How to make UK energy policy more predictable again

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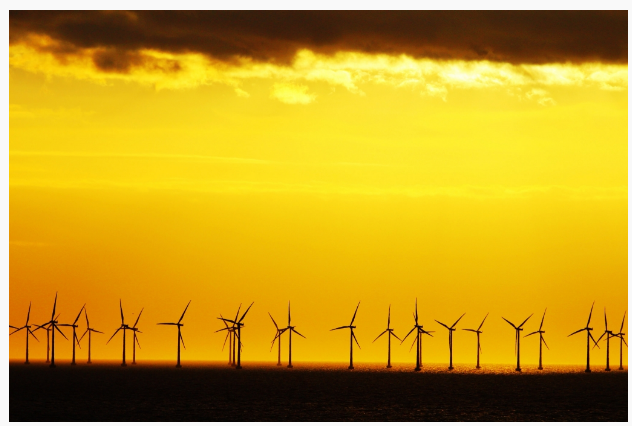
A series of policy U-turns have made aspects of British energy policy unpredictable. With such reversals having been politically motivated, state involvement must be revisited if the industry is to re-establish its credibility, argues ***Sam Fankhauser****. He explains that making strategy and decision-making more transparent, and delegating regulation to independent bodies, are some steps that will depoliticise the energy sector and increase investor trust.*

Is there an energy investor left who still trusts the UK government? Since the last general election there has been a constant stream of policy re-sets and reversals that has left the industry reeling. The latest U-turn was a terse statement to the London Stock Exchange on 25 November, which announced that "the £1 billion ring-fenced capital budget for the Carbon Capture and Storage (CCS) Competition is no longer available. This decision means that the CCS Competition cannot proceed on its current basis". It was a blow to an industry that had spent years developing projects under the scheme.

CCS is not alone. It joins the solar industry and onshore wind, which have both been at the receiving end of recent policy changes. Coal-fired power generation, it was also announced on 25 November, will be phased out in the mid-2020s. The government instead wants to promote natural gas, both conventional and unconventional. But by cancelling the CCS competition it has inadvertently cut the economic life of gas investments to about 20 years. As the Committee on Climate Change has pointed out, there is next to no room for gas without CCS in the UK electricity system from the mid-2030s, if the government is to meet its statutory carbon targets. The government also supports off-shore wind, but made it clear it will change its mind if costs do not come down as expected. This leaves nuclear, which has its own finance and technology risks.

It is normal for new governments to come in and change things around. That's democracy and investors will get this. They also understand that politicians don't always do what they promise in their manifestos. The Tory Party's aversion to on-shore wind was well-known, and coal-fired power producers will have known that the writing was on the wall.



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Other changes, though, were sudden and unexpected, and this is where the problem lies. They left investors with no time to adjust and with often substantial sunk costs. The government's commitment to CCS, in particular, had been reiterated repeatedly, the last time only a week before the axe fell. The extension of the climate change levy to renewable energy was also introduced without much warning. And it is not just this government. The previous coalition government was criticised in 2011 for slashing solar power subsidies more or less overnight. No wonder, then, that energy professionals see policy continuity as one of the biggest challenges for their sector.

So what can be done to re-establish trust in UK energy policy? The literature highlights a number of institutional features that enhance policy credibility. They include clear objectives, ideally grounded in legislation; transparent decision-making and the possibility of legal recourse. There is also a potential role for independent bodies. Some of these features are present in the UK energy sector. The UK's carbon targets, in particular, have a clear legal basis in the Climate Change Act and they are scrutinised by the independent Committee on Climate Change. Because of these safeguards Britain's mandatory carbon budgets are arguably one of the least ambiguous aspects of energy policy, although a stern test awaits with the fifth carbon budget, which needs to be passed by June 2016.

The problem is that (relative) certainty over carbon targets does not automatically translate into clarity over the policies used to achieve them. The government has options, and may prefer one policy instrument over another, say regulation instead of subsidies. It is over those policy choices that investors would like more clarity.

Investors derive comfort from a binding contract, and these are available through Contracts for Differences and the capacity market. Unfortunately, securing a contract also entails policy risk, as the CCS experience shows, and this is reflected in the commercial terms bidders seek. Ultimately, there is no substitute for policy credibility.

The area where the art of policy communications is most perfected is monetary policy, which was in fact determined by politicians until operational policy-making was delegated to the Bank of England in 1997. Central bankers now go out of their way to ensure the predictability of their decisions. In fact, the market's ability to anticipate policy decisions is one of the yardsticks against which a good policy regime is measured. Central bankers have learned that predictability is associated with a transparent strategy, procedural clarity and the clear explanation of decisions, which includes the timely availability of underlying data. There is no reason why a similar approach could not be adopted in energy policy, for example when deciding the subsidy level for renewables under various support schemes.

The predictability of monetary policy is further enhanced by the fact that decisions are in the hand of technocrats, rather than politicians, although their targets and objectives come from parliament. Delegating authority to an independent body is also standard practice in regulation, for example in railways and water. This is thought to enhance decision-making, reduce political interference and lengthen the short time-horizons imposed by the electoral cycle. Many aspects of energy policy are independently regulated already, while others are so deeply political that they should not be left to unelected officials. Yet, the same was once said about interest rates.

There is no question that the energy sector has become more politicised over recent years. This was necessary to correct fundamental market failures, not least those related to climate change. But the time may have come to revisit again how that state's involvement in the energy sector is best structured.

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