

EMR: complementing or substituting for market processes?

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Some ABCs of competition and regulation I

- Competition (rivalry) is a *process*.
- Markets are complex, adaptive social institutions.
- Outcomes are decided by the many, not the few.
- The processes are governed by market rules (laws, regulations, social conventions, ethical standards of conduct, etc.)
- Different market rules imply different processes and outcomes.
- The chief merits of competition lie in its capacities for discovering and making effective use of new, economically valuable information; due to strong incentives and to information processing capacity. *Ergo* there is an irreducible unpredictability about outcomes.
- Compare with monopoly , with its tendencies toward poor information, low pressures for innovation, and inefficiency.

Some ABCs of competition and regulation II

- Two types of regulation can be distinguished:
 - Type 1: *rule-making*
 - Type 2: *outcome-targeting*
- These are often confused in general discourse, but they are fundamentally different in nature.
- Rule-making is generally *complementary* to market processes (although poor rule-making can also hinder those processes).
- Outcome-targeting generally *substitutes* for market process in that it is an *alternative* way of determining outcomes.
- Specifically, outcome-targeting substitutes forms of central planning (monopolistic processes) for the market process in determining outcomes.

The two don't mix well

- Clearly, there is a fundamental conflict in that given types of outcomes cannot simultaneously be determined by two, quite different decision processes.
- But can there be a division of labour, with market processes determining some types of outcomes but not others?
- On the classroom black/white-board, yes; but in practice it would, it would be hubristic to make that claim on a general basis.
- Why? Because politically driven, outcome-targeted regulation/policy tends to lead to unstable and unpredictable rule-making, which is damaging to effective market processes, *particularly in relation to longer term decisions (e.g. Long-term investment projects)*.
- The term we give to this is regulatory/policy/political *uncertainty*.

If it ain't broke ...

- Consider the triad of broad policy objectives: affordability, security of supply, low carbon.
- UK energy policy worked well for the first two of these, via a combination of promotion of competitive market processes (Type 1 regulation) and price control (Type 2 regulation) where competition was not feasible, both largely delegated to an independent regulator.
- There have been claims that supply security was a problem, but there are good arguments to the effect that theory and evidence indicate, if anything, a bias toward slightly excessive security.
- The arrangements were not designed to address climate change issues.

What has happened?

- Outcome-targeted environmental regulation has been substituted for market rule-making regulation in energy. That is, new rules are being invented with the express purpose of achieving specified outcomes.
- The substitution has gone too far: we have created an electricity market with unstable and unpredictable rules, because the rules are being driven by preferences over outcomes which are subject to unstable and unpredictable political preferences.
- Triple A market processes are being replaced by triple C political processes, and the UK's reputation in energy policy is being steadily downgraded.
- It is a case of forward to the past.

Naught for our comfort

- There is no comfort to be drawn from the fact that not everything is being centrally planned: the scope of outcome-targeted regulation has got to a level where it is undermining the stability and predictability of market rules more generally.
- This can actually be worse than full centralization (i.e. The pre-privatization arrangements), since the planners are making decisions which will have diffuse effects for which they will be able to deny responsibility (i.e. at least full centralization makes it clear where responsibility lies): e.g. the demagoguery around the 'Big 6'.
- To instability and unpredictability, therefore, add irresponsibility.
- See the evidence of half-assed electricity market reforms elsewhere in the world.

It's a mad, mad world

- The old arrangements, in a cap-and-trade and/or carbon tax framework, could comfortably have met 2020 carbon targets, but outcome-targets for renewables lead DECC to tear up the rule books.
- The planners also worry about what happens after 2020, and try to solve that problem *on the basis of today's information*. The beliefs that this is (a) feasible and (b) sensible are examples of what has been called the *fatal conceit* of central planning.
- It is not feasible because the plan will, with high probability, be undermined by new information ('events'), and abandoned because tomorrow it will look even sillier than it looks today.
- It is not sensible, because it does not promote and allow for the effects of the discovery of new information that will inform developments post 2020.

Black swans and dead parrots

- “Events, dear boy, events.” (Attributed to Harold Macmillan)
- “... one of those pretty, polite techniques which tries to deal with the present by abstracting from the fact that we know very little about the future.” (Keynes, *The General Theory*)
- Four weeks last Monday, after a presentation at the Lib Dem conference, I was told that not much was happening on the shale gas front in the UK. Three days later, the media were announcing the discovery in Lancashire. Already the discussions about security of supply and the predictions about gas prices in the EMR appear to have the tinge of a Norwegian Blue about them.
- What if, as Caltech researchers have claimed this year might be feasible, energy yields per hectare from wind turbines can be increased by a factor of ten or more? What does that imply for offshore wind? What does it imply for nuclear?

Summary

- EMR is highly unlikely to work (a consensus of economists?).
- Since it is not entirely clear how, why, and when the policy framework will be abandoned and replaced (and with what?), its very existence is a source of instability and unpredictability in market rules going forward.
- Bad for security of supply: tendency to delay investment, to 'wait' for planners to make their decisions and, in the absence of stable market rules, to wait to negotiate contractual terms with government.
- Bad for affordability: given the regressive nature of electricity price increases, customers might become very angry indeed.
- And no compensating benefits on the climate change side.