

## Political opportunism and energy policy: windfall taxes, arm-twisting and their effects on investment

The British government prides itself on creating a stable, competitive energy market, and advocates the same for Europe. Indeed, so convinced is it of the superiority of this model that it argues that even nuclear power developers can rely on its transparency, predictability and stability so that they can invest on a commercial basis. In particular, they can be secure in the knowledge that there will be independent regulation and a long-term price of carbon.

Credibility is hard to establish, and easy to lose. Expectations of private companies and their investors are conditioned not by what happens when things are going well, but by how far politicians and regulators hold their nerve when the going gets tough. The golden rule for credibility is that ministers and regulators should steel themselves against exploiting popularism and avoid political and regulatory opportunism. Even the merest hint that they might behave opportunistically damages longer-term expectations, and with a major investment requirement in the coming decade and the desire by government to see investors sink capital in new nuclear plants which are over a decade from delivering commercial returns, now is the time to be particularly careful about expectations.

So, faced with this imperative, it is alarming to see the Treasury and the regulatory body, Ofgem, engage in some of the most damaging forms of political opportunism. In January, the Chancellor, Alistair Darling, kicked off what appears to be one of the worst episodes in messing with the market since the great arm-twisting over the ending of the coal contracts in 1998, when Gordon Brown, Geoffrey Robinson and Peter Mandelson

tried to force National Power and Powergen to buy more coal against a battery of veiled threats and pressures.

To be fair, Darling's initial intervention was a reasonable one: looking at the way the electricity market was behaving, he asked Ofgem to take a good hard look at whether the market was as competitive as both the government (in the 2006 Energy Review, and the 2008 White Paper) and Ofgem claimed it was. Not unreasonable in itself, but naive in what it then triggered.

The next move was from Ofgem. It claimed that there was in fact no problem because the market was competitive. In other words, the Treasury should keep its nose out of Ofgem's business. Exactly how under the NETA trading arrangements Ofgem could know this—given that, unlike the electricity pool NETA replaced, contracts were private, vertical integration blurred the margins and cost allocation, and Ofgem therefore had little idea what the costs (as opposed to wholesale price) of each generator in fact were—remains a mute point, to which we return below.

But what blew Ofgem's reputation for credible regulation was its blatant attempt to stick the boot into the Treasury by suddenly coming up with an alternative—a £9 billion windfall tax on the generators to reflect Ofgem's view of the value of carbon permits granted under the Phase 2 of the EUETS. Popularist yes, and immediately jumped on by Labour backbenchers and the Liberal Democrats' front bench, but very bad economics. Auctioning of carbon permits is a good idea in principle, and indeed it is widely proposed for Phase 3. But there is a world of difference

between an *ex ante* auction announced well in advance, and a surprise *ex post* windfall tax.

It is very surprising that Ofgem, which prides itself on its economic literacy, could go for such an ill-thought-out proposition, and it is hard to know where to start on its faults. But here are a few. First, the decisions of a generator faced with an *ex ante* auction will factor in the effects on its plant closure and maintenance decisions. *Ex post*, it has no such opportunity. Second, the permits are not strictly sunk costs: they will be financed through borrowing and the changes to the balance sheets will have an impact on investment. This is true in normal times—witness the impact of the 3G licences on BT and other companies' ability to roll out broadband and fast Internet services. The idea that the volume and type of investment are independent of the financial position of the companies may hold under very restrictive assumptions about perfect competition, but that is not remotely representative of the actual economy. But third, these are not normal times—there is a very severe credit crisis in full swing, and raising £9 billion now will have significant costs. In particular—and this is the fifth point—it will disproportionately damage the smaller and non-vertically integrated companies. In other words, it will have a very damaging effect on the very competition the Chancellor and Ofgem are so keen to promote. Just imagine the effects on new entrants—or even DRAX—in the current markets.

These are just some of the immediate difficulties. But there are more profound ones too. Consider the following question: just how does Ofgem know the answer is £9 billion? The implied ignorance of how markets work, which this claim reflects, is truly astonishing. How does Ofgem know what companies would have bid in an auction? Did the Treasury know how much would be bid

for the 3G licences? And would all the generators have bid at the outset for the full amount of the permits they might turn out to need? Think about the position of a coal generator. It might have the option of closing—or simply not running—in, say, 2010 or 2011. Why should it be forced to pay now for permits it might not need? Instead, it might wait to see what wholesale prices looked like in due course and then decide. All of this is prejudged by Ofgem, which apparently knows the right price now.

With this profound analytical weakness comes a more depressing consideration. How can the companies and the investors rely on Ofgem in the future? Why should they rely on Ofgem's claims? If this episode blew its carefully won credibility, Ofgem then went on to make matters much worse. Having told the Chancellor that the market was competitive—and hence there was no need to have an inquiry—it then watched the BERR Select Committee start an investigation and Energywatch encourage a public debate and, fearful of losing control, promptly executed a remarkable U-turn, deciding that in fact there were reasons for concern over competition which merited a in-depth inquiry. In its own words, notwithstanding its earlier staunch defence of the competitiveness of electricity markets, 'increased public concern' merited intervention. All of this has of course made Ofgem more popular (especially when combined with the recent large fine on National Grid), and generated great headlines for its leadership. But that is what popularism is all about—getting good headlines.

