Response to the Electricity Market Reform Consultation

Energy and environmental policy in the UK is currently on a fundamentally misguided path, which is inconsistent with accumulated evidence and experience on best practice public policy.

At home, current policies and proposals have been widely excoriated by leading economists, notwithstanding the normal diversity of views among practitioners of the dismal science which tends to be observed when difficult issues are being tackled. Abroad, followers of UK policy must be surprised by an approach that seeks to abandon policies in which the UK has led the world – and that have considerable potential to contribute to global progress on climate change issues – in favour of illiberal, central planning of investment, an activity in which past UK performance has typically[1] been more abysmal than in many comparable economies. The principal benefits of the UK's pioneering approach have yet to come, and the due yield on past efforts will therefore be considerably diminished unless the government is now brave enough to think again.

A consensus of economists?

In general, I concur with recent critiques of the EMR proposals by Simon Less, of Policy Exchange, who rightly identifies current trends as involving the *re-monopolisation of power*, and by Graham Shuttleworth and Sean Gammons of NERA, who rightly summarise much of the economic analysis in the EMR documents as *wishful thinking*.

Investment problems are 'made in Westminster'

In relation to the substantive issues, it is true that the UK now has a major problem in attracting required investment into the electricity sector; but that problem is, almost in its entirety, "made in Westminster". The world is awash with capital seeking safe and profitable projects, but that capital will not be attracted by the heightened political and regulatory risk that current policies have created, and that they will continue to create if the current direction of travel is maintained.[2]

Ways forward

There are two major ways forward: steam full ahead with the re-politicisation and re-monopolisation of the power sector, and pay the higher investment costs involved, or return to economic liberalism and enjoy the large investment flows that, globally and

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[1] There are some exceptions but, unlike the present situation, they have tended not to be characterised by unusually high levels of uncertainty about the future.

[2] To avoid any potential misunderstanding, the problem is not that investment will not eventually be made; it is that consumers (principally) and taxpayers will (consistent with the effects of monopolisation more generally) have to pay above, and quite possibly substantially above, market rates for it.

historically, have tended to be attracted by such policies. From historical experience, we know that monopoly can work in the electricity sector – it was, for a long time the preferred approach – although arguably this experience relates to less challenging economic contexts than those that we now face. Recent UK policy, and the experience of others who have followed a similar path (such as Australia and the Nordic countries) shows that competitive market approaches can also work, and, with current information technologies, can be expected to work better than monopoly. What has <u>not</u> been found to work are attempts to combine the two approaches: political and regulatory 'fixes' tend to undermine markets in sectors such as electricity, which are potentially vulnerable to 'crashes'.

There is good reason for this incompatibility. Competitive markets work on the basis that there is no controller who is fixing the results; monopolists fix the results. Government policies based on fixing the results of competitive processes are chimeras: it is like fixing the result of a general election and seeking to pretend that this is democracy.

The cost of monopoly

Since the extra investment costs of centralisation are likely to be high – the last time the UK relied on the centralised approach, power stations cost about twice as much to build as they should have – and since the distributional effects of higher electricity prices are highly regressive (low income households spend proportionately more of their income on energy), it is difficult to understand the current enthusiasm for potentially wasting resources on the grand scale at a time when the incomes of large sections of the public are being hard hit (in large part as a result of the last, major public policy folly associated with neglect of economic fundamentals: banking supervision).

Alternatives

If the main driver of policy is a perceived environmental imperative, there are much simpler and more effective ways of proceeding than, in effect, taking the axe to policies in which the UK has been a world-leader over the past quarter of a century. If the EU ETS is considered insufficient, one of the options is to bolster it with domestic constraints on emissions, for example implemented by a supplementary scheme that bites on the carbon content of energy at the point of sale by suppliers (but similar to the ETS in terms of trading possibilities).

