



House of Commons  
Trade and Industry Committee

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# Fuel Prices: Responses to the Committee's Twelfth Report of Session 2004–05

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**Second Special Report of  
Session 2005–06**

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to be printed 19 July 2005*

## The Trade and Industry Committee

The Trade and Industry Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of the Department of Trade and Industry.

### Current membership

Peter Luff MP (*Conservative, Mid Worcestershire*) (Chairman)  
Roger Berry MP (*Labour, Kingswood*)  
Mr Peter Bone MP (*Conservative, Wellingborough*)  
Mr Michael Clapham MP (*Labour, Barnsley West and Penistone*)  
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Miss Julie Kirkbride MP (*Conservative, Bromsgrove*)  
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### Publications

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### Committee staff

The current staff of the Committee are Elizabeth Flood (Clerk), Philip Larkin (Committee Specialist), Grahame Allen (Inquiry Manager), Clare Genis (Committee Assistant) and Joanne Larcombe (Secretary).

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# Second Special Report

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The previous Committee published its Twelfth Report of Session 2004–05<sup>1</sup> on 23 March 2005. The Government's response was received on 30 June 2005 and Ofgem's response was received on 25 May 2005. They are published as Appendices to this Special Report.

## Appendix 1: Government response

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### Introduction

The Government welcomes the Trade and Industry Committee's report as a useful independent investigation of the gas and electricity markets.<sup>2</sup> In addition to making several helpful practical suggestions for actions in the short term, it makes many positive statements that should serve to dispel a number of myths about how the markets work.

As the report recognises, the UK is in a substantially different position now from even two years ago with regard to its gas supplies. The supply/demand balance was tight for last winter, and is expected to be tight next winter. This requires a fundamental shift in behaviour of buyers and sellers if we are to minimise price spikes in the future. It also bears repeating that gas prices are currently to a large extent determined by the price of oil, which has experienced some historic highs over the past few months.

The Government takes the issue of high energy prices extremely seriously and is very mindful of the hardship they are causing for consumers, especially the energy-intensive industrial sectors and the domestic fuel poor. There is a big challenge ahead in ensuring the timely commissioning of new import and storage facilities and in persuading our European partners to introduce fully liberalised markets. We face a tough couple of winters, but we have developed a range of measures to tackle the issues and we are working with industry, consumer groups, Ofgem and across Government to deliver these as a matter of the highest priority.

We are reassured that the Committee supported Ofgem's view that there is no evidence that producers have withheld supply from the market in order to drive prices up. We also welcome the conclusion that the advantages of receiving information from all major parties (including Norway) even on a voluntary basis, outweigh any benefit from imposing any element of compulsion. We are also pleased that the Committee has applauded the firm stance that the Government has taken on the centrality of energy liberalisation and the Lisbon Agenda.

### Impact of price increases on business customers

**1. The recent gas and electricity price rises have created major problems for the competitiveness of UK manufacturing industry. As the EIUG suggested, industry**

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1 Twelfth Report from the Trade and Industry Committee, Session 2004-05, *Fuel Prices*, HC 279

2 In this and the following Appendix, paragraphs in bold are quotations from the Committee's Report.

would be able to live with these problems if it felt that the competitive disadvantage would shortly disappear—after all, UK industrial consumers have experienced a relatively long period of below average fuel prices to offset the recent peak, and such fluctuations are an integral part of a liberalised market. However, industry fears that the autumn 2004 price spike will not prove to be an isolated incident, partly because one cause of it was the lack of liberalisation in European Markets which will not be rectified quickly, and partly because it feels the spike has not been fully explained by market fundamentals and is probably a symptom of serious market failure. We believe such a failure could be attributed to supply side rigidities. We return to this issue later. (Paragraph 24)

The Government takes the concerns over high energy prices and whether the market is working properly very seriously. The price spikes in the spot and forward gas markets have been looked at by the Competition Authorities, who found no evidence of market abuse. The DTI has commissioned its own work because of the importance of this issue. The report on the Forward Gas Market by independent consultant Global Insight concluded that the price spike in September/October 2004 was a price excursion rather than a serious market failure. Their analysis concluded that the UK forward market is a functionally liquid efficient hedging and trading market, free from market distortions and major abuse, with efficient price formation outside of short spike periods. We are working with others, especially the energy intensive users and Ofgem, to see what can be done in the short term, but the biggest long-term challenge is how to cope with imports from the unliberalised EU into the fully liberalised UK market.

**2. We accept that the overall statistics mask significant price imbalances between individual UK companies and sectors and their competitors in Continental Europe. However, we note that Continental supply contracts also usually contain provisions for a time lag of between three and nine months before customers are affected by any price increases in the commodities to which the contract is indexed. We suspect that I&C customers on the Continent will soon experience higher prices for gas too—E.ON confirmed that this was already beginning to happen in Germany. This would reduce the competitive disadvantage experienced by a number of UK companies. (Paragraph 15)**

We agree with the Committee's view that it is difficult to find up to date robust equivalents when looking to compare energy prices in the UK with those seen on the Continent. We have been in the forefront in pressing for further liberalisation of Continental markets, which will lead to more liquid trading markets which, in turn, will increase price transparency and comparability between Member States.

**3. Industrial customers continue to run the serious risk of paying much higher prices for their energy if they opt for the stability of annual contracts over the risk associated with shorter-term contracts. They must make this decision for themselves. However, we urge trade associations and the DTI to work quickly to provide (especially smaller) business customers with the information they need about options. We also think that companies should seriously consider disconnecting their energy contracts from the October renewal date: although annual contracts should smooth out the seasonal price**

peaks and troughs whatever the starting date, the effect of so many contracts being renewed at the same time would tend to make it a sellers' market. (Paragraph 25)

**4. In this context, we were pleased to hear from the Minister that the DTI intended to hold a seminar early in spring to enable I&C customers to discuss different purchasing strategies and to share ideas on how they might reduce the problem of the autumn price spike by smoothing out the bunching of contract renewals. (Paragraph 26)**

**5. Universities and Public Sector bodies have experienced particularly sharp price rises. We expect the DTI to include them in the proposed discussions with industry on how to cope with the price rise. (Paragraph 27)**

The Government acknowledges that this is a challenging time for many major users of energy, and we are in close and continuous dialogue with the affected sectors. Further study has shown that, while some participants do still rely on the old system of annual contracts starting on 1 October or 1 April, there has been a significant move towards more flexible contracts over the past year, in terms of length of contract and in the dates when they are negotiated and signed.

We would expect the EIUG and MEUC to provide guidance to their members on different purchasing strategies, and for the sector specific trade associations such as the CIA and EEF to provide examples of best practice. However, there is also a role for energywatch, with its remit for protecting the interests of all consumers, not just domestic, to provide advice to some of the smaller companies and public sector organisations. We are considering organising a seminar over the summer with energywatch and Ofgem to share ideas on flexible purchasing policies with these smaller energy users.

The DTI hosted the seminar on Forward Gas prices on 16 May. The seminar was attended by 40 senior and well-informed representatives from a broad cross-section of bodies actively involved in the forward gas market, such as producers, traders, shippers, suppliers, consultants and a variety of end users from industry, commerce and the public sector. The new Energy Minister attended, gave a short address emphasising that he considered the gas prices issue one of his major priorities, and listened to the concerns of the intensive energy users and the public sector. There was a good level of constructive debate and we drilled down into the factors influencing the forward market. The Government and Ofgem will be continuing the dialogue with end users with a view to seeing what changes could be put in place before next winter, and what other longer term steps could be taken to improve the functioning of the forward gas market.

In addition to the representative bodies for the end user sectors, such as the Major Energy Users Council, the Local Authority General Utilities Resource (LAGUR), The Energy Consortium (representing over 130 universities and colleges) and the Institute of Purchasing and Supply, also invited to the Forward Gas Prices Seminar on 16 May were: the Department of Health, the Welsh NHS Trust and the University of Leicester. LAGUR also gave a presentation on the Public Sector perspective, which proved very stimulating.

