OGUK

Investing in the transition

Reflections on the investment challenge facing HM Government to deliver the Net Zero Strategy and COP26

December 2021

Summary

UK energy and fiscal policies continue to evolve at an increasing rate as the government strives to deliver its net zero climate ambition. Since our publication in March, *Energy Policy Review: Driving the Transition*[1], there have been several key policy announcements, including commitments at COP26, which continues to place the UK as a global leader in the energy transition. Most recently, the government's *Net Zero Strategy: Build Back Greener* document[2] set out plans for reducing emissions from each sector of the economy whilst promoting low carbon technologies to capture any additional emissions. The common thread throughout all these publications is the significant level of capital that needs to be raised and the opportunity this creates.

This year has also seen major changes on companies financial reporting and disclosure requirements, with investors and regulators looking far closer at environmental, social and governance performances. This has been on a national and international scale with the introduction of taxonomies and the taskforce on climate related disclosure (TCFD) requirements to drive forward transparency. The HMT net-zero review, and greening finance framework published alongside the net zero strategy are key milestones in this evolving landscape with each working in unison to provide **momentum, cost, and delivery** to unlock net-zero.[3]

One of the most significant commitments from 2021 regarding disclosures, saw the chancellor confirming that the UK would be the first G20 leader to mandate climate disclosures by all large companies in 2022. In addition, the anticipated International Financial Reporting Standards (IFRS) Sustainability Standards Board proposal will build on the work of the Climate Disclosure Standards Board (CDSB) and Value Impact reporting to create a global standard. Both will be key steps in ensuring clarity and confidence in the market regarding climate and transition risk.

Additionally, once the details of the mechanism have been agreed, Article 6 of the Paris Agreement will encourage investment to reduce emissions in developing countries though the linking of emission trading schemes. This is a key measure that could quicken the pace at which emissions are cut globally, alongside other developments such as carbon border adjustment mechanisms (CBAM) being introduced.

Key COP26 outcomes: The Glasgow Pact

- *153 countries put forward new 2030 emissions targets (NDCs). Over 90% of world GDP is now covered by net zero commitments.*
- *The conference finalised the Paris Rulebook - agreeing the 'enhanced transparency framework' (common reporting of emissions and support), a new mechanism and standards for international carbon markets (Article 6).*
- *The negotiated agreement contained the first references to 'phasing-down coal power' and ending fossil fuel subsidies in the UNFCCC's 26-year history. 34 countries and 5 public finance institutions committed to end direct public support for overseas unabated fossil fuel energy projects.*
- *137 countries committed to halt and reverse forest loss and land degradation by 2030 in the Glasgow Leaders' Declaration on Forests and Land Use.*
- *Over 100 countries signed up to the Global Methane Pledge to reduce global methane emissions by 30% by 2030.*
- *Over 450 institutions, responsible for over $130 trillion of private finance assets, are committed to net zero targets through the Glasgow Financial Alliance for Net Zero (GFANZ), within the UN's Race to Zero.*
- *Over 40 countries - representing over 83% of global GDP - will support a new international body, the International Sustainability Standards Board (ISSB), that will develop sustainability disclosure standard.*

[1] https://oguk.org.uk/wp-content/uploads/2021/04/UK-Energy-Policy-Driving-the-Transition.pdf
[2] Policy paper overview: Net Zero Strategy: Build Back Greener - GOV.UK (www.gov.uk)
[3] Policy paper overview: Net Zero Review Final Report - GOV.UK (www.gov.uk)

OGUK is pleased to see the acceleration of green opportunities in the UK and the focus of government to accelerate this. The North Sea Transition Deal, signed in March this year is the backbone of UK Energy Policy. Critically though, and as highlighted by COP26, investment must ramp up to deliver this deal. This will benefit from the interaction of public and private finance coming together to address climate change and deliver a just transition.

OGUK's reflections on the emerging policies regarding investing in the transition include;

1. **The role of finance:** Private finance will play a pivotal role in scaling low carbon opportunities and delivering investment at scale however the interaction of public and private sector will underwrite the success needed to achieve net-zero.

