Promoting choice and value for all gas and electricity customers

Wholesale gas prices rises explained

Energy regulator Ofgem is taking a number of steps to make sure that the causes of recent movements in the wholesale price of gas market reflect changing supply and demand factors and are not the result of market abuse or other distortions.

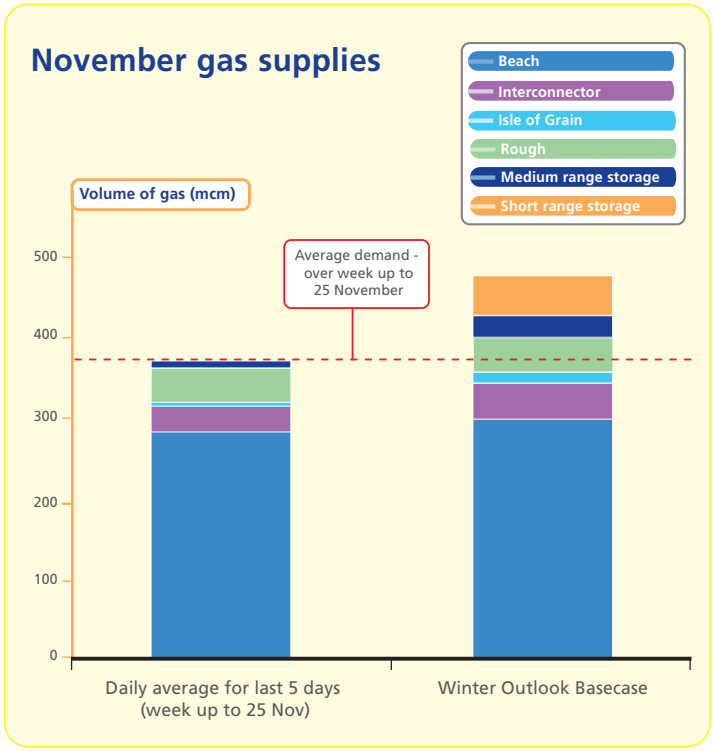
Why have wholesale prices risen so sharply in November?

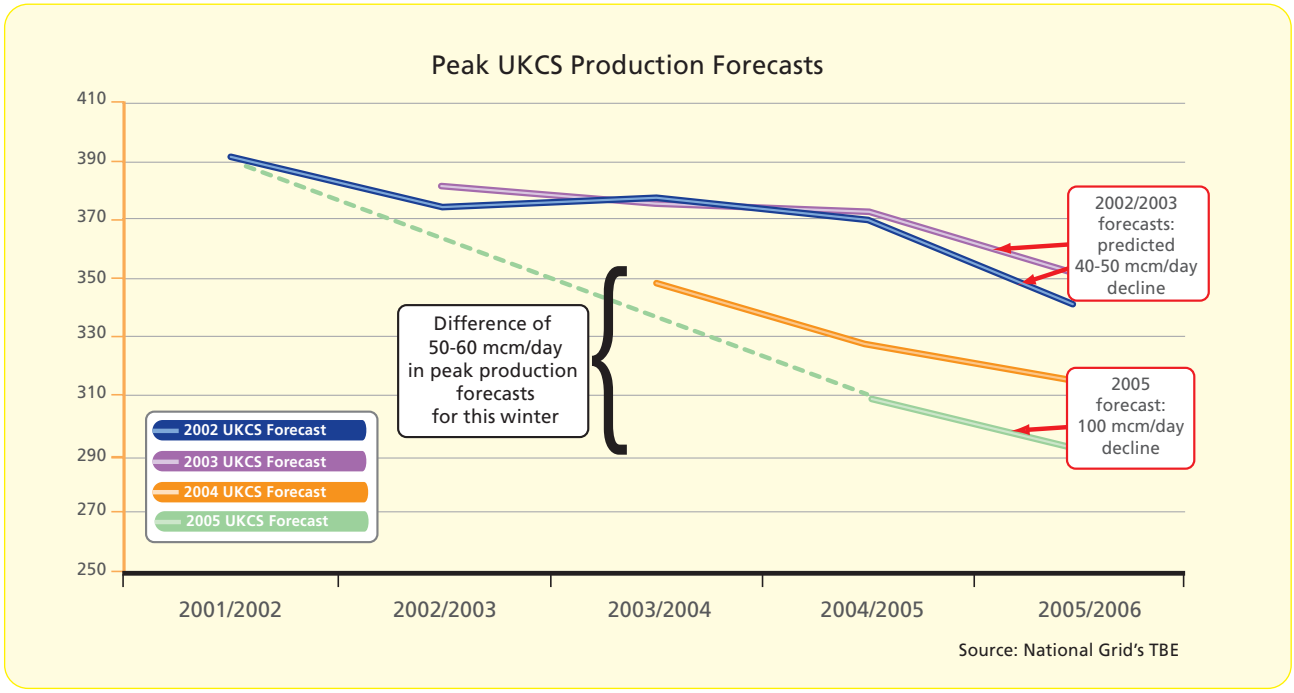
Since the beginning of October, spot gas prices have risen from around 30 pence a therm to over 150 pence a therm during the recent spell of unseasonable cold weather. Wholesale electricity prices have also risen from around £40/MWh to over £100 MWh as around a third of our generation is gas-fired and generators have had to pass through the higher gas costs.

