DTI Consultation:
Concerns about Gas Prices and
Possible Improvements to Market Efficiency

Response from the Energy Intensive Users Group

Contents

1. Introduction

EIUG gives credit to the efforts of those involved in producing the consultation document. We wish to record our response to a number of the specific issues raised but also, more importantly, to set out our considered opinion on the state of competition in the wholesale market.

EIUG called for a comprehensive investigation into the workings of the UK gas market nearly two years ago against the background of sharply accelerating gas prices. In so far as this consultation represents the first tangible steps towards such an investigation, however belatedly, it is welcomed.

The current situation is profoundly unsatisfactory for customers. A period of active gas to gas competition, hard won, is at an end, and with it the comparative advantage rightly enjoyed by the UK's industrial consumers. UK prices no longer reflect the fundamentals expected in a competitive market.

We do not accept that prices can be fully explained by arbitrage with the continental markets. The fact that UK spot and forward prices have often exceeded those on the continent, and the recurrence of interconnector flows in opposition to price, demonstrate that arbitrage alone cannot be responsible for the level of UK prices. We contend that there is no longer an adequate relationship between UK prices and the balance of supply and demand. Nor are prices consistent with reasonable estimates of the long run marginal cost of production either from existing or future North Sea sources.

Suppliers now assert that UK prices are again oil-linked, though we think the picture is more complex than this. The oil-linkage/arbitrage argument, that UK prices simply reflect continental (oil-indexed) contract prices may be seductive to some but is simplistic and probably false. We argue that oil-related prices are as much the outcome of the current situation as the cause. Furthermore, we fear that excusing recent price levels on these grounds effectively gives the green light to price manipulation, at least up to or around the oil-related level.

EIUG believes that the establishment of fully liberalised, single EU gas market will indeed form part of the long-term solution, but this argument does not invalidate the need for urgent action closer to home. It is accepted that full liberalisation will take at least five years to achieve. What are UK manufacturers supposed to do in the meantime? We agree with the European Commission's view, as expressed in our discussions with the Competition Directorate, that there is plenty that could – and should – be done to address problems within the UK market.

It has been suggested by DTI officials that this consultation is an occasion for consumers to 'put up or shut up', that the onus is somehow on customers to provide conclusive evidence of foul play. We cannot provide specific evidence of anti- or non- competitive behaviour (smoking guns) – that is up to the competition authorities, which have the appropriate powers. The offshore industry consists of complex structures with interwoven contractual arrangements, where the commercial interests of competitors are commercially aligned. Within this we believe lies the potential for trespassing the boundaries of propriety.

We recognise that many of the observations we make in our response are not necessarily alarming on their own. Taken as a whole, however, there is a structure that facilitates the abuse of market power. Calls for further evidence therefore miss the point. We argue that there is already sufficient circumstantial evidence to warrant a formal investigation, which would most appropriately be conducted by the OFT using its powers under the Fair Trading Act.

We are therefore copying this response to the OFT with a formal request that it investigates whether the competitive situation in the natural gas market in the UK is adequate.

2. The Role of Dominant Players in the Wholesale Market

We are unclear what is actually driving the wholesale market. Large users buy gas at wholesale market related prices (which could cover the full spectrum from daily spot, month ahead to annual prices) plus transmission, plus the supplier's margin. Movements in the wholesale price therefore have a direct impact on consumer prices.

Traders have suggested to us that the UK spot market is relatively illiquid compared with, say, Brent crude, so it is easier to manipulate. It is interesting to note that gas is one of the most volatile commodities on the exchanges.

EIUG is concerned by the ability of a few dominant players to move the market. There is an imbalance between large suppliers, producers and trading agents versus smaller consumers. A few oil/gas companies, who trade gas amongst each other, undoubtedly have the ability (should they choose to use it) to set the spot price. Specifically, we are concerned that five very large, vertically integrated companies effectively control over 80% of the wholesale market. We understand that the two next smallest producers, BG and Conoco, sell to or through the big five. The remaining players are effectively price-takers. Analysis of estimated sales shows that market concentration has increased significantly since 1998, and is now highly concentrated:

Estimated Sales in Wholesale Market - 12 months to Sept. 2001

Producer/wholesaler	**%**	**$(\%)^2$**
Exxon-Mobil	25.5%	652
BP	25.5%	652
Centrica	20.4%	415
Shell	18.1%	326
Total/Fina/Elf	10.5%	111
	Herfindahl Index:	**2,155**

<u>Notes:</u>

The corresponding index for 1998 is below 1,523.