2. **Importance of greening companies and sectors:** To unlock net-zero, there is a role and need for every company and sector to set out detailed transition plans that span the whole value chain.

3. **Growth of Non-Financial Reporting:** Expectations of both institutional and retail investors are changing. Taking ownership of environmental and corporate social responsibility is becoming key to all investment decisions.

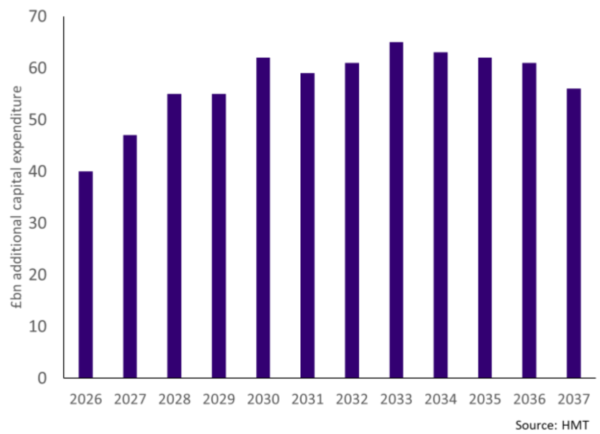
4. **Regulatory compliance:** Managing the numerous accounting and financial regulation standards governing climate reporting to meet investor needs will be paramount to all businesses.

Ultimately the investment landscape is evolving with providers of finance looking far closer at ESG metrics. This has a fundamental impact on the cost of capital and project economics. To continue to raise capital, companies in all sectors will have to meet these growing expectations. For them, there will be substantial capital available. The growing focus of ESG in both fiscal and energy policy along with wider markets is a significant opportunity for the UK sector with an established set of finance providers already interested in the sector's decarbonisation activities.

The size of the opportunity and challenge from Energy Transition

The HMT's Net Zero Review clearly demonstrates that a step-change is required in investment levels in the economy to adapt infrastructure, businesses, homes, and transport to new energy solutions. This increase will be particularly noticeable in the UK given the historically low levels of investment as a share of GDP. It will be important for government to consider the role of policy in unlocking investment and ensure that the necessary energy and fiscal policies are introduced.

HM Treasury projections predict additional net zero



investment peaking at over £60 billion per annum by the mid-2030s with key investment areas including a range of offshore technologies alongside major investments in energy infrastructure and efficiency improvements onshore.

This includes more fixed and floating wind, new energy networks, carbon capture usage and storage and the greater use of hydrogen in industry and transport. At the local level, buildings will need to be more efficient; heat pumps will have to be considered; and charging points for electric and hydrogen vehicles will have to be widespread.

Likewise, continued investment in conventional technologies including oil and gas will also be required to ensure consumers needs are met during the transition period. Success of the transition will be measured by the ability to continue to access affordable energy supplies.

Given the expansion in investment required, it will be crucial that companies can secure capital on affordable terms. In this context, an increasing offering of debt and equity products are being introduced to the market with sustainability linked performance indicators. Sustainability linked loans are designed to encourage positive commitments and actions by a company and will be instrumental in incentivising and supporting change. An example of this within the oil and gas sector is where the cost of finance is less because of achieving emission reduction targets and conversely would incur increased cost should the target be missed. This creates a major opportunity for transitioning and greening companies to access capital and incentivise change.

More than **one quarter** of European leveraged term loans have a pricing mechanism with ESG language included.

Source: S&P

Raising finance - public and private

Clearly, we will require several new sources of finance to achieve the scale needed for net-zero. The interaction between public and private investment including governments commitment to mid-long term business models will be key to delivering this.

Private sector investment will be the lion's share of funding required as identified in the HM Treasury Net-Zero Review. However, for the transition to be successful companies need to continue to have access to affordable finance to achieve the scale required. Additionally, the interaction between public and private investment will be the backbone to this. Therefore, it is important to government to maintain a predictable regulatory and fiscal regime for new energy sectors just as for the existing areas including oil and gas. For this capital to be provided most efficiently, clear alignment between financial models and policy is needed to ensure momentum.