The Office for Government Commerce (OGC) established a Procurement Work Stream for energy in late 2004 in response to the Gershon report. It has been talking to a number of large Government Departments such as MoD and DoH, about how they do their energy

procurement, and is aiming to make recommendations for doing things differently, e.g. strategic sourcing solutions such as aggregation of small contracts. They are seeking to establish an Energy Users Forum, involving all the main Government purchasing departments, and to share best practice with other public sector bodies such as LAGUR and The Energy Consortium. DTI will work with OGC in developing purchasing guidelines and taking advantage of their existing communication channels.

## Impact of price increases on domestic customers

**6. energywatch and the Fuel Poverty Advisory Group advocated a number of actions that could be taken to mitigate the effect of the price rises on poorer customers. We endorse all these suggestions, which repeat our recommendations over a number of years in our Reports on various aspects of fuel poverty. It is clear that the long term solution to the problem of fuel poverty must not rely on low energy prices. We note Ofgem’s assurances that some of the necessary responses are already happening—for example, the development by companies of innovative tariffs, and continued pressure by the regulator for companies to follow best practice guidelines on dealing with customers in debt. (Paragraph 32)**

**7. However, more efforts are required. We particularly emphasise the need for greater co-ordination within Government to deploy key providers of public services (especially in the fields of health, social services and social security) in the task of identifying those in fuel poverty and informing them where they can obtain advice and help. (Paragraph 32)**

The Government shares the Committee’s view that it is important to increase efforts to target, reach and assist the fuel poor, particularly those in vulnerable households. A good deal of progress has already been made. Work will continue with a range of organisations, within central Government and beyond, to ensure there is a co-ordinated, and increased, effort to help the fuel poor.

As the Committee recognises, low energy prices have significantly contributed to the substantial decline in fuel poverty since 1996. However, the Government has always taken the view that fuel poverty cannot be eradicated by low energy prices alone: that will require further energy and non-energy measures and approaches.

The Government considers it important that households have access to tariffs that minimise energy cost, and it encouraged the development, and welcomes the introduction, of ‘social’ and other innovative tariffs. Households should also be encouraged to use the most appropriate payment method (usually direct debit).

The Government has also taken steps to improve the energy efficiency of homes, particularly through changes to the Energy Efficiency Commitment, Warm Front and Building Regulations. Warm Front also offers Benefit Entitlement Checks (which have increased household income by an average of £1,000 per annum for successful claimants), which promote access to measures under the Scheme as well as increasing household income. The industry has also supported a range of individual fuel poverty programmes, including the Warm Zones model, the pilot of which was funded by the Government.

However, whilst key measures to address fuel poverty are in place, the Government agrees that more needs to be done to continue to target, reach and assist fuel poor households. This entails improving and extending the way in which the lead Government Departments work with, and co-ordinate the activities of, a range of parties, including central and local Government, the health service and the voluntary sector. There are three main strands to this activity.

Within central Government, DTI and Defra have discussed with DWP and DoH how to improve cross-Departmental involvement in tackling fuel poverty. These discussions are geared towards improving the reach, delivery and impact of fuel poverty messages and measures, for example, by improving referrals between those in contact with the most vulnerable and those delivering energy efficiency schemes. Identifying and reaching fuel poor households will be aided by, *inter alia*, DoH's Single Assessment Process for those with multiple needs and DWP's LinkAge scheme. The recently formed Health, Housing and Fuel Poverty Forum will encourage further activity in the health sector. The Government is also considering whether delivery of the Strategy could be improved by the identification of fuel poverty 'champions' in local authorities.

However, individuals in need are often hard to reach and help. The Government recognises that many of the organisations with which individuals deal, and which they trust, are not within central or local Government. The Government is, therefore, working with the voluntary and care sector to establish what it might do to improve advice to disadvantaged customers and promote take-up of measures critical to removing households from fuel poverty.

These activities in turn link with a major initiative being developed by the industry, following discussion with Government. This involves the introduction of a Helpline for disadvantaged customers. It is intended that the Helpline project will identify the most vulnerable customers, assess how they can be helped and, following one initial call, deliver measures that will provide affordable energy. The Helpline, which will be accessible by individuals or intermediaries, is due to be in place by October 2005.

The Government shares the Committee's appreciation of the contribution that the Fuel Poverty Advisory Group and energywatch have made to the debate about fuel poverty and the development of the measures required to eradicate it. The Government will continue to work with these and other key parties to deliver the Strategy.

## Social responsibility of production companies

**8. Since we started this inquiry, a number of oil companies operating in the UKCS have announced record profits. These are multinational companies producing both oil and gas, and it would be wrong simply to assume that much of this profit is attributable directly to the dramatic increase in UKCS gas prices. We also acknowledge that the production industry is subject to a higher rate of Corporation Tax than other sectors. Some of our witnesses advanced arguments for a windfall profits tax, but we have received too little specific evidence on its potential impact on future investment in the UKCS to report on this issue. However, if the current very high levels of world oil and gas prices continue and if a specific proportion of the profit can be identified as coming from the UKCS, then we believe that the Chancellor of the Exchequer should carefully**

**consider the options. We would prefer those companies that have benefited from the price rises voluntarily to contribute to the alleviation of fuel poverty as part of their Corporate Social Responsibility programmes: it would enhance their reputation and would provide help more swiftly to those who, though unable to afford it, are contributing to their unearned profits. We do not expect the production companies to set up fuel poverty programmes themselves—as they pointed out, government agencies and the energy supply companies are much better placed to identify those in need of help and deliver that help. But we do not believe it would be difficult to devise a mechanism through which they could donate money to such schemes. (Paragraph 36)**

We agree that any contribution from production companies to deliver their own corporate social responsibility goals should be made on a voluntary basis. We note that many offshore producers are already either members of, or participate in programmes run by, Business in the Community. This is an independent business-led charity with over 20 years experience whose purpose is to challenge business to improve continually its impact on society. Others have their own programmes reflecting their social responsibilities and charitable trusts. The Government believes businesses benefit from a positive corporate social responsibility profile but that it is very much up to individual businesses to devise their own strategy for delivering this.

## **Decline of the UKCS**

**9. Because of the difficulties in extracting the—substantial—remaining reserves of gas from the UKCS, it is not at all clear that the decrease in production will take place in a managed and predictable way. This simply highlights two points which we address later in this Report: the need urgently to put in place infrastructure to ensure that adequate supplies can be imported into and stored in the UK to meet any shortfalls from the UKCS; and the need for sufficient information to be supplied to the market about why production rates are lower than expected, in order that the market players can then take a more rational view of pricing. (Paragraph 42)**

We agree with the Committee's views that the decrease in production of the UKCS needs to be met with adequate storage and import infrastructure projects. The Energy White Paper expectation that market participants, in anticipation of future needs and in response to price signals, will deliver these projects can be seen with the number of planned projects already underway, none of which have required any subsidy from the taxpayer. The financial burden of risk rightly falls to the private sector businesses who have most to gain from making these investments. We will continue to ensure that the correct market framework is in place, and this includes the markets being governed by an independent regulator, so that market participants are appropriately incentivised to make these investments while at the same time representing the best value to GB customers.

Projects underway include three new LNG import terminals at Milford Haven and Isle of Grain, two new pipeline connections to import gas from Europe and an expansion of the import capacity of the existing interconnector. By 2008, import capacity from new pipelines and LNG facilities will be equivalent to annual production from the UKCS, each at 80% of total annual forecast demand. In addition, by 2009/10 new storage capacity is anticipated to be in the region of 2 billion cubic meters (bcm). This is additional to the

existing short, medium and long-range storage capacity of 3.7 bcm; and there are more new storage project proposals coming forward that are not yet in the public domain. Progress on these projects will be carefully monitored and we will not be satisfied until they are complete.

We agree with the Committee that the decline of the UKCS is one that must be monitored closely. This year's programme of work in support of the Joint Energy Security of Supply committee includes further and more detailed analysis of offshore performance including field commissioning; within seasonal reservoir decline; plant availability and unplanned shut downs.