Total sales are assumed to be proportionate to own production

HHI <1,000 = competitive marketplace

1,000-1,800 = moderately concentrated marketplace

>1,800 = highly concentrated marketplace

(US Department of Justice rules of thumb for evaluating mergers)

It has been suggested that minor producers would seek to undercut the larger players to increase market share if market prices were unnaturally high. This is questionable - what incentive do minor players actually have in practice? They can sell all their volume at good prices to a few customers, in a market they cannot greatly influence, whilst avoiding retaliation from major players which would result from challenging the established order.

We wonder if there are parallels to be drawn with other fuel markets. Margins in petrol retailing are tight, as in gas supply, reflecting the competitive nature of the retail market. This fact is often emphasised to deflect attention from the non-competitive wholesale market for road fuels (the cartel nature of the oil market is not in dispute).

The extent to which the industry relies on joint ventures serves to align the commercial interests of the upstream players with one another. The argument that these arrangements are necessary in order to manage high risk sounds persuasive when applied to smaller players, but it is not obvious why companies the size of BP and Shell should be seen as insufficiently large to take on more of these risks on an individual basis. We question why joint ventures should necessarily be the norm in North Sea developments if there is truly a competitive upstream market. It is not generally a feature of competitive commodity markets, certainly not those in which EIUG members sell their products (few if any EIUG members have the luxury of joint ventures to mute the effects of competition). It also strains credulity to suggest that information shared between participants in joint ventures is not used to their advantage. We therefore believe that the current situation is unhealthy. Whatever their historic justification we see the extent of joint ventures as further evidence of a lack of real upstream competition.

3. EU Gas Market Liberalisation

Unliberalised EU markets, to which we are physically and economically connected, are a fact of life for the next five to ten years. If the current problems in the UK market can indeed be wholly blamed on the lack of liberalisation (which we doubt), is the DTI prepared to see UK industry face the consequences of delayed liberalisation with no effective UK government support?

Long term contracts remain a big problem and not just on the continent, as UKOOA figures confirm. We agree with the European Commission that these represent a barrier to the development of competition.

We understand that Zeebrugge prices are effectively an extension of UK prices. UK consumers cannot cannot buy Zeebrugge spot gas – it is not a liquid market.

EIUG believes consideration should be given to barring large, non-competitive continental monopolies from accessing UK gas via the interconnector. Such a measure would be no more a restraint on trade than the refusal to open up continental markets, and would of course be unnecessary once liberalisation is achieved. Gas release will also be needed on the continent, as happened with BG in the UK.

Resistance to liberalisation is not confined to the so-called national champions. Indeed, shortly before submission of this document, the chief executive of Shell's gas and power business publicly took issue with the European Commission's aims of enhancing security of supplies by introducing full competition, and argued against the idea of tying gas prices to the mechanisms of supply and demand.

4. The Role of the Interconnector

EIUG is concerned that the Commission has yet to report its findings over a year after the investigation was launched. We understand that a conclusion is expected to be reached very soon, but it is highly regrettable that we, and other respondents, will not had the opportunity to see their report before the end of the DTI's consultation period.

