

The privatisation of the energy sector economics essay



**ASSIGN
BUSTER**

The issue of energy has been a turbulent one, with different governments changing and restructuring the processes by which energy is produced, transmitted and distributed. The two dominating energy policies are the opposing privatisation, where there is minimal government intervention, and price regulation, where the government actively sets controls on the pricing of energy supply. The aim of intervention would be to reduce costs for industry and domestic users, as well as fulfilling sufficient energy supply. This report will discuss the history of the energy policies in the UK and the effect of the recent changes that British Prime Minister David Cameron has proposed. It will also demonstrate whether the policy of price regulation is compatible with efficient energy distribution.

A Brief History of the Privatisation of the Energy Sector

After the Conservative Party election in 1975, policies implemented by Margaret Thatcher were coined 'Thatcherism'. Thatcherism is often compared to the American policies of Ronald Reagan in the 70's which were called 'Reaganomics'. Thatcher and Reagan both shared the view that deregulating the market would lead to more competition between businesses, therefore higher productivity, more efficiency and lower prices overall. Therefore, all previously nationalized industries were privatized, with the aim to transform the economy into a more market-oriented one, encouraging an enterprise culture such as investing and risk-taking, without government intervention, to lead to wealth maximisation. Thatcher believed that the private sector would be more efficient, as the private sector is profit driven and would lead to greater efficiency than government owned companies; the aim was to eliminate state socialism and increase "popular

capitalism” by giving more ordinary people the chance to become shareholders. Indeed, between 1988 and 1989 the British government derived over £7 billion from privatisation, which dramatically improved Britain’s economic situation. From the period of 1992 until 1996, the government continued to push privatisations in the required areas, selling British Coal, National Power and Powergen. The United Kingdom’s electric utility industry privatisation began in 1990 and ended in 1996. The aim of deregulation was to remove price ceilings and generate profits for the firms, subsequently attracting new companies into the market. An increase in competitive markets would then, in principle, then drive prices down towards a price that is socially affordable. This would benefit customers in the obvious way in addition to forcing producers to become more efficient in their productivity to compete.

The price of domestic gas and electricity has generally increased over the past eight years after around a decade of falling prices; although there have been some price cuts over the past few years, these have been smaller than the price rises. So far, this autumn five of the big six energy suppliers have increases gas and electricity prices by between 6% and 11%. These price increases have been attributed to higher operating, network and environmental costs. In the long term, the pressures on the price all appear to be increasing; the only way that domestic and industry consumers can decrease the effect of increased unit costs and reduce bills is by improving energy efficiency. This note focuses on trends in the domestic market – the costs of gas, electricity and other fuels used for heating and its impact on fuel poverty. An analysis of the impact of earlier price trends on levels on

consumption can be found in energy price rises and their impact on demand. The note fuel poverty looks at trends, patterns and projections of fuel poverty and the article Energy prices and fuel poverty gives a brief snapshot of trends in prices, fuel poverty and prospects for the future.

Setting and controlling energy/electricity prices and recent price changes in the UK

There are four elements to the price of electricity charged to the final consumer. There are the wholesale prices charged by the generators, the prices charged by the National Grid company for use of the national transmission network, the prices charged by the owners of the regional distribution networks and finally the prices charged by the supply companies to final consumers. British Prime Minister David Cameron said his government will change the law to tackle rising energy bills by forcing companies to charge each customer the lowest rate for their type of use. Cameron's statement came after announcements of price increases by energy companies in October. British Gas, the biggest supplier of power and natural gas, said it would raise prices for both gas and electricity by an average of 6%; RWE Npower Plc said it would increase rates for power by an average 9.1% and 8.8% for gas. Field said that only a minority of consumers were taking advantage of the possibility of switching providers to find the lowest gas and electricity prices. "We need to place more obligation on companies," he said. "At the moment, everything is down to the consumer. We feel we need to go further," (Field). A number of companies have suggested their increases in costs are the result of wholesale increases or government environmental schemes which affect their costs. The energy

companies blame wholesale price increases but even the regulator has found that prices don't fall when the wholesale price drops. The sector is dominated by a handful of big and powerful players who are seemingly unaffected by the normal competitive pressure of price and customer service. People are questioning whether they are paying a fair price for their gas and electricity.

More on recent energy price changes

As part of Ofgem's aim to create a " simpler, clearer, fairer and more competitive" energy market, suppliers would have to tell each customer about the cheapest offer available to them based on how they pay their bill - whether by direct debit, pre-payment or credit. Customers would also default to the cheapest option at the end of fixed-term contracts. Ofgem also proposes a cap of just four " core" tariffs. At the same time, it wants to trial a proposal to provide vulnerable customers, and those who have not switched supplier for three years or more, with information about the cheapest market deal. Ignacio Galan, Iberdrola's executive chairman told the Financial Times that it would be better to move to a fully regulated energy market i. e. stepping away from privatisation and moving towards an energy market with government intervention. He also commented that if companies had to offer all customers their cheapest deal there would be no point in energy providers enticing customers with loyalty plans, products and services, different payment plans and other incentives. Ofgem, the industry regulator, stopped endorsing Mr Cameron's plan, publishing its own proposals that would force suppliers to cut the number of tariffs and tell customers about

the cheapest deal on offer, but would not force them to put all consumers on their lowest tariff.