In this context, government commitment to medium- and long-term business models has begun to emerge and policy such as we have begun to see within sectors such as CCUS and Hydrogen strategies this year. More direct government funding will also need particularly to drive initial outcomes and open market opportunities.

In October, HM Treasury issued the first green gilt in the UK raising £10 billion which will be used to finance green projects including CCUS and the protection and enhancement of biodiversity. On top of the environmental focus, any activity financed by the bond will be committed to reporting on social co-benefits. This is an important KPI that will support the transition of all parts of the economy and paves the way for future finance expectations. Similarly, setting a time limit for the bond funded activity ensures the attention is focused on delivering now.

Managing growing disclosure expectations

The expectations on companies to ensure they have strong governance, accountability for environmental outcomes and corporate social responsibility is now well embedded in the market. This is something which is not just affecting energy intensive industries. Indeed, all parts of the economy are now expected to have both a clear disclosure strategy and a progressive transition plan.

The UK government has been central to promoting the importance of non-financial disclosures through efforts over the last 12-18 months with the objective of making London a green financial centre.[4] Several new requirements in the UK will be consulted on and introduced in 2022 and 2023 such as:

- Mandatory climate-related financial disclosures by publicly quoted companies, large private companies, and LLPs by 2022.

[4] [Policy paper overview: Greening Finance: A Roadmap to Sustainable Investing - GOV.UK (www.gov.uk)]

- Sustainability Disclosure Requirements across the economy and a sustainable labelling system for investment products.

- Consultation on defining taxonomy aligned activities as per the climate change mitigation and climate change adaptation environmental objectives.

On a sector-level, the increasing focus that the Oil and Gas Authority places on ESG performance under new governance guidance brings an added level of compliance for the sector.

What does the changing policy and investment landscape mean for the oil and gas sector?

As financial and non-financial disclosures are becoming inherently linked to market expectations of companies, it is clear climate related disclosures and ESG requirements are things that is something companies must embrace with both hands. These measures should be seen as an opportunity for companies to be open and transparent about their progress to date on key decarbonisation efforts. These include emissions reductions and the opportunity to be recognised for this. As ESG becomes more deeply ingrained in regulation and policy makers thinking it will be important that ESG reporting continues to be recognised as a journey rather than a destination.

While ESG performance is something which all companies in all sectors must address, oil and gas companies will by their very nature face increased scrutiny. Failure to act on the new ESG requirements will make it much harder to raise finance at affordable rates compared to others. To that end, OGUK has established a new work stream to positively position the industry to meet appropriate ESG criteria and will support industry as it navigates these new expectations.

The UK's opportunity of net-zero, including the £60 billion per annum of investment expected, means that there is capital out there. The challenge will be on how companies unlock it.

Looking ahead – delivering net-zero

Reflecting on the rate of policy intervention and development since our last UK Energy Policy statement, we have made significant progress in several key areas.

- The introduction of the UK Emission Trading scheme in 2Q21.

- The revised policy cost of carbon figures that have largely succeeded in recognising the externalities of carbon.

- The continued development of investable and long-term low carbon business models; CCUS and hydrogen.

- Support and promotion of the objectives set by the TCFD across the whole economy will be critical in seeing clarity and promoting confidence in the UK economy.

OGUK believes that to continue to accelerate net-zero opportunities at pace, further consideration should be given to ensuring the policy framework supports the step-change in investment needed. This includes the introduction of frameworks and other investment classifications, such as the UK taxonomy, to support investment into all energy sources and products needed to deliver the energy transition. Furthermore, it is important that UK businesses continue to be globally competitive, and consideration should be given to how industries in the UK can be supported as they undergo essential decarbonisation whilst retaining in the UK. This includes the opportunity for measures such as Carbon Border Adjustment Mechanisms.

Ensuring fit-for-purpose policies in the UK will be critical to anchoring industry and companies that will be key for delivering the energy transition on an economy wide level. The UK government should remain alert to the risk of carbon leakage and remain focused on the ambitions to be a global leader in net-zero whilst retaining a prosperous economy.