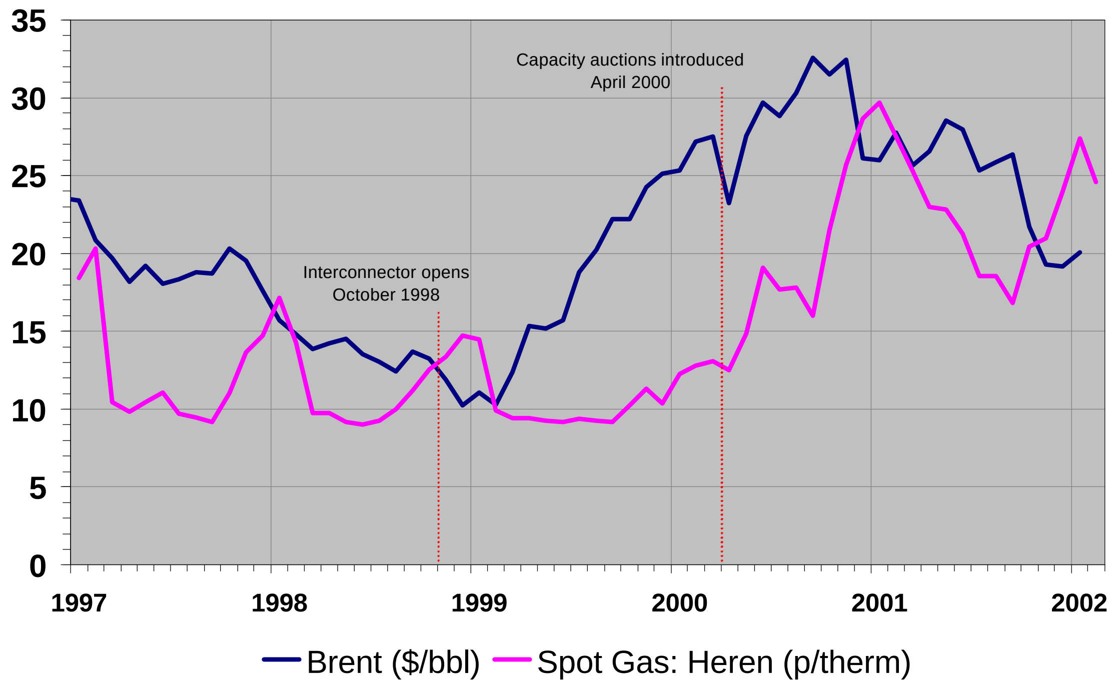
Nevertheless, as things stand, the interconnector appears to be facilitating inefficient arbitrage at best. There have been a number of instances over the last eighteen months of flows against price, which have yet to be explained. We are concerned that the operating rules still seem to result in unnecessarily slow flow reversal. We are also concerned about the secretive way in which the interconnector has been operated, although (albeit against the background of the Commission investigation) better information is now available on this.

It is accepted that high continental prices provide a considerable opportunity for arbitrage by sourcing UK gas for immediate sale, or storage, on the continent. However, given the extent of this apparent opportunity, it is strange that capacity seems rarely – if ever – to be completely utilised. Why is full advantage not being taken? Theory suggests that when full capacity is reached, further sales cannot be made and the UK and continental markets would disconnect – yet this has not happened – why not?

We note that a number of those who own interconnector capacity also have an interest in high UK prices. We expect that those involved in market surveillance, investigating trades across the interconnector that had the effect of raising UK prices, should take due account of this. We are concerned that it could be in the interests of a UK producer/shipper to take a loss on a small volume through the interconnector and take a much larger gain on benefits of a higher NBP price, to which UK users' prices are (directly or indirectly) linked.

5. Arbitrage and the Alleged Influence of Oil Prices

It is often asserted as a matter of undisputed fact that UK prices are now simply tracking continental prices which themselves follow oil. The data do not bear this assumption out, at least not with the degree of significance that is generally claimed. Large industrial contracts on the continent tend to be indexed to heavy fuel oil on a three-month lag, and to gas oil on a six-month lag for smaller users. If this theory is correct, UK prices might be expected to show a three to six month lag to oil:



