



**POLITICAL
INTELLIGENCE**

Obstacles to Net Zero

Regulatory



Introduction

World leaders have not done enough to deliver on their [Glasgow Climate Pact](#) commitments. That was the frank assessment of Alok Sharma, the UK's COP26 President, at an event in May to mark six months since almost 200 nations signed the agreement at the UN Climate Change Conference. He acknowledged the world had changed since he had fought back tears and apologised after a late amendment on coal was added to the COP26 deal. War has returned to Europe, inflation is spiking, debt is mounting, energy prices are rising, and people are struggling to feed their families as the world continues to deal with the shock of the Covid pandemic, he said. "[But frankly we need to up the pace](#)," he added. When countries meet in November at COP27 in Sharm El-Sheikh in Egypt, they must show a global audience, "that though the world has changed, our resolve has not."

Hosting COP26 helped spur the UK government to try and lead by example on climate change policy. The government's [Net Zero Strategy](#)—published just before the UN conference—set out the UK's ambition to reach net zero emissions by 2050. Since then, the focus has inevitably shifted to how the climate targets will be met. "It is easy for the government to have the rhetoric and goals of achieving net zero, yet this cannot be done without making hard choices," Lord John Krebs, Professor of Zoology at Oxford University and an active participant in the Environment Act passing through the House of Lords, told Dods Political Intelligence.

To shed light on the challenges the government faces in delivering its climate change policy, Dods Political Intelligence has produced four short reports, each exploring a key obstacle to net zero: economic and financial, regulatory, technological, and social. The final report also includes a case study of how these challenges are playing out in the drive to green the NHS, the world's first national health service to commit to reaching net zero.

This second report in the Obstacles to Net Zero series explores the regulatory challenges to reaching net zero, such as Solvency II, litigation, energy regulation and the social discount rates.

Report by Catherine Fredette, Michael Thorogood, Dr Joshua Wells, Helen Hill and Alexandra Ming.





Solvency II

The government's own environmental and climate governance structures represent a key challenge for achieving the UK's net zero target. As the UK seeks to improve financial services regulation after Brexit, Solvency II has come into the spotlight as an area in need of reform. Solvency II sets out the regulatory requirements for insurance firms and groups in the European Union, covering financial resources, governance and accountability, risk assessment and management, supervision, reporting and public disclosure.

Although considered a major regulatory accomplishment for the sector and the bloc when it was developed, Solvency II is a product of its time. When it was agreed in 2014, EU member countries and stakeholders were primarily concerned with creating a harmonious regime across the bloc and ensuring financial stability and security in the wake of the financial crisis. Since then, the UK has left the EU, endured a pandemic, [and committed to being the world's first 'green finance' hub, aiming to channel £130tn worth of private assets towards funding net zero by 2050.](#)

It remains to be seen if the government's plans to reform the Solvency II regime will support a push towards a net zero economy or prioritize slashing climate risk red tape over climate risk. If the [speech](#) by the then Economic Secretary to the Treasury John Glenn to the Association of British Insurers in February is to be taken as any indication, the government is largely focused on making the UK's solvency regime less burdensome, more agile, and more attractive for innovative investment. Proposed reforms include a substantial reduction in the risk margin, increased flexibility to allow insurers to invest in long-term assets, and a meaningful reduction in the current administrative and reporting burden on firms. The government claims this will unlock tens of billions of pounds for insurance firms to invest in long-term growth and UK infrastructure. While there is potential for such unleashed capital to be directed towards climate goals, net zero ambitions are not a central concern of the reforms.

Lord Jonathan Oates, a long-time Liberal Democrats election and policy advisor, has been a consistent voice in parliament criticising the UK regulators' pricing of risk in terms of climate. He has said he plans to put forward a Private Members' Bill in the House of Lords in the coming year, which he hopes will challenge the government to think of climate change more seriously in the context of Solvency II. His view is that while quantitatively modelling investment in relation to climate risk is a complex challenge, we know the climate impact of certain things, such as burning coal, will be significant and severe. He argues that there are simple and basic risk principles that are not being applied, which means climate-damaging investments carry a lower risk premium than they should.

