

by [Sheridan Titman](#) on December 21, 2011

In our inaugural [University of Texas Energy Poll](#), we asked participants to identify the factors influencing energy pricing. Of the approximately 3,000 respondents, 36% thought that the pricing power of energy companies and/or electric utilities had the most impact on prices, 21% thought that global politics had the most important impact, government regulation was next at 18%, while demand (15%) and supply (9%) were viewed as having the least impact.

These poll participants, who represent a broad representative cross-section of the U.S. population, have it exactly backwards. The supply and demand for oil, natural gas and electricity are the most important determinants of energy prices.

To further explore this issue, we conducted an informal, anonymous survey asking energy industry experts* the same question about factors influencing pricing. It is important to note that the majority of these industry experts were not energy producers, but academics, bankers, consultants, accountants, private equity investors, etc. Although the sample size is small (21 respondents) and the results were not statistically validated, the responses indicate that the industry experts believe basic economics drive pricing, not companies' pricing power.

71% of industry experts selected demand/supply as having the most impact on energy prices. None of the industry experts believed companies' pricing power had the most impact.

Recent events in Asia, as well as the United States, illustrate how supply and demand factors influence energy prices. The past decade has seen a substantial increase in demand for transportation fuel in developing markets like China and India. This increase in demand, combined with a diminishing supply of cheap and easy to produce oil, has led to an increase in oil prices, which has in turn led to an increase in more difficult, and more expensive, oil production from oil sands, shale rock, and offshore deep water drilling.

The dynamics of the natural gas market have been very different. During the past four years we have seen a substantial increase in the supply of natural gas extracted from shale, and because of this, a substantial decline in natural gas prices. This decline in natural gas prices, in turn,

leads to relatively inexpensive electricity prices.

In comparison to supply and demand, regulation and the pricing power of energy companies have only modest effects on prices.

While regulation is sometimes misguided, it can potentially influence prices because of its effect on supply. However, thus far the effect seems to be relatively modest. If regulation encourages offshore drilling in the Gulf of Mexico, or off the coast of Florida or California, this will increase supply, which may reduce the price of oil. However, oil is a large global market, and the increase in supply from the U.S. is likely to have a modest effect on total global supply and be somewhat offset by supply cuts in other parts of the world. Similarly, the supply of natural gas is currently constrained by low prices rather than regulation. However, there is the potential for draconian regulations on hydraulic fracturing, which I think are unlikely, to have an important influence on natural gas prices, particularly on the East Coast.

The pricing powers of energy companies and utilities probably have the least important influence on prices. In short, the oil and gas industries are extremely competitive, and the individual firms have very little influence on prices. Indeed, the profits of these firms, which are quite large because they are very large firms, are not particularly big as a percentage of the oil and gas that they produce. Some electrical utilities are monopolists in their regions and therefore have pricing power; however, they are regulated and cannot get away with overcharging their customers. It should also be noted that while some mistakes during the deregulation process opened opportunities for price manipulation, such as in California at the turn of the millennium, I am not aware of any evidence of pervasive manipulation.

So where do these misperceptions about energy prices come from?

A closer look at the data reveals significant differences in the opinions of Democrats and Republicans. They are equally misinformed, but misinformed in very different ways. Democrats tend to believe that the pricing power of energy firms has the most important impact on energy prices while Republicans tend to believe that regulation has the most impact. Beliefs about the lack of importance of supply and demand considerations seem to enjoy bi-partisan support.

It's not surprising that Democrats tend to distrust large corporations and that Republicans tend to think that regulation does more harm than good. However, a casual evaluation of the recent political discourse suggests that politicians, in their pandering to the world view of their base, slant information in ways that reinforce misperceptions. Democracy requires an educated and

informed electorate. A political process that encourages misinformation can't be a good thing.

*Of the approximately 65 individuals who received the survey, only one-third were from energy companies and/or utilities or retail electric providers.

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