

Oxford Energy Comment

May 2012

Death by a thousand regulations: the New Energy Bill

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Introduction

An earlier Oxford Energy Comment (*Electricity Liberalisation in the UK – the end is nigh* from February 2009) forecast that the liberalised UK electricity industry was likely to die not with a bang (renationalisation) but with a whimper, suffocated by an increasingly complex network of regulation. With the government's new Energy Bill, which was published as a consultation draft on 22 May, we seem already to have reached that point.

The draft Bill's provisions on Electricity Market Reform

The Bill is designed primarily to implement the government's proposed electricity market reforms (EMR) which were discussed in previous Oxford Energy Comments *Return of the P-word* in July 2011 and *Back to the Future* of December 2011. It contains provisions to implement Contracts for Differences (CfDs), the Capacity Market and so-called Investment Instruments, which are intended to prevent delays in investment as the other measures are being developed. What is noteworthy in the Bill is that despite the words "contract" and "market", all these provisions are designed around the same pattern – a power for the Secretary of State to make regulations by means of which obligations would be imposed on electricity generators and **all** suppliers. In other words, what will underpin both decarbonisation and security of supply in the future electricity industry will not be a market or private contracts but a complex set of government regulations – an ironic outcome for a process originally described as one of "deregulation". That is, however, deliberate. The government believes that the risks of investment (and along with them required rates of return) would otherwise be too high to be acceptable to investors and consumers; the regulated approach is designed to reduce risks and costs. But it also entails a massive and unprecedented degree of centralisation and detailed decision-making by the government.



For instance, the regulations on CfDs can specify:

- The means by which electricity is to be generated
- Generating capacity
- Plant location
- Location of supply
- Duration of the CfD
- Requirements to enter into agreements with third parties
- Setting the strike price
- Setting the market reference price
- Setting maximum overall costs
- Penalties, enforcement and many other administrative matters.

Similar provisions apply to the other instruments, and it is this complex web of regulation which will govern the future operation of the industry.

Other provisions in the draft Bill

Other provisions in the Bill are less radical but generally point in the same direction. For instance, one new power is for the Secretary of State to issue a Strategy and Policy Statement setting out the government's energy policy priorities. Ofgem will then have to act in the manner best calculated to further the delivery of these policy outcomes. Again (although the government does not admit it), this is a significant change. Originally Ofgem's duties focused exclusively on economic regulation – the promotion of competition and consumer protection. There was a clear demarcation – the government was responsible for energy policy; the regulator for the operation of markets. This distinction can no longer be drawn. It started to become blurred in the early 2000s. The regulator's duties were amended to include the promotion of sustainable development and a requirement to have regard to the effect on the environment in carrying out its functions. Under the Utilities Act 2000, it also had to have regard to social and environmental guidance issued by the government. By the late 2000s "E-Serve" (which implements the environmental aspects of the regulator's functions) constituted the bulk of Ofgem's spending. The latest development is the outcome of the recent Ofgem review. Ofgem will not just have to take account of the government's policy goals; it will be expected to set out annually how it plans to deliver its contribution to each policy outcome. In other words the job of the regulator will be as much to help deliver the government's policy goals, as to police markets.

The Bill also contains various supporting elements for EMR, such as the Emissions Performance Standards and transitional arrangements for Renewable Obligation Certificates. In addition to these provisions, the Bill sets up a new independent Office for Nuclear Regulation – again this is a measure designed to support the decarbonisation process. The old system of nuclear regulation within the Health and Safety Executive was felt not to be sufficiently well resourced – potentially leading to delays in regulatory decisions or a lack of



the (expensive) nuclear expertise needed. The new independent body will be outside the civil service; this is designed primarily to help it overcome the resourcing problems and so, at least in principle, help speed up the approval of nuclear investment – though recent developments in this area might raise the question of whether such a highly resourced and expensive new body is in fact going to be needed.