Huw Evans, on his final day as director general of the Association of British Insurers (ABI) in December 2021, said that under the current (re)insurance regime, it is [easier to invest](#) in a mining company than a wind farm. "Are we serious about funding Net Zero? If so, not to use the immense investment power of the UK's world-leading long-term savings and insurance sector would be a massive mistake," he said. While the technical particulars of Solvency II reforms are complicated, the choice to integrate net zero goals into the regime is simple. Until climate-related risks are underwritten appropriately, the insurance sector will be an obstacle for investment in sustainability, rather than an asset.



Setting a new precedent for litigation

The road to net zero is also a legal tightrope with lawsuits over climate action or inaction becoming more commonplace. Courts are increasingly being asked to rule on whether companies and governments can be forced to act on their net zero commitments, setting legal precedents that will be referred to for years to come. The outcome of such rulings could be pivotal in deciding whether climate pledges can force tangible action or are just a load of hot air. Governments worldwide are facing lawsuits for introducing climate policies deemed too heavy-handed by some, yet too weak by others.

The UK government is [being sued](#) by campaign group ClientEarth over its Net Zero Strategy. ClientEarth argues the strategy fails to meet legally binding carbon budgets and would therefore impact young people's right to life, a view the government rejects. Companies are being sued too, with a [Dutch civil court ruling](#) in May 2021 that Shell must cut its CO2 emissions by 45 percent compared to 2019 levels, representing the first time a company has been legally obliged to align with the Paris climate agreement. While the case brought forward by over 17,000 Dutch citizens only applies in the Netherlands, it has been seen as a precedent-setting judgement.

A prime example of the legal complexity surrounding climate change policy is evident in the [Energy Charter Treaty](#), which provides a multilateral framework for energy cooperation. The Treaty—which entered into force in 1998—aims to protect foreign investments against non-commercial risks but has enabled some energy companies to sue governments for lost profits owing to the implementation of climate policies. A recent [study](#) by campaign group Global Justice Now found that five fossil fuel companies were suing governments for more than \$18bn over the introduction of climate policies which they claimed breached existing agreements and undermined their operations. UK-based law firms have represented the companies involved in these cases, which Global Justice Now warns could drastically inflate the cost of climate action, "suing governments into a state of climate paralysis."

The lawsuits, which are demanding almost as much in compensation as wealthy countries offer to low-income countries in climate finance, include companies suing governments over decisions to phase out coal, bans on offshore oil drilling, and requiring environmental impact assessments. The companies argue that they should be compensated for climate change-related decisions to revoke existing agreements or change the rules after long-term investment decisions have been made. While the UK government has not yet been sued under the treaty, the UK is a hub for the Investor-State Dispute Settlement legal process under which the demands are being made, and UK-based energy companies are among those taking legal action.

In the UK, observers suggest there is also potential for flashpoints to emerge. For example, the government's [Energy Security Strategy](#) published in April 2022 confirmed that there will be a role for oil and gas in the short-term as a key transitional fuel on the road to net zero, with a new licensing round planned in the autumn. However, the International Energy Agency has [warned](#) last year that no new fossil fuel exploration and development should take place in future to keep the world on track with 1.5C of warming. The UK financial sector has also faced [criticism](#) from environmental campaigners in recent months for pumping billions into new oil and gas production despite their own net zero pledges.

Experts suggest that litigation by campaign groups and energy companies is set to become an [established](#) mechanism by which stakeholders can stimulate public debate and shape the



outcome of climate policies. Rulings in the coming months could set a precedent that could determine the fate of the UK's net zero commitments for decades to come.

Regulatory hurdles and shortfalls

While the UK retained much of the EU's regulatory framework following its departure from the bloc, there remain significant areas of ambiguity. Chief among these is the role of the energy regulator, Ofgem, in ensuring delivery of net zero, especially given its changing responsibilities after Brexit, for example on electricity licence conditions. Ofgem is required to be independent from the government, yet ministers are also required to advise regulators on how they can help achieve social or environmental goals.

