

Impact of short-term challenges on the net-zero transition





- 4** Global risk landscape
- 8** And what of the impact on green energy and transition?
- 11** How firms can buttress their business models against these global currents and pressures
- 12** Conclusion

Contents



For many, 2022 will be a year of turmoil and tipping points. After emerging from the pandemic, our optimism was stymied by geopolitical tension and inflation. One constant that has remained has been the global drive towards a net-zero future.

At COP27, we saw world leaders gather once again in Egypt to progress commitments and plans to mitigate climate change. The challenges of galvanising change were highlighted a year earlier during COP26 – as Alok Sharma, COP26 president, notably stated at the end of the Glasgow gathering: *“We can now say with credibility that we have kept 1.5 degrees alive. But its pulse is weak and it will survive only if we keep our promises and translate commitments into rapid action”*.

Despite this cautionary message, COP27 demonstrated that the pace of change is dictated by more than the diminishing viability of the 1.5°C target. One key promise from COP26 was for governments to revisit government commitments to national CO₂ reduction plans. Of the 193 countries that made commitments at COP26, in the lead up to COP27, only 28 returned in the interim¹

with revised targets and plans. In addition, very few of these submissions were net positive or better.

Global inter-connectivity (including international trade, support, and migration), collaboration, and co-operation are essential for addressing climate change. However, there are several global risks and trends altering the backdrop against which we are striving for a net-zero future. The question is, are these trends here to stay, and what does this mean for businesses? To answer this, we need to explore how recent geo-political unrest, inflation, and wider realities of the growth cycle are changing the world around us.

¹ 28 member firms correct as at mid September 2022, last noted reporting of changes to commitments

Global risk landscape – the impact of macro shocks on climate transition strategy

One of the biggest challenges of 2022 has been the Russia-Ukraine conflict and the impact it has had on the rest of the world. The speed and severity of action has caught many dependent countries unprepared. Resulting back-up plans, and the implications of commodity supply change, have driven significant direct and indirect inflationary pressures into the wider global economy. Sanctions have taken effect and are reshaping market pricing (see following rebased commodity and gas pricing last 24 months). This has led to steep increases in wholesale gas pricing and subsequently to many countries having to change their energy mix strategies. The weaponisation of economic theory via fuel supply is not a new phenomena, on either the supply or demand side. However, the focus on energy affordability over the last 20 years saw a reduced focus on energy security concerns.

For example, Germany, the worlds fourth biggest economy, had been highly reliant on Russian gas for both domestic and industrial purposes for some years — it was not alone. In light of mounting issues relating to energy provision from Russia and the sanction-related closing of Nordstream 2 gas from the East, a rethink of provision has been required for winter 2022/23. This supply-side dependency was not prioritised 18 months ago, clearly a great deal has changed.

To highlight this risk, recent warnings from the International Energy Agency (IEA)² urged governments not to be complacent with their plans

and supplies for this winter – a salutary warning. This caution has been heeded, but circumstance, political allies, and affordability are all factors affecting the rapidly adjusted plans and approaches of governments; this has been notable in Europe, but this issue has echoed across the World.

Looking closer at Western and Central Europe, EU constituents have relied heavily on Russian gas for many reasons, including proximity, price, volume, availability, and green considerations. As well as these wider economic benefits, cheap gas from the East to dislocate heavier hydrocarbon fuels was always a given as part of climate transition planning.

