Business, Enterprise & Regulatory Reform Committee Inquiry: possible anti-competitive behaviour in the UK's energy market

Memorandum from the **Energy Intensive Users Group**

1. EIUG represents the energy intensive sectors of UK manufacturing industry (steel, chemicals, paper, cement, glass, ceramics, aluminium, industrial gases, etc.) that compete in international markets and depend on secure, competitive energy supplies to remain in business.

2. Energy supplies represent a high proportion of our members' operating costs – especially the variable costs. Energy purchases account for around 25% of production costs for steel and paper manufacturing, 40% for aluminium smelting and certain chemical processes and up to 70% for the production of industrial gases. These industries share a strong commercial interest in the efficient use of energy in order to remain competitive, and in most cases are also subject to Climate Change Agreements that require continuing attention to be given to energy efficiency.

3. Energy intensive industries in the UK currently purchase around **£2.4bn** gas and **£5.2bn** electricity per annum. Around 70%-80% of the cost of industrial energy supply is typically attributable to the wholesale cost of gas and electricity.

4. Energy intensive industries are highly exposed to international competition and increasingly operate under international ownership. The continuing presence of these industries in the UK depends on the faith of international investors that UK energy supplies will, in the long run at least, remain internationally competitive. Our members are therefore much more concerned about *relative* energy costs (i.e. the extent to which UK energy prices differ from those of our competitors) than the *absolute* cost of energy (rightly a concern for others, with regard to fuel poverty).

5. UK energy prices have risen substantially in recent years, as they have worldwide – though the increases in UK wholesale prices have been particularly dramatic (see charts 1 & 2 appended to this memorandum). There has clearly been a step change in the price of oil, gas and coal on the international markets (and carbon, within the EU) which has unavoidable implications for the price at which gas and electricity can be sold in the UK. But this development does not explain why the wholesale prices of gas, and especially electricity, have become so much higher in the UK than in most of the rest of Europe.

6. Wholesale energy prices are dynamic and volatile, so quoting a single figure to describe the extent of the UK/EU competitiveness gap is not straightforward. Account needs to be taken of seasonal factors, as UK gas prices tend to trade at a premium to continental prices in winter (when the UK is import dependent) and a discount in summer (when exporting and continental prices effectively put a floor on UK summer prices). There is no obvious reason why UK prices be expected to trade a premium on an annual basis, however, especially considering the liberalised nature of the UK market and the price-supporting influence of oil indexation elsewhere. This last factor is important – sales of gas to industry remain indexed to oil products in continental markets, so comparisons with hub price data (equivalent to the UK NBP) may not accurately reflect the competitiveness position as far as industrial users are concerned.

7. EIUG disagrees with BERR's assertion, as recently as January this year, that the UK energy markets are the most competitive in the G7/EU. This can only be true in a most narrow of senses, e.g. the extent to which the market is theoretically open to new entrants, or that consumers are able to switch suppliers. Important though these factors are, the test that really matters to consumers is whether *prices* are competitive – and on this test, for industrial consumers at least, the market is failing. We also urge caution in interpreting BERR data on energy supply prices, which is by its nature historic and so (unlike market data) more useful in painting a picture of what things might have looked like up to six months ago than what they actually look like now, or are expected to look like a year or more ahead. Industry contracts ahead for its energy supplies and is therefore relatively well placed to see what is coming – and the current pricing situation, unfortunately, looks worryingly similar to that of two years ago. We recognise however that it is perhaps unrealistic to expect official UK or EU price survey data to adequately reflect the competitive position for the very largest of industrial consumers, where pricing arrangements tend to be more individual in nature and transparency is often lacking.

8. EIUG recommends that the Committee pays particular attention to forward year-ahead wholesale prices, which tend to be the price base suppliers refer to when quoting for typical annual industrial supply contracts. On this basis, as of April 2008, UK gas prices are around **5%** above those in continental Europe (and higher still than in the USA) and UK electricity prices are around **30%** higher than those in France or Germany (see charts 1 & 2 appended to this memorandum).

9. In an attempt to avoid locking in costs at potentially uncompetitive levels, some industrial consumers opt to receive gas supplies at a floating rate indexed to day-ahead prices, or with the option to fix at the market price at any point during the contract period. Such supply contracts tend to provide lower costs on average compared with fixed price deals, but with the downside of significant additional risk to the consumer, and are not therefore suitable for all businesses. Indexed supply prices are inherently more volatile and, as events two years ago confirmed, may turn out to be higher than would have been available under a fixed price deal.

10. It is worth recalling what occurred during the last occasion when the UK faced a sustained competitiveness gap, somewhat larger than at present, in the run up to winter 2005-06. Day-ahead gas prices rose to record levels on the wholesale market as gas supplies ran perilously low, forcing a number of energy intensive manufacturers to cut or suspend production on cost grounds (for three months, in the case of one major feedstock user). By the end of that winter, with storage stocks already low, a fire broke out at the Rough gas storage facility and National Grid issued its first ever 'Gas Balancing Alert', warning the market to reduce demand as the UK came within 24 hours of having to ration gas to industry. ONS data later confirmed that around 100,000 manufacturing jobs were lost in the twelve months to the following autumn, with energy prices cited as a key factor – i.e. 'demand destruction' had occurred. Wholesale prices fell the following year, perhaps leading some to conclude that problems in the UK's energy market were largely over, having arisen as a result of an temporary coincidence – namely that the UK found itself still completing essential import infrastructure just at the time it started becoming a net importer of gas, and was unlucky enough to do so when EU energy markets, then still assumed to be moving towards full liberalisation, remained largely unreformed.

