Are regulation-driven distortions jeopardising energy markets?

George Yarrow
Regulatory Policy Institute, Oxford, UK
www.rpieurope.org
Pallanza Group seminar
4-6 October 2012, Sestri Levante

The short answer is ...

- Yes, but they are not the only factors of relevance.
- Look first at some of the issues, then at aspects of GB developments as a case study.

Wholesale/retail distinctions

- There are different political pressures at wholesale and retail levels.
- But the issues are not separable: distortions/problems at one market level tend to spread to the other.
- Common problem: there has been faster liberalization at wholesale than retail . Leads to increased risks of failure during the transition. The now classic example is California electricity (2000/1).

Distortion of what?

- Markets are institutions that facilitate trade.
- For much of the twentieth century, and in most places, competitive markets in electricity and gas have not existed.
- The liberalization agenda has therefore been largely about developing the required institutions.
- It can be misleading to think of this energy-sector process in same terms as liberalization of some other sectors in which the central focus has been on removing restrictions placed on *established* market processes (‘de-regulation’).
- May be better to think of ‘dysfunctional developments ’ rather than ‘distortions’, since the latter term suggests something pre-existing and near-perfect (i.e. undistorted) that is being undermined – gets close to the Nirvana fallacy, a common mistake in policy making.

Wholesale market issues

- There is a general, political reluctance to ‘let go’ of regulation of peak prices, particularly in electricity.
- There <u>is</u> an underlying problem to be addressed – vulnerability to market power when systems come under stress due to high demand relative to available capacity.
- But regulation of peak prices is a poor response, because of the severity of its harmful side effects.
- Specifically, capping of peak prices can be expected to chill investment, peak prices being crucial for remunerating investment.
- The unwanted effects in turn give rise to secondary regulatory interventions, giving rise to further side effects, and so on.

Retail pricing: where the politics bites

- There is a historical overhang: voters are familiar with political intervention in energy markets.
- Familiarity stimulates a demand for, or at least acceptance of, political intervention in pricing that is greater than in a number of other markets, on a *ceteris paribus* comparison.
- Competitive energy markets are an institutional innovation of the recent historical period, and have faced the task of establishing legitimacy/acceptance.
- This is a core function of liberalizing regulators, but it is one where performance has recently been poor.
- The critical question: why?

One or two possible answers

- External political pressures, of course, but those are always with regulators, and the point simply pushes things back a level: why do the political pressures vary?
- One obvious answer: upward pricing pressure due chiefly to global demand growth and environmental (climate change) policy pressures. Explains why politicians have sought to ‘take back’ delegated powers, but it doesn’t explain why regulators themselves respond in dysfunctional ways, by appeasement. What is the proper role of the regulator?
- Two conjectures about the motivation for much regulatory conduct nowadays:
  - Playing to the gallery.
  - Bureaucratic sectarianism.

Playing to the gallery

- Beesley lecture 2010 conjecture: "A principal objective of regulators today is *to convey a good impression of themselves*?" Induced a strong positive response from the audience.
- Regulators get caught up in the media cycle, which tends to have a very short time period and to be associated with short attention spans on the parts of its audiences.
- Regulatory PR departments and press releases start to acquire heightened significance within the organisation. Internally, staff are circulated daily with the most recent press cuttings.
- These are matter of *regulatory culture*.
- *De facto, regulators politicise themselves.* The political game is exciting, regulators want to join in, even though this is an abuse of their delegated powers, and arguably unlawful in a number of respects.

Bureaucratic sectarianism

- Good institutional structures tend to be characterised by individual parts of a system pursuing their own, limited objectives in ways that contribute to the effectiveness of the system as a whole.
- The internal organisational structures of government tend to find the required coordination difficult to achieve and sustain. There is no ‘invisible hand’ or ‘selection mechanism’.
- The pursuit of the narrow organisational interest tends to undermine the stability of the institutional structure as a whole. Eg. The conflicts erode the legitimacy of the whole.
- Counteracting pressures/incentives are weak. Cf. markets, which, if they fail to serve their purposes, will simply not be used. That is, selection mechanisms exist at the institutional level.