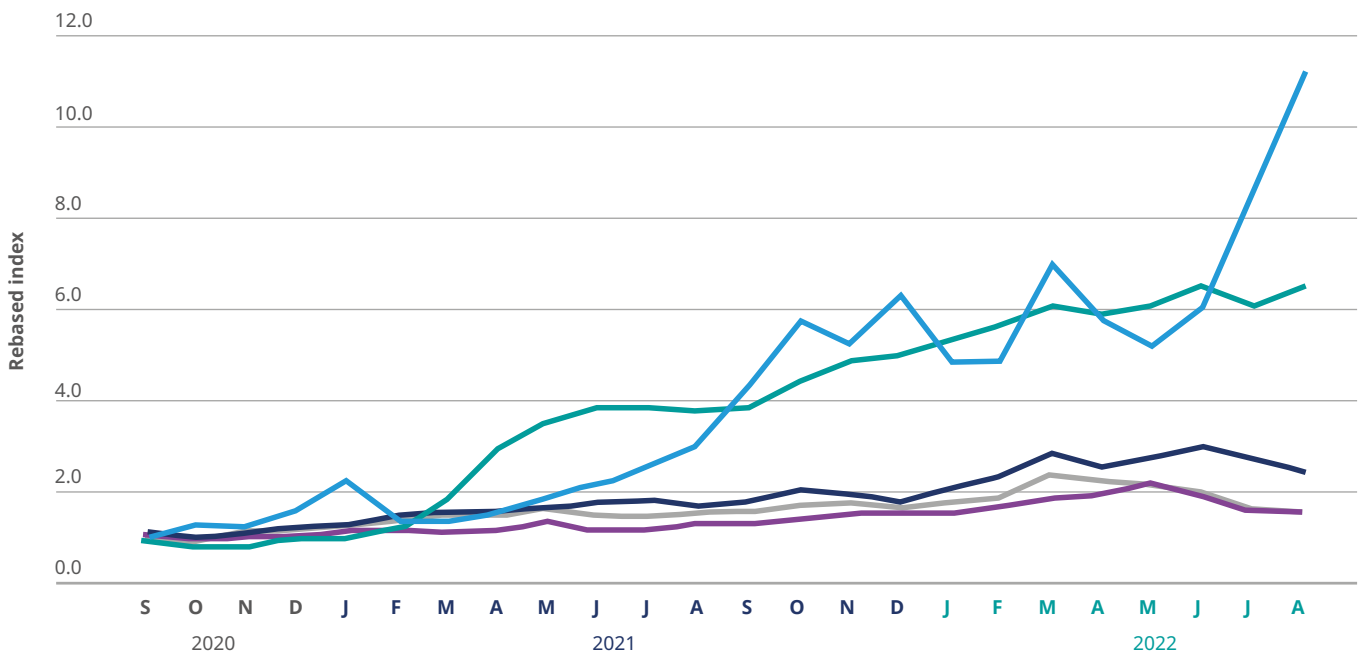
Now, natural gas price rises are out-stripping many other commodities, which in-and-of-themselves were bad enough due to post-pandemic demand-side increases. When coupled with capacity constraints, again related to the Russia-Ukraine conflict (note 2019 wheat and cooking oil exports from Ukraine below), one can see the drivers and leading indicators of inflation and how they track back to the conflict. The below graphs highlight the enormity of the pressure that now can be felt by all – considering these realities, keeping people fed and warm this winter is becoming the key political priority and transition priorities have, temporarily, taken a back seat.

² [International Energy Agency 'Alarm Bell' article](#)



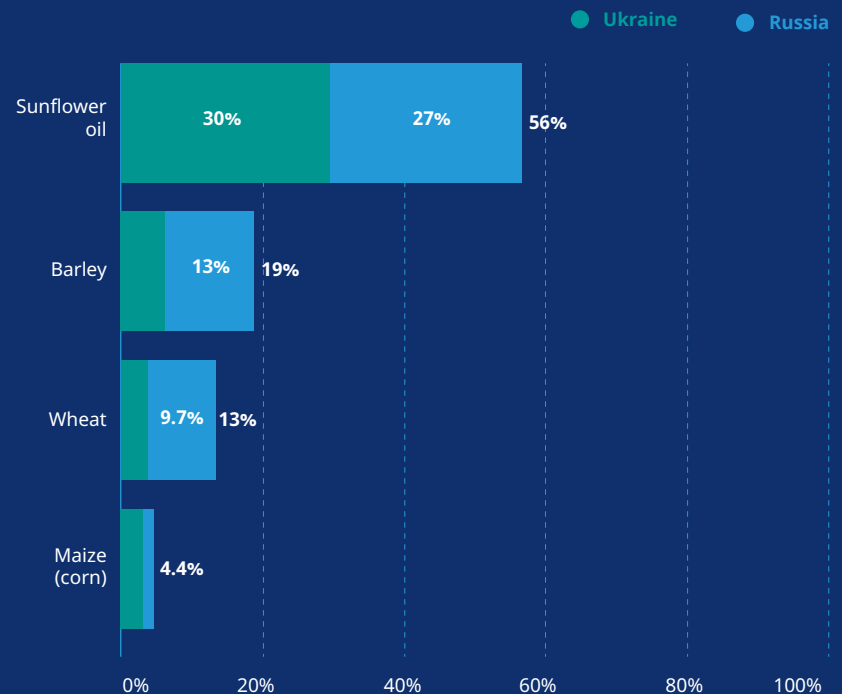
01| Global indexed inflation indicators last two years³