If firms had to offer the “cheapest” deal to householders, there would be nothing to stop them ditching their lowest tariffs so that more expensive deals became the “cheapest”. However, “the danger is that they will pull their cheap deals and put everyone on more expensive standard tariffs, meaning that people will end up paying more,” says Mark Todd, director of energyhelpline.com. Even consumer groups argued that it was unworkable and would destroy what little competition there is in the energy market, forcing prices up not down. The Prime Minister has been warned he will kill off competition in the energy market if companies are forced to give all their customers the lowest tariff available.

Government intervention – yes or no? Impact on producers, consumers and fuel poverty

Generally, the proposed government intervention is not capable with the free market system. As in the open market system, prices are determined purely by the market forces of supply and demand without any government intervention. Moreover, the prices of goods and services are determined by unrestricted competition between privately owned businesses. At first glance, regulated prices seem to be contrary to the principles of a competitive retail market. Government intervention in a functioning and open market would probably be anti-competitive would certainly go against the beliefs of most Tory and Lib Dem MPs. The main problem lies in whether the regulated prices should be set higher or lower compared to market prices. This section will review whether governmental price regulation is

<https://assignbuster.com/the-privatisation-of-the-energy-sector-economics-essay/>

beneficial for producers, distributors, consumers and the issue of fuel poverty.

Price regulation should be permitted under certain conditions, one of which is that it must not distort competition; price regulation prevents suppliers from offering attractive services and personal, dynamic pricing schemes. Setting regulated prices too low is also not compatible with the development of competitive markets. Regulated prices can be qualified as being lower than market prices. Low level of regulated prices distorts the functioning of the market, both at wholesale and retail levels, by decreasing the functioning of the retail market in addition to the whole liberalisation process. If regulated prices are not in line with wholesale market conditions, suppliers without significant low-cost generation capacity or equivalent long-term contracts will not be able to make competitive offers that will allow them to recover their costs. Consequently, with a limited number of suppliers, there will be no development of the wholesale markets - liquidity will remain at a low level. As a result, neither the wholesale nor retail markets will be competitive. Regulated prices limit the opportunities and incentives for customers to switch suppliers and thereby limit competition in the market. On the other hand raising the level of regulated prices may not be the solution either, because the costs to be recovered are nearly impossible to assess and even regulated prices set at wholesale price levels will not ensure that incumbent suppliers can recover their costs. It could be that the nature of regulated prices itself is incompatible with the opening up of electricity and gas markets to competition. The issue of setting regulated

prices at an appropriate level is much more complicated than it appears at first sight.

There are two main reasons explaining that despite their levels, regulated prices are deemed to be incompatible with a competitive market. First, methods for establishing regulated end-user prices are contrary to market price-setting mechanisms. Regulated prices are set by an external authority, while market prices emerge when supply meets demand. Suppliers and customers are directly interested in finding a "fair price" to meet their needs, while an external authority may be motivated by reasons other than those of a well-functioning market. Therefore, the process and methods for setting regulated prices are likely to have an impact on the market. Secondly, regulated prices are not designed for competitive markets. Some regulated prices (or price control mechanisms) were designed to regulate monopolistic electricity and gas sectors, and predominantly, vertically-integrated undertakings. The purpose of monopoly price control has often been the development of optimal capacity at the lowest possible cost for the whole of society. Not only are the levels of regulated prices likely to impede the development of liberalised markets, but the mere existence of these prices has effects on liberalised markets.

However, there are price regulations which could present benefits within a liberalised market and even be considered as necessary for the achievement of market opening, depending on the structure of the relevant market. A good example of the best practices in the area of price regulation is in the Netherlands, where for both electricity and gas retail markets, the regulatory authority sets the maximum reasonable price for household customers and <https://assignbuster.com/the-privatisation-of-the-energy-sector-economics-essay/>

SMEs per product (price capping). This price is not made public, so as not to distort the mechanisms for setting market prices, but the regulatory authority may oblige suppliers to comply with these regulated prices if their prices are above the regulated prices.

It is also important to recognize that consumers can be harmed as a result of underpricing, because under-pricing tends to restrict the supply-side of the markets; certainly in the long term by discouraging investment and innovation and possibly also in the short-term by reducing reliability and security of supply. Therefore, it is crucial to inform customers of their rights and their ability to switch supplier is certainly the first step to promoting customer empowerment and to allowing them to benefit from the effect of competition on electricity and gas retail markets. Regulated prices can have direct damaging effects for consumers in open electricity and gas markets. Price regulation may impede customer's access to information, diversity in offers or it can provide the opportunity for the collusion of suppliers deciding to exert their market power. Some household customers would not find any suitable offers and customer surplus is not reached. A sufficient level of information should allow customers to exert their choice in the market.

Regarding fuel poverty, especially protecting vulnerable customers, regulation is necessary in a competitive market. Under EU law, "vulnerable customers" are safeguarded under the liberalised market framework, because they are considered more susceptible to suffering in open markets and to becoming victims of misleading commercial practices. Vulnerable customers may be protected through specially established social schemes, like social aids ensuring their continuous access to electricity and gas.

<https://assignbuster.com/the-privatisation-of-the-energy-sector-economics-essay/>

Furthermore, tools used for the protection of these customers must work in line with and support the prerequisites of competitive markets. Protecting “vulnerable customers” should not be confused with maintaining regulated energy prices for all, or certain categories of customers. Any policy aimed at protecting vulnerable customers must be brought into line with market conditions. It is of the utmost importance that any attempt to protect vulnerable customers does not hinder the efficient functioning of a competitive market.