Source data: IPE/Heren month end for month ahead

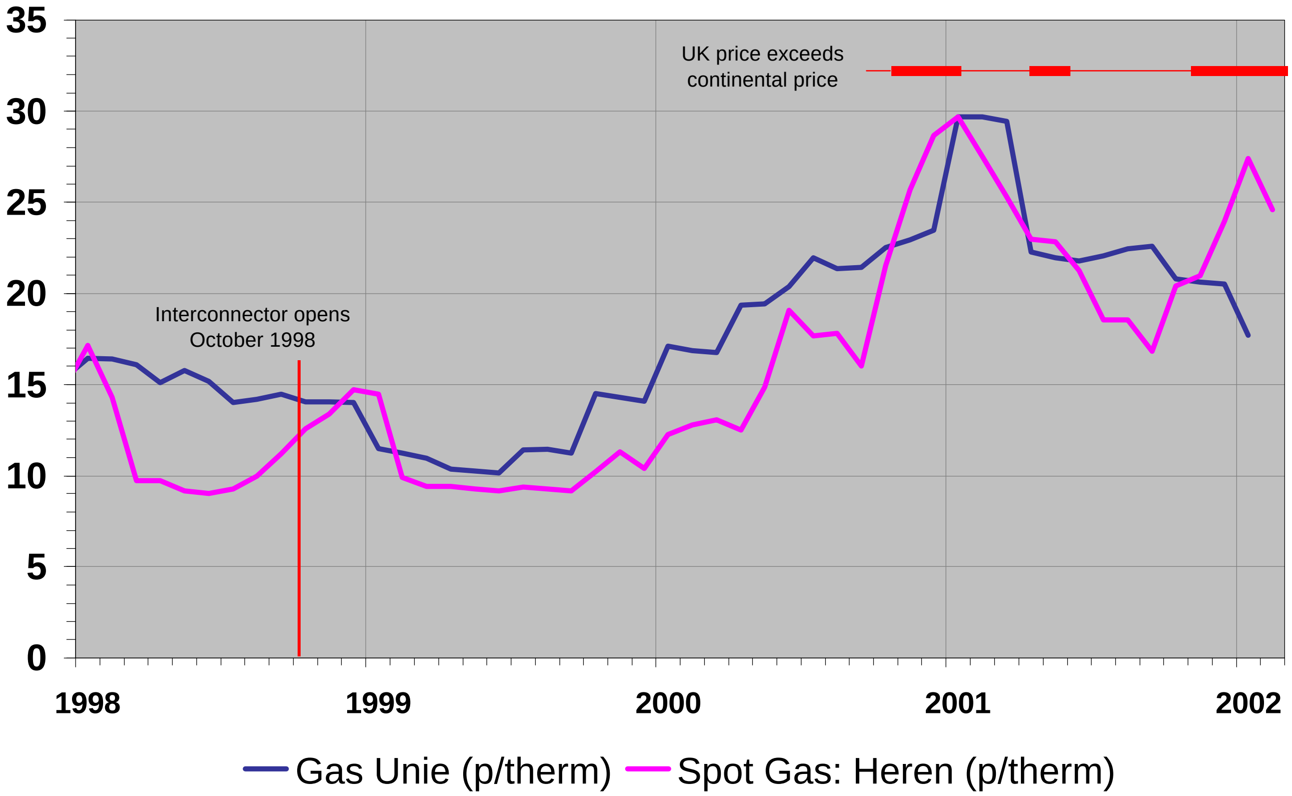
The chart above shows no such relationship until mid 2000, nearly two years after the interconnector opened, despite surging oil prices. In fact, the gas price explosion occurred in the spring of 2000 (coincident with the introduction of entry capacity auctions). If UK prices had been linked to oil then, why had they not risen earlier? If they were not linked then, why now? Current oil prices of around $20 bbl coincide with 1-year gas at 18p/therm, yet the same oil price coincided with 10p/therm gas in 1999 – why is this?

No one disputes a relationship between international oil and gas prices. There is a degree, but only a degree of substitutability, so one will tend to influence the other, but it is limited. Most customers have little ability to substitute in practice (especially where gas is used as a feedstock) and the situation is similar for most electricity generators whose primary fuel is gas. We do not accept that there is any sound basis for a rigid link between the price of gas and that for oil. They are distinct products sold to different customers in different markets. Where free markets operate, the price data bear this out.

We therefore question the assumption that market prices of oil and gas from associated fields should move in tandem with one another. In an efficient market, when oil prices are higher, oil output would be expected to increase and with it the output of associated gas – this should put a lid on gas prices, or even drive then lower.

