

Competitive, Sustainable and Secure Energy – How Markets Deliver

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The narrative ...

We're all doomed....

- >Reserves are running out
- >We still need gas for some time
- >Gas needs to come from overseas
- >The vast majority of overseas gas is covered by long-term contracts
- >We rely on volatile short-term markets
- >Markets won't deliver enough low-carbon capacity in time

So, don't rely on markets

- > Adopt mechanisms to smooth/support prices
- > Introduce non-market price mechanisms
- > Make people build useful/strategic things
- > Get some long-term contracts!

An alternative narrative ...

Markets work

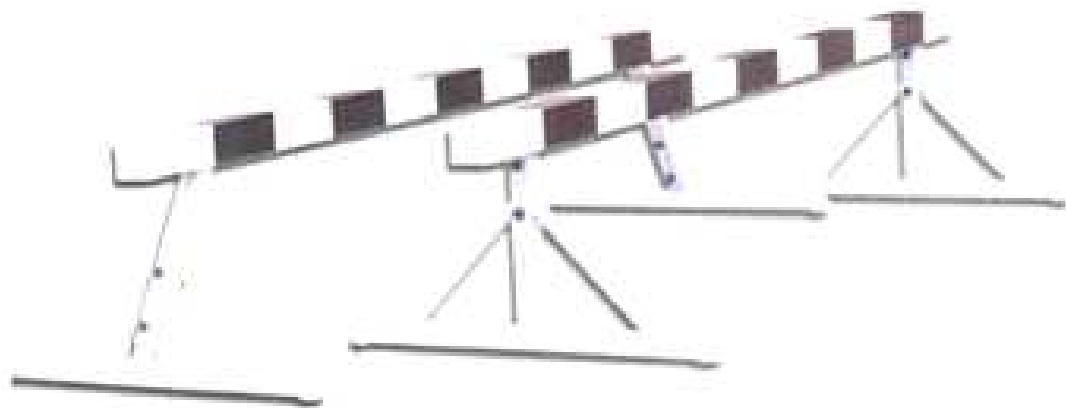
- > When allowed to work, markets are incredibly resilient
- > Volatile markets have driven significant investment in “options”:
 - Production & storage
 - LNG
 - Interconnectors
- > Problems have resulted from:
 - Politics and non-payment
 - Inflexible long-term contracts
 - Short-term markets not being sufficiently developed
 - Insufficient delivery infrastructure
 - Tree-logging
 - Wrong place, wrong time generation

So, make them work better...

