



The Impact and Possible Causes of the Rise in Wholesale Gas Prices

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EXECUTIVE SUMMARY

Europe Economics was commissioned by the Chemical Industries' Association (CIA) and the Energy Intensive Users' Group (EIUG) to examine the impact and possible causes of the rise in wholesale gas and electricity prices.

Impact on competitiveness

The government's energy policy objectives in relation to industrial competitiveness are being undermined by recent rises in UK wholesale energy prices. Wholesale gas prices in the UK are now showing a significant premium to prices on the continent, and the effect has fed through into the electricity market because of the large proportion of generation which is gas-fired.

The impact of these price increases is most pronounced on energy-intensive sectors of the economy. ONS figures show that these sectors also tend to be more open to international trade and to have lower gross operating margins than the economy as a whole. Firms which compete on international markets are unlikely to be able to pass cost increases through to consumers. Furthermore, where margins are already low, cost increases may have a significant impact on profitability.

Possible causes

Europe Economics' analysis concludes that the behaviour of forward prices for the coming winter cannot be easily explained with reference to market fundamentals. In particular, the majority of the rise in forward prices cannot be explained by rising world oil prices, partly because the price of heavy fuel oil has not risen in line with crude oil prices.¹ Furthermore, while the interconnector is likely to be constrained this winter, and thus UK prices might rise above continental prices consistent with economic fundamentals, the magnitude of the price rise exceeds what would appear reasonable in light of Ofgem's modelling.

Ofgem's investigation has identified the drivers behind reductions in physical supplies which pushed up prompt gas prices in November/October 2003 and summer 2004. However, the regulator is continuing to pursue enquiries on a number of issues, namely contractual arrangements which appear to have prevented gas supplies from reaching the market and the behaviour of European gas supplies during October/November 2003.

Europe Economics examined the theoretical potential for anti-competitive behaviour in the gas market. This analysis concluded that upstream consolidation and co-operation, the historical lack of transparency and the inelasticity of gas demand might in theory create the conditions for such

¹ The prices of heavy fuel oil and gas oil tend to be used for indexation purposes in gas contracts on the continent.



behaviour. However, it must be emphasised that the firm is not aware of any evidence to suggest that such behaviour is actually taking place.

Key recommendations

Europe Economics suggests that further investigation into forward gas prices is vital, given the impact of these prices on customers locking into energy supply contracts. Such investigation might seek to gather evidence on whether there has been a change in the willingness of upstream gas producers to sell forward, as has been suggested by a number of buyers. If so, the reasons behind these decisions should be examined carefully, and remedial action considered if any market distortions are identified.

Unanswered questions in relation to the spot gas market also deserve attention. In particular, Europe Economics suggests that:

- checks should be made on whether the field outages seen during summer 2004 were justified and completed in an appropriate timescale;
- it may be appropriate to examine upstream production to verify that year-on-year declines in beach flows are caused by a genuine acceleration in UKCS decline;
- Ofgem should be encouraged to speed its enquiries in those areas where it is still pursuing its investigation.

Europe Economics suggests that the FSA should be asked to provide further details of the enquiries it carried out into the gas market and how it reached its conclusions.