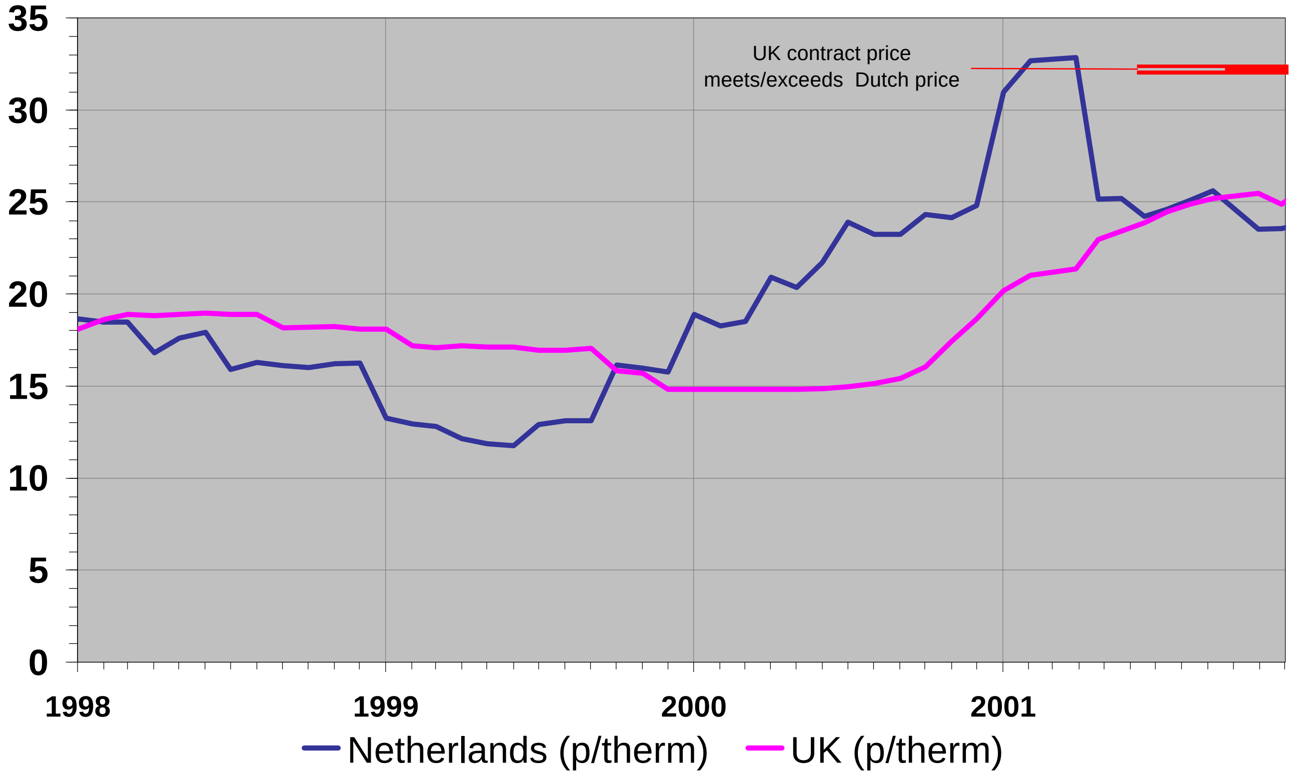
We also question the view of the UK simply as a minor player within the larger European whole, bound to accept continental prices. UK gas accounts for a large proportion of total production/consumption within the EU (around 25%) and the bulk of the freely traded gas within the EU markets.

If we accept that the natural (isolated) UK price is lower than current continental levels, and is been driven up by arbitrage, we would expect UK prices to meet the continental level less the cost of transportation across the interconnector. Yet there have been a number of occasions – not all in winter – where UK prices have exceeded continental prices for months at a time:



Source data: Heren month end for month ahead/published tariffs

A similar picture is presented by UK/continental price data for contracts in force:



Source Data: Energy Advice Ltd. (40m therm / firm gas)

These prices reflect a basket of contract prices of differing maturity, which will tend to smooth out transient spikes caused for example by spells of unexpectedly cold weather or plant outages. Again, we believe this undermines the argument that UK prices are simply continental prices by the back door.

There is also the question why there is so little a relationship between prices and production costs. We understand that most fields in the North Sea are profitable at 13p/therm, and that some are profitable at as low as 8p/therm. Even UKOOA's consultants estimate the long run marginal cost of production to be around 15p/therm, i.e. well below current price levels. We were interested to learn at a recent UKOOA workshop that fields which would have required a number of manned platforms a decade or so ago could (if developed now) be serviced by a single unmanned platform, which themselves cost around a tenth the amount of a manned alternative. Additionally, it is often possible to tie in to existing offshore pipelines, many of which have spare capacity, an option which would not have been available on the earliest developments. This is a considerable set of efficiencies to set against any increased costs that might be associated with declining field size.