There are two exceptions to the generally centralising trend of the Bill. One is relatively minor (the sale of the Government Pipeline and Storage System – a relic of history). However, the Bill also contains technical provisions on Offshore Transmission which will clear the way for offshore wind operators to build transmission connections to shore (which are then to be transferred to a transmission owner through a competitive tender process). It does not however change the generally market-led approach to offshore transmission, an interesting contrast to the EMR arrangements themselves. Transmission involves monopoly assets, potentially creating opportunities for extracting rent; there are also coordination problems (which may at times cross international borders) in relation to the development of complex offshore wind farms, decisions about the sizing of transmission systems etc. For these reasons, most countries regulate their offshore transmission infrastructure. With offshore wind expected to take such a large share of the burden of meeting the UK's renewables target, the arguments for a clear sense of direction in this area might be expected to be even stronger. It therefore seems anomalous that for this part of the system an approach has been adopted which seems to have an entirely different basis from the wider reforms – in Ofgem's words the aim is “an open, competitive approach that is built on encouraging innovation and new sources of technical expertise and finance.” No real explanation is given for the differences of approach between offshore and onshore. It can, however, be regarded as a continuation of a long-standing, if odd, practice – it has long been a feature of the UK energy system that lighter regulation has been applied to offshore infrastructure, such as oil and gas pipelines, than to onshore infrastructure.

The Way Forward

Publication of the Bill is not likely to answer many questions about the details of EMR and the contents of the CfDs in particular; nor is it likely to reduce controversy. The more the proposals are developed, the more complexity is revealed, while much of the substance remains as elusive as ever. Although the Bill sets out the powers the government will use to create CfDs and the capacity market, it gives no further details about their content. Similarly, in the supporting material, a number of key issues are only raised in passing – for instance, on market liquidity the government says it agrees that further commitments are needed but only promises to work with Ofgem and the industry and act “if necessary”; in relation to the European dimension it similarly says that DECC “are working closely with the Commission” to ensure that EMR is consistent with European legislation; on the Investment Instruments which are supposed to provide comfort for investors in the interim before EMR is introduced it still contains the delphic caution “even if DECC agrees that a project has the required



characteristics this should not be treated as an indication that the Government will offer any product or arrangement in relation to that project” .

So, few questions are being answered; indeed, new questions are being raised as the process progresses. The explanatory material for the Bill sets a clear goal of stepping back from intervention, but without spelling out the exit strategy. It lists four stages of EMR. By the fourth stage (late 2020s and beyond) it expects “technologies are mature enough and the carbon price is high and sustainable enough to allow all generators to compete without intervention”. But it does not explain how the government will then escape from the complex web of regulation and long term contract arrangements which will be in place. Nor does it say why this heavy administrative superstructure is needed if the outcome is so clear – that is, if it is indeed the case that a carbon price of £70/tCO₂ (which is the target for 2030) will be sufficient to remunerate all forms of low carbon generation, including carbon capture and storage, nuclear, and offshore wind, why cannot the government simply commit to that price now and let the market respond by building low carbon generation accordingly? If on the other hand, that outcome is uncertain (as must be the case) how will the government remove itself from the scene, when the whole system is underpinned only by its decisions and instruments?

Perhaps the greatest uncertainty is about the costs and benefits of the whole exercise. The government’s assurances that the overall costs will be bearable and lower than on alternative approaches have been increasingly challenged as fuel poverty increases, and the various elements of its case have been questioned (eg on the cost of nuclear, or the assumption that energy efficiency measures will offset the effect of higher electricity prices). It is a little unsettling in this context to read the government’s impact assessment for the capacity mechanism it is introducing. It is forced to admit that either version of the capacity mechanism (strategic reserve or capacity market) would have a significant negative net present value and that its own favoured approach (the capacity market) is worse, rather than better. To explain its decision, it effectively dismisses the cost calculations – the assessment says “we do not believe the net costs in [the assessment] are representative of the likely impact of implementing either a Capacity Market or a Strategic Reserve”; the government appears to regard the costs as simply a result of the modelling approach. But the same could be said both of the wider cost calculations which underlie the government’s optimistic view of the impact on consumers and prices, and the market modelling which suggests that the renewables target is achievable. Both outcomes are essentially a function of the modelling approach – it is just that, in these instances, the government is using its own models and getting results which support its case.

So while the publication of the draft Bill marks a significant step forward, it will not answer all the questions or satisfy all the critics. Indeed it is likely to result in renewed controversies. The complexity of the new system and its highly interventionist nature are becoming more and more apparent, while the likely benefits and the robustness of the underlying assumptions, are becoming less and less clear. Unless the government can respond to the



consultation on the draft Bill in an effective manner and justify its Bill convincingly during its passage through Parliament, the debate is likely to continue, and with it all the uncertainty about the future framework of the electricity industry which the proposals are intended to reduce.