Following this U-turn, it was next the turn of the Treasury to make matters much worse. The tactics are very reminiscent of the political black arts of the coal episode in 1998. The Treasury went into action to try to bend the arms of the companies in the shadow of the Budget

statement. Not ruling out a windfall tax, it made sure a message was sent out through the front page of the *Financial Times*. Exploiting understandable popularist concerns about energy price rises, using the windfall tax as an implied threat, it tried some old fashioned arm-twisting to get itself off a hook of its own making—fuel poverty. A ‘star chamber’ was set up to pressurise the companies.

Back in 2000 the minister then responsible, John Prescott, announced that Labour would abolish fuel poverty. This would have been ambitious at any time, but Prescott appeared to fail to notice that even then the oil price had doubled, and that it might go on ever up. If fuel poverty is defined by the percentage of income spent on energy costs above a certain threshold, if the relative price of energy goes up, fuel poverty will rise unless the growth of incomes of the poor is big enough to offset it, or energy efficiency measures are sufficient to reduce the energy demand of the poor. The former—sufficient income growth—is a practical impossibility when oil prices (and gas, coal and other commodities) are heading north. Indeed, since they may carry on going up, fuel poverty is going to get even worse. And on the latter—offsetting efficiency—there is no evidence to suggest that a compensation on this scale will be made.

This is a muddle of the government’s own making. It set a target which is getting harder and harder to achieve. But it is not impossible. There are two ways of subsidising the fuel poor: either better-off electricity consumers can pay more to cross-subsidise the fuel poor; or the taxpayer can provide compensating social security payments. The government obviously favours the former, especially if it is disguised.

But here is where the economic illiteracy comes in again. The government seems to

think that the private companies and their investors should lower prices to the poor in what they claim is—or at least should be—a competitive market. If it is competitive then they cannot do this. So the solution is that the cross-subsidy must be imposed outside the competitive market. There are two ways to do this: raise the money from the monopoly transmission and distribution charges; or impose a supplier obligation so that all suppliers face the same requirements (as with energy efficiency revenue-raising). In other words, the government needs to impose an (implicit) tax on energy customers.

Since increased prices or increased taxes are hardly likely to be popular, it is not surprising that government has flirted with the popularist route (along with Ofgem) of taxing the companies themselves through a windfall tax. Not only is this objectionable for all the reasons set out above, but it has apparently not dawned on either of them that it will not solve the fuel poverty problem. For this is a *permanent* problem, and cannot be solved by a one-off measure. Worse still, the fact that the market sees such blatant political opportunism now must give rise to the expectation that in a year’s time—and especially if prices have increased again—they will do it again.

Now none of this implies that there are not problems with the electricity market, and that competition might not be quite as intense as Ofgem and (previously) the government have claimed. There are good reasons for having a detailed look at the operation of the market—and for the particular reason that under NETA it is hard for any independent party (including Ofgem) to know what is going on. Indeed, when NETA was proposed, a number of commentators, including academic specialists, pointed out some of the consequences that might follow once the compulsory, liquid and transparent pool,

open to all buyers and sellers, was replaced by the opaque NETA voluntary markets.

Such a thorough review is now probably inevitable. The BERR Select Committee will reveal the complexity of conflicting claims and evidence, and Ofgem is now sufficiently damaged in its U-turn that the results of its internal inquiry will probably be treated with scepticism. The Competition Commission therefore looms over all of this, and indeed it is now probably in everyone's interest to have its stamp on the issues.

In the process, it will be important to ensure that sight is not lost of the energy policy framework within which competition should operate. There may or may not be evidence of market abuse. But whether there is or not, the market itself is not well designed to address the broader questions with which it is challenged. The real competition now is competition for investment. And not only is NETA far from transparent, but it has poor investment incentives too.

At the core of the NETA concept is the idea that prices are allowed to rise to whatever level is necessary to trigger sufficient investment to provide security of supply. In electricity, supply always equals demand. It is just a question of the price. After the behaviour in recent weeks of both the Treasury and Ofgem, who would believe that politicians and regulators will actually keep their hands

off, and resist the populist pressures that will inevitably follow big price spikes?

The sad fact about the latest bout of public and media pressure is that under what will probably be just the first episode in a series of price shocks, both the Treasury and Ofgem cracked. They have both behaved opportunistically. With perhaps 35GW new capacity needed by 2020, a mountain of renewables investments needed to meet the new EU renewables targets, and with the government's desire for a whole fleet of new nuclear power stations, this is one of the worst times to behave in this way. Inevitably the consequences to the cost of capital—and to the overall incentives to invest—will have been very negative, whether or not any windfall tax is actually levied. A great deal of damage has already been done.

Of course, it is right to inquire into the competition issues, and Darling was right to raise this question, but the answers are about competition and market design. Fuel poverty and windfall taxes have nothing to do with these issues. It is the deliberate conflation of these issues which will have done lasting damage, exacerbated further by the media manipulation and the arm-twisting behind closed doors. This will go down as a very sad and sorry blot on the face of the attempt to create a sustainable and competitive market in Britain.

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