment for China, whether economically, politically or environmentally.

While ambitious COP26 targets have been set and the use of renewables is growing, it is open to question whether this will be enough to feed an ever more energy hungry world. While the global supply of renewables is forecast to grow by 35 gigawatts from 2021 to 2022, global power demand growth is expected to go up by 100 gigawatts in the same period.² Renewables also face a secondary challenge from weather risks, such as low wind spin and grey days. These can create variability in energy supply and reliability concerns in renewables, affecting market prices and forcing users (and by association planners) to seek alternative back up forms of energy. With shortages in renewable supply comes increased fossil fuel prices, particularly across Europe and the UK.

The challenge of relying on renewables is accompanied by the risk of public unrest and protest as the energy transition looms. As governments look to reconcile the cost of transition via rising public debt, increased taxation and immediate consumer price burdens, a public that is reliant on fuel but unable to pay higher prices will inevitably suffer.

In addition, there are further challenges in meeting the revised timelines proposed by the EU and UK. The speed of the EU transition to renewable energy is constrained by existing infrastructure, coupled with a scarcity of the resources and time required to effect the necessary changes. Power grids, for example, do not typically cater for 'energy smoothing' that is a necessary part of generating renewable energy (a function of seasonal, climactic and other factors that result in peaks and troughs in the amount of energy generated). There are also not only sizeable costs, but also lengthy timelines and bureaucratic hurdles associated with creating new wind farms or solar plants.



2. https://www.cnbc.com/2021/11/04/gap-between-renewable-energy-and-power-demand-oil-gas-coal.html

IMPLICATIONS FOR FINANCIAL SERVICES FIRMS AND REGULATION

As signatories to many Net Zero-linked initiatives, financial services firms have committed to supporting the transition. The current geopolitical turmoil introduces further risks – but also areas for potential supplementary action.

A significant risk for many firms may be their exposure to stranded fossil fuel assets, whether due to geographic/ geopolitical factors or because of accelerated renewable energy plans. Financial services firms will need to obtain – and, critically, challenge – updated transition plans and financial forecasts from businesses to which they are exposed in order to understand the full ramifications of revised national policies and commitments stemming from Versailles, REPowerEU, and local governments.

Firms should also be looking to understand any potential increases to expected credit losses in their own property portfolios, whether residential or commercial, due to likely future cost of living increases and inflation. These increases may also reduce the headroom available for borrowing among their customers, meaning that lending targets may also have to be revised due to reduced affordability.

Given the revised energy transition commitments made by the EU and UK (amongst others), financial services firms operating in these markets will need to revisit their own sustainable finance targets to ensure that their claims to finance the transition are in line with the revised shape of energy requirements. This has the potential to trigger an acceleration in sustainable finance offerings to meet wider EU and UK energy requirements; the same can be considered for the rest of the world. Firms' own lending and investment strategies should also be challenged in light of the revised direction of travel. Once strategy and targets are revised, there are significant opportunities for lending and investment across financial services, including finance for initiatives such as electric vehicles, solar and wind farm infrastructure, hydrogen and biomethane, and home greening for residential customers. With the requirement for more energy security, plus continued focus on climate, this would suggest a 'home-run' for renewable focused initiatives and the associated financial services products and firms but what will get in the way of these opportunities?

Given the strategic importance of investments in the energy infrastructure, the UK and EU member states may seek direct involvement in financing related projects, very much as they did via emergency business loans at the height of the COVID pandemic. The instability in world brown energy markets may deter private sector firms, so national governments may choose to drive through change both to maintain momentum around existing climate commitments and – importantly – to negate the sovereign risk arising from being an 'energy hostage'.

Regulation will no doubt play its part, but there already exist a raft of robust and planned measures to set the conditions across lending and investment spaces necessary to stimulate good ESG behaviours and conduct. What is perhaps more interesting is the role information, analytics, pundits and arbiters will play in determining how entities' ESG credentials are viewed going forward. Firms' reliance on third-party data analytics providers has been criticised³ in respect of Russia-related risks, with Ukraine described as "a 'warning signal' for all those working within ESG in financial services".

3. https://www.ft.com/content/fad3e241-08fa-47fc-bdbd-32dd5b72403d

Scenarios can be envisaged where strictures around the environmental component of ESG are relaxed to accommodate the new energy security landscape, with decarbonisation timelines softened and nuclear and natural gas deemed more acceptable. At the same time, the LNG boom in Europe will inevitably boost shale extraction in North America.⁴

Such scenarios, with President Biden in the White House and COP26 still front of mind, would have seemed unthinkable only weeks ago and considered a huge retrograde step. However, the collective mission to green the world may now have to accommodate certain new realities and imperatives – not least that keeping the lights on may take precedence at least in the short-term.



 $4. \ \underline{https://www.ssga.com/se/en_gb/institutional/ic/insights/esg-implications-of-the-russia-ukraine-war$

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