- Global natural gas price
- Brent crude per barrell
- Global vegetable oil price
- Global wheat price
- US CPI



³ Source Statista and Marsh economic data

02| Ukraine and Russian historic supply (2019) of foods as percentage of global market⁴



With all the unanticipated supply and inflationary pressures on countries, and importantly their voting public, governments have pivoted their priorities. The manifestation of this was seen at COP27, where the progress between COP26 and COP27 was not as great as was hoped. The contrary argument to this issue is that climate is a long-run strategy, governments cannot affect long-term change if they are not in power, and empowered, to maintain this long-run mandate.

Overall, a balanced view of priorities, across a longer-term change agenda for climate must be managed by respective and successive governments. This is essentially a case of political expediency and the voters' hierarchy of needs in action — the choice between staying comfortable and productive now, versus longer term issues.

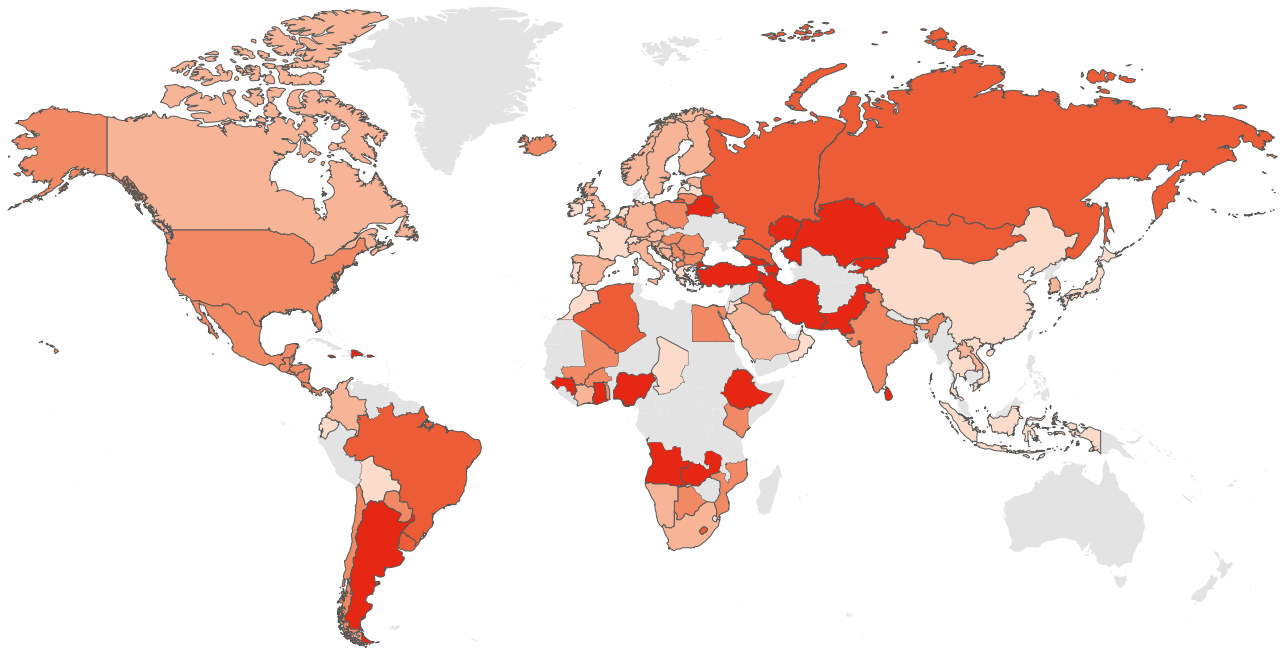
What we can see clearly today is that commitments made, in a safer, growing, more prosperous world of 12 months ago at COP26, are now strained and tangential infrastructure and trade policies are under review.

