Trade and Industry Select Committee Inquiry into Fuel Prices

Evidence from the **Energy Intensive Users Group**

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

2. Energy supplies represent a significant proportion of our members' operating costs - especially the variable costs. Energy purchases account for around 25% of production costs for steel and paper, 40% for aluminium smelting and certain chemical processes and up to 70% for the production of certain industrial gases. The bulk of these costs, typically around 75%, are attributable to the wholesale cost of gas and electricity.

3. Energy intensive industries in the UK currently purchase around **£1.3bn** gas and **£2.8bn** electricity per annum. We estimate that the dramatic increase in wholesale prices over the last year and a half, once fully reflected in new contracts, will have added around **£0.5bn** and **£1bn** respectively to the annual cost of industrial gas and electricity supplies.

4. Industry tends to be concerned with relative energy prices (i.e. the extent to which UK prices differ from our competitors) because of the potential impact on competitiveness. The absolute level of energy prices, rightly a concern for the economy as a whole and especially for the fuel poor, is less of an issue for industry than often assumed.

5. Forward wholesale market prices for the year ahead have risen by around **75%** for gas and **50%** for baseload electricity in the UK over the last year and a half. Prices are dynamic and volatile, so it is not easy to quote a more precise figure. Forward prices are particularly significant as they are used by suppliers as the basis of their quotations for industrial supply to consumers who wish or need to fix their fuel prices for the year ahead.

6. Some industrial consumers opt to receive gas supplies at a floating rate by buying their gas indexed to day-ahead prices, often at lower average cost than can be obtained through fixed price deals. Other types of flexible contracts allow consumers to fix at the market price at any point during the contract period. However, these methods of purchasing entail a significant degree of additional risk to the consumer. Indexed prices are inherently more volatile and may turn out to be higher than would have been available under a fixed price deal. Such deals are not therefore suitable for all businesses.

7. Continental European consumers do not benefit from liberalised gas markets like in the UK, but the price of gas tends to be much more predictable and competitive with their immediate neighbours. Industrial consumers in these markets typically buy gas at prices indexed on a lagged basis to the price of oil products - generally heavy fuel oil, sometimes gas oil - i.e. substitute fuels. In contrast to dollar-denominated crude oil, which has recently hit record highs, the prices of euro-denominated heavy fuel oil has barely risen over the last year. High oil prices have not therefore caused a surge in continental gas prices, so they cannot be an explanation for the dramatic rise in gas prices in the UK.

8. In recent months the forward price for UK gas has become substantially more expensive than the (oil product indexed) price in continental Europe - by as much as **30%** for the year ahead. Yet the UK supposedly benefits from a liberalised gas market and remains, on an annual basis, a substantial net exporter of gas.

9. Wholesale electricity prices in the UK are sensitive to the price of gas - there is a strong correlation between movements in gas and electricity prices. Around 40% of generation is gas-fired - much of this is marginal plant whose operating costs can directly affect the market price. Other factors, especially the advent of EU emissions trading in 2005, are also driving up forward electricity prices but in recent months the growing price of UK gas has become the dominant factor. There is no evidence that the market price reflects a tightening of supply margins. The margin of excess generating capacity above peak demand is higher for the coming winter than last year, and in any case the UK has one of the highest supply margins in Europe. Forward electricity prices for 2005 are now around **30%** higher in the UK than for major EU competitors such as France and Germany.

10 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.

11 EIUG is disappointed that Ofgem, having spent almost a year working on their report into the surge in UK gas prices, was unable to explain why the majority of the price increase had come about. Ofgem's analysis showed that 'oil price' rises explained less than 30% of the increase in gas prices. We are also disappointed that Ofgem, having identified a 'knot of contracts' that might have been a factor, and promised a swift decision as to whether further action is required, has yet to make any further comment on this matter two months later. We agree with Ofgem that the lack of liberalisation in continental markets could be part of the problem and indeed have been involved in lobbying the Commission ourselves on this

matter since 2001. However, we are sceptical about whether there is any realistic prospect of full market opening being achieved in the medium term. We also believe that there are serious problems within the UK wholesale gas market, including a concentration of market power, an inequitable access to market information and a fragmentation of regulatory responsibilities which remain to be addressed. We have therefore called for a comprehensive investigation of the wholesale gas market, to be carried out by the Competition and/or European Commission, i.e. a body with the appropriate onshore, offshore and/or international regulatory powers, and would hope that the TISC would also consider the case for such a referral.

12 EIUG and the Chemical Industries Association commissioned a report from Europe Economics on the impact and possible causes of the rise in wholesale gas prices, a copy of which is appended to this submission. The report identifies areas of concern regarding the structure and regulation of the UK gas market and makes recommendations for further investigation and reforms to policy and regulation, which we endorse. In addition, EIUG would draw particular attention to the need for seamless, independent market regulation to replace the current fractured regime under which DTI is charged with an uncomfortable dual responsibility as sponsor and regulator of the offshore gas industry.

13 EIUG opposes the idea of imposing a windfall tax on gas producers in response to the high gas prices. If the problem is essentially one of market failure, then that is the issue which needs to be addressed. Raising taxes would not address the problem of uncompetitive industrial energy prices and would discourage future investment in North Sea production on which the security of our energy supplies depend.

14 EIUG believes that the impact of uncompetitive wholesale gas and electricity prices, should they persist, will need to be taken into account when reviewing the UK's climate change policies, especially measures such as the Renewables Obligation (the escalating subsidy to encourage uneconomic renewable generation) and the Climate Change Levy, which add to the competitive burden on the UK's energy intensive industries.