It must be stressed that the UK's record on attracting investment into the UKCS, including the exploitation of marginal fields, is widely recognised as being excellent. The Government, working jointly with industry under the high-level PILOT forum, is fully committed to the objective of maximising economic recovery of UKCS oil and gas. In the last 4 years measures unique to the UK have been introduced to, *inter alia*, open up acreage that is not being developed, reduce barriers for potential new licensees, promote access to infrastructure, and improve access to seismic and well data. All these have helped to generate fresh interest and investment by an increasingly diverse range of companies. 97 licences were awarded in the most recent licensing round—a level not seen since the 1970s—with over half being 'promote' licences that seek to encourage smaller, more nimble firms. Moreover, production levels are now in line to meet the PILOT target of three million barrels of oil equivalent per day by 2010—well above anticipated levels given the relative maturity of the North Sea basin. Recent industry commitment to Codes of Practice and novel criteria for 'good stewardship' to extend the life of older producing fields are further steps in ensuring that Government and industry are wholly in partnership in ensuring that any changes in future North Sea production will take place in a predictable and managed way.

## Gas storage

**10. As we discuss below, there are currently plans to build significant storage capacity in the UK. However, this does not help with the immediate problem of a tight supply over the next year to 18 months. Both Ofgem and the DTI suggested that the price spikes had provided strong market signals that extra storage capacity was necessary. So they have, but even before the price spikes it was absolutely certain that storage would be needed as the UKCS declined: we pointed out the consensus on this issue in our January 2002 Report into the Security of Energy Supply. We are therefore disappointed by the lack of progress in the last three years. We recognise that this is not entirely due to lack of foresight: because of difficulties in obtaining planning permission, construction has begun only recently of the storage facility in Cheshire, which we were told in the winter of 2001–02 would shortly be built. As one of the witnesses from Ofgem indicated, the tight supply situation this winter would have been significantly eased if even one of the proposed facilities had already been built, and both domestic and I&C consumers might have been spared a proportion of the recent price increases. Planning guidelines should be reviewed to ensure that the strategic importance of gas storage and other infrastructure projects is fully recognised. (Paragraph 48)**

Planning decisions for gas storage will need to address and balance a range of issues including local concerns and the national need for energy infrastructure. The planning process may take time and it is only right that new gas storage projects are considered thoroughly. At the same time the DTI recognises the importance of making sure that national energy policy considerations are fully taken into account in planning decisions regarding gas storage and will be drawing on its experience with renewable energy projects to ensure the message is understood. The DTI also recognizes that for the planning process to operate as efficiently as possible, new investors will need to engage with stakeholders early in the process and plan ahead to factor the time taken by the planning process into their project timetables, especially where an appeal may be necessary.

## Overall supply situation

**11. Over this and perhaps the next two winters, the UK will be in the uncomfortable position of having a relatively small surplus of gas over normal winter demand. As National Grid Transco has indicated, because supply cannot be increased measures may have to be taken to decrease demand—which means that customers with interruptible supply contracts may find their gas supply temporarily suspended. Although the existence of the price spikes seen over the last six months is explicable by the actual state of supply in relation to demand, it seems to us that the degree of volatility is not fully explained by this. (Paragraph 49)**

In general we would expect gas demand to reduce of its own accord in response to higher prices reflecting tightness in the supply–demand balance. We have seen this in particular in the electricity generating sector; and empirical evidence from last winter, as well as research undertaken for DTI, indicates that there is also potential for demand reduction by other large users of gas, e.g. in energy intensive industrial sectors. Where further reductions are necessary to maintain balance on the national gas network it is normally for gas suppliers, who are responsible under the terms of the Network Code for balancing their own inputs and their customers’ off-takes on a daily basis, to deliver this by arrangement with their customers in the first instance. We would expect last winter’s experience to encourage more large consumers to investigate with their suppliers ways in which flexibility to reduce gas demand at times of supply-demand tightness can be turned to commercial advantage.

As noted above in the response to paragraph 1, in view of concerns over difficulties in explaining the price excursion in the forward market experienced in October 2004, the Government commissioned research into the workings of the gas forward market. This concluded that the UK gas forward market is a functional hedging and trading market, but that it is immature, structurally limited and, by global standards, insufficiently liquid; such factors, along with the general high energy price climate that was being created around persisting high crude oil prices, the general decline in UKCS production levels and reactions to public comments by certain organisations, provide a general explanation. The report made a number of recommendations to Government and to end users and these are now under active consideration.

## Behaviour of the gas market

12. Although we are not suggesting that the shipper subsidiaries of production companies are able to buy gas at a lower cost than external competitors can—we accept that the transfer price of gas sold to the shipper arm by the production company is scrutinised closely by the tax authorities—such vertical integration between producers and shippers may give shippers better access to pertinent information than other market participants. (Paragraph 51)

13. We received no evidence that producers have withheld supply from the market to drive prices up. None of our witnesses has suggested collusion or any other illegal behaviour in the offshore production market; nor do we consider that the sharing of information between companies owning or making use of the same facilities is improper or unnecessary. However, the structure of the UKCS production market does mean that participants in it have access to significantly more knowledge than those to whom they are selling their gas. We note also that there have been allegations in the past that the oil majors have shown a disinclination to share infrastructure with newer market entrants—a situation that, the industry hopes, it has addressed by a new Code of Practice “to ensure equitable and timely access to infrastructure”, which was launched in September 2004. These factors, together with the fact that the big gas production companies also act as shippers, result in a market where actual competition appears less than might be expected from the number of players and market share. This leads to a further question, which is whether the market therefore needs to be regulated or made subject to closer monitoring. (Paragraph 58)

We note that the Committee found no evidence to support suspicions of collusion or other illegal behaviour by upstream producers. There is an extensive competition framework in place, with the gas market subject to both general and sector-specific competition law. Government policy is that it is the role of the UK’s independent competition authorities or regulators (where they have the powers) to investigate competition matters. Ofgem has concurrent power under the Gas Act 1986 to investigate agreements or conduct relating to the shipping, conveyance or supply of gas and ancillary activities. It already has an ongoing remit to monitor the market and has powers of investigation, if needed. Against that background, we are confident that any market abuses can be identified and dealt with. We are also confident that the updated industry Infrastructure Code of Practice is working to facilitate the continuing development of the UK Continental Shelf.

14. There is a serious shortage of companies willing to sell gas in the wholesale market when prices are high. Unfortunately, because of the tight supply situation, prices are likely to remain high over the next two years. This does not bode well for I&C customers. We hope that Ofgem’s prediction about the imminent arrival of more active traders proves correct. Perhaps—if they are financial institutions themselves—they will not be subjected to as tight a credit straitjacket as current market traders, and greater liquidity will return. However, we can only conclude that at present the market is not functioning efficiently. Price spikes are more and more frequent, and they seem to be higher each time. Much of the volatility can be attributed to real difficulties in balancing supply and demand, but the scale of the peaks will remain high until more traders are encouraged to sell short. (Paragraph 65)

In the main body of the report of their findings, the Committee makes reference to a witness who stated that the forward price excursion in the Autumn of 2004 represented a market failure. The Committee also refer to a lack of shippers active in the forward gas wholesale market.

As we said in answer to Recommendation 1, in response to claims that the forward market was 'broken', earlier this year the DTI commissioned independent energy consultants Global Insight to undertake a detailed analysis of the workings of the UK forward market in the UK, which included an assessment of the events of Autumn last year. Their analysis suggested that the price spike was a "perfect storm" of a number of coincidental factors, some of which were unlikely to be repeated, and with that experience in mind, the market players would be better prepared to avoid a similar price spike occurring in the future. They also noted that banks and commodity traders have been joining the market over the last two years with no sign that this steady trend is about to change. We acknowledge that there is room for improvement in terms of developing the liquidity and critical mass of the forward gas market and key future objectives will be improving the confidence in the market and encouraging more players to trade within it.

