
Position Paper: Ofgem's Proposals for UK Energy Policy

Ofgem is right to advocate a change in direction, but the regulator has yet to recognize the full impact of unconventional gas extraction technology

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DATAMONITOR VIEW

CATALYST

At the beginning of February 2010, Ofgem published part two of Project Discovery: "Options for delivering secure and sustainable energy supplies". The proposals entail a radical change of course in UK energy policy, meriting close analysis by all stakeholders.

SUMMARY

In the past five years, Britain's energy landscape has shifted at a pace faster than anyone could have anticipated. Indigenous supply has declined with unexpected rapidity, and climate change has become a mainstream concern. Ofgem's recent proposals for maintaining security of supply while reducing greenhouse gas emissions recognize these developments. The regulator advocates a radical departure from the free-market approach which has defined UK energy policy for the past 20 years, and argues instead for increased government intervention to ensure price visibility and private investment. In doing so, Ofgem has demonstrated an adroit capacity for independent analysis and a readiness to break with convention. Unfortunately, these admirable qualities are less forthcoming in Ofgem's questioning of the assumptions which underpin the received wisdom concerning the problem itself: the establishment is yet to recognize the impact of shale gas.

METHODOLOGY

This Position Paper explains Ofgem's proposals and sets out Datamonitor's views on the issues raised.

ANALYSIS

Letting go of the invisible hand: in its recent proposals, Ofgem has demonstrated a refreshing willingness to break with convention

The UK energy regulator has recognized the changed energy landscape and has altered its approach accordingly

Last week saw Ofgem publish part two of Project Discovery: "Options for delivering secure and sustainable energy supplies". The investigation began as an inquiry into capacity margins but in the wake of the financial crisis and a "green stimulus package", it has evolved into a wider attempt to address the UK energy conundrum, namely: the pressing need to reduce greenhouse gas emissions, replace aging infrastructure, and ensure reliable upstream supplies.

More specifically, Ofgem has identified four key issues for redress: uncertain carbon prices; limited incentives to invest in peak energy supplies; over-exposure to volatile markets; and energy poverty.

The report delivers a refreshing departure from conventional thinking. Ofgem's proposals advocate a significant shift away from free-market principles and towards a more centralized energy industry. This reflects comments made most recently by Ed Balls, UK Secretary of State for Children, Schools and Families, but also expressed by other government policy makers in recent months.

Indeed, a gradual loss of faith in purely liberal-economic approaches to the UK energy market has been apparent within the industry and community for some time. This is partly driven by general antipathy towards the Anglo-Saxon neoliberal economic model in the wake of the financial crisis, but is also a function of energy policy becoming an issue of "high politics"; as security of supply has risen up the agenda (on account of geopolitical tensions, high and volatile wholesale prices, or environmentally driven legislation eroding generation capacity) so politicians, academics and the energy commentariat at large have recognized the need for greater government intervention in the energy market, albeit to varying degrees.

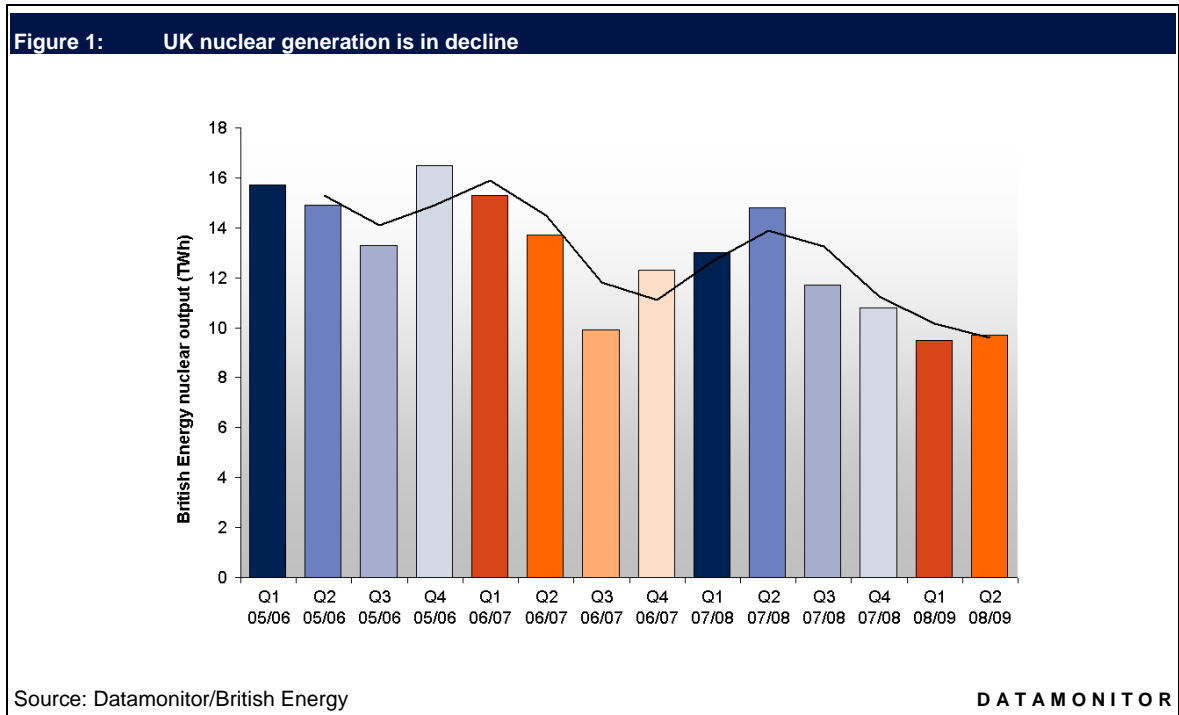
Ofgem's proposals follow this trend closely. The document puts forward five possible policy packages, each one offering a more centralized market structure than the last. In the least intrusive Option A, the regulator proposes three key reforms: improved prices signals; improved ability to meet demand-side response; and a minimum carbon price. In the more drastic Option E, the regulator goes so far as to advocate a government-run energy-buying authority. Options in between suggest a centralized renewable energy market and a forward-based capacity market for all forms of generation.

