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Adaptive Regulation and the Green transition

Reshaping regulatory uncertainty to lower the cost of green investment

Key Policy Recommendation

- Provide the clarity of an **underlying vision** and its **direction of travel** to **secure private capital engagement** in financing the green transition.
- Develop the **pathway for adaptive regulation** that is consistent with the underlying vision.

The impact of not moving to adaptive regulation

- **Securing investors' confidence is essential** in securing the financial support necessary to implement the green transition given that, at least, **70% of the green transition cost have to be financed by the private sector**.
- A **lack of consistent green policies**, and **weak governmental commitment** to green policies, **delay private investments** and make non-green investments more attractive. This may have a detrimental effect on climate, and make future policies more onerous and costly.
- **Policy uncertainty increases risk of investments**, leading investors to demand greater returns on any investments that they make.
- The increase in the returns demanded by investors **increases the cost to households and reduces the competitiveness of the UK economy** on international markets.
- Increasing the cost of basic utilities (water, energy) **increases social inequality** given that a **higher cost of utilities has greater impact on poor households** than on rich households. The **income share of utility bills of poor households is three times that of rich households**.

According to the Climate Change Committee, **in order to meet the Net-Zero target**, the UK has to increase its low-carbon investments from £10bn per year in 2020 to around £50bn per year by 2030.

The need for Adaptive Regulation

The UK lags behind her major European competitors in investing in low-carbon energy policies (electricity networks, energy efficiency, innovation on fuels and technology, low-carbon and efficient transport and low-carbon electricity)

In the period 2000-2023, the UK's spending on low-carbon energy policies per capita was USD1,100, while in Germany it was USD4,050, in Italy USD2,950, in France USD2,200 and in Spain USD1,850.

Renewable energy capacity building in the UK has likewise seen slowdown. In 2023, the UK capacity increased only by 2.7GW (considerably less than the peak of 6.0 GW in 2015). At the same time the UK's dependency on primary fuel imports is rising (it was 34.2% in 2019 (pre-Covid) and 40.8% in 2023).

The limited progress is reflected in opinion polls. DESNZ's survey shows that, in 2022, 56% of the UK's residents were very concerned that the UK is not investing fast enough in alternative sources of energy (increase from 23% in 2020). Yet, the sustainability agenda is often perceived as unattractive by businesses.

Accenture's survey of big international companies shows that one in five CFOs in companies with strong ESG capabilities think that focusing on sustainability negatively affects the interests of shareholders; this proportion increases to over six in ten in companies with weak ESG capabilities. Uncertainty and a lack of confidence in the direction of travel of regulators and governments does not help to reduce these attitudes.

To increase the level of engagement of and financing from the private sector, regulatory commitment is needed to reduce the value of waiting on green investments. If there is no clear underlying vision of the green transformation path, it is beneficial for companies to wait before making green investments.

Evidence base

Contrary to arguments made by companies seeking higher return on investment due to uncertainty over the regulation of the green transition, regulation does not have to be set in stone to reduce the risk of investment.

There is a fundamental difference in risk arising from policy changes that are driven by unforeseen circumstances and those caused by a lack of commitment and a lack of credibility of policy makers and regulators.

56% of UK residents are very concerned that the UK is not investing fast enough in alternative sources of energy

(DESNZ survey, 2022. Increase on the 23% reported previously (2020))

Research shows that unanticipated changes in policy do not necessarily lead to investors changing their view on the underlying risks associated with investments, including those leading to achieving Net Zero, and similar social and economic objectives, providing that the changes remain consistent with the underlying vision and its direction of travel.

Regulation does not have to be "rigid" and "inflexible" to achieve the desired outcome.

In fact, given the current level of technological innovation, flexibility in designing regulation and policies is necessary. Modern regulation must be "adaptive" to ensure that it supports the market, it is fit for purpose, and stimulates further development.

Investors' confidence and willingness to invest is not adversely affected when policies change as a response to unforeseen events rather than being driven by political and/or short-term expediency.

Research also shows that investors are sensitive to political debates on the future of regulation even if these debates do not result in any policy changes.

That is, research illustrates that even political debate about changing the vision, rather than the specific change having to have occurred, is sufficient to induce changes in investors perception of risk and the flow of funding. Moreover, these changes in investor perception are consistent with that predicted by economic theory.

The changes in the cost of financing are nontrivial. An 0.5% increase in the cost of capital for energy and water companies would increase the cost to consumers by around £720 million a year.

Implementation

It is essential to design high-level regulatory principles to increase public confidence and investor engagement, and to lower the cost of the green transition. These principles should be developed through consultation with businesses and financial intermediaries as the main private investors and should facilitate:

1. **The development of a broadly accepted valuation and pricing of environmental risk.**
2. **An appropriate balance between risk and reward for both consumers and investors**
3. **A design of appropriate governance oversight and monitoring.**

It is essential that the principles and the direction of travel are set without further delay. It has been 16 years since the UK passed the Climate Change Act which legally binds the UK to reduce its emissions by 80% compared to 1990 levels by 2050. Yet, the direction of travel to achieve this grand target, or even the fundamentals for achieveing it, have not been put in place.

As problematic as it is, it should be perceived as an opportunity to set the principles and the direction of travel that will take into account not only cutting down emissions, but also a much broader spectrum of issues related to the nature protection and restoration.

The change in business and investor attitudes, strategies and practices, will not happen without a clear guidiance, commitment and oversight of the governmental and regulatory bodies.

This policy briefing paper was produced by Prof. Ania Zalewska, Research Chair and Professor of Finance, Director of the Cluster for Finance, Governance and Enterprise, University of Leicester School of Business with the support of the University of Leicester Institute for Policy.

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University of Leicester
University Road
Leicester, LE1 7RH, UK

e: instituteforpolicy@leicester.ac.uk
w: www.le.ac.uk/research/institutes/policy