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Dear Sir/Madam

Ofgem's response to the discussion paper "What is the Economics of Climate Change?"

Ofgem welcomes the discussion document "What is the Economics of Climate Change?" published by the Stern Review Team in January 2006 and the opportunity to comment on the key questions for the review identified in the paper. Ofgem supports the aims of the review and welcomes the opportunity it provides to undertake a broad review of climate change issues without the constraints of short-term considerations. The work and conclusions of the Stern review will be a valuable resource to inform government decision making in other major reviews, such as the current reviews of energy policy and of the Climate Change Programme.

The gas and electricity industries are major contributors to the emission of greenhouse gases and also play an important role in the wider economy. Consideration of the role of energy industries is therefore crucial to the economics of climate change mitigation and adaptation. Ofgem particularly welcomes the recognition in the review of the importance of understanding how climate change policies interact with existing incentives embedded in energy markets. Ofgem's principal objective is to protect the interests of present and future gas and electricity consumers, where appropriate by promoting effective competition. Ofgem therefore considers that governments should seek to minimise the economic and social impact of meeting the ambitious environmental targets by careful selection and design of measures. As such, Ofgem has welcomed the introduction of emissions trading as a flexible instrument that should allow emissions reductions to be achieved at least cost to consumers.

The discussion document highlights the substantial complexity involved in understanding the economics of climate change given the global and long-term nature of the problem. These characteristics are unique to the climate change problem and, as such, it is essential to consider innovative analytical approaches and techniques that recognise these

characteristics. For example, the validity of frequently used techniques, such as the valuation of environmental impacts and the use of discount rates, needs to be reconsidered in the analysis of such broad effects. The issues of uncertainty and irreversibility of effects also add to the complexity.

The issues of addressing climate change are compounded by the characteristics of industries such as the power sector. Energy assets, including both generation and network assets, are long-lived. Investment decisions made now will have a long-lasting influence on both the level of emissions from the sector and the cost of reducing emissions associated with energy production and delivery for many decades into the future. A clear long-term approach to the economics of climate change mitigation and adaptation is essential to provide the appropriate signals for investment to minimise the risk of prematurely retiring capital stock, which would increase the costs of meeting emissions reduction goals. The discussion paper notes the interaction between mitigation costs and economic development. The choice of framework could itself substantially affect this interaction and this should be captured in the long-term analysis.

The discussion paper also acknowledges the importance of understanding the nature of market failures and barriers to entry of new and existing low carbon technologies. Consistent with a market-based approach to energy supply and reduction of greenhouse gas emissions, Ofgem would support the research into removal of market barriers which may be preventing cost-effective technologies from coming to market. Allowing market participants to respond appropriately to incentives, rather than promoting the development of specific technologies, is more likely to result in emissions targets being achieved at least cost. This also allows innovative technologies to be brought to market, if they are cost-effective.

Ofgem will continue to follow the progress of the review's work. Full consideration of all of the issues identified will entail significant work by the review team and others over the coming months. Building on the useful meetings that have already taken place between Ofgem and the review Team, Ofgem would be happy to provide further assistance on energy matters where we have knowledge and expertise that you may require in areas relevant to the gas and electricity industries. In particular, Ofgem has recently commissioned research reviewing the costs of generation technologies and considering scenarios for meeting carbon constraints within the UK energy sector. We would be happy to share the results of this analysis with the review team if that would be helpful.

Yours sincerely



Steve Smith
Managing Director, Markets