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Energy Producers and
Consumers
Can We All Get Along?



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Energy Producers and Consumers: Can We All Get Along?

It may seem that the premise of the question is whether we – the consumers – can establish good relations with the producers, whether we can be pally with Putin, Chavez and Sheikh Al-Naimi? But this is not a question of international conferences and conventions but of markets, for that is how the positions of producers with energy to sell and consumers who need to buy energy are resolved. So the issue really boils down to how well do markets function in the following dimensions:

- Are they free, fair and competitive?
- Are they secure, i.e. are they free from political risk of interruption or social upheaval?
- Are they stable or are prices highly volatile?
- Do they produce the right signals for producers and consumers, especially in relation to climate change?

By these criteria energy markets score pretty poorly. Firstly, oil and to a lesser extent gas markets are distorted by a cartel controlled by countries many of which are politically hostile to the West. About half of the 100 largest oil companies are state controlled and they own over 70% of oil reserves and 50% of gas reserves. Many producers have large financial reserves and so can afford to interrupt or restrict supplies while the consumers have under-invested in resilience.

Secondly, markets are far from secure. Oil and gas producers have the power and some, e.g. Russia, have shown they are prepared to use it to secure political advantage; and some, e.g. Saudi Arabia are potentially very unstable.

Thirdly, prices are very volatile. Market stabilisation mechanisms are weak, storage capacity is low and energy networks and grids function poorly.

Fourthly, energy markets generate poor signals. The biggest distortion is the absence of a unified price to reflect the social costs of carbon emissions. Phase I of the EU Emission Trading Scheme has made a poor start

by over-issuance of credits which are not auctioned. I fear that in Phase II things may not get much better as the scheme may be undermined by the so-called Linking Directive which permits Kyoto credits to be bought in with little proven additionality. The result could be that very little CO₂ saving will be required within the EU. Given the short term unreliability of the mechanism it is not surprising that long term investors have no reliable guide to the future price of carbon.

Fifthly, regulation is sometimes justified, e.g. where there are small savings to be made by many people but the saving for each is not large enough to be triggered by price changes, e.g. light bulbs and standby appliances. Too often the implied cost of a ton of carbon saved is not calculated and, where it is, it is much higher than the values thought necessary in any cap and trade scheme.

Finally, we see pursuit of renewables *per se* rather than because they offer the prospect of low carbon emissions. The 20 percent EU target has no costs attached to it and assumes that percentages 18, 19, 20 of renewables are better than percentages 1, 2, 3 of non-renewable but lower cost sources of energy, e.g. nuclear or carbon capture and storage.

All this is pretty unsatisfactory, though I should make it clear that I regard the consumers just as culpable as the producers for having allowed themselves to get into such a weak position.

What can be done to improve markets? First clarity is needed on objectives; is it climate change; is it security of supply and energy independence; or is it economic development?

The US (or rather that diminishing bit still run by the Bush Administration) places a very high premium on security and little on CO₂ reduction so it is prioritising the reduction of oil imports even if the methods used such as biofuels or unconventional hydrocarbons have poor CO₂ gains. The EU prioritises CO₂ reduction but believes that what it does under the climate change banner will do enough to reduce dependence on unreliable energy supplies. China and India prioritise economic

development even though with nearly 40 percent of the world's population between them they stand to be the biggest losers from the effects of climate change.

Secondly, a consensus is needed on the dimensions of climate change. There seems to be a working assumption that we should try to limit temperature change to 2°C or less, and CO₂ concentrations to 500ppm or less. At this stage this can be no more than a working assumption but at least it provides a starting point while the scientific work is refined. Better to work to such an assumption than wait until the scientific work is complete.

Thirdly, intensive work is needed to establish a better carbon pricing mechanism than the Phase I of the EU ETS, better by having a wider geographical coverage, a wider coverage of users, a more robust process for determining the quantum of permits which is less vulnerable to political horsetrading, use of auctions to issue them, and less scope for buying the modern equivalent of medieval indulgences.

Fourthly, the EU should abandon the privileged position of renewables versus non-renewables. This distinction should be replaced by a low carbon versus high carbon. There are rumours that the UK government may be rethinking what I regard as a seriously flawed EU objective of sourcing 20 percent of all energy supplies from renewables. The UK could start by removing the illogical bias in the Climate Change Levy where near zero CO₂ producing nuclear energy is subject to the levy.

Fifthly, there should be no targets for market shares for individual technologies and an end to "my favourite fuel good / your favourite fuel bad". There will be a need for a portfolio of technologies and all should stay in play. Some will develop further than others and we should be placing our bets widely.

Sixthly, wherever a regulatory as opposed to a market approach is used, all regulations should be compared on a common basis of cost per ton of CO₂ avoided.

If these precepts are followed, the vulnerability of consumers will be reduced, energy markets will be more competitive and cartel and political power will be diluted. We won't need to be pally with Putin, Chavez or the

Saudis but consumers will be able to engage in political dialogue on a more normal basis.

The real dialogue, however, is not between consumers and producers – Russia, USA and China are both – but between all countries as contributors to climate change. Only through dialogue can the free rider problem be solved and an agreement on burden sharing be achieved.

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