29 September 2022

The Cost of Living crisis: Analysis

Introduction

The UK is gripped in the middle of a cost of living crisis. There are many reasons for this which will be explained in the following briefing. However, it follows on from Brexit, the Covid-19 pandemic and the Russo-Ukraine conflict.

The ongoing impacts of the cost of living crisis on CLA members have imposed increased pressure on rural businesses which will take time to overcome. The Government has intervened in the energy market to attempt to bring in an element of stability but there will be measures that members need to consider to mitigate the worst effects of the cost of living crisis.

The origins of the crisis

So how did the crisis begin – what are the origins? It is important to stress that energy prices did not start to increase when Russia invaded Ukraine. We need to go back to July/August 2021 when economies began to reopen after the pandemic.

It is actually a case of an imbalance between supply and demand and the lack of market equilibrium. If supply and demand for a product are in balance, prices stabilize. However, if there is a surge in demand but supply cannot meet that demand surge, prices increase. As far as the wholesale price of gas is concerned, having industries reopening, there was a substantial surge in demand for gas and as such, prices rose.

As importantly, the volatility in the energy and fuel markets was exacerbated by the Russo-Ukraine conflict as the trends in wholesale gas prices show. We look at this below.

Defining a cost of living crisis

Although price volatility and instability are factors used to define a cost of living crisis, we also need to look at:

- Inflation rates and inflationary pressures: the rise in energy and fuel costs has led to an increase in the costs associated with production which had led to retail price increases; however, we are seeing a major disparity between the inflationary costs to producers and the higher prices for consumers;
- Interest rates: as far as the Bank of England is concerned (and most, if not all, central banks) the main tool to cool inflation is to increase interest rates. The theory is that by increasing interest rates, the amount of money circulating in the economy is reduced which dampens demand;
- Employment levels and availability: one of the big problems we have, particularly in rural areas, is labour shortage. As we know, a major factor is the restriction on labour availability following leaving the EU (no migrant labour). But for rural there are other issues; the willingness to do certain types of jobs, affordable housing which is not the case for urban areas;
- Wages and disposable income: with inflation comes wage increases and pressures that may lead to wage spirals meaning further inflationary pressure. It also leads to higher costs of production which are either offset by the producer or absorbed by the retailer. Again, there is a real chance that economic imbalances will remain;
- When all these factors come together you have far less stability and far more market volatility. It is the combination of a rigid fiscal policy and the stabilization of markets that leads to market adjustments.

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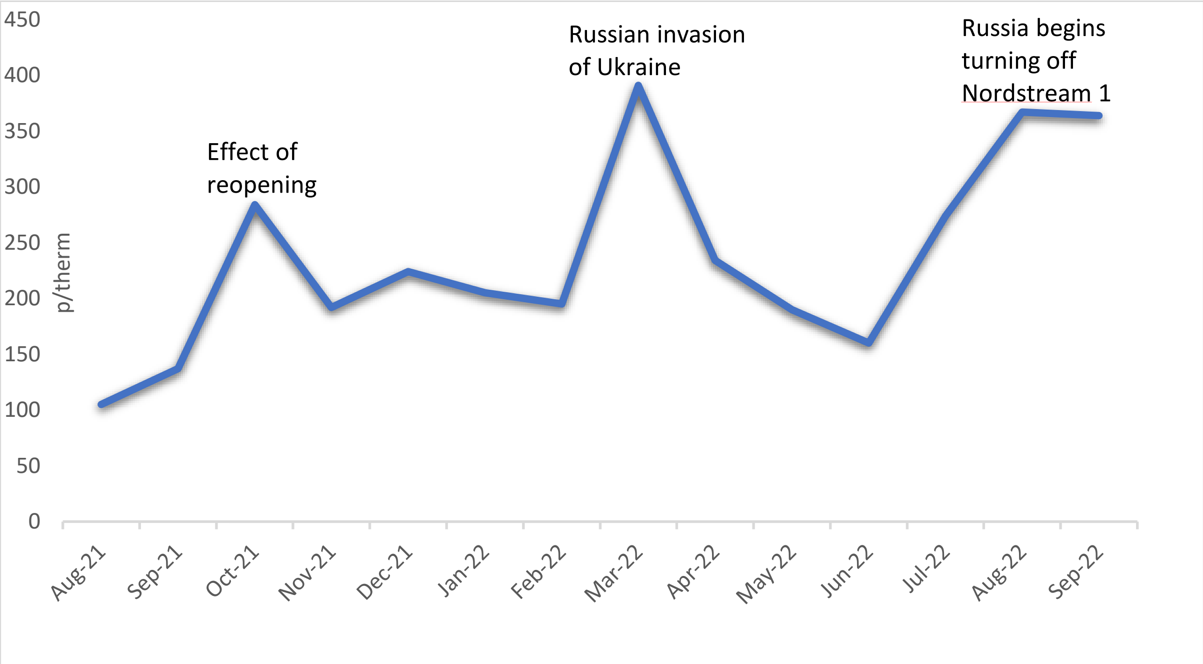
The evolution of the wholesale gas price