This, like other, workable, alternative options, has the property that it operates at a more aggregate level, and thereby (i) affords more incentives and opportunities for non-state initiatives and (ii) tends to introduce fewer distortions into economic decision making. Problems of policy credibility also tend to be less severe under broad-brush policy approaches than when politicians and civil servants seek to micro-manage markets.

The elephant in the room

In relation to non-environmental objectives, I have already noted that costs, particularly investment costs, can be expected to be higher when government has more influence over market outcomes (and therefore when political/regulatory risk is higher); and the claims to the contrary in the EMR consultation document are simply an example of the wishful thinking identified by Shuttleworth and Gammons. Much of the discussion of risk in the EMR documents is focused on simply shifting risk around[3], typically from companies to consumers and taxpayers, rather than actually reducing it (as implied); and the elephant in the room – the increased political and regulatory risk that the proposals would create, and which is the category of risk that is most problematic for capital markets – is hardly mentioned.

Security of supply

It is not to be expected that the EMR proposals will enhance security of supply either. Theory, recent evidence and historical experience suggest that monopoly, including political monopoly, is more vulnerable to security of supply problems than competitive markets: if one wrong decision can undermine an empire[4], it can certainly destroy an electricity market. As in relation to cost performance, it is relevant to note that the last time this country had major security of supply problems, those problems were intimately related to monopolistic behaviour. Compared with systems in which outcomes are influenced by the many rather than by the few, monopolies have more limited information discovery and processing capabilities, have weaker performance incentives, and have a tendency toward abuse of power and corruption.

The introduction of unwanted moral hazard

Illustrating some of these adverse tendencies, what appear to be the government's currently preferred proposals would introduce a form of moral hazard – in fact a form of double moral hazard (see below) – into the provision of peak capacity: the consultation document is clear, for example, that there the government has a preference for transferring responsibility for maintaining an adequate capacity margin from 'the market' [5] to the

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[3] There are also significant technical flaws in the EMR process's analyses of risk, which should set alarm bells ringing very loudly. Many of the issues in energy policy at the moment are to do with risk management, and, given the transparent lack of Whitehall expertise in this area which is displayed in the EMR documents, the re-nationalization of risk management that is proposed appears ill justified.

[4] See Niall Ferguson's account of the end of the Ming Dynasty in his recent book on Civilization, currently also to be found on Channel 4.

[5] As in many economic policy documents, 'the market' tends to be treated as an abstraction, rather than as a participatory institution, or set of institutions, of civil society. Thus, the arguments for centralisation in current energy policy documents seem to have been written down without any apparent appreciation that they point in a direction that lies approximately 180^0 from the government's 'big society' aspirations. Thus, as if by an invisible hand, do governments, in going about their business, unwittingly promote ends that are no part of their own intentions.

government, but what it doesn't do is fully explore all the risks and unintended, adverse consequences that such a transfer might be expected to bring.

If government does more, other parties can be expected to do less; so a substitution of government action for private action can be expected, a 'big government, small society' sort of effect. But more than this, the availability to government of control over a capacity mechanism provides scope for opportunistic abuse of an apparently technical device to influence market prices at peak periods, prices that are crucial for investment and contracting incentives. For example, faced with a period of high electricity prices, a government will be tempted authorise a reduction, for a period, in capacity margins, in order to reap the perceived political gains of being seen to do something about energy prices; and it is very difficult to provide credible promises that this will not be how a future minister would in fact behave.

It is generally a bad idea to lead future government ministers into temptation in this way; since, when they succumb, as surely they will, the adverse consequences can be expected to be more than personal.

Conclusion

For the above reasons – and for many more – I urge the government to rethink; and, in this context, I add the further comment that such rethinking could feasibly be done quickly, not least because the UK is very well endowed with people with the technical skills required to develop and maintain competitive energy markets (and to carry forward past, innovative UK policymaking into new, environmental policy arenas). And that would be a contribution to global energy/environment policy that would be worth making.

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