Long-term price visibility is critical to incentivizing private investment in new, low-carbon generation; the issue is becoming critical as existing generation reaches the end of its lifespan

The concept of a carbon floor price has been widely discussed within the energy industry and has received considerable support from a diverse array of interests. Ofgem suggests that since an EU Emission Trading Scheme (EU ETS) carbon floor price is unlikely to emerge from Brussels in the near future, the UK could introduce a "carbon top-up tax". The free-market mechanism would still operate, but only above a given EU Allowance (EUA) price.

New nuclear generation in particular demands a clear carbon-price signal. There are 23 reactors generating electricity at nine sites in the UK. Together, they supply roughly one fifth of UK electricity. By 2015, all but one of these stations will be

closed or facing closure. Without a strong carbon price (around €35 per tonne) the investment needed to ensure new capacity by 2020 may not be forthcoming.



Datamonitor has argued in the past that a carbon tax is the simplest way to provide visibility and encourage investment, but that the word “tax” has been too politically sensitive a term to employ. That Ofgem—an institution with liberal economic instincts—should put forward such a proposal is a startling departure from convention and shows a willingness to question precedent.

What is also clear from Ofgem’s analysis is that consumer bills must rise by double digits in order to stimulate this required investment and shift to a low-carbon economy. This is in keeping with expectations: consumer bills have been rising steadily over the last five years on account of higher, more volatile wholesale prices, but the estimated £200 billion required to update infrastructure will inevitably come from end-users.

In its more drastic proposals, Ofgem has put forward an option for creating a central energy-buying authority to co-ordinate investment, which amounts to a wholesale recalibration of UK energy policy

However, if Option A is a departure from precedent, Option E is a positive U-turn. In this alternative, Ofgem envisages the creation of a central energy-buying authority, operating as a broker through which utilities compete to sell to consumers. The purpose of this package is to guarantee the delivery of the UK’s strategic energy objectives by co-ordinating future investment via a single entity, eliminating the reliance on volatile price signals for investment.

While recognizing the significant risk of such an entity making incorrect decisions and the difficulties in creating such an institution within the parameters of EU legislation, Ofgem argues that a scenario could emerge in which a free-market approach to energy policy is simply inadequate to deliver security of supply and decarbonization.

