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By Edward Chancellor

Climate policy requires a more realistic approach

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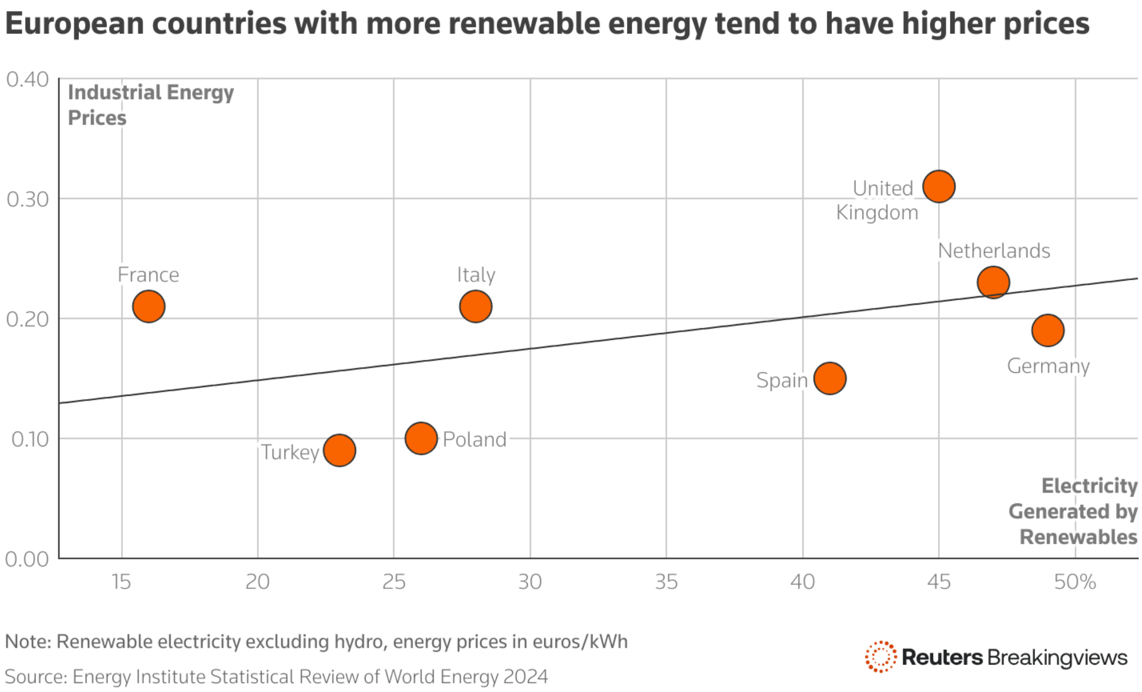
A giant Earth artwork is displayed in the Hintze Hall inside the Natural History Museum in London, Britain, November 30, 2018. REUTERS/Simon Dawson Purchase Licensing Rights, opens new tabs

LONDON, Feb 27 (Reuters Breakingviews) - The pursuit of net zero carbon emissions has been a resounding failure. Despite trillions of dollars spent on renewable energy, hydrocarbons still account for over 80%, opens new tab of the world's primary energy and a similar share of recent increases in energy consumption, according to The Energy Institute. Coal, oil and natural gas production are at record highs. Emissions of greenhouse gases continue to rise inexorably. The financial markets were already losing confidence in the energy transition before Donald Trump returned to the White House. A more realistic approach to climate policy is urgently needed.

Solar and wind power have grown to a mere 3.5% of primary energy production. The levelised cost of renewable energy – which measures of the net present value of electricity produced over a plant's lifetime – has declined sharply over the years. But this has not resulted into lower electricity prices. In fact, as the share of the energy mix provided by renewables has risen, electricity prices have tended to increase. That's because wind and solar power are intermittent. Since storing energy in batteries is uneconomic, traditional sources of power are still needed as backup, which is expensive.

Germany and the United Kingdom, which get a relatively large share of their electricity from renewables, also suffer from the world's highest electricity costs. This is partly due to the Ukraine war, which exposed the risks inherent in Europe's historical dependence on Russian gas and domestic bans on hydraulic fracturing. High energy costs have crippled domestic manufacturing. German industrial production is down 15% from its peak, according to Andy Lees of MacroStrategy Partnership. German chemical company BASF (BASFn.DE), opens new tab last year announced it was scaling back, opens new tab domestic production. Britain's last remaining blast-furnace steelworks at Port Talbot closed last October. "The European Union and the United Kingdom present the sternest warning against attempts to force emissions reductions while neglecting the physical realities that distinguish hydrocarbons from modern renewables, such as wind and solar," Chris Wright, then the CEO of Liberty Energy, wrote, opens new tab last year. Wright is now the U.S. energy secretary.



Scatter plot showing the relationship between industrial energy prices and electricity generated by renewables