The Russia-Ukraine conflict has placed significant pressure on countries who rely on effected food imports from the region; dissatisfaction at the shops is the direct manifestation of this economic trade reality.

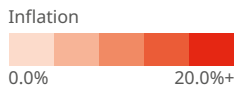
When this is matched against the embargoes on energy provision of Russian hydrocarbons, we see a wide array of upwards supply-side pressures. This pricing issue, coming off the back of a rebound to productivity post COVID-19, has seen dramatic shifts on numerous price fundamentals; with wide ranging knock-on producer and input price inflation pressures compounding together (see below inflation map, from Covid's arrival to conflict in Ukraine inception) across the globe.

⁴ Source Our World in data

03| Global inflation from the start of Covid to the conflict in Eastern Europe



Source: MapBox, OpenStreetMap and Statista



Map based on Longitude (generated) and Latitude (generated). Colour shows sum of Inflation. Details are shown for Country. The data filtered on Modified inflation, which keeps non-Null values only.

Although not all of the world’s inflationary woes can be levelled solely at COVID-19 and dynamics relating to the Russia-Ukraine conflict, there is certainly a marked component on top of “normal” steady-state monetarist policies and challenges.

Notably, 2022 is set to be the year with the greatest consumption of coal, and certainly the first year consumption has increased since 2013’s peak. Consumption this year is predicted to top 8 billion tonnes globally. Given the various commitments to coal reduction at COP26, this increased level of coal utilisation is concerning. It is not yet clear whether this is a short-term blip or a worrying trend, but the financial markets have reacted accordingly with coal grades rising steeply. All of this could have significant implications for businesses downstream, particularly from an ESG standpoint.

EDF, the French power national, announced that they will be reinstating all 56 nuclear power stations to meet demands in France. The inclusion of nuclear in the green mix has been hotly debated across the EU with a significant bifurcation of members — on one side France leading the charge for nuclear as a green option, with Germany leading a group that leans towards other options. When contextualising these country level macroeconomics and policies, it is evident that this energy provision and the security of supply is a key example of the potential impact these decisions may have on businesses from an ESG, business planning, and strategic risk management standpoint.

And what of the impact on green energy and transition?

Local energy policy is equally fraught; to some extent, the proximity to business has a more immediate impact on risk considerations and approach. In the UK, there has been some noted back and forth on the contentious fracking agenda. The three-year moratorium on fracking was recently lifted by at the time Business secretary Jacob Rees-Mogg⁵, as attention was placed on domestic energy needs and almost immediately reinstated by his successor. This speaks to a more self-reliant approach to power and energy, certainly from the UK, but also highlights the shifting sands of politics and how energy policy and risk for business can be affected. This policy shift and reverse was during a particularly and uncharacteristically unstable time of politics in the UK, but certainly paints a picture of how energy polarises politics and intersects with commerce.

This example, while it talks to hydrocarbon opportunity and security, highlights a trend of near/on-shoring energy (value chains) where possible; this trend is a perfect opportunity for the green energy agenda. While there has been some regressive activity, there is some light at the end of the tunnel driven by government policy and stimuli.

Governments and supra-national bodies, to amplify these new alternative renewable dynamics, have latterly chosen to intercede in laissez-faire dynamics. The existential challenge for said economies is the extent to which they *interfere* in markets dynamics, to set conditions for their desired energy mix; especially key now in a transition context. We have to look no further than renewables as a prime example where market interference and intervention (stimulus

supply-side support, price tariffs, central land planning, and state ownership) can lead to inefficiencies as policies are exploited.

The case for and against free market economies or government intervention and regulation in power is ongoing and always will be. The case for '*market intervention*' to shape capital distribution and the electricity generation mix can be seen across many regimes (free-market or state managed), with varying degrees of success; they all seek the same nirvana of energy security, but at the cheapest price or at least an affordable one.