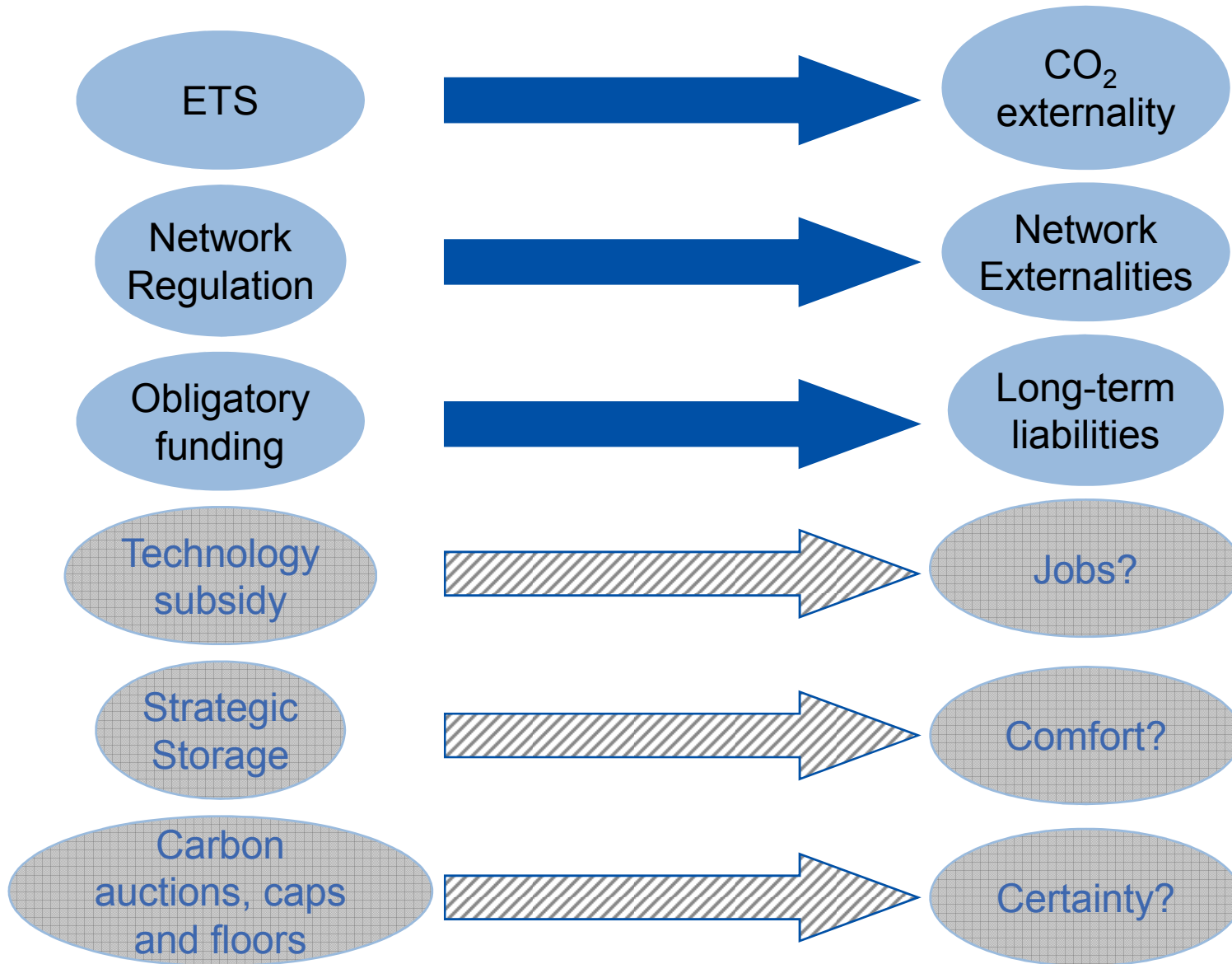
- > Remove barriers to participation
- > Fill the gaps
- > Polish the rules
- > Regulate for success
- > Don't second guess

Remove the barriers to participation

- > Free, unhindered network access
- > Anti-trust
- > Planning and site restrictions/limits
- > Information transparency
- > Licensing, logistics, credit, clearing
- > Transactions costs
 - Information
 - Metering technology
 - Energy efficiency



Identify and fill the gaps



Polish the rules

Capacity pricing is essential

- > Consumer value (of unserved load) should feature in market prices
- > First-best solution is directly via real-time metering
- > Second-best solution is via market rules