Ofgem has looked into the causes of these price movements. Our analysis shows that over the last ten days much colder weather than usual for this time of year has increased demand and led to gas being taken out of storage. This is a more expensive source of gas than supplies from the North Sea and interconnector, as storage operators will only sell stored gas if prices are at, or above, the levels that they would expect to receive if they sold their stored gas in January or February, the period when storage gas is usually used.

It is this storage price that is partly driving the significant increases in wholesale gas traded on the spot market over recent days. Other factors are also driving market sentiment and prices. Suppliers and traders are concerned about the amount of gas that the North Sea will deliver over the winter and the amount of gas that will be supplied from Europe both through the interconnector and through the UK's new Liquefied Natural Gas (LNG) import facility on the Isle of Grain in Kent.

The diagrams compare the actual gas which flowed on the system from 21-25 November and the amount of gas likely to flow on a typical winter day.





Further enquiries

Supplies from the North Sea have been slightly lower than predicted so far this winter. The interconnector has only been running at between 60 and 75 per cent of capacity despite very high prices. And the Isle of Grain LNG facility has only just received a shipment of gas despite UK prices being the highest in Europe. Ofgem is analysing the causes of reduced supplies to reassure the market that there are legitimate reasons to explain why this has happened.

Ofgem has taken the following steps. We have:

- written to the European Commission asking them to investigate why the interconnector has not been flowing at full capacity when UK gas prices are much higher than prices in Europe. The Commission recently published a report as part of its investigation into European gas markets highlighting a range of problems with the European gas market
- asked the Commission to look also at market arrangements in other countries (such as Spain) that may be distorting trade in LNG and leading to LNG not being delivered to the UK even though gas prices here are higher than in other European countries
- asked National Grid to make sure that arrangements are in place to allow other companies to deliver LNG through the Isle of Grain if the companies who bought capacity at the terminal are not using it, and
- asked Interconnector UK to provide us with information about who holds import capacity this winter to assist our ongoing analysis.

In addition to this, Ofgem is working with the Department of Trade and Industry (DTI), which regulates the offshore industry, to establish why offshore deliveries have been lower than expected. This work will ensure there are legitimate reasons for lower flows and that supplies are not being deliberately withheld to raise prices.

Who is affected by wholesale gas increases?

Industrial and commercial customers are hit hardest by the price rises. Some very large gas customers such as power stations and large chemical companies have had to switch to other fuels or reduce or halt production in response to high prices.

Domestic customers are not affected directly by short-term variations in the spot market as domestic suppliers tend to contract longer term to meet their domestic customer needs.