Without statutory limitations on its influence, Ofgem has significant autonomy in deciding how it delivers these duties and balances them alongside other commitments, such as to ensure energy security, promote healthy competition in the energy market and protect consumers. Given these other responsibilities, some law firms say Ofgem is likely to approach net zero with a cost-benefit approach that weighs up the costs of climate action alongside the possible impact on consumers and the industry, especially at a time of significant pressure from soaring energy prices.

This means that energy system decarbonisation may only proceed at a pace that ongoing crises and other considerations allow. In this light, both Ofgem and the Department for Business, Energy and Industrial Strategy (BEIS) have [supported](#) the creation of an independent Future System Operator (FSO) to consider long-term energy challenges and support the net zero transition. This would involve a prominent role in network planning and offering advice across the energy system on decarbonisation, including to the government and Ofgem. However, it too will have to balance net zero alongside other key considerations, such as market stability and consumer costs.

There are other regulatory hurdles to net zero that the government must overcome. Energy Performance Certificate (EPC) rules mean that replacing a gas boiler with a heat pump can paradoxically lower a home's energy efficiency rating and potentially the property's value too. This owes to the fact that EPCs are currently based on estimation of costs to heat a home, rather than the emissions generated, and while heat pumps produce less emissions than burning gas, they are not necessarily cheaper to run and can increase energy use.

Such regulation could inhibit the uptake of more energy-efficient home improvements, prompting the government to look into [overhauling EPC rules](#), with meetings held with industry earlier this year to discuss a possible rule change.

Projects in the UK are also subject to cost-benefit evaluation by analysts in each government department according to Treasury guidelines set out in [The Green Book](#). The discount rate used in the Green Book is known as the 'social time preference rate' (STPR)—an estimate of how society values consumption at different points in time—and is set at 3.5 percent. The importance of the social time preference rate can be seen by contrasting analysis performed by Nobel prize-winning climate economist William Nordhaus, and Lord Nicholas Stern. Stern produced [The Economics of Climate Change: The Stern Review](#), which was commissioned by the government and helped inform its approach to climate economics. Nordhaus in contrast



developed the DICE model of climate economics, which has also had a strong impact on public policy and was adopted by the US Environmental Protection Agency. The two approaches reach different conclusions about the extent to which climate change should be addressed which they acknowledge stems from their different estimates of the social discount rate. The government has been aware of the issues raised by discount rates since at least 2008 when a [Treasury Committee report](#) dedicated a subsection to issues raised in the Stern Review to discount rates.

Consider a possible proposal to building a wind farm, using cost benefit analysis. Let's imagine it costs £4m to build a wind farm now, and that it is predicted to produce £6m of benefit by 2050. The governments discount rate of 3.5% values a 6m benefit by 2050 and a 4m cost now at – £214,000, so the costs of building the wind farm are greater than the benefits from it.

A lot of work in our wind farm example is being done by this 3.5% number. Consider the same wind farm, yet in this scenario there is one change, the government uses a discount rate of 2%. In this scenario the cost benefit analysis tells us that the wind farm produces a benefit of £278k. The building of the wind farm is endorsed with a lower discount rate but rejected with a higher one. This illustrates why the social discount is such a powerful number, it can determine whether an infrastructure is worthwhile or not, and presents a potentially significant barrier to policy, particularly if it is set too high.

About Dods Political Intelligence

We provide insight, intelligence and impact through our comprehensive suite of policy tools. Our services comprise of three main elements: *Dods Consultancy* – based in Brussels and London, our industry experts offer real-time analysis and impartial guidance on the latest policy developments and trends. *Dods Monitoring* – our recently relaunched platform offers instant alerts and contextual insight from over 13,000 sources across the UK and the EU. *Dods People* – the original who is who in politics, Dods Parliamentary Companion, was established in 1832. Today, our stakeholder management tools cover the UK and the EU, helping you identify and communicate effectively with key contacts.

Contact Us

For further information, please visit dodspoliticalintelligence.com or contact us at customer.service@dodsgroup.com or UK customer service +44 207 593 5500 or EU customer service +32 274 182 30