My Conservative Home Article: Tackling the energy crisis is the key to defeating both recession and inflation

Below you will find my latest Conservative Home:

The new prime minister will want to finalise plans to tackle the cost of living crisis within days of taking office.

We read that there have been preparations both in her transition team and at the Treasury under the outgoing chancellor, speeding the task of bringing together the ideas and the official appraisal of options to produce an early statement to Parliament.

The immediate task is to see off a long and deep recession by putting enough money back into the economy that sky-high energy costs will be taking out.

Some of the extra cash removed from people and companies has been lifted by the Treasury itself, a winner from all the extra VAT, energy profits taxes and other energy levies that high prices bring. Some of the extra cash is effectively a tax imposed on us all by overseas energy markets, as the UK needs to import oil, gas and sometimes electricity to get by.

We cannot get any of this back, nor can we tax it, but we do need to take it into account when deciding how much help to offer people and businesses. It is a deadweight cost to all of us and a big loss for our country’s finances.

Many people and businesses can benefit from the promised tax cuts. Where they remove taxes on energy, they also help get the inflation rate down; it is a pity Rishi Sunak did not get agreement that the £400 effective cut to all electricity bills should help lower the rate.

The Government will need to do more to help those who rely on benefits, as well as choosing tax cuts that have the best effect on tackling the squeeze brought on by the price hikes. Cutting the inflation rate by removing taxes from energy prices is particularly helpful, given the adverse impact of high inflation on public finances.

There are medium-term tasks as well if we are to chart a course out of this rolling energy crisis. It is a double problem. There is the severe jolt to the system and ratchet in prices caused by the war in Ukraine and the need for Europe to replace all its Russian gas and oil imports.

There are also the underlying issues posed by the long road to Net Zero, where we are at that point where substantial renewable power on the system is good when the wind blows and the sun shines, but causes difficulties at other times. Then we need back up power usually from fossil fuels, whilst we await commercial roll out of storage and hydrogen technologies that could underpin a further major expansion of wind turbines.

All this points to the need to develop our energy policy around three objectives: environmental sustainability, affordability, and availability. The overriding environmental objective of recent years has skimped us on the other, two leaving us too dependent on imports.

Recent events also remind us how we need an energy policy that responds to the phases of the electrical and renewable revolution at the pace it occurs. It was always going to be the case that Europe and the UK would need a lot of fossil fuel this decade. All the time most people still have gas boilers with petrol or diesel vehicles and industry runs on gas we will need plenty of gas as a transition fuel.

It was never a good idea to rely too much on imported gas. Now we know Russia will use it as a weapon that is even clearer. Imported gas means paying more than for domestic gas, if only because of the higher transport costs, and can mean desperate last minute bidding for additional supplies in a world market chronically short of offers.

If it comes as LNG rather than piped gas, it means generating a lot more CO2. Compressing and transporting the gas by sea uses a lot of extra energy. It means far fewer well paid jobs at home. It means we miss out on the often substantial tax revenue collected from those producing gas.

There are things current producers are doing and can do in the North Sea to lift output from existing fields using existing investment. Flows can sometimes be turned up, maintenance periods shortened. Specifications of gas used to supply pipes might be safely flexed.

There is then the possibility over a matter of months of adding extra wells to an existing field, tied into the present production facilities. There is the opportunity to drill the production wells in known field deposits where they can be tied into existing production facilities and pipes nearby.

Finally, there is the longer term opportunity to invest in an entirely new field with new production facilities, and to explore to find new deposits.

There is also a huge opportunity to develop onshore fields away from centres of population, with revenue or gas sharing with local residents. This would need to be done with agreement.

As we are not about to produce sufficient gas to cover all our needs, we also need to put in more storage capacity which we can fill in summer or other times of low demand as a protection against shortages in global energy markets and a way of smoothing prices.

Price controls distort and deter investment. They make the imbalance between supply and demand worse, when you need to bring the two together. Nationalisation of energy businesses would impose a huge strain on finances as current owners would need compensation. More supply is the true answer to dear prices born of shortages.

The Government needs to work as it has been doing with the nuclear industry to see if the productive lives of our current nuclear fleet can be safely extended and to see how a new fleet of smaller nuclear reactors could be commissioned at sensible prices and in a realistic time frame.

Promotion of renewables needs to continue alongside work to encourage commercial development of battery storage and the green hydrogen roll out. If we are going to have an electrical revolution we will need a great deal more generating capacity to fuel it. Government and industry in the meantime need to ensure there is enough reliable capacity to meet our power needs on days when the wind does not blow and the sun does not shine.

We are fighting inflation and recession at the same time. As energy is the single biggest contributor to the price rises, supplying more and cutting energy taxes is important. As the big loss of spending power brought on by the big energy price hikes is the single biggest cause of economic slowdown, so again improving the energy position is crucial to fighting recession.

Zimbabwe, Venezuela, Sri Lanka – three poster countries for price controls

Venezuela has been brought low by printing lots of money, by price controls and nationalisation. A potentially rich country with the world's largest oil reserves, Venezuela has seen its income per head fall from $12,000 in 2011 to just $1877 last year after a decade of price controls and nationalisation.

Zimbabwe, once a relatively prosperous agricultural state with plenty of food has seen its income per head fall to $1362 a head and lived through food shortages. Compulsory land transfers and price controls have not been kind to the economy.

