

Will Domestic Competition Benefit Gas and Electricity Consumers?

Notes from the Third BIEE Seminar on Competition and Regulation of Energy Utilities, 18 September 1996

Michael Morrison of Caminus Energy opened the discussion with the following points:

- Considerable progress had been made in introducing competition in nondomestic markets, both in gas and electricity, and in both industries this process had been associated with substantial reduction in "real" prices. Competition thus had a good track record so far.
- There was substantial scope for cost reductions in the supply of both domestic electricity and domestic gas. This was so even though supply costs *per se* represented only a small proportion of the total costs to final consumers. The crucial point was the effect of competition in the domestic market in reducing "wholesale" electricity and gas prices (represented by generation prices and "beach prices") which were by far the largest part of unregulated costs. Without full competition in the domestic sector, effective price competition in the wholesale electricity and gas markets could not be sustained.
- Domestic electricity and gas under competition will take on many of the characteristics of other retail markets. The keynote would be innovation built around new information technology. New entrants such as supermarkets, insurance companies and financial services would become involved; and there would be new "alliances" and joint ventures (with considerable scope for the "building" of electricity and gas.)
- Domestic competition is likely to lead to more customer segmentation and "targeting." Sophisticated metering is the key to cost-reflective pricing. In this process, it is by no means certain that lower income groups will lose out.

Much of the ensuing discussion was concerned to test the proposition that domestic sector competition was essential to obtain the benefits of lower wholesale electricity and gas prices for fuel consumers. Some of the points made included the following:

- Competition in fuel markets, which prevented simple cost "pass-through" was inherently superior to "economic purchasing" regulation. It was the size of the domestic sectors in both electricity and gas which made them crucial in influencing wholesale price competition.
- Once the gas interconnector with Continental Europe was in place, the wholesale price of gas would become linked to prices in the West European gas market as a whole. There were differences of opinion as to whether, in these circumstances, the introduction of domestic gas competition would have a material influence on beach prices.
- The present position, whereby different players had widely different gas costs, was the transitional effect of unwinding the former BG monopsony, and was unlikely to be sustained.
- In electricity, the main competitive mechanism which would reduce wholesale (i.e., generation) prices would be the costs of new entry to generation, since incumbents could not afford indefinitely to sell at above new entry

costs. It was argued that the process would be weakened if domestic competition was abandoned.

Other points made in discussion were:

- Reductions in prices of electricity and gas in already competitive sectors owed much to other factors such as falling coal and gas prices under conditions of surplus.
- Currently load factors were not recognized in domestic tariffs for electricity and gas. Although much of this question concerned regulation of the monopoly networks, competition in the domestic sector would increase pressure to make regulation of the networks more cost-reflective.
- It was by no means clear that the market mechanisms in the wholesale gas and electricity markets would be sufficiently developed to underpin full competition in 1998. Electricity and gas might become more like oil, with sophisticated spot markets and financial instruments to set prices, manage risk and balance supply and demand.

M. J. Parker

The Outlook for U.K. Coal: Short-term Plenty, Long-term Famine?

*By Michael J. Parker**

The year 1995 was a good first year for the privatized U.K. coal industry. Output and sales both increased and the industry was generally very profitable. Broad stability should continue to 1998.

However, when the major coal contracts with the electricity generators expire in March 1998, the *fundamentals* become much less favorable and the industry will be exposed to much greater risks. This is for a number of reasons:

- The increasing impact of gas-fired generation and, above all, of new SO₂ emission limits from 2001, will make it almost certain that the demand for U.K. coal will continue to fall.
- The planned end of the Regional Electricity Companies' monopoly franchises in 1998, and further increases in competition, will make it very difficult for U.K. coal producers to contract forward for a term of years at predetermined volumes and prices, giving greater exposure to the uncertainties of international prices and exchange rates.
- It is almost certain that prices available to RJB Mining (which makes up three-quarters of the industry) after March 1998 will be significantly lower than those in current contracts, and very likely that sales volume will also decline, with much smaller profit margins.
- The market outlook is not conducive to major deep-mined investment (as distinct from routine replacements). Yet in the absence of major investment, deep-mined output could halve over the next 10-15 years; and future opencast output will depend on planning permission for new sites, which is likely to be increasingly difficult.

Thus, after 1997-98 the U.K. coal industry will be a high-risk, declining business for the foreseeable future.

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