## Transparency of the gas market

**15. We understand and accept NGT's explanation of why it is currently impossible to provide real time information on gas flows. This may not be very significant: information delayed by an hour represents a huge increase in the transparency of this market, and is, we believe, quite sufficient for the needs of customers. However, we suspect that to restore market confidence there may be a need for still more information about production outages, not least because of the mistrust that has arisen over maintenance patterns in 2003. It is too soon to make a firm judgement on this, but we recommend that the DTI and Ofgem keep a watch on this area to see whether further information is needed. (Paragraph 72)**

**16. We note that the Norwegian gas production companies have agreed to participate in the arrangements for providing voluntary information. We welcome this. We consider that the advantages of receiving information from all major parties, albeit on a voluntary basis, outweigh any benefit from imposing any element of compulsion which might lead the Norwegian companies to withdraw from the scheme altogether. (Paragraph 73)**

We agree with both of these recommendations from the Committee. The issue of information is one of a number of important factors to consider when assessing how a market operates. This is why the DTI drove forward an agreement with UKOOA, to which the Norwegians have also agreed to participate relating to Norwegian gas exported to the UK, to voluntarily release information to help the market work better. As the Committee notes, this agreement is less than a year old. It is already delivering important information. Publication of the final element (aggregated near real-time flows) is scheduled for July 2005. We share the Committee's view that some time is needed before the value of this information can be properly assessed.

The Government welcomes the Committee's support for a voluntary framework and its recognition of the wider advantages. In addition, we consider that well focused voluntary

arrangements are likely to attract more co-operation from producers, leading to them being more successful, effective and responsive to market needs. However, if there remain concerns relating to the release of information, we will not hesitate to address them, ensuring that all stakeholders' views are accounted for by balancing the evidence on prospective benefits against the commercial concerns of the information providers.

## **Oil indexation in gas contracts**

**17. Because of the variety of ways of determining future price increases under long-term gas contracts, it is impossible to come to a firm conclusion about the degree to which UK gas prices have been affected by the increase in prices of crude oil and some oil products. The effects will vary markedly from company to company. There seems to be a strong trend to replace oil indexation in contracts as they come up for renewal. There was a consensus that this trend was likely to be beneficial in the medium to long-term. However, there is no guarantee that gas prices would fall if oil indexation ended. Shell cited the example of the USA where—it said—there was no indexation to oil but gas prices had increased significantly, being at higher levels during the winter of 2004-05 than in both the UK and Continental Europe. (Paragraph 79)**

**18. Oil and gas prices will to some extent tend to move together even if the explicit indexation to oil is broken because oil and gas are still, to a degree, competitive products. However, what the actual correlation between the two will be remains unclear. (Paragraph 80)**

We agree that it is unclear whether gas prices will fall significantly as a consequence of the ending of oil indexation. However, further liberalisation and competitive pressures on the Continent, coupled with new import capacity and gas supplies, are likely to lead to increased gas-to-gas competition (where the cost of the marginal source of gas sets the price) which can be expected to put downward pressure on prices in the medium to longer term.

## **Competition within Europe**

**19. We welcome the European Commission's announcement of inquiries into competition within the European gas and electricity markets. We note the timetable announced to us, and look forward to the completion of both inquiries by the end of 2006. We are also pleased that the UK Government has taken such a firm stand on the centrality of energy liberalisation to the whole Lisbon Agenda. However, we recognise that both the Commission and the UK Government will need to exercise considerable persuasive powers to convince other Member States of the need to take prompt action. (Paragraph 90)**

The Government has taken the lead in pushing for fully competitive EU gas and electricity markets, which we see as a key plank of the Lisbon economic reform agenda. This led to the agreement of a landmark liberalisation package in 2003 which requires full market opening and full legal separation of network businesses by July 2007. The importance of this achievement should not be underestimated. We recognise, however, that there is still a long way to go before EU energy markets function as they should. This is why an

important theme of our Presidency in the second half of this year will be the need for full implementation of existing EU energy market legislation and effective enforcement action by the Commission, where necessary, to achieve this. In this context, we will be looking to the Commission to carry out a thorough assessment of the practical impact in each Member State of the existing legislation, in the report that it is required to publish before the end of this year.

We welcome the sectoral inquiry formally announced by the Commission on 13 June, and we will be working with Ofgem and UK market players to ensure that the inquiry identifies the real barriers to the proper functioning of EU gas and electricity markets, and leads to appropriate remedial action. By highlighting the areas where EU energy markets are not working at present and proposing action to improve their functioning, these two reports should have a significant impact on the pace of liberalisation in Europe. To ensure that this happens, we will continue to play a leading role in keeping up the pressure for reform.

**20. Without further real (not just cosmetic) liberalisation of the European gas market, the wholesale market in the UK will malfunction: it will continue to be difficult for buyers to access adequate supply and, because of this and other distortions caused by the mismatch between the liberalised market in the UK and the more rigid contractual arrangements on the Continent, there will be a tendency for prices to diverge significantly. Even on the most optimistic forecast, it is unlikely that the Continental market will be functioning as a fully liberalised one before about the end of this decade. Moreover, as BP reminded us, “Liberalisation does not, per se, lead to lower prices. Rather it gives consumers the freedom to choose suppliers, encourage the development of new products and services and lets the market react more quickly to changes in supply/demand fundamentals.” European liberalisation is not a complete answer to the problems in the UK gas wholesale market. In fact, the Director for Conventional Energies, Directorate General for Transport and Energy, observed that the object was not cheap energy but rather a more efficient mechanism for establishing energy prices. (Paragraph 91)**

We agree that it will take time for EU energy markets to function as they should but we have come a long way and all Member States now agree that there can be no going back on liberalisation. We will continue to work together with the Commission and national regulatory authorities over the next few years to bring about the changes needed for market players to have easier access to gas supplies and transport facilities on non-discriminatory terms, leading to greater market liquidity. This in turn should ensure that price movements reflect market fundamentals, i.e. rise and fall depending on the supply/demand balance.

## Regulation of the gas market

**21. The DTI and Ofgem consider that the current regulatory regime is robust; they base this view on their assessment that the gas market is competitive. We believe that some of the peculiar aspects of gas production and trading militate against full competitiveness at present. The result is a loss of confidence in the market, and suspicions by gas users that those benefiting from price spikes have somehow engineered them. None of our witnesses suggested any failure of the market in respect**

of areas wholly subject to the sectoral regulator, Ofgem: concerns focussed on the supply of gas to the wholesale markets, not the ‘downstream’ operations. We acknowledge that any extension of Ofgem’s remit would require primary legislation, which would mean delay, when the problems of supply/demand balance in the gas market are likely to be at their worst over the next two years or so. Furthermore, attempting such legislation would undermine investor confidence at this crucial time. (Paragraph 97)

We believe that the current regulatory regime is sufficiently strong. There is a comprehensive framework of sectoral, general competition and financial regulation. The Government, through Ofgem and the Competition Authorities keeps the market under close scrutiny, and we will not hesitate to act if there is any evidence of market abuse or failure. We will continue to pursue our PSA target to “Ensure that the UK remains in the top three most competitive energy markets in the EU and G7.”

**22. We therefore recommend that the DTI itself should take a more active role—not necessarily by increasing its intervention in the offshore industry but by monitoring the situation more closely to ensure that there are no activities which would warrant referral to the Competition Commission. We accept that such an increase in activity may require greater staff resources within the DTI; we would expect extra resources to be made available, if required. (Paragraph 98)**

We disagree with the Committee that more resources need to be made available to discover if there are any activities which ought to be referred to the Competition Commission.

The Competition Act 1998 and Enterprise Act 2002 have established a robust framework for the investigation of competition concerns by independent competition authorities (including the sectoral regulators) who we believe are well resourced. We can give the Committee our assurance that should we become aware of any anti-competitive arrangements or behaviour in relation to the offshore sector these would be brought to the competition authorities’ attention without delay.

