Liberal markets create an addiction to gas - the Oil Drum in the Financial Times

Posted by Jerome a Paris on February 2, 2007 - 1:00am in The Oil Drum: Europe
Topic: Policy/Politics
Tags: electricity, europe, gas, liberalisation, russia [list all tags]

I am pleased to inform you that the Financial Times is publishing, in its edtion dated 1 February, an article by the Editor of the European Tribune and Contributing Editor to the Oil Drum which covers a number of topics that we've discussed here before. Its conclusion:

> Taking into account pollution, carbon emissions and the expected depletion of resources, moving away from burning hydrocarbons should be an overriding long-term goal. A sane energy policy should focus, as a priority, on reducing our electricity demand via conservation and energy efficiency and on switching to capital-intensive, locally built, renewable energy sources. That will require thinking again about how we finance the sector.
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> Energy market deregulation is incompatible with the fight against global warming – markets like to finance gas plants – and with security of supply when exporters will not play by our rules. There is no reason to expect them to do so at a time of increasing tightness in energy markets. We have solutions available, if we act on demand reduction and promotion of renewable energy. Sadly, we seem to be doing the exact opposite.

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> **Liberal markets create an addiction to gas**
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> *By Jerome Guillet*
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> Energy has become a hot political topic in Europe. Oil price volatility, cross-border mergers and concern about global warming and the security of future oil supplies have conspired to keep the issue in the headlines. Added to this have been fears that the Kremlin will use our increasing dependence on Russian gas as a geopolitical weapon, and the European Commission's plan to tackle climate change while pushing on with energy market liberalisation.
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> In all this some basic realities of energy markets seem to be have been forgotten, in particular the growing connection between electricity and gas markets. Electricity market liberalisation has meant that wholesale prices are no longer set by regulated utilities on the basis of production costs, but by supply and demand.
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> Electricity demand is inflexible – users, except for some industrial consumers, turn on the switch whenever they need electricity. They do not do so on the basis of price. In a

market situation, this inflexibility leads to the price's being set by the production cost of the most expensive power plant needed at a given moment. This is the marginal price, and it is usually higher than the average production cost of available capacity.

Gas-fired power plants provide technical flexibility, thanks to the speed at which they can vary their output. They are also cleaner and emit less carbon than coal-fired plants. This has helped make gas the fuel of choice for electricity generation during the past 15 years. With their ubiquity and rapid response to demand peaks, gas-fired plants are almost always the market's marginal cost plants, and thus set the electricity price – creating a direct link between gas prices and electricity prices.

Low gas prices during the 1990s created the illusion that marginal prices were almost as low as the price of base load electricity (production from coal-fired, nuclear or hydro power plants, which is needed all the time and is usually cheaper). That is no longer the case. Gas prices – which, in Europe, still largely follow oil prices – have increased sharply and drawn wholesale electricity prices up with them. Retail prices have followed.

Politicians who pushed for deregulation never described marginal pricing to consumers and now have to explain why liberalisation is not bringing prices down as promised. Rather than face the music, they blame price rises on insufficient liberalisation or "uppity" suppliers such as Russia.

But the fundamental reason gas-fired plants have been favoured in today's liberalised environment is their lower financing costs. Some technologies have lower investment costs and higher fuel costs (gas); some have higher investment costs and lower operating and fuel costs (nuclear and wind). Deregulation and competition rules put the burden of funding investment on financial markets instead of the public purse. This makes financing costs higher than for public utilities that could rely on state guarantees and thus borrow at lower rates.

The increase in financing costs favours technologies with lower initial investment costs – that is, gas and, to a lesser extent, coal-fired plants. Thus liberalisation increases the European Union's demand for gas and its dependence on imported gas at a time when domestic supplies are declining.

Worrying about Russia controlling our supplies while de facto encouraging investment in gas-fired power plants appears silly. If we are so concerned about our dependence on energy imports, why do we not focus our policies on what we actually control – our demand – instead of concentrating only on the supply side?

Taking into account pollution, carbon emissions and the expected depletion of resources, moving away from burning hydrocarbons should be an overriding long-term goal. A sane energy policy should focus, as a priority, on reducing our electricity demand via conservation and energy efficiency and on switching to capital-intensive, locally built, renewable energy sources. That will require thinking again about how we finance the sector.

Energy market deregulation is incompatible with the fight against global warming – markets like to finance gas plants – and with security of supply when exporters will not play by our rules. There is no reason to expect them to do so at a time of increasing tightness in energy markets. We have solutions available, if we act on demand reduction and promotion of renewable energy. Sadly, we seem to be doing the exact opposite.

The writer, an investment banker for the energy sector, is the editor of European Tribune and a contributing editor to The Oil Drum

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