11. EIUG believes there is an inadequate level of competition within the UK energy markets, which has come about for a number of reasons, listed in the paragraphs below. We suspect that a combination of inadequate competition, high worldwide fuel prices and energy interventions arising from government action (or inaction, in the case of past prevarication about nuclear power) is sufficient to explain why current price levels have become uncompetitive by international standards. We are sceptical that recent price increases can be blamed on anti competitive behaviour but if others have evidence to the contrary, or it is thought necessary in order to restore public confidence in the markets, we would support a referral to the Competition Commission to settle the matter.

12. The current structure of the electricity market discourages effective competition. There has been a persistent trend in recent years towards further consolidation and vertically integration – there are few independent players left, especially retailers. The extent of internal contracting is the primary reason for the very low liquidity in the forward power markets. Money is largely being made at the wholesale end of the market, especially by generators that have been handed an opportunity to make windfall profits, at the expense of consumers, as a result of free allocation of allowances under the EU emissions trading scheme. We note that 'green' spark spreads (allowing for the price of carbon) have also widened considerably, above continental levels, but that this may be consistent with the acknowledged need for new build in the near and medium term to replace considerable capacity of nuclear and non-LCPD-compliant coal plant scheduled for retirement. Consolidation has partly been driven by credit issues and the increasing regulatory burden, both economic and environmental, all of which have tended to disadvantage smaller players. The complexity and overhead costs associated with code structures (BSC, CUSC) is now a major barrier to new entrants and smaller players, including auto-generators and demand side participants, and we believe it should be a clear objective for Ofgem and others to make these simpler and more accessible. We also believe that, absent compensatory reforms elsewhere, any attempt to reduce competition by merger among the 'big six' producers should be most strongly resisted.

13. EIUG has had longstanding concerns about the operation of the wholesale gas market. The UK is increasingly dependent on imported supplies, including now LNG which is already a key marginal source of supply. If National Grid forecasts are correct, LNG may need to provide 40% of our supplies within the next ten years. We believe it was a mistake to grant exemption from regulated third party access arrangements at LNG terminals. The lack of adequate arrangements at the existing Isle of Grain Terminal – and those in the process of being constructed at Milford Haven – is a barrier to their use that has worrying implications both for the price of gas in the UK and security of supply. We are not aware that a third party has yet managed to make use of spare capacity at the Isle of Grain terminal (which has remained largely unused this winter) and, given the current limited notice period for spare berthing slots, it is doubtful whether this can be expected to occur. The UK remains also at a disadvantage in being able to make use of attractively priced LNG or other imported gas during periods of low demand periods due to our relatively low levels of gas storage. The lack of storage capacity is one reason why UK wholesale prices are so volatile, and also appears to be a partial explanation for the extent of the risk premium in forward prices, which seems set to remain an issue for the foreseeable future. There has however been an improvement in market transparency as a result of Mod 006 (publishing close to real time information on sub-terminal flows) improving information access to the benefit of market efficiency.

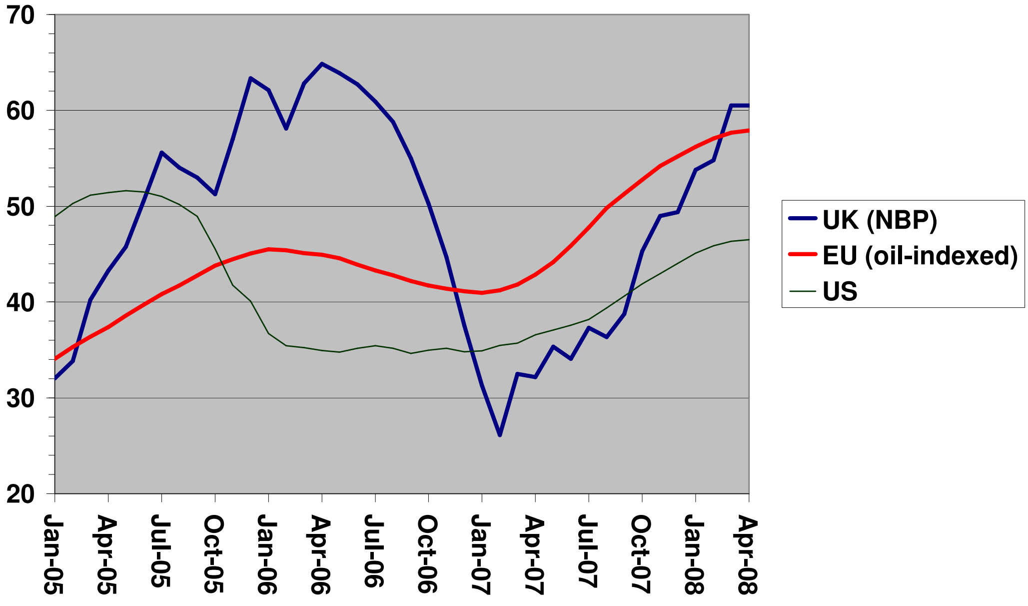
14. The interaction between UK and EU energy markets remains a matter of concern. Despite encouraging proposals from the Commission last year, and significant movement by a number of member states, we remain unconvinced that continental energy markets will be fully liberalised within the near future. Continuing political resistance from a small but significant group of member states to the full unbundling of their energy grids from production and supply is a matter of record, so it is still far from clear that the majority view in support of the Commission's proposals will prevail. Absent substantial reforms on unbundling, combined with strong independent energy market regulation at both national and EU level, prices are likely to remain divergent. The continued lack of common contractual terms with respect to continental gas supplies – in particular the complete lack of an oil-indexed option in the UK, or the alternative to it elsewhere in Europe, even when supplied by the same company – also remains a concern. The brutal truth is that there is no immediate prospect of UK companies or energy consumers enjoying reciprocal access to continental supplies of the sort we have already granted to our continental competitors. This leaves the UK in a vulnerable position – increasingly import dependent, subject to external shocks through physical interconnnection to continental markets, but unable to access continental gas storage or network infrastructure to help secure our own supplies.