Britain as a case study

- In 2002 described as “the poster child of global liberalizers” (Economist magazine).
- As late as 2007/8: “In my view, the gold standard for electricity sector reform is England and Wales” (Prof Paul Joskow, MIT, ‘Lessons learned from electricity market liberalization’, *Energy Journal*, 2008)
- Today?
  - ‘The GB wholesale electricity market is more centrally planned than that of Kazakhstan.’ GB now better described as a ‘basket case’.
  - The leader of the Labour Party has proposed the abolition of the regulator, Ofgem.

The wholesale electricity market

- The wholesale market has been taken over by politicians to be an *instrument* of an environmental policy based on central planning.
- The responsible department, DECC, now effectively contracts for supplies at different prices for different types of plant (nuclear, offshore wind, onshore wind, etc.)
- This necessarily affects investment in unsupported (uncontracted) technologies, via higher regulatory uncertainty and higher capital costs.
- It is proposed that a mandatory system of capacity payments, which are akin to 'administered' options contracts, be introduced. Why should anyone think that government will be any good at regulating <u>options prices</u>???
- Result: a government department lacking the necessary resources for the tasks it has been allocated, pursuing an approach that has always failed in the past.

An example of dysfunctional regulatory dynamics: security of supply

- Start with government taking control of investment in nuclear, wind, etc. Highly inefficient in itself.
- This creates unwanted side effects: fear of under-investment in gas, etc., due to the regulatory uncertainty created.
- Hence re-introduce capacity payments, on grounds of need for security of supply.   Adds in a further layer of cost.
- Blame others for this: God has located gas fields in some unfriendly and risky places, so we need nuclear, wind, etc. for security of supply, as well as for environmental reasons.
- Fail to notice that He hasn't. Blackpool? Australia? Canada? USA? ... Precisely when did they become hostile?

Ofgem's own contribution

- In playing to the gallery, and in pursuit of its own bureaucratic agenda, Ofgem contributed directly to the notion that there might be an underlying security of supply problem in Britain.
- 'Shale gas will not be a factor in the GB market until around 2025'. (It already is, via the effects on world prices of US policy.)
- 'Project Discovery' (focused on security of supply issues) was wholly self-initiated and, at best, tangential to the legitimate agenda of the organisation.
- It thereby facilitated the process of the unravelling of the 'gold standard' wholesale market reforms (e.g. Capacity payments, an original feature of the post-privatization markets, had been abolished in 2001, on the basis of evidence that they were not functioning as intended – now they are back on the agenda.)

The retail market: a similar story

- Political pressures to 'do something' about increasing retail energy prices, at least for identifiable groups of consumers (e.g. those on a particular type of tariff).
- Ofgem acquiescence/appeasement:
  - Misuse of procedure: Ofgem initiated an internal retail price probe itself, over which it could maintain control, rather than refer the matter for consideration by the Competition Commission (see points on bureaucratic sectarianism and the legitimacy of the system as a whole).
  - Misuse of economics: constant insinuation of 'co-ordination' among energy suppliers in the absence of any concrete evidence, thus echoing the preferred political narrative and undermining confidence in (and the legitimacy of) market processes.

‘Feeding the crocodile’

- The result of all of this is a widespread public view that the consumer is being ripped off by big companies.
- The fact that there is no coherent account of how this is happening simply serves to reinforce the paranoia (‘what they are doing must be really bad, if it is so deeply hidden’).
- Energy companies are often mentioned alongside banks in this context.
- The end result is that the legitimacy of delegated regulation has itself been eroded since, after huffing and puffing to the media for so long, there is a perception that the regulator has not solved the (largely imaginary) problems that it has huffed and puffed about.
- Eg. responding to the contradictions in the reasoning of successive Ofgem reports, the FT likened the CEO to a cork bobbing about in the ocean.