If the high prices continue throughout the winter then domestic suppliers may have to pass some of these costs through to customers. Competition in the retail sector has kept pressure on prices and spawned social tariffs, price caps and special arrangements in particular for energy suppliers' most vulnerable customers.

Are we facing a gas shortage this winter?

Britain's gas supplies are tighter this winter, but while there is clearly no room for complacency, National Grid's analysis shows that gas supplies to domestic customers can be maintained even in a severe 1:50 winter – last seen in 1962-1963.

If we were very unlucky and had a severe 1:50 winter, a significant demand-side response would be required. However, as this demand-side response would be around 16 per cent of total business demand and would be likely to be met by very large industrial users, it would be business as usual for most of Britain. In a 1:10 winter the demand response from industry would be around 8 per cent of total business gas demand.

This is common in other countries when they experience extreme weather conditions and we saw large scale interruptions of large gas users in France and Spain earlier this year.

Why didn't any one foresee that North Sea gas would run out so quickly?

Over £6 billion pounds of investment has been invested in new import facilities, but these import projects were based on the best forecasts available on the rate of decline of the North Sea gas fields. The diagram, Peak UKCS Production Forecasts, shows that it was not until 2003-2004 that the offshore industry was able to forecast that the decline in UK gas supplies was going to be greater than that previously forecast. This is because it is difficult to predict peak supplies from older gas fields.

Given the long lead times needed to obtain planning permission and to build new import and storage facilities, this revised warning came too late to allow the market to 'fast forward' its construction programme. However, the market did deliver this year enough extra import capacity to cover the decline originally forecast.

Looking ahead...

Providing the projects scheduled for completion for next year are delivered on time, gas supplies are expected to increase by around 10 per cent for next winter. Over the next two-three years, the market will deliver over 100 bcm of new import facilities, which is nearly the same amount of gas that Britain currently uses in a year (around 100-120 bcm). The market is also planning to invest to double Britain's gas storage capacity by 2008.

Ofgem's role

Ofgem's role is to protect customers' interests and ensure that there are no barriers to effective competition in the onshore gas market.

A major part of this role is to carry out day-to-day market surveillance to make sure that gas and electricity prices are not being manipulated. Ofgem has carried out a number of detailed investigations into the causes of unexplained price spikes in gas and electricity over the last 5 years.

We have been working closely with the European Commission, in particular over the past two years, towards stronger competition in continental markets with which the British market closely interacts. Ofgem is contributing fully to the Commission's present enquiries into the competitiveness of Europe's gas and electricity markets.

Market information

A key component of Ofgem's role is getting good quality information into the market about the supply and demand positions for the winter, and in sufficient time for generators, suppliers and customers to act upon it.

That is why in 2004, Ofgem asked National Grid to reorganise its winter operations reporting. As a result Ofgem have for the last two years published National Grid's preliminary winter operations report in May, enabling market participants to contribute to National Grid's analysis and respond accordingly.

This has been followed, in both years, with the publication of National Grid's final Winter Operations Report in October.

Also, Ofgem is assessing the effectiveness of the current voluntary agreement for the provision of information about offshore gas supplies to the market. This was negotiated between the DTI and the UK Offshore Operators Association. The new arrangements were fully implemented in October this year. This has given the gas market and customers more information about the workings of the Offshore gas industry.

Demand-side

Given that gas supplies are lower this winter than in previous years, there may be an increased need for large gas users to reduce their demand in response to severe weather. This is called demand-side response.

This is why Ofgem has given a special focus to helping industrial and commercial users engage more effectively in the market.

Measures for customers include:

- new National Grid website for customers with better information on the demand and supply position,
- new 'Gas Balancing Alerts' which will give large gas users advance warning of National Grid's need for demand-side response,
- Ofgem-hosted events in London and in Newcastle to bring market participants together to help customers improve their energy buying options for the winter, and
- Ofgem participation in October's customer-led delegation to the EU Competition Directorate in Brussels.

For further information please contact:

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