Policy Exchange: Keeping the lights on

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Learning from experience: what works well, and what doesn't work well, in achieving security of supply in electricity

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My remarks today are necessarily brief, and there is no time to set out, in any detail, the reasoning and evidence that underpins them. I will simply assert that the necessary reasoning and evidence exists, in abundance; and then follow this up with a string of other assertions and points. For those interested in a more reasoned approach, a potential trail starts with relevant 'Beesley Lectures' to be found at www.rpieurope.org

UK energy policymaking in the 1980s found its way to a position based on twin pillars: much greater reliance on markets than hitherto (liberalisation), and a system of independent regulation, both to promote and oversee the liberalisation process and to regulate those parts of the sector where monopolisation of supply remained (chiefly, but not exclusively, wires and pipes). My first assertion is that this policy worked well – not perfectly, of course (perfect regulation is, for all practical purposes, an oxymoron), but significantly better than what went before, and probably better than any obviously available alternative at the time. In 2002, by which time liberalisation in California had collapsed, the Economist described the UK as the poster child of global liberalisers.

My next assertion is that, although the problems and challenges have changed, and although the current institutional structure is not well adapted to the new challenges, the twin pillars are as sound today as they were in the 1980s and 1990s, for two critical reasons.

- Effective and efficient resolution of climate change issues will require quite massive 'discovery' and innovation over the next few decades, and market competition is, by a very long mile, the most effective environment for discovery and innovation known to man.
- Very substantial investment in infrastructure is going to be required over the next decade or so. The public finance cupboard is bare, but the private finance cupboard contains vast quantities of capital waiting for reasonably safe and reasonably profitable homes. Independent regulation is the key to unlocking this cupboard, because it 'de-risks' projects in the way that is of greatest value to investors, by mitigating important aspects of 'political risk'. Unlike the alternatives (public private partnerships, private finance initiatives, etc), it does this at zero cost to the taxpayer.

Notwithstanding this heritage, things have since gone wrong in the energy policy field: the poster child of 2002 is now closer to being a basket case. Although there have been many occasions over the last twenty years when critics have warned about the lights going out, these have typically been cases of 'crying wolf' on the part of those with old longings for a bit more central planning. It is as well to remember, though, that, in the story of the boy who cried wolf, the wolf did eventually turn up. That is where we are now. Why?

Because energy regulation, and electricity regulation in particular, has been re-politicised. It is not now possible to contemplate major investment projects in electricity without extensive appraisal of political and regulatory risks, and those risks are the most difficult for capital markets to quantify and price. Particularly when the general mood of capital markets is one of caution, and not of irrational exuberance, this can seriously chill new investment.

The next question is: why did re-politicisation occur? The full story here is complicated, but the main plotline isn't: it is a result of (a) the impact of climate change policy on the energy sector, particularly electricity, and (b) the ineffectiveness and inefficiency of UK environmental policy (in which the UK has never been anything other than a class dunce, albeit one of many dunces). Climate change policy is a highly politicised area, and, unsurprisingly given that fact, it is incoherent and unstable in both its formulation and implementation. Independent, 'de-politicised' energy regulation has been undermined as a result. The stream of investment in infrastructure that we could potentially be enjoying, and which would be particularly welcome in current macro-economic conditions, is flowing less vigorously than it could or should be.

What then is to be done? There is a fork in the road at this point. One way is the red route: re-politicise the energy sector and accept the consequences: political direction of investment from the centre of government. This will likely work, at least in the sense of keeping the lights on, but it will, with high likelihood, be very expensive for consumers and taxpayers. The other, better way is to build on, and extend, the policy that has worked in the past: wherever feasible, de-politicise aspects of climate change regulation, and roll out the 'twin pillar approach' – promote markets where feasible, and rely on devolved, independent regulation where not – into environmental policy as well as energy policy. The *sine qua non* for this to work is the establishment of an independent climate change regulator, to whom aspects of regulation can be devolved/delegated as and when particular parts of policy become more settled, and as and when political conditions allow.

What we shouldn't do in the electricity sector is to continue trying to serve two masters, by paying lip service to markets whilst adding political 'fixes' here, there and everywhere. That tends simply to cause markets like those in electricity to malfunction, leading to cries of 'market failure', demands for more fixes, and so on round the circle. We have seen the effects in electricity (e.g. the Californian debacle), and also in finance (the credit crunch, partly caused by political pursuit of cheap credit): it is not an approach that usually works.