15. EIUG does not support the imposition of a windfall tax on energy suppliers, generators or gas producers. If problems are thought to have arisen because of market failure, then that is the issue which needs to be addressed, ideally by referral to the Competition Commission. If problems have arisen because of government failure (windfall profits arising from free allocation of power sector emissions allowances, overly generous subsidies to onshore wind generators, etc.) then the relevant policy failures themselves need to be addressed. Taxing energy producers or suppliers would do nothing to address the problem of uncompetitive industrial energy prices. The imposition of a windfall tax, or even the threat of it, raises the cost of capital for investment in UK energy supply – and the cost of this, ultimately, would fall on consumers.

16. EIUG submitted evidence to the Trade & Industry Committee's 2004-05 inquiry into fuel prices, concluding: **"Industrial consumers in the UK are therefore facing a substantial competitiveness gap in the cost of both their gas and electricity supplies. Energy intensive industries are most at risk if this competitiveness gap is allowed to persist."** Regrettably, this statement does not require updating.

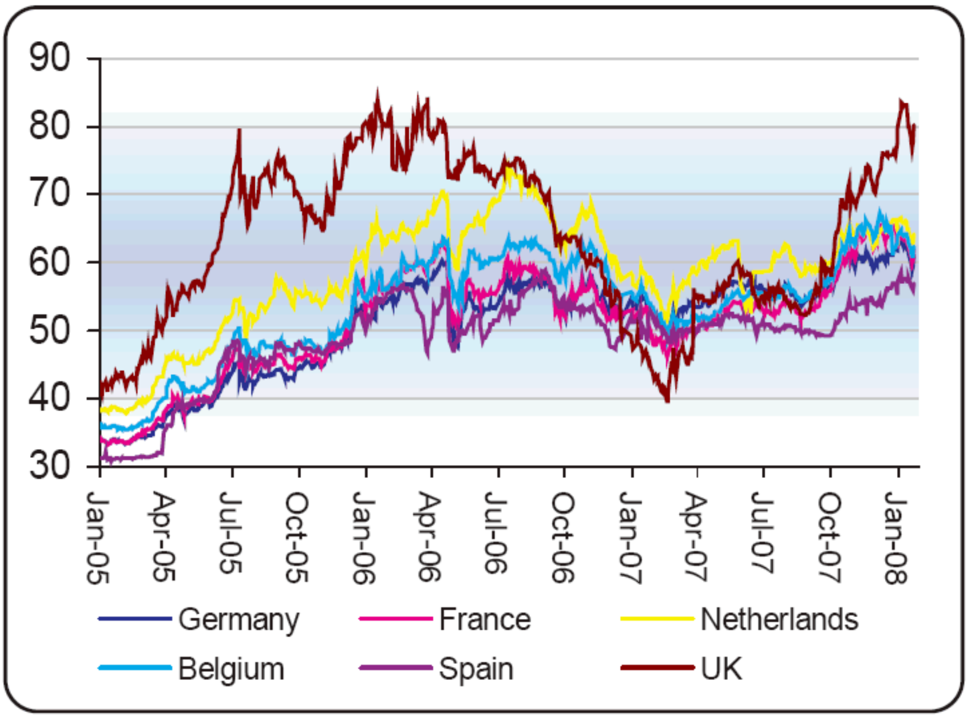
Appendix – Energy Price Charts

Chart 1 – Gas Prices – wholesale, year-ahead (p/therm)



Source: EIUG

Chart 2 – Electricity Prices – wholesale, baseload, year-ahead (€/MWh)



Source: EnergyQuote