Figure 1 below highlights three peaks of interest:

- The effect and impact of reopening after the Covid-19 pandemic;
- The Russian invasion of Ukraine; and,
- The turning off of the Nordstream 1 gas supply line to the EU.

Figure 1: Development of wholesale gas prices: Aug 2021 – Sept 2022



Electricity unit prices and the standing charge

Tables 1 and 2 below show a range of prices for electricity unit prices and standng charges from CLA members across England and Wales.

These highlight the rate in which energy prices have increased. Although some may have negotiated longer term contracts in the early part of the year as a means of mitigating rising costs, many were forced to wait until June and July this year when prices shot up. As the data shows, the disparity between different suppliers is substantial and it is hardly surprisng that businesses began to feel a real economic squeeze. Of course, with the government's Energy Bill Relief Scheme, an element of price stability has entered the market for trading businesses. However, the relief scheme is only set for six months (compared to the two years for the domestic energy support scheme). It is very possble that businesses could face a cliff edge come April 2023.

Table 1: Electricity unit prices

Current unit price (p)	Quoted unit price (p)	Difference (p/kwh)	% difference
13.4	35.6	22.2	+166
16.2	50.0	33.8	+209
20.7	36.9	16.2	+78
14.0	79.0	65.0	+464
14.6	75.5	60.9	+417
25.0	39.0	14.0	+56
43.9	86.1	42.2	+96

The business relief scheme does not provide support for any increase in standing charges. Table 2 below shows very clearly there is a huge disparity between the levels of current standing charges, which appear quite reasonable, it is the quoted price (the proposed increase) that, for some, is quite staggering. Such increases will exacerbate the problems aready being experienced by members irrespective of the general relief scheme.

Table 2: Standing charges

Current price (p/d)	Quoted price (p/d)	Difference (p/d)
29.7	71.2	+41.5
26.1	331.6	+305.5
25.5	30.0	+5.0
30.0	123.1	+93.1
56.5	437.1	+380.6
15.4	425.9	+410.5
22.3	41.9	+19.6

<u>The evolving fundamentals</u>

Where we are now? In July 2022, inflation rose to its highest level for 40 years to 10.1% although it fell back slightly to 9.9% for August. But despite the minimal increase we still expect inflation to rise to between 14% to 18% unless there is clear and effective govt intervention.

The evolution of interest rates is interesting. Over the last 6 months, the Bank of England has made interest rate policy the main mechanism through which to try and control inflation. As inflationary pressures have taken hold, interest rates have increased to their present 2.25%. Although this is far higher than we have seen this century, the rate is still considerably lower than during the 1970s to 1990s.

However, the increased pressure being exerted on Sterling by the money markets and increasing the cost of government borrowing may lead the Bank of England to intervene more quickly than intended with a further 0.5% increase. Were this trend and the situation continue, it is very possible that interest rates could increase to 5%.

It is also important to stress that although business energy costs may be capped for the next 6 months, that protection is not extended throughout the supply chain. It is very possible that the cost of raw materials, inputs and imports will increase, further fueling inflation.

Indeed, if energy market volatility continues for another 12 months, it is very possible that measures by the govt and the bank will not have the impact needed. This would mean that the government would need to intervene again in the market which would further increase public borrowing and put more pressure on public services.