6. Transmission Constraints

There is no doubt that capacity constraints, particularly at the St Fergus terminal, are a contributory factor restricting effective competition and driving up wholesale prices. Where constraints exist, it is easy to manipulate markets – someone will exploit them.

The decision to allocate scarce entry capacity by means of short-term capacity auctions has not helped the situation. Shippers are forced to bid against one another to land gas in the UK market, driving up the entry price, sometimes by as much as 13p/therm. The excess revenue this generates for Transco is recycled through lower transmission charges and capacity buy-backs – no additional investment to alleviate the congestion has yet resulted. The need to secure entry capacity, particularly for gas from associated fields (which might have been expected to flood the market during a period of high oil prices) has resulted in upward pressure on wholesale prices. Ofgem accepts that entry capacity auctions have raised wholesale prices by around 2-3p/therm.

Ofgem's solution to the current problem, the introduction of long-term capacity auctions, will undoubtedly be an improvement on the current regime. However, there is scepticism about how effective these will be in generating the appropriate investment signals and revenue, signals and investment to remove the constraints. We all hope that Ofgem's optimism is well founded. Either way, there is no realistic prospect of increased capacity within the next three years. Dissatisfaction about the current state of affairs is not of course confined to end-users.

7. Offshore/Onshore Regulation

Recent events have exposed shortcomings in offshore regulation. We are concerned that DTI does not appear to believe that it has a responsibility in the area of market surveillance.

The dual role of DTI as sponsor and regulator of the offshore industry is an uncomfortable one and compromises its ability to champion the cause of industrial consumers. EIUG believes there should be a formal separation of DTI's offshore responsibilities, and that that gas production and offshore transportation should be subject to independent regulation. We would therefore support an appropriate extension to the gas and electricity market authority's remit.

We would contrast the situation in gas with that in electricity, where Ofgem has clear responsibility for generation, transmission, distribution and supply, and is adequately resourced to carry out the necessary level of market surveillance. The arrangement is seamless and, in our opinion, has served customers well. Most importantly, customers do not have cause to doubt Ofgem's independence from producer interests. EIUG can see great benefit in the establishment of parallel arrangements in gas, with a single authority having seamless regulatory responsibilities from well head to burner tip.

EIUG also believes that competition issues within a pan-European energy market, as it emerges, may necessitate more substantial arrangements for pan-European regulation. Informal links between the national regulators (e.g. the Madrid process) are a welcome development, but may not prove to be an adequate substitute for a formal structure in the longer term. We therefore believe that it is premature in conclude (as the PIU appear to have done) that there will be no need for a pan-European regulator. The case may not yet be compelling, but it could become so, and the option should remain open.

8. Access to Information

Customers are currently disadvantaged compared with other market participants, principally shippers, due to an imbalance in available information. EIUG argues that, in principle, information currently shared between shippers should be available to all. This position has been endorsed by energywatch, and accepted by Transco, which holds (though not necessarily owns) much of this information.

The highest priority for us is to make available information currently shared between shippers, via Transco's AT link system. We are pleased to note that energywatch were very receptive to our concerns when we first raised them a year ago, that they have played an active part in persuading Transco of the case for greater openness. Transco has since responded positively, and we understand this information will become available on a regular basis in April.

Release of offshore information appears to be more controversial. We are currently still finding out about the extent to which offshore information is collected and exchanged, and to what extent it may be of value to the different market participants. Consequently, we cannot yet say precisely what information should be made more widely available, but our general position is that information should not be withheld unless there is an particularly convincing reason (in terms of market efficiency) to do otherwise. This certainly applies where information is already shared between participants in joint ventures – arguments about the need for commercial confidentiality in these instances seem to us to be particularly flimsy.

The offshore industry clearly recognises that some of this information has market value. Indeed, it was interesting to hear at a recent UKOOA workshop that some commercially sensitive information is distributed by fax on a rotating system so that no one recipient company would consistently have knowledge of it in advance of the others. We trust that those in receipt of such information are aware of the legal restrictions regarding trading when in receipt of privileged information, and that the FSA is aware of circumstances where this might occur.