In the case of renewables, it is however fair to say, that the profit motive has needed stimulus, as low investment returns and IRR's and tech and supply chain risk have led to modest institutional up take. To get passed this notion of investability of these assets, and to create a stimulus seed of growth or a *green injection*, governments have mostly acted to bring the market pricing in-line with brown comparable generation assets. We need to look no further than the Biden administrations recent IRA (Inflation Reduction Act) that has sought, amongst wider measures, to stimulate growth by tax and tariff measures with noted positive impact on renewables. When considered against the backdrop of increased trade costs and manufacturing across the renewables sector in the EU, the strides taken in the US to stimulate the market are particularly poignant.

This interventionist approach will likely continue for reasons of timings and alignment of interest; potentially tapering off as allocation of resources and profits normalise with the success of the maturing market forces. The challenge lies in that

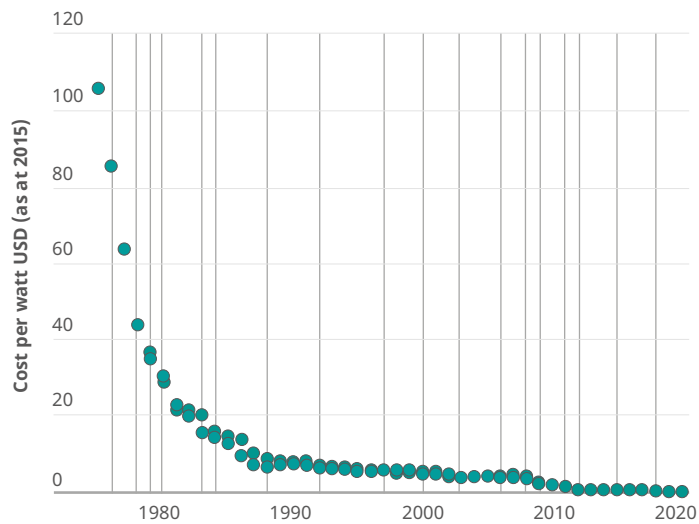
⁵ [Fracking ban lifted](#)



governments (read federal/government employees and not politicians) are typically planning 15-100 years ahead, while the private sector at best 10-20 years in the case of pension funds (but more likely 1-5 years). This timing profile is aligned to their stakeholders' needs and investment and risk tolerance, but also what they can reasonably control and manage.

To align the short and long term imperatives of 'returns' (financial and/or social value), we will likely see that governments with the most aggressive net-zero targets will need to continue to stimulate the transition, through tariffs, incentives, or indeed direct investment. These 'help-ups' will set conditions for an ongoing spur to the factors of production: land, labour, technology and capital; and in doing so will drive how they hit their prescribed and desired over the horizon GHG aims. This, however, must go beyond domestic borders in order to support a just transition for developing nations – and in turn drive opportunities in these locations.

04| Solar PV module cost 1970-2020



Source: Bloomberg and International Energy Agency (IEA)

Vertical lines show each doubling of cumulative capacity installed.

If active support of this green power market paradigm isn't continued, notwithstanding dramatically improving capex investment costs, we will likely see targets missed at national level for GHG plans - the very real risk is a failure to *take-off* without a government *shove* all the way down the *green* runway.

Once stimulus is injected, then free markets naturally step in, and indeed they are — solar panel price reduction in last 40 years (see above) a prime example of increased cost and production efficiency (capex to KWh capacity) leading to less state led pricing support (tariffs are dropping/ gone). Ultimately we must look to free markets and a better competitive market for renewables to stand on their own feet, to drive innovation, capital efficiency and allocation of capital, and ultimately drive the market space for green energy projects going forwards.

The ability of developed nations to shift their attentions may highlight the possibility for a just transition – or at least open the door for discussion.



It is important to note that these decisions addressing the potential energy issues relating to the Russia-Ukraine conflict are borne out of access and the privilege of choice. The need to adjust the energy mix to ensure energy security is not dissimilar to the challenges faced by developing countries as they look to transition to net-zero – while transitioning societally – in a smooth and secure way.

Indeed, the parallels shed much-needed light on the complexities of balancing the use of available resource against net-zero ambitions in these developing countries – particularly when the need for support and investment from developed nations is tied to these decisions.