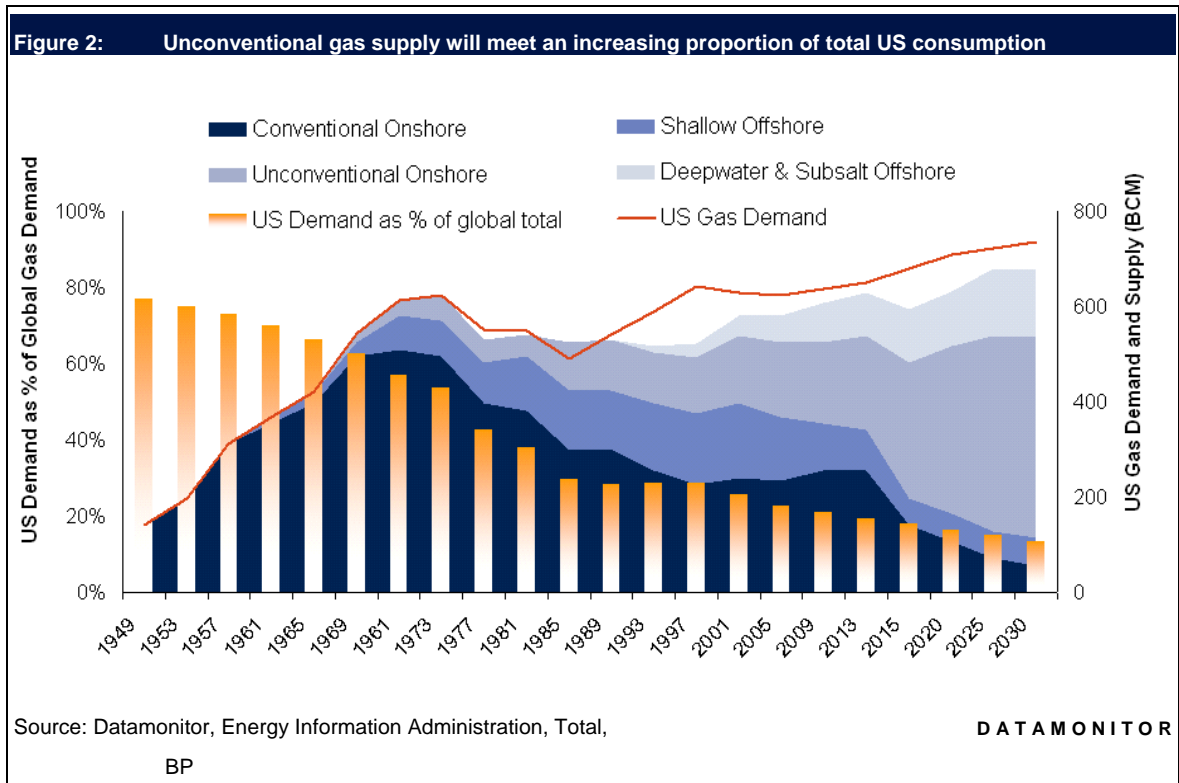
Perhaps unsurprisingly, this last option has divided opinion rather sharply. Major energy users' industrial groups in particular have welcomed the proposals vociferously. Others have sought to emphasize the trade-offs that such a policy would imply: a monolithic national energy broker would surely impede innovation and potential efficiencies, simply for the sake of replacing a mechanism which has worked well for the past 20 years.

Updated, but not up-to-date: although Ofgem's capacity for adapting its policy to a changed environment is laudable, the regulator mistakenly assumes tightening near-term gas supplies

Ever since Nigel Lawson initiated the privatization of British Gas in 1986, the UK energy industry has followed a path of liberalization and competition. Given the abundance of cheap supplies of North Sea gas at the time, this policy was entirely appropriate and has performed well: prices came down and security of supply was assured. However, in the past five years, a new picture has emerged. Indigenous reserves have declined faster than anticipated and climate change has shifted in the public eye, from being a fringe issue to an existential threat. In light of this relatively rapid development, it is appropriate for Ofgem to propose an overhaul of the market structure and the general approach to energy policy. It is laudable that the regulator has not shied away from breaking with convention and rejecting its own former arguments.

Yet, despite revising policy to address the new challenges, Ofgem's strategy still operates within the parameters of an out-dated assumption: that the European energy landscape is defined by declining indigenous gas reserves and unreliable foreign suppliers. These assumptions are made clear in the earlier-released part one of Project Discovery: "Energy Market Scenarios" (October 2009).

This view ignores the reality of unconventional gas production in America (see Figure 2), increased global liquefied natural gas (LNG) supplies, and on-going investment in Russian delivery capabilities. LNG supply to the UK increased to nearly 2,000 million tonnes last year, even as overall gas consumption declined some 12%. Shale plays in North America are economically viable at less than \$2 per million British thermal units, and the fact that super-majors such as Exxon and Total are rushing to buy into such assets reflects the massive role they will play in future supply. Furthermore, despite the credit crunch Russian investment in Nord Stream is proceeding apace, which will reinforce Russia's capacity as a reliable energy partner. Indeed, it is worth noting that even Gazprom expects the current gas glut to continue and sees low prices as being a result of a structural shift in supply fundamentals, not a result of the recession alone.



The growth in available gas supply outlined in Figure 2 is the result of innovative technological advances in hydraulic fracturing techniques and large-scale liquefaction, which have both been delivered by free markets and competition. The development of shale plays in particular is the direct result of higher US prices in 2001, following a period of conventional supply decline: the market mechanism worked according to plan.

Moreover, this availability of gas undermines the assumptions which underpin the current taste for government intervention: free markets have in fact delivered an abundant supply of clean energy to bridge the gap between the current high-carbon energy mix and the “green pastures of 2025” when new nuclear facilities will have been constructed. Gas supply is sufficient to keep the lights on without reneging on commitments to reduce dependence on coal.

Ofgem deserves credit for questioning the received wisdom, but ministers should not be so quick to bite the invisible hand that feeds them.

APPENDIX

Ask the analyst

The Energy & Utilities analyst team can be contacted at asken@datamonitor.com

Datamonitor consulting

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