Current UK rules fall short

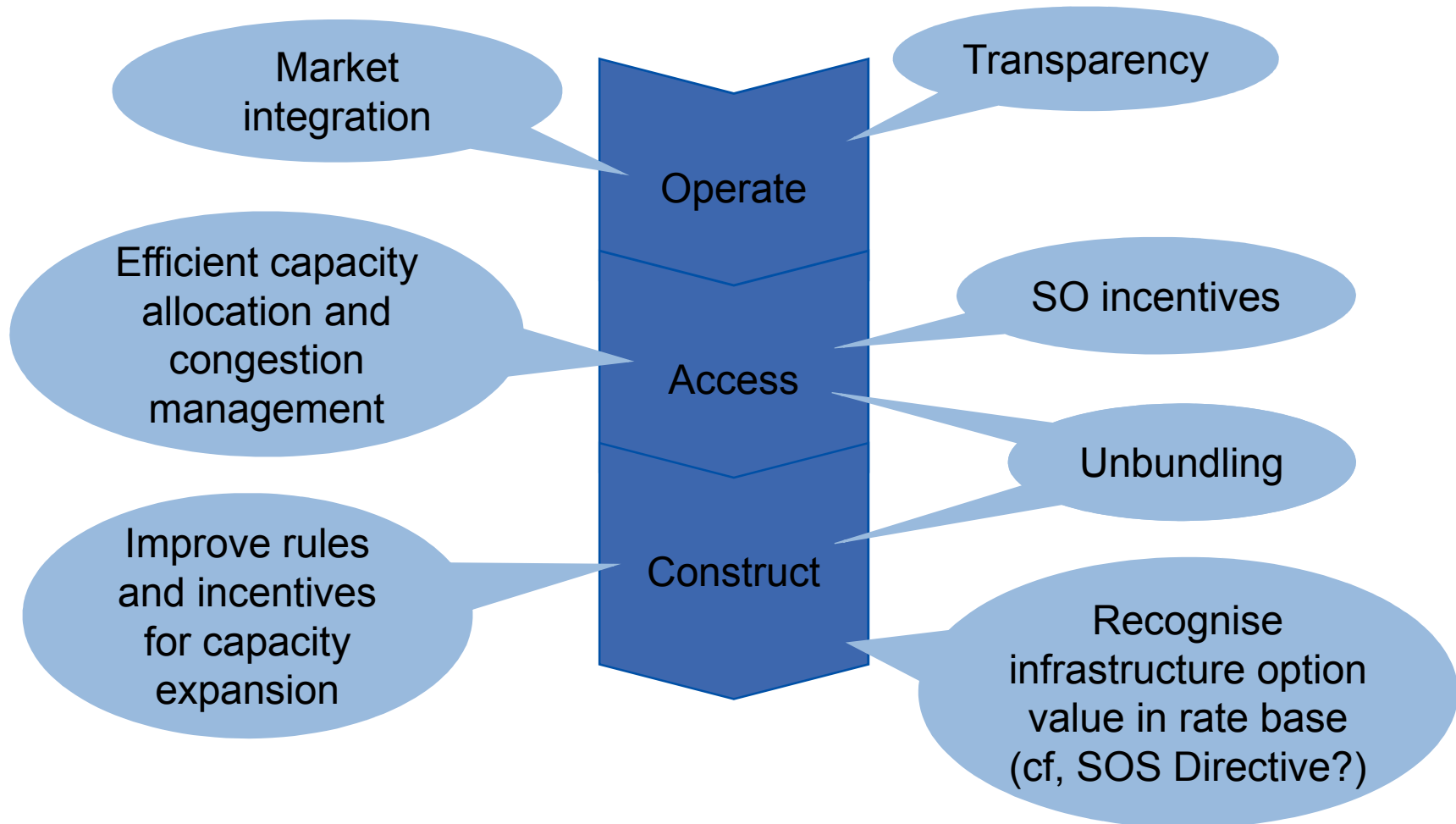
- > Reserve options are procured “off-market” and capacity “value” not in price paid to all capacity
- > Implicit cap on energy prices below shortage price
- > Shortfall increasingly requires more “off-market” transactions?

Capacity markets have fundamental problems and flaws

- > “Availability” is non-measurable or deliverable
- > Huge monitoring resource required
- > Shortage price will be the “default” incentive in any case

Solution: ensure marginal energy prices include shortage value

Regulate for success ...



And don't second guess ...