## **Vertical integration in the gas and electricity industries**

**23. It is clear that company mergers are creating gas and electricity markets dominated by a few, vertically integrated companies. We know that Ofgem monitors this situation closely to ensure that no anti-competitive behaviour emerges. However, we detect increasing unease among consumer groups, I&C customers and some companies within the industry about the possible effects of such integration. (Paragraph 102)**

As indicated in our response to recommendation 12, we do not consider that vertical-integration leads to any significant loss of competition. There are enough companies in the gas and electricity markets to ensure a good level of competition. Indeed, some argue that vertical integration leads to greater efficiency and should therefore enhance the competitiveness of market players.

## Electricity market

**24. Although some individuals who wrote to us felt that the electricity price rises for consumers were unjustified, the vast majority of our witnesses accepted that they were a direct result of the increase in the cost of the main generating fuels, coal and—especially—gas. We, too, believe that electricity producers have not been profiteering. The variations in price rises from company to company can be explained in part by the differences in their portfolios of generating plant and the degree to which they have been able to offset the gas price rises by changing to cheaper fuels; and in part by the different commercial approaches they have adopted (whether they have chosen to increase prices across the board or to shelter some customers from the full effects of the price rises, for example). (Paragraph 108)**

The Government welcomes the Committee's conclusion that they believe the electricity producers have not been profiteering. To the extent that we expect gas prices to decline after 2007, there will be a downward impact on electricity prices as well. Coal prices have been pushed up largely as a result of the increase in freight rates rather than a change in the economic fundamentals in coal mining. World coal markets are competitive, with a diversity of sources of supply, so we would expect prices to decline as the freight capacity situation unwinds.

**25. However, the effect of the price increases on customers has been significant, and further increases are inevitable, given that the cost of environmental legislation has yet to be passed through to customers. We note that the cost of the Large Combustion Plant Directive and the EU Emissions Trading Scheme will add to the existing cost of the Renewables Obligation and the Climate Change Levy. Although fluctuations in fuel costs will occur, over the medium to long-term electricity is unlikely to be as cheap in real terms as it has been over the last six years. I&C customers have considerable incentives to reduce their energy use. As a result, we think that it is now time for the Government to re-examine the operation of the Climate Change Levy, and in particular to consider the scope for reducing it to help UK industry during its present difficulties. (Paragraph 109)**

The Government announced in Budget 2005, partly in response to recent movements in energy prices and the advent of the EU ETS, a freeze in the rates of the Climate Change Levy (CCL) for 2005-06. Decisions on future rates are a matter for the Chancellor as part of the Budget process.

The Government published, at the time of the Budget, a report by Cambridge Econometrics suggesting that the CCL is expected to deliver over 3.5 million tonnes of carbon savings by 2010, well above estimates made at the time of the levy's introduction.

With the introduction of the EU Emission Trading Scheme from January 2005, overlapping policy measures will cover some business sector emissions. This mix of climate change measures is under consideration as part of the Climate Change Programme Review. Some business stakeholders have argued for greater simplicity and streamlining of instruments and this will be an important consideration in deliberations for the Review.

## New infrastructure projects

26. We have no doubt that the UK will shortly have significant extra import capacity, but we cannot predict when construction of this capacity will be completed. We note that, between UKOOA's submission of its original Memorandum to us in late November 2004 and the production of its Supplementary Memorandum in mid February 2005, the target dates for completion of three facilities had been put back, and there had been a reduction in the expected capacity of two facilities (including Phase 1 of the Isle of Grain LNG facility, which is likely to be the first to come into operation). This is in the nature of large infrastructure projects. However, this does prolong the uncertainty to which the wholesale gas market is prey. Government departments should ensure they are well placed to facilitate these developments where they have a regulatory or planning function. (Paragraph 112)

Gas infrastructure projects have a strong incentive to commission on time, because that maximises the commercial benefits to the project. One of the DTI's important roles is to facilitate new gas infrastructure projects by working with them to identify, and where possible address, non-commercial barriers. Recent examples include:

- new inter-Governmental treaties with Norway and the Netherlands, which will facilitate the new Langeled gas import pipe-line into Easington and the proposed BBL gas interconnector between the Netherlands and Great Britain;
- putting in place the legal framework to enable Ofgem to exempt certain projects from the requirement for Regulated Third Party Access;
- providing exemptions from the requirement for a gas transporter licence in respect of further classes of project, including LNG import terminals;
- and, for the longer term, reviewing whether Great Britain's gas quality requirements constitute an avoidable barrier to new projects.

The Government response to the TIC's comments on the planning function is covered in response to Recommendation 10 above.

## Future of gas prices

27. We cannot take the Panglossian view of the gas wholesale market that the DTI and Ofgem appear to hold. There are failures in the market which arise from significant problems with physical supply, the lack of information about supply available to participants, the difficulties caused by operating a liberalised market (the UK) alongside a relatively unliberalised market (Continental Europe), and the dearth of traders willing to sell gas into the forward market. These problems are serious enough for us to conclude that the autumn 2004 price spike, and the recent spike in late February, will be repeated over the next two years. We urge Ofgem and the DTI to keep a close watch to ensure that the market is responding to all the proposed developments likely to make it function efficiently (extra infrastructure and storage capacity, the provision of more information, and so on). If there continue to be well-founded

**concerns over the operation of the market after these changes have taken effect, then we conclude that the market must be considered to be failing. (Paragraph 116)**

The Government recognises that energy is fundamental to the economic and social welfare of the country. Within a liberalised market our role is to set the regulatory framework which allows a competitive market to flourish. Where there is market failure the Government will not be complacent but take action to redress it. There is strong evidence that business is flourishing and increasing opportunities are developing in global energy markets. The DTI recognises it has a significant task in pushing for further liberalisation in Europe and it does not underestimate this challenge.

**28. Although all the problems with the market could, and probably will, be solved eventually, customers—and especially I&C customers—will face serious disadvantages in the meantime. The DTI is placing heavy reliance on customers changing their buying practices: avoiding the October bunching, and purchasing gas on short-term markets when forward prices seem excessive. We think that this is going to be difficult for companies, especially the SMEs whose interests the DTI has pledged itself to take particularly into account. (Paragraph 117)**

Government acknowledges the impact high energy prices are having on industrial and domestic consumers and is working with those sectors to ease the pain. Discussions with industry members, both major users of energy and the smaller buyers, will continue, with a view to helping them understand the dynamics of the gas market and to adapt their purchasing strategies to the changed situation. In order to address fuel poverty, we will be working with agencies and the voluntary sector to better target assistance to vulnerable households, and help them to help themselves.

## Appendix 2: Ofgem Response

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### Introduction

The Committee is rightly concerned about the impact of high British wholesale gas prices on business and domestic customers, including the customers in fuel poverty. Ofgem shares the Committee's concerns. Consistent with our principal objective to protect the interests of consumers, wherever appropriate by promoting effective competition, Ofgem carried out a comprehensive review of the causes of the increases that identified the main factors behind the increases. Ofgem is continuing to explore whether certain contractual arrangements in relation to the Sean field prevented some gas from reaching the market during periods of high prices. Ofgem also highlighted some potential concerns about the availability of European gas supplies through the interconnector. Ofgem hopes that these concerns will be thoroughly investigated as part of the European Commission's recently announced investigation into the European gas market.

Given the importance of gas prices to consumers, Ofgem continues to devote considerable resources to pursuing these issues. Ofgem also continues to monitor the wholesale energy markets on a day-to-day basis, and is satisfied that it has the necessary powers to investigate and take action should any anti-competitive conduct be identified in the GB market. Declining UK gas supplies will continue to have an impact on prices. However, there are a number of confirmed major infrastructure developments that are likely to mean that prices will ease going forward. That said, Europe will remain an important and growing influence on UK prices and hence the establishment of a fully competitive European gas market remains a priority. With that in mind, we welcome the European Commission's decision to review the gas as well as the electricity market. The scope of this review will be published shortly.