Over the last 4 years, we have gone through Brexit, the Covid-19 pandemic and post pandemic surge in demand and the immediate impact and longer term effects of the Ukraine conflict. We would call this the perfect storm. All these issues when brought together does suggest that growth will be sluggish with a recession for the last quarter of 2022, highly likely.

<u>The rural economic impacts</u>

If we examine the various rural economic impacts, we can see that they affect different sectors at different times. In agriculture, the rise in input costs, such as fertliser, energy and raw material costs, has led to a number deciding to reduce production and as a result leading to a slow down in productivity. In addition, this year's drought has exacerbated the situation.

It is this rise in energy costs as well as the shortage of certain materials, such as CO2, which has put the hospitality sector on the back foot and it does seem inevitable there will be a number of closures in rural hospitality either permanently or over the winter months.

But if we look at the wider context, the rise in fuel costs makes logistics and transportation more expensive and inflationary. Although oil prices appear to have come down, this has not fed through to the pumps to extent envisaged, suggesting that there are questions as to whether a market monopoly is in operation?

When we put this all together, there has been increasing pressure on rural businesses over the last 12 months. These pressures will continue, margins will remain tight and some businesses will inevitably be unsustainable.

<u>Mitgation</u>

The combination of geopolitical and geoeconomic events has created the foundation for economic fragility. Whilst it can be argued that many of these factors are not in the control of businesses, and that is certainly the case, there are a number of mitigations that businesses need to consider:

- Business planning: this remains a perennial problem. It is important that businesses can plan in the short, medium and long term in order to be both flexible and to be able to adapt more quickly to changing market conditions. The CLA has produced a series of short briefing notes on business planning and its importance that can be found here.
- Always look at the relationship with suppliers other than the energy market, where savings may be possible;
- Look to reduce energy consumption by becoming as efficient as possible;
- Ensure that the relationship with the bank is healthy – the dialogue needs to be ongoing and honest. The CLA is already discussing how to develop easier relationships with the banks to ensure a consistent approach;
- Re-examine the potential of the business – it may be possible that there are other market opportunities outside the primary business operation.

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Government intervention

We now know that the price cap for business will be for 6 months and set at 21.1p/kwh for electricity and 7.5p/kwh for gas. We also know there are no guarantees that the Energy Bill Relief Scheme (for business) will be extended. An extension is vital as there would be the real possibility of a cliff edge for many businesses without such government support.

But it will also be crucial that the price guarantee exerts sufficient pressure on the wholesale gas market without excessive government borrowing. This is where the impacts of the recently announced Growth Plan, whether real or potential, will be able to dampen demand to a level where markets cand be corrected in time.

However, we need policies where we can generate renewable energy but at a significantly lower cost than wholesale gas. The CLA has produced a Frequently Asked Questions briefing for members that will help them in reducing their domestic energy costs through solar panels and solar energy.

Potential future impacts

It is important to look at future impacts. There are clear indications that there will be a reduction in the number of rural hospitality businesses. That still holds true but the number of other types of rural business going into administration could also increase. The effect of this will inevitably lead to increases in unemployment levels. Although unemployment is currently at a very low level, concerns remain that attracting labour to rural areas is not easy because of wages, infrastructure, housing and the actual type of employment on offer. It is therefore important to look at other types of labour pool availability, such as veterans and ex-offenders.

It is likely that the pressure on existing agricultural businesses will continue and potentially increase. As a result, it could lead to a faster restructuring of the sector and the potential of greater economies of scale.

One issue we have already highlighted is that of increasing costs of fuel, diesel and red diesel. This will increase levels of fuel poverty and put pressure on services that require transport.

For example, Council budgets are already hard pushed. We do not see this being alleviated quickly enough by central government action and these will be squeezed, particularly if there is an extended recession. This will mean certain public services will need to be restricted unless the central government grant is increased. Due to geography, rural areas will be the hardest hit.

Finally, recession is very possible. A recession is where the economy enters two consecutive quarters of negative growth. Indeed, the Bank of England has suggested that it believes the UK is already in recession. The main impact of recession is that there will be a reduction in investment, contrary to the ambitions of the government which will ultimately lead to a reduction in growth.