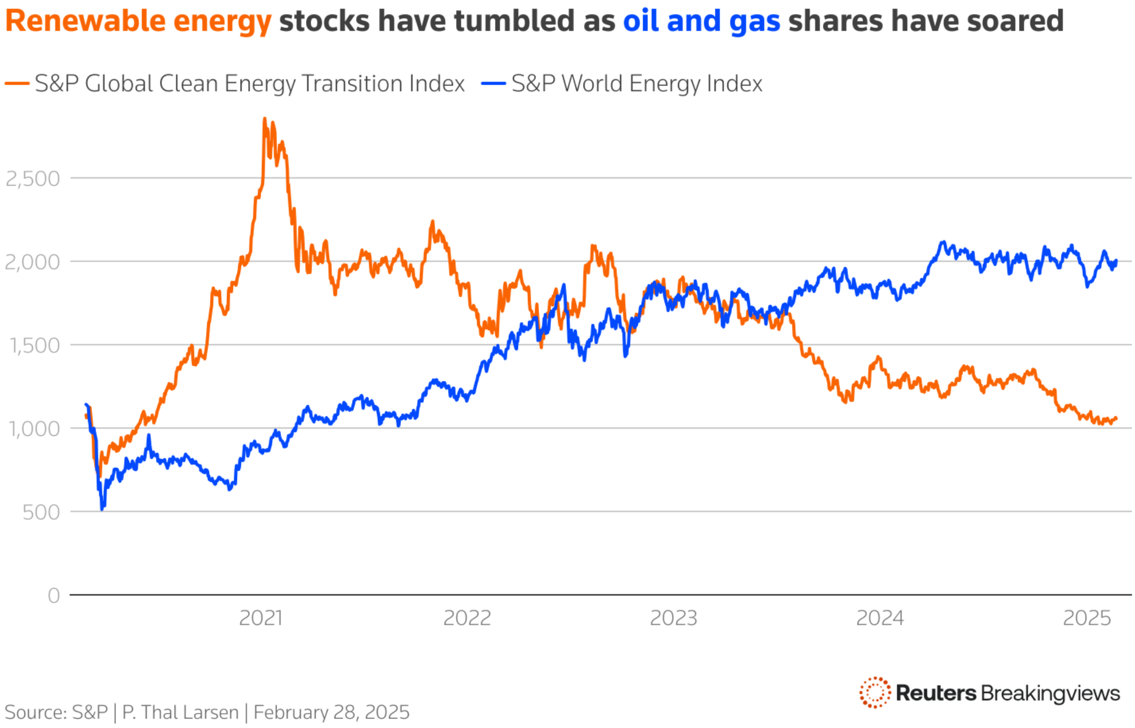
At least the European countries pursuing net zero targets can take comfort that they're doing their bit to reduce global warming, whose effects are already showing up in more intense heatwaves, storms, and floods. That's an illusion, says, opens new tab the energy economist Dieter Helm. Targets for reducing greenhouse gas emissions are measured on territorial production. This incentivises countries to switch from domestic manufacturing to importing energy intensive goods, often from countries such as China and India, whose factories are largely powered by coal-powered electricity. Thus, the reduction in an individual country's emissions can lead to an increase in global emissions.

There's another problem. Addressing climate change is a collective action problem, as hedge fund manager Paul Marshall recently observed. The benefits from lower emissions are shared by the whole world but the costs are borne by individual countries. Global deals like the 2015 Paris climate agreement were an attempt to solve this conundrum. However, they allowed countries like China to keep emitting more carbon, even as it simultaneously ramps up renewable power.

The People's Republic currently consumes more than half the world's annual coal supply and last year started construction of coal-fired electricity plants with an output equivalent to twice Britain's total generating capacity. India, which like China gets most of primary energy from coal, is also rolling out many new coal-fired plants. Meanwhile Trump last month signed an executive order to withdraw the United States, the world's second-largest producer of greenhouse gases, from the Paris Agreement for the second time. The president wants to increase domestic production of oil and gas. His administration hopes cheaper energy – which includes some forms of renewable power - will encourage a U.S. manufacturing renaissance. It also plans to increase exports of natural gas, much of which will end up in Europe.

The energy expert Vaclav Smil has likened, opens new tab the costs of the planned energy transition to those incurred by a nation fighting total war for decades on end. The era of zero interest rates created a sense that the supply of capital was infinite and its cost negligible. Rising interest rates dispelled that illusion. The economics of wind and solar power, with their large upfront investment costs and relatively low operating expenses, have been upended. Wood Mackenzie calculates, opens new tab that every 2 percentage point increase in the risk-free rate raises the levelised cost of renewable electricity by around 20%.

Financial markets have got the message. The S&P Global Clean Energy Transition Index is down around 65% from its peak in early 2021. Over the same period, the S&P World Energy Index, comprised of oil and gas producers, has nearly doubled. Orsted (ORSTED.CO), opens new tab, the world's largest wind farm operator, recently slashed its capital spending plans and dropped its targets for delivering renewable energy.



A line chart of renewable energy stocks

Not long ago, investors worried that traditional energy companies would be left with "stranded assets" – oil and gas fields abandoned as demand for fossil fuels dried up. Yet earlier this month Shell (SHEL.L), opens new tab announced a near-$1 billion writedown for its investment in a wind project off the New Jersey coast. BP (BP.L), opens new tab is scrapping targets for increasing generation of renewable energy and cutting oil and gas production. As Lees writes, "across the sector, oil majors that shifted their portfolios to green energy are now realising their mistake and are looking to rebuild their fossil fuel business."

As the energy companies change tack, institutional investors and banks are unlikely to stand in the way. Earlier this year, BlackRock (BLK.N), opens new tab announced it was withdrawing from the UNconvened Net Zero Asset Managers initiative, which prior to the giant fund manager's departure counted members overseeing some $57 trillion of assets. The largest U.S. banks, including JPMorgan (JPM.N), opens new tab and Citigroup (C.N), opens new tab, have withdrawn from the Net-Zero Banking Alliance.

Energy transitions, as Smil has pointed out repeatedly, take a very long time. There have been successful earlier shifts – from wood to coal, coal to oil, and oil to natural gas. Each was accomplished by market forces rather than government fiat. The world still urgently needs an alternative to fossil fuels. The failure of net zero shows that the best governments can do is to encourage the search for viable new sources of energy. Human ingenuity was responsible for developing fossil fuels which delivered improvements in material prosperity while endangering the planet. It's up to human ingenuity to solve the problem.

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