### Impact of price increases on business customers

**1. The recent gas and electricity price rises have created major problems for the competitiveness of UK manufacturing industry. As the EIUG suggested, industry would be able to live with these problems if it felt that the competitive disadvantage would shortly disappear—after all, UK industrial consumers have experienced a relatively long period of below average fuel prices to offset the recent peak, and such fluctuations are an integral part of a liberalised market. However, industry fears that the autumn 2004 price spike will not prove to be an isolated incident, partly because one cause of it was the lack of liberalisation in European Markets which will not be rectified quickly, and partly because it feels the spike has not been fully explained by market fundamentals and is probably a symptom of serious market failure. We believe such a failure could be attributed to supply side rigidities. We return to this issue later. (Paragraph 24)**

Ofgem shares the Committee's concern about the effects of the recent high British wholesale gas prices on domestic and business customers. We undertook a detailed review into gas prices during winter 2003 and forward gas prices for winter 2004/5. We found that price movements appeared to be in line with market fundamentals although, as stated

above, we are currently looking into a number of offshore contracts relating to the Sean field.<sup>3</sup> We also undertake routine market surveillance work. We agree with the Committee that the physical nature of supply in gas will have the potential to exacerbate any unexpected price spike, given the relatively long lead times associated with the response from many supply sources.

**2. We accept that the overall statistics mask significant price imbalances between individual UK companies and sectors and their competitors in Continental Europe. However, we note that Continental supply contracts also usually contain provisions for a time lag of between three and nine months before customers are affected by any price increases in the commodities to which the contract is indexed. We suspect that I&C customers on the Continent will soon experience higher prices for gas too—E.ON confirmed that this was already beginning to happen in Germany. This would reduce the competitive disadvantage experienced by a number of UK companies. (Paragraph 15)**

The current high wholesale gas prices should be viewed in their proper context: the current increases have come after a long period of steadily decreasing prices since privatisation. Indeed, for most of the post-privatisation period, British industrial gas prices have been among the lowest in Europe. Industrial businesses are long term concerns that are likely to take this fully into account in deciding where to locate.

As we stated in our oral evidence to the Committee, industrial customers are likely to consider a number of other factors when deciding where to locate, in addition to the wholesale price. For instance, they will consider network charges and the state of competition in the market. In this context, we noted that German network charges were very substantially more expensive than the British network charges and that competition in Germany remained markedly less developed than in Britain. In addition, given the new sources of gas supply that are expected to reach the market, the market expectation is that these projects will have a downward effect on prices. Taking all of these factors into account, Ofgem believes that the competitive British gas and electricity market in which consumers have freedom to choose and change their supplier and in which good service is available consistently over a long period, is best placed to maintain the competitiveness of UK industry in the long term.

**3. Industrial customers continue to run the serious risk of paying much higher prices for their energy if they opt for the stability of annual contracts over the risk associated with shorter-term contracts. They must make this decision for themselves. However, we urge trade associations and the DTI to work quickly to provide (especially smaller) business customers with the information they need about options. We also think that companies should seriously consider disconnecting their energy contracts from the October renewal date: although annual contracts should smooth out the seasonal price peaks and troughs whatever the starting date, the effect of so many contracts being renewed at the same time would tend to make it a sellers' market. (Paragraph 25)**

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<sup>3</sup> Note: Since submitting its response, Ofgem has concluded that there is no reason to take any further action at present in respect of the flows of gas from the Sean Fields on the Sean gas contracts: Ofgem press notice, 'Ofgem closes gas probe', dated 24 June 2005.

This is primarily a commercial matter for the companies concerned, and Ofgem notes that gas suppliers continue to develop new and more flexible contract options that allow customers to manage the risks associated with high and volatile prices.

**4. In this context, we were pleased to hear from the Minister that the DTI intended to hold a seminar early in spring to enable I&C customers to discuss different purchasing strategies and to share ideas on how they might reduce the problem of the autumn price spike by smoothing out the bunching of contract renewals. (Paragraph 26)**

**5. Universities and Public Sector bodies have experienced particularly sharp price rises. We expect the DTI to include them in the proposed discussions with industry on how to cope with the price rise. (Paragraph 27)**

We welcome the assistance being provided by DTI in this area.

### **Impact of price increases on domestic customers**

**6. energywatch and the Fuel Poverty Advisory Group advocated a number of actions that could be taken to mitigate the effect of the price increases on poorer customers. We endorse all these suggestions, which repeat our recommendations over a number of years in our Reports on various aspects of fuel poverty. It is clear that the long term solution to the problem of fuel poverty must not rely on low energy prices. We note Ofgem's assurances that some of the necessary responses are already happening—for example, the development by companies of innovative tariffs, and continued pressure by the regulator for companies to follow best practice guidelines on dealing with customers in debt. (Paragraph 32)**

The Government faces a major challenge if it is to succeed in eliminating fuel poverty in vulnerable households by 2010. While the broader poverty agenda is primarily an issue for Government, Ofgem and the energy industry have a part to play.

Ofgem continues to consider what more can be done to help mitigate the impact of rising prices on poorer customers. We will shortly be publishing our Social Action Strategy and will be consulting on ways in which energy companies, working with other stakeholders including Government, can better focus help where it is most needed. We have welcomed the companies' intention, through the Energy Retail Association, to establish a national fuel poverty helpline. This could help customers more readily get information on tariffs and services which could help them manage household bills.

We have recently published a review, commissioned jointly with energywatch, into the progress made by the six main energy suppliers with implementing good practice guidelines on debt prevention and have recommended that industry sets targets to help reduce debt and disconnection. We will shortly be publishing a further review into progress with the adoption of Corporate Social Responsibility programmes by the main suppliers. Ofgem will be seeking to increase the spread of best practice identified in these reviews.

The other major challenge for all involved in this area is to increase awareness among vulnerable consumers of the help that is available. Ofgem and energywatch are working together, under the Energy Smart' campaign, to promote the message to customers that there are three things they can do to bring bills down: switch to a cheaper supplier, pay by a cheaper payment method, and install energy efficiency measures.

**7. However, more efforts are required. We particularly emphasise the need for greater co-ordination within Government to deploy key providers of public services (especially in the fields of health, social services and social security) in the task of identifying those in fuel poverty and informing them where they can obtain advice and help. (Paragraph 32)**

Ofgem agrees that there is a need for greater co-ordination across Government, industry and all concerned with tackling fuel poverty to get the most out of the many measures and schemes available to help keep homes warm and comfortable. Ofgem will use its knowledge and influence to help Government, companies and voluntary organisations adopt a more joined-up approach to identifying which households are most in need, and better target support to where it is most needed. Separately, Ofgem has urged industry to improve the targeting and quality of energy efficiency advice and the take up of benefit health checks.

### **Social responsibility of production companies**

**8. Since we started this inquiry, a number of oil companies operating in the UKCS have announced record profits. These are multinational companies producing both oil and gas, and it would be wrong simply to assume that much of this profit is attributable directly to the dramatic increase in UKCS gas prices. We also acknowledge that the production industry is subject to a higher rate of Corporation Tax than other sectors. Some of our witnesses advanced arguments for a windfall profits tax, but we have received too little specific evidence on its potential impact on future investment in the UKCS to report on this issue. However, if the current very high levels of world oil and gas prices continue and if a specific proportion of the profit can be identified as coming from the UKCS, then we believe that the Chancellor of the Exchequer should carefully consider the options. We would prefer those companies that have benefited from the price rises voluntarily to contribute to the alleviation of fuel poverty as part of their Corporate Social Responsibility programmes: it would enhance their reputation and would provide help more swiftly to those who, though unable to afford it, are contributing to their unearned profits. We do not expect the production companies to set up fuel poverty programmes themselves—as they pointed out, government agencies and the energy supply companies are much better placed to identify those in need of help and deliver that help. But we do not believe it would be difficult to devise a mechanism through which they could donate money to such schemes. (Paragraph 36)**

This is primarily a matter for the Government and for the companies concerned. As stated above, we will shortly be publishing a review of the Corporate Social Responsibility programmes adopted by the main downstream suppliers. This will enable Ofgem to help spread best practice and to encourage a responsible attitude by suppliers toward their more vulnerable customers.