So far, a number of expected outcomes or Nationally Determined Commitments (NDCs) on GHGs have not moved forward for developing and developed nations alike, seemingly driven by recent economic pressures; the noted modest progress from COP26 to COP27 typifying this. This regression must be considered across the long-game – particularly in light of current inflationary pressures and pending recessions. For a just transition, with conversely

some good steps at COP27, developing and developed nations will need to play their part, while recognising developmental maturity and economic scale such that everyone does their part, at the appropriate time.

Clearly, central governments are taking a positive stimulus role in driving their, and societies, green energy agenda and not relying on free market only drivers. What will now be key, as a global family with collective consequence and desire, is to pull along lagging countries and regimes, with trade and cooperation incentives. This ‘coalition of the willing’, and the support and ‘nudging’ that will go with it, will be increasingly important as countries continue to develop at a different paces, with their own short-term needs competing with the longer-term energy transition agenda. For the various states and inter-governmental actors, collaboration will be the enduring totem to support in order to continue to move in the right direction – climate change, now more than ever, is everyone’s collective responsibility to solve.

How firms can buttress their business models against these global currents and pressures

What can be seen now in terms of conflict in Eastern Europe and inflation, will likely and sadly be seen again over the horizon as we journey to a net-zero future over the coming years. As politically motivated energy policy sharpens — balancing as ever national security needs against the new environmental considerations — we will see a (fundamental) tightening of traditional hydrocarbon supply. This tightening is the goal, but geopolitical / energy security pressures may continue to impact the journey.

This slow, but inevitable, as both a function of environmental considerations but also as a finite resource, restriction will have impact on the full spectrum of business models going forward — regardless of size, geography, or reliance. Changes to the risk landscape, by direct impact or value chain association, will be noteworthy and few businesses will be able to comprehensively isolate in their commercial and operating models.

Conversely, opportunity for those that embrace the transition will no doubt manifest. New sources of green aligned and positive capital, creation of new markets, and interconnection opportunities will likely increase in availability. The upside and downside to the economics of transition risk will now need to be considered fully in corporate strategy — not just as a procurement 'price-at-the-pumps' issue, but to the wider knock-on effects to many basic demand and supply side factors.

Whether it's the distribution of new green money and capital from financial institutions to a mega Cap listed entity or the single person trader considering their customers changing needs, energy security, cost, sourcing, and how this will change over the next 30 years must now be added into the risk matrix of any and all business plans.

At the most basic level, the provision of electricity and fuel is a central construct of economic stability and prosperity. With many European nations unsettled in their energy security, the fluidity of the net-zero transition journey has been brought to the surface. Fundamentally, business managers and leaders across all functions (regardless of scale) now need to add energy transition risk considerations into their thought process and risk appreciation and subsequent management process. Supply chains and business processes, including risk, interruption, capital sourcing, pricing, levies, and tariffs, to name but a few, will at worst need adaption; at best, they will require revisiting as the old paradigms and cornerstones of a business change – a once in a generation economic factor shift. Despite the long-term nature of net-zero objectives, the path is susceptible to macro shocks and impacts. What must be managed with greater cross-business focus is the operational and commercial implications, considering additional resilience and control measures to manage these emerging risk factors.



Conclusion

What has happened in Eastern Europe has reverberated across global energy markets. The ramifications and knock-on effect to consumers, governments, and business are and will be felt for some time. The impact on how, where, and at what price we pay for our energy has been solidly felt, but this paradigm echoes through history. The new major difference between today and the past is the implications to climate change and how these long-term policies are being affected by short-term global issues. This sadly will not be the last time that challenges will have to be accommodated on the path to a net-zero future. As such, government, business, and society will need to be adept at course correcting immediate shorter-term issues with the eye on the longer-term climate approach.

This balance of short to long-term risk and reward and value creation for corporates, against a longer-term climate agenda, will need global micro economies that can accommodate and adapt to smooth the path going forwards. This built-in corporate level mind set of agility and resilience will afford business leaders, of now and the future, the ability to not only manage for the downside of transition risk, but also harness new opportunity as well. Embracing the net-zero transition will become a differentiating leadership factor over the next 10 years.

The question now for owners, operators, and employees in all firms will be the extent to which they can face the challenge head-on, build resilience around this emerging long-term risk trend, and turn change into commercial advantage.

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