The areas where we believe information should be more widely available include terminal flows, linepack, flows in and out of storage, field failures and flows through the interconnectors. On the latter point, we welcome the fact that timely information is now available on flows through the Bacton interconnector, whilst noting that the announcement of a Commission investigation appears to have been necessary to bring this about.

Whilst access to information will not of itself cure the deeper market problems, it will help level the playing field for market participants. It will also make it easier to identify whether gaming or malpractice is influencing prices.

Appendix

Notes follow on the specific questions posed in the DTI consultation document, in addition to our comments on the general issues on the preceding pages:

<u>Section 3</u> Concerns about how upstream gas affects the downstream gas market

Concern 1: upstream mergers have resulted in over-concentration of gas ownership

We do not agree that sufficient weight has been given to UK gas market aspects when approving recent mergers, which have resulted in a significantly more concentrated market. The five largest, vertically integrated companies do the trading – these, plus BG and Conoco/Phillips (who do not trade directly) have over 80% of the wholesale market between them – the remainder are price-takers. All have joint ventures – there is a 'culture of co-operation' (as the European Commission has aptly phrased it) rather than competition.

Concern 2: gas producers have limited gas production to influence prices

We note the arguments by UKOOA and DTI about the physical and economic constraints on gas production, and the fact that production from associated fields is necessarily influenced by the economics of oil production. We understand that there is there is considerable potential to vary production despite these constraints.

Concern 3: the lack of regulated third party access for offshore transportation and ancillary infrastructure may result in inefficient utilisation of existing infrastructure

Whilst we see advantages in regulated third party access, we cannot comment on whether the present arrangements have proved unsatisfactory in practice.

Concern 4: end of day gaming or within day gaming skews the profile of gas delivery into the NTS to influence Transco's behaviour and gas prices

We cannot shed light on the widespread rumours that this form of gaming is, or could be a problem. We are in the process of considering Ofgem's latest proposals on changes to the gas-balancing regime, which may help address this issue. We note that no action was taken following Ofgem's prolonged investigation into shipper behaviour, but cannot comment on what might have resulted had better information been available. Transco's behaviour clearly affects gas prices, but we are not in a position to comment on what is influencing its behaviour although within-day gaming, if it is occurring, could be a significant factor. There is a related issue about end of day gaming on the OTC.

Concern 5: gaming around the Belgian interconnector has manipulated prices

We agree with this – there is evidence of perverse behaviour, as the graphs in the consultation document would appear to confirm.

An additional problem is that there is no proper spot market on the continent – Zeebrugge is essentially an extension of the UK gas market.

Concern 6: lack of liberalisation, principally outside the UK, results in gas-oil indexation and various restrictive practices

We agree that this is a problem, but one exacerbated by the role of the interconnector and additional problems within the UK market. Lack of liberalisation may take ten years to sort out in any case – immediate action is therefore also required closer to home.

The UK situation is proof that retail competition is not enough. We are sceptical that retail competition alone will break the oil link on the continent.

Concern 7: vertical and horizontal integration of some gas producers within and across EU boundaries has affected gas prices

The relationship helps keep UK prices up – we are sceptical that the gas directive alone will solve this. The market needs kick starting – gas release and strong regulatory action is needed on the continent. All the evidence from Europe suggests that this will take many years, as it did with British Gas in the UK.

The Commission cannot break up companies – national governments have this power but are reluctant to use it.

Concern 8: some or all of the above combine to push up gas prices

We partially agree with this. There is certainly a combination of problems, some exacerbating one another. However, we cannot be certain that they do not individually make a significant difference to gas prices.

Section 4 Information Flows

We agree with the points raised in the consultation document. Information release is likely to improve market efficiency and transparency, but will be not in itself a substitute for other necessary regulatory action.

As a matter of principle, we believe customers and shippers should have access to the same information at the same time.

There are legitimate questions about information accuracy, who is responsible for this, duty of care, the possible need for disclaimer, etc. which need to be debated. We foresee pettifogging which the DTI should lead in resisting.