## Decline of the UKCS

**9. Because of the difficulties in extracting the—substantial—remaining reserves of gas from the UKCS, it is not at all clear that the decrease in production will take place in a managed and predictable way. This simply highlights two points which we address later in this Report: the need urgently to put in place infrastructure to ensure that adequate supplies can be imported into and stored in the UK to meet any shortfalls from the UKCS; and the need for sufficient information to be supplied to the market about why production rates are lower than expected, in order that the market players can then take a more rational view of pricing. (Paragraph 42)**

Ofgem recognises that the decline of the UKCS presents challenges to the industry in providing new sources of gas supplies to meet demand. Ofgem is continuing to work to ensure that market conditions enable new sources of supply to come on line as quickly as possible. For example, Ofgem has granted a number of exemptions to requirements for third party access for new infrastructure and storage projects where appropriate.

The wholesale gas market has responded well in meeting future supply needs and has attracted substantial new investment in LNG, pipelines and storage facilities. As Britain continues to make the transition to become a net importer of gas over the next three years, investments providing 105bcm pa (out of an annual demand of around 400bcm pa) will be made in our gas infrastructure. Some of these new supply projects are close to completion and will begin to flow gas in the next couple of years. The market expectation is that these projects will have a downward effect on prices. This effect can already be seen in current forward prices.

Ofgem agrees with the Committee that it is essential for a well-functioning market that all participants have access to sufficient gas production information (for details see our response to recommendation 15).

## Gas storage

**10. As we discuss below, there are currently plans to build significant storage capacity in the UK. However, this does not help with the immediate problem of a tight supply over the next year to 18 months. Both Ofgem and the DTI suggested that the price spikes had provided strong market signals that extra storage capacity was necessary. So they have, but even before the price spikes it was absolutely certain that storage would be needed as the UKCS declined: we pointed out the consensus on this issue in our January 2002 Report into the Security of Energy Supply. We are therefore disappointed by the lack of progress in the last three years. We recognise that this is not entirely due to lack of foresight: because of difficulties in obtaining planning permission, construction has begun only recently of the storage facility in Cheshire which we were told in the winter of 2001-02 would shortly be built. As one of the witnesses from Ofgem indicated, the tight supply situation this winter would have been significantly eased if even one of the proposed facilities had already been built, and both domestic and I&C consumers might have been spared a proportion of the recent price increases. Planning guidelines should be reviewed to ensure that the strategic importance of gas storage and other infrastructure projects is fully recognised. (Paragraph 48)**

We agree with the Committee that planning regulations are a key reason for the delaying of several storage projects which could have eased the situation last winter. However, planning regulations are a matter for Government.

## Overall supply situation

**11. Over this and perhaps the next two winters, the UK will be in the uncomfortable position of having a relatively small surplus of gas over normal winter demand. As National Grid Transco has indicated, because supply cannot be increased measures may have to be taken to decrease demand—which means that customers with interruptible supply contracts may find their gas supply temporarily suspended. Although the existence of the price spikes seen over the last six months is explicable by the actual state of supply in relation to demand, it seems to us that the degree of volatility is not fully explained by this. (Paragraph 49)**

The Committee is correct to state that over the next one or perhaps two winters the supply/demand balance will be relatively tight in the event of very cold weather, and that there may be occasions on which customers who choose to enter into interruptible gas supply contracts may have their gas supplies interrupted. These gas contracts are offered by suppliers at prices below firm contracts, enabling customers to secure cheaper gas. A recent consultancy report suggests that all large industrial users with interruptible contracts have back-up energy supplies, which will enable them to continue production in the event that their gas supplies are interrupted under contract. It is also open to many customers with firm gas supply contracts to sell back the gas that they have previously bought for a profit. Interruptible contracts are a common feature of all gas markets and Ofgem notes that during the very cold weather in northwest Europe last March, French industrial and commercial customers were interrupted on a number of days to manage demand.

We welcome the Committee's conclusion that the recent spikes in prices appear to be driven by underlying supply/demand fundamentals. Ofgem is not complacent, however, and continues to monitor the market. We would also note that volatility in the spot market is not necessarily passed through to customers, as hedging mechanisms are available to those participants who do not wish to be exposed to these price movements, ranging from fixed price contracts to more sophisticated financial products.

## Behaviour of the gas market

**12. Although we are not suggesting that the shipper subsidiaries of production companies are able to buy gas at a lower cost than external competitors can—we accept that the transfer price of gas sold to the shipper arm by the production company is scrutinised closely by the tax authorities—such vertical integration between producers and shippers may give shippers better access to pertinent information than other market participants. (Paragraph 51)**

Ofgem is currently consulting on issues surrounding the disclosure of offshore information (see the response to recommendation 15). Ofgem notes that it has the necessary powers to investigate if complaints are made about anti-competitive behaviour.

**13. We received no evidence that producers have withheld supply from the market to drive prices up. None of our witnesses has suggested collusion or any other illegal behaviour in the offshore production market; nor do we consider that the sharing of information between companies owning or making use of the same facilities is improper or unnecessary. However, the structure of the UKCS production market does mean that participants in it have access to significantly more knowledge than those to whom they are selling their gas. We note also that there have been allegations in the past that the oil majors have shown a disinclination to share infrastructure with newer market entrants—a situation that, the industry hopes, it has addressed by a new Code of Practice “to ensure equitable and timely access to infrastructure”, which was launched in September 2004. These factors, together with the fact that the big gas production companies also act as shippers, result in a market where actual competition appears less than might be expected from the number of players and market share. This leads to a further question, which is whether the market therefore needs to be regulated or made subject to closer monitoring. (Paragraph 58)**

The issue of whether the gas production market needs to be regulated or made subject to closer monitoring is one for Government.

Ofgem’s view is that wholesale markets work best when participants have access to transparent prices based on an informed view of supply and demand fundamentals. This is particularly important because it allows market participants to anticipate and react appropriately to potentially tight supply situations and to make efficient decisions regarding potential movements in prices.

Ofgem is currently considering specific options and proposals in the context of the DTI-led voluntary offshore information scheme on this issue, which is discussed in more detail in relation to recommendation 15 below.

**14. There is a serious shortage of companies willing to sell gas in the wholesale market when prices are high. Unfortunately, because of the tight supply situation, prices are likely to remain high over the next two years. This does not bode well for I&C customers. We hope that Ofgem’s prediction about the imminent arrival of more active traders proves correct. Perhaps—if they are financial institutions themselves— they will not be subjected to as tight a credit straitjacket as current market traders, and greater liquidity will return. However, we can only conclude that at present the market is not functioning efficiently. Price spikes are more and more frequent, and they seem to be higher each time. Much of the volatility can be attributed to real difficulties in balancing supply and demand, but the scale of the peaks will remain high until more traders are encouraged to sell short. (Paragraph 65)**

Ofgem recognises that declining liquidity is a key issue. We stated in our Corporate Strategy that Ofgem would continue to discuss with stakeholders what, if anything, Ofgem should do to promote liquidity and new entry.

### **Transparency of the gas market**

**15. We understand and accept NGT’s explanation of why it is currently impossible to provide real time information on gas flows. This may not be very significant:**

**information delayed by an hour represents a huge increase in the transparency of this market, and is, we believe, quite sufficient for the needs of customers. However, we suspect that to restore market confidence there may be a need for still more information about production outages, not least because of the mistrust that has arisen over maintenance patterns in 2003. It is too soon to make a firm judgement on this, but we recommend that the DTI and Ofgem keep a watch on this area to see whether further information is needed. (Paragraph 72)**

Ofgem notes that the DTI-led voluntary agreement between offshore producers, terminal operators and Transco has improved and standardised certain offshore data provided to Transco, for example on available gas supplies, planned and unplanned outages. Market participants, including producers, have particularly welcomed the improvements to Transco's annual 'Transporting Britain's Energy' planning and operations process that have arisen because more data is being submitted to Transco. Nevertheless, a number of market participants continue to believe that more information should be disclosed to the wider market.

