Freezing energy prices could be disastrous [1]

Written by **Victoria Freeman** [2] | Wednesday 25 September 2013

Having worked in the energy industry in the UK since the beginnings of market liberalisation in the 1990s, I found myself somewhat alarmed by Ed Miliband's pledge to freeze on energy prices between 2015-17 if elected. Labour's standpoint seems based on some fundamental misunderstandings about the energy market.

Many outside the industry appear to be dismissing the security of supply issue, as if this were mere scare tactics by the energy companies. But it is a very real problem. When energy demand increases during cold winters, such as those we have experienced recently, a minor supply shock such as a unscheduled gas platform or pipeline shutdown can cause prices to spike.

If energy companies are prevented from passing on these increased costs in consumer price rises, how will they stay solvent? It could come down to a choice between cutting investment, returns to investors, or staffing costs. Given that energy companies' largest shareholders include UK pension funds, none of these options are appealing.

Another area where there is a great deal of misunderstanding of the way the industry works is the way energy companies buy the gas and power they need to supply their customers. Politicians and the press are very vocal about issue of wholesale price falls not always being passed on to consumers. This ignores the fact that energy companies do not buy most of their gas or power at the wholesale spot prices quoted on any given day. It is far too risky for a company to leave themselves exposed on price until the day of delivery, so they buy tranches of their gas or power up to two years in advance.

Energy firms also use long term contracts whose prices can be fixed or floating. The spot market is often only used to balance requirements when there are changes in the portfolio of supply or demand. As such, the price paid for gas or power by energy companies will be a basket of different types of prices, not simply the wholesale spot price of the day of delivery. Therefore, an energy company may not be able to respond to a reduction in the wholesale price as its commodity costs are not based solely on this spot price.

While I agree wholeheartedly that our energy companies should be subject to close scrutiny to ensure that they are delivering fair value to UK consumers, context is important, too. In the UK, domestic consumers pay the least of all EU15 countries for gas [3] and we are the fifth cheapest for electricity. A safer method than price fixing of cutting UK energy costs would be to reduce the levels of tax paid on North Sea gas

production, which can be as high as 81%. Cutting taxes would reduce distortions in the energy market: freezing prices could make those distortions disastrous.

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