29 September 2022

Possible scenarios under the Cost of Living Crisis

Introduction

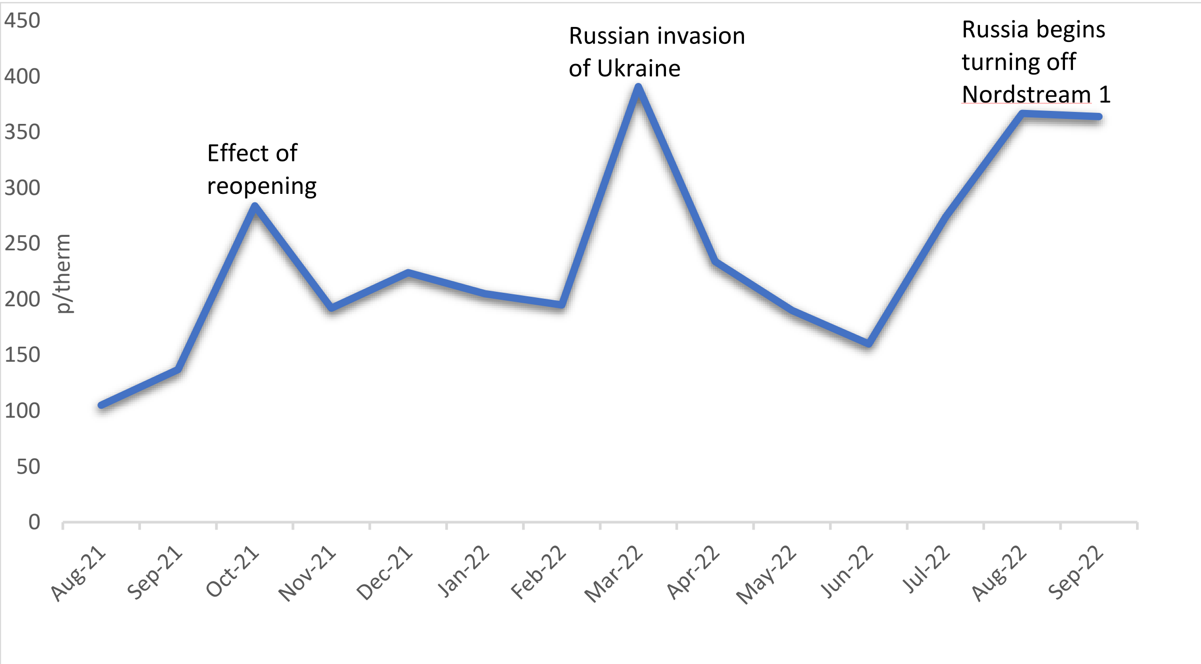
This briefing looks at three possible scenarios relating to the development of the wholesale gas price. It examines what would happen if wholesale gas prices continued to increase over the next 6 to 12 months (Scenario 1); what would happen if gas prices stabilised (Scenario 2); and what would happen if wholesale gas prices began to fall (Scenario 3).

The current situation

As we know there has been enormous volatility in the wholesale gas market. This has affected prices for fertilisers and general energy costs and, through the supply chain, the production of CO2 that is vital in both the agriculture and hospitality sectors. The imbalance has been the main cause of the rise in inflation and the policy to increase interest rates to dampen demand and stabilise inflation.

Figure 1 shows how the gas price has fluctuated between August 2021, when economies began to reopen after the pandemic, the Russian invasion of Ukraine and the decision to turn off the Nordstream 1 gas pipeline.

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



There has been a general weakening of the wholesale gas price between September 10 and September 26, with prices as low as 300p/therm. However, the potential damage to the Nord Stream 2 pipeline has exacerbated worries about the future of Russian supply to the EU. Nevertheless, prices have fallen by more than 60% from their March 2022 record peak as recent data from the Aggregated Gas Storage Inventory shows that European natural gas storage sites are being filled faster than expected. Gas storage sites in the UK were 95.8% full as of September 25th, higher than the EU average of 87.7%.

29 September 2022

Scenario 1: Wholesale gas prices continue to increase

Let us start by looking at scenario 1 where gas prices follow a rising trend. The first impact is that the current pressure on business will ramp up and severely squeeze margins. To combat this, businesses will need to have sufficient resilience built in to their operations.

In terms of the overall economy, higher prices will increase inflationary pressures that will mean that we are looking at a higher inflation range of between 16% to 18%. It is inevitable that this would will force the Bank of England to use interest rates as the main tool with which to try and control inflation, with the real prospect that interest rates could increase to as high as 6%.

In terms of implications, we could see a rise in rural business insolvencies and certainly at a higher rate than during the pandemic. Whether the government would intervene further in the market is very much dependent on the success of the Growth Plan. If this leads further negative impacts, the government could very well follow the precedent of the Covid-19 pandemic and begin to directly support business.

One of the major negative effects will be on public services. Local authority budgets are already tight and, in order to manage public services some may need to be reduced or even temporarily withdrawn. Given the challenges faced in rural areas by geographic location, it is likely that rural communities would be disproportionately affected.

Scenario 2: Wholesale gas prices begin to stabilise

What would happen under scenario 2 where prices began to plateau and stabilise? Certainly, input prices and raw material costs would begin to fall over a period of time and this would indicate a better balancing of the economy. However, this could be set off-track by external geopolitical events.

Importantly, we would also expect demand to begin to balance with supply. But this would be very dependent on whether the government's decision to cut taxes has an almost immediate effect in increasing demand. Given the failure of supply to match demand, injecting further money into the economy could stimulate increased demand and so reinforce inflationary pressures.

But, it needs to be stressed that the previous 12 month impact is still being felt, particularly in tourism and hospitality which may mean further direct support required to shore up markets.

If prices were to stabilise, it should lead to Aginflation (the increase in producers' input and raw material costs) beginning to fall with less pressure on consumer prices.

However, all types of rural business have been affected negatively, one way or another over the last 2 to 3 years that they require at least 12 months of stability and certainty to be able to generate a solid economic base.

But if business insolvencies are less than forecast, there would need to be a stimulus and this could be provided by the new Rural England Prosperity Fund that would see a rise in diversification opportunities.

Scenario 3: Wholesale gas prices begin to fall

Finally, let's look at scenario 3 where we see wholesale gas prices beginning to fall over an extended period of time. The first indications are likely to be a dampening of market volatility with demand and supply beginning to reach equilibrium and balance.

The main impact will be to reduce inflationary pressure, and over time, reduce inflation. However, it could take some time before we see inflation down to the government's benchmark of 2%

As a result of changing circumstances induced by falling prices, business confidence begins to return and we see far greater market stabilisation with the Bank of England easing its reliance on using hikes in interest rates as the main method to control inflation.

What this ultimately means for business is that the economy begins to recover and investment begins to re-energise the rural economy. However, this would not be immediate and could take a further 4 to 5 years.

Some concluding remarks

The idea behind assessing different scenarios is that the provide situations where different policy options can be explored. The cost of living crisis is no different and the CLA will continue to monitor developments and inform members as to both the consequences and the implications.

What we have seen so far is that ever since the economy began to reopen following the pandemic, the indications of economic activity strongly suggested that there was a glaring imbalance between supply and demand to such an extent that it began to fuel inflation. What is probably worse is that surge in demand has also led to very volatile energy markets which has seen the wholesale gas price, for example, dictating the production and operational decisions being made by rural businesses.

As the cost of living crisis develops further in the next few months, the CLA will ensure, through the Cost of Living hub that members receive all the information and advice they need to make cogent decisions as well as provide much needed support where needed.