- > Unintended consequences
 - Market abuse versus commercial behaviour

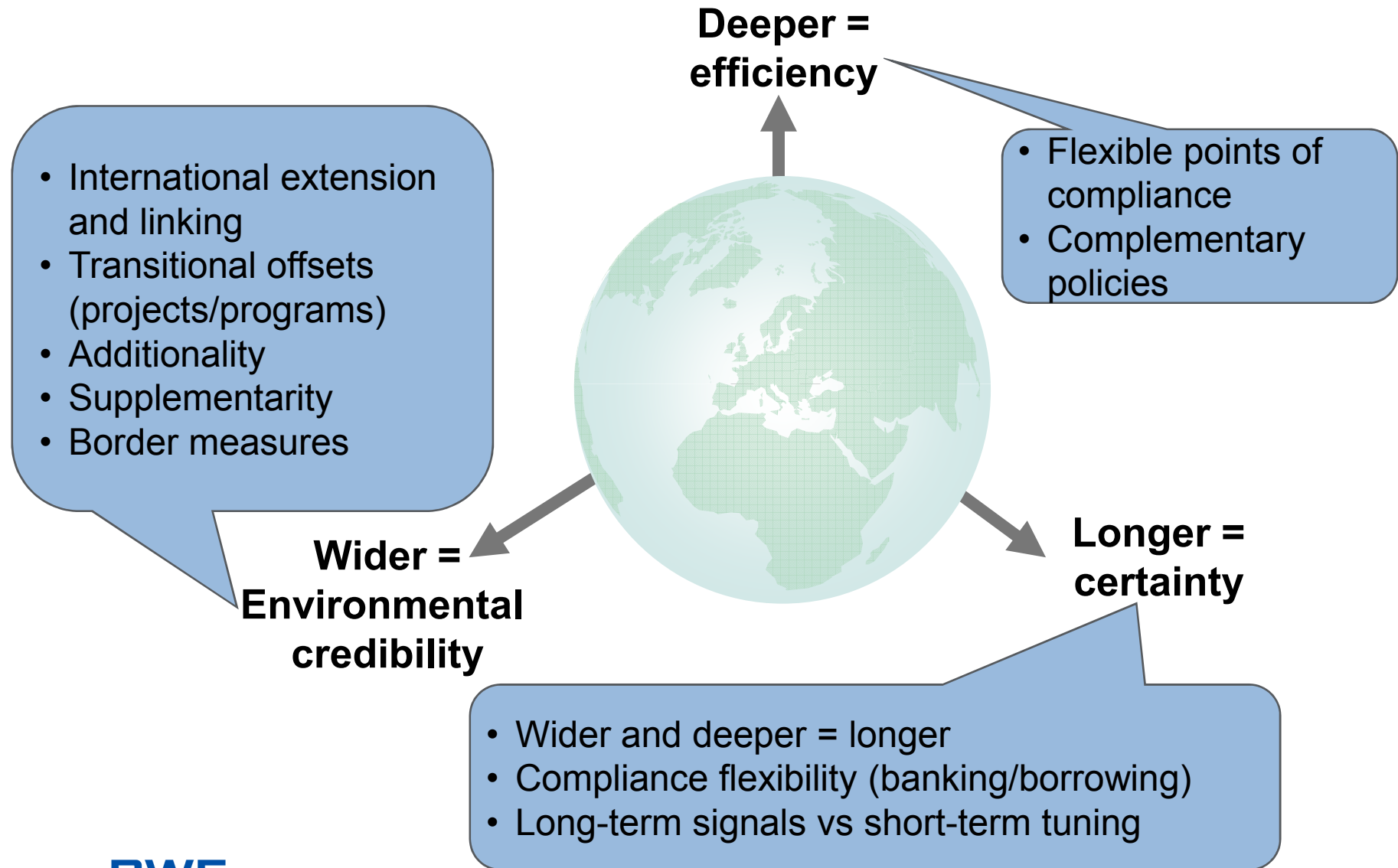
- > Supplementary support
 - Bicycle generators
 - Why pay twice (eg, once for carbon and again for “low carbonness”)
 - Pick losers and crowd out alternatives
 - Mask residual market signals

- > Caps and smoothing
 - Under-delivery
 - Moral hazard
 - Crowd out commercial risk-management solutions

- > Floors
 - Why discard upside?
 - Overprovision

How credible is a policy which is inefficient, costly, insecure and admits failure from the outset?

Regulate for success - credible carbon policy



Conclusions

- > Markets work
- > Perceived problems are due to insufficient scope not inherent failure
- > Energy policy is generally fit for purpose
- > More effort required on expanding scope, implementation and enforcement
- > Second-guessing market is at best unnecessary and at worst dangerous and expensive

» Many forms of Government have been tried and will be tried in this world of sin and woe. No one pretends that democracy is perfect or all-wise. Indeed, it has been said that democracy is the worst form of government except all those other forms that have been tried from time to time. «

Winston Churchill 1947