Sri Lanka has been less extreme but has seen its income per head fall to $3698 last year and experienced food and other shortages as controls have been used. As a Professor at Colombo University wrote of their price control "it has never sorted out our supply shortages, but is has eliminated the quality goods from the market, and it has created a black market for good quality products, and it has not helped in any way eliminate poverty"

Food riots, protests against government, high inflation and damaging price controls have created misery in each of these potentially successful countries. Price controls have taken too many goods off the shelves, have bankrupted businesses that could otherwise have supplied more, have driven foreign companies out and put off more investment in capacity to supply. They have bred black markets, fostered smuggling subsidised and price controlled goods out of the country to sell at better prices elsewhere and prevented imports.

Why do so many people think they would work? Why will they not study what happens when they are used widely in inflation ridden economies?

Why price controls and windfall taxes do not work

Let me begin by making it clear I do want government to ensure everyone has sufficient money to be able to keep warm and do their cooking this winter. That is best done by allowing people to keep more of their income through tax cuts , or by giving people more in benefits to cover the bills who cannot earn. This blog is about the underlying problem of high prices and how you solve them.

Most people want there to be an easy answer to the ultra high prices of energy. Some say just stop any price increase for any energy sold to anyone. Some say control the prices of oil and gas that producers from UK reserves can charge us. Some say stop the renewable producers charging the same price for their electricity that the gas based producers have to charge now the gas price has gone up. Maybe there is a way to do the latter that the industry would accept, but they do need to be able to make a profit on their investments and need some long term visibility on contracts. The first proposal would stop all price rises. The second and third would stop some of the price rises, but would leave us paying the new high prices for all imported fuels and for the items of domestic production they leave out.

All these schemes mean government to a greater or lesser extent stops price doing what price will always do, balancing available supply with available demand. Higher prices now surging if left in place will solve the imbalance. All those in business or on better incomes who can economise on their power use will now do so, reducing demand. The state will need to rein in its extravagant use of energy by reviewing its over night street lighting, its heating and lighting of little used offices and the rest. Better off households will reach for the thermostat or timers to slice a bit off their past use. So demand will fall.

More importantly the price signal will incentivise businesses to put in more capacity to produce energy. Oil and gas producers will be encouraged to bring forward marginal new prospects that used to be uneconomic for development. Renewable investors will have more profits to plough back into additional capacity or into all important storage. In the short term energy companies will sweat their current assets more to maximise output. In the medium term they will add to their stock of producing assets and in the longer term the whole industry stands a better chance of achieving major commercial throughs with nuclear, battery, hydrogen and other technologies.

If you stop the energy industries in the UK earning the extra revenue from high global prices you will divert profit and investment capital away to countries that do allow them the benefits. If you stop them charging world prices they will divert as much of their current product as possible to markets where they can charge more. Anyway you look at it, price controls prevent more supply and impede lower demand from energy saving. It is no accident that the countries that have relied most on price controls are often those in the lower income bands worldwide, short of domestic supply. I will deal with those who think that means the answer is nationalisation in a later blog. That too would make the position worse.

An independent Central Bank

I read various bizarre articles defending the Bank of England's independence against an imaginary threat from Liz Truss. I only know what she has said in public, where she issued no threat to Bank independence. She said she favoured a review of the Bank's mandate to see if it met best standards in the world of independent Central Banks, and to find out what can be learned from the Bank's failure to forecast or prevent the high inflation we now suffer. The inference was she wanted a tougher Bank, not a Bank that printed more money and artificially depressed interest rates to suit the government.

The articles are bizarre because they always ignore the radical change to Bank policy launched by Mr Brown and Mr Darling and continued by all subsequent PMs and Chancellors. They agreed with the Bank a policy of creating more money and buying up state debt to keep rates down. Right from their start of this policy it has been a dual control policy, with the Bank needing the consent of the Chancellor and requiring a full Treasury guarantee or underwriting of the transactions. As this policy has dominated money policy between 2008 and 2021 we cannot say the Bank was then genuinely independent. It does have and did have throughout the sole power to fix the official interest rate. No-one in this debate is recommending taking that power away.

Going forward I would like to see the Bank introduce quantity of money and circulation of money as important information to monitor and take into account when settling interest rates. It has proved difficult to control inflation whilst allowing a large increase in the money supply triggered by substantial Quantitative easing. The Bank may not want to go back to strict money targets that were used in the early 1980s to end the last big inflation, but monitoring money and showing an awareness of its importance might help them make better calls. The current money figures show they have now reined things in considerably. They do not need to overdo the tightening from here to make the opposite error to being too loose as they were in the previous two years. The IMF does usually call for monetary discipline when it puts in a recovery programme for a state that needs financial help.

The ONS makes life more difficult

When Rishi Sunak announced a £400 payment to every electricity bill payer I was concerned about that way of offering some relief. I would have preferred tax cuts on energy which would directly cut the CPI/RPI measurements of inflation. The government thought these cash payments might qualify as reductions in energy bills and help the CPI figure. Instead after considerable delay the ONS has decided to call them “current transfers” to households that do not cut the price of power.

They rightly go on to remind us they have the legal power to make a judgement about such matters, They say “Decisions on whether to include rebates, subsidies and discounts in our consumer prices inflation statistics are taken on a case by case basis”. As these £400 payments cannot be withdrawn and spent on anything else but take the form of a cut in the electricity bills that need to be paid there is a perfectly good case to say this is a cut in the price of electricity for all users.

All this matters. Allowing the full bill cost to boost the CPI without allowing for the discount that is available means we face higher inflation with all the knock on effects. This decision will increase public spending and the deficit given the way some spending items are directly linked to the inflation index. It raises the repayment amount for indexed debt. The Treasury should have asked the electricity companies to put it on bills as a discount to the price of power, which is what it is. A sum equivalent is payable by the Treasury to the companies as a subsidy. This is another missed opportunity.