In February 2005, Ofgem issued a consultation document about the onshore regulatory framework governing information disclosure. There are currently rights under industry code documents for relevant market participants to raise proposals requiring Transco to disclose certain information provided to it by offshore producers. Producers and Transco have raised concerns that these disclosure requirements pose risks to commercially sensitive data and confidentiality clauses. Ofgem is carefully considering these issues and is due to issue a decision on this shortly.

**16. We note that the Norwegian gas production companies have agreed to participate in the arrangements for providing voluntary information. We welcome this. We consider that the advantages of receiving information from all major parties, albeit on a voluntary basis, outweigh any benefit from imposing any element of compulsion which might lead the Norwegian companies to withdraw from the scheme altogether. (Paragraph 73)**

Ofgem welcomes the fact that producers, including those from Norway, have recognised the benefits of providing improved data to Transco under the voluntary scheme and that there is general support for the overall principle of transparent market conditions. As stated above, Ofgem is currently considering further issues in relation to governance arrangements and will issue a decision shortly.

## **Oil indexation in gas contracts**

**17. Because of the variety of ways of determining future price increases under long-term gas contracts, it is impossible to come to a firm conclusion about the degree to which UK gas prices have been affected by the increase in prices of crude oil and some oil products. The effects will vary markedly from company to company. There seems to be a strong trend to replace oil indexation in contracts as they come up for renewal. There was a consensus that this trend was likely to be beneficial in the medium to long-term. However, there is no guarantee that gas prices would fall if oil indexation ended. Shell cited the example of the USA where—it said—there was no indexation to oil but**

gas prices had increased significantly, being at higher levels during the winter of 2004-05 than in both the UK and Continental Europe. (Paragraph 79)

**18. Oil and gas prices will to some extent tend to move together even if the explicit indexation to oil is broken because oil and gas are still, to a degree, competitive products. However, what the actual correlation between the two will be remains unclear. (Paragraph 80)**

The British experience suggests that the oil link will weaken in Europe as liberalisation gathers pace and gas-on-gas competition develops. Clearly, the challenge is to secure effective liberalisation in other EU countries so that gas-on-gas competition is able to develop.

Historically it made some sense to link the gas price to oil because certain large industrial customers could operate using either gas or heavy fuel oil, particularly given the lack of a wholesale market at that time. Given that gas is becoming, for environmental and other reasons, the fuel of choice, substitutability is increasingly limited, and it follows to that extent that gas should be priced with reference to gas. Additionally, we note that the majority of the new gas supply contracts struck by the owners of the new gas supply infrastructure projects are largely indexed to UK gas prices.

## Competition within Europe

**19. We welcome the European Commission's announcement of inquiries into competition within the European gas and electricity markets. We note the timetable announced to us, and look forward to the completion of both inquiries by the end of 2006. We are also pleased that the UK Government has taken such a firm stand on the centrality of energy liberalisation to the whole Lisbon Agenda. However, we recognise that both the Commission and the UK Government will need to exercise considerable persuasive powers to convince other Member States of the need to take prompt action. (Paragraph 90)**

Ofgem has a key role to ensure both that liberalisation of European energy markets is carried out fully and effectively, and to ensure more broadly that EU policy develops in ways that are consistent with Britain's existing market-based regulatory arrangements. Respondents to our Corporate Strategy consultation expressed strong support for Ofgem to commit resources to influencing the European agenda where this would be important for British consumers. Ofgem will engage fully with the European Commission, national regulators and National Competition Authorities in addition to continuing our close work with the DTI on European energy issues. We will also use our membership of the Council of European Energy Regulators and the European Regulators Group for Electricity and Gas to make the case for full and rapid implementation of the Directives and Regulations. Our top priority here will be to seek a fully liberalised wholesale gas market in Europe, particularly in terms of facilitating the unfettered transmission of gas across the rest of Europe on a fair and non-discriminatory basis. We are therefore pleased that the European Commission has decided to undertake a review of the European gas, as well as electricity, market.

One of Ofgem's primary goals in relation to Europe is to enable Britain to have available secure supplies of piped gas and LNG from within the EU and from outside but transported through it at competitive prices. This means that we need, within the framework of liberalised markets, regulated third party access to gas pipes, proper investment incentives for the development of gas pipes, LNG import facilities and gas storage, and liquid traded gas markets across Europe, including access to gas storage. Other significant issues for the UK are to resolve potential difficulties posed by differences in gas quality, and to address any abuses of market power. We hope that the Commission's review of European gas markets will address some of these important issues.

**20. Without further real (not just cosmetic) liberalisation of the European gas market, the wholesale market in the UK will malfunction: it will continue to be difficult for buyers to access adequate supply and, because of this and other distortions caused by the mismatch between the liberalised market in the UK and the more rigid contractual arrangements on the Continent, there will be a tendency for prices to diverge significantly. Even on the most optimistic forecast, it is unlikely that the Continental market will be functioning as a fully liberalised one before about the end of this decade. Moreover, as BP reminded us, "Liberalisation does not, per se, lead to lower prices. Rather it gives consumers the freedom to choose suppliers, encourage the development of new products and services and lets the market react more quickly to changes in supply/demand fundamentals." European liberalisation is not a complete answer to the problems in the UK gas wholesale market. In fact, the Director for Conventional Energies, Directorate General for Transport and Energy, observed that the object was not cheap energy but rather a more efficient mechanism for establishing energy prices. (Paragraph 91)**

European gas markets will have an increasing impact on energy markets and consumers in Britain. This is because European energy markets are physically linked to Britain by the interconnectors and because European energy prices have a major influence on British energy prices. British wholesale gas prices are directly influenced by European wholesale gas prices and, given that nearly 40 per cent of British electricity generation is gas-fired, there is also a significant impact on British wholesale electricity prices. Clearly, to the extent that European gas markets are not properly liberalised, they might be expected to have an adverse impact on British energy markets.

That is why it is a major priority for Ofgem to ensure that the liberalisation of European energy markets is carried out fully and effectively, and to ensure—more broadly—that EU policy develops in ways that are consistent with Britain's existing market-based regulatory arrangements. Ofgem will work with the Commission, national regulators and National Competition Authorities to promote full and effective liberalisation of the European energy markets and to shape the regulatory agenda going forward.

New EU legislation on environmental and consumer issues (for example on carbon or other emissions, energy efficiency or billing) is also likely to have an impact on the prices paid by British consumers. A challenge for Ofgem and the Government will be to encourage Europe to follow the approach of securing carbon reductions in the most efficient way, and to adopt the better regulation agenda on consumer issues, rather than adopting a more prescriptive regulatory approach.

## Regulation of the gas market

**21. The DTI and Ofgem consider that the current regulatory regime is robust; they base this view on their assessment that the gas market is competitive. We believe that some of the peculiar aspects of gas production and trading militate against full competitiveness at present. The result is a loss of confidence in the market, and suspicions by gas users that those benefiting from price spikes have somehow engineered them. None of our witnesses suggested any failure of the market in respect of areas wholly subject to the sectoral regulator, Ofgem: concerns focussed on the supply of gas to the wholesale markets, not the ‘downstream’ operations. We acknowledge that any extension of Ofgem’s remit would require primary legislation, which would mean delay, when the problems of supply/demand balance in the gas market are likely to be at their worst over the next two years or so. Furthermore, attempting such legislation would undermine investor confidence at this crucial time. (Paragraph 97)**

We welcome the Committee’s recognition that none of the witnesses to the inquiry suggested that there had been any failure of the market in respect of areas wholly subject to regulation by Ofgem. The issue of whether changes should be made to the regulation of the offshore gas industry is for the DTI. For our part, we remain content that we have the necessary powers, through the Competition Act 1998, to tackle anti-competitive behaviour by offshore parties in the UKCS where that has an effect on onshore British energy markets. As stated earlier, we believe that a key issue remains the relative lack of transparency in the market and the relative paucity of information about gas production that is made available to the market.

**22. We therefore recommend that the DTI itself should take a more active role—not necessarily by increasing its intervention in the offshore industry but by monitoring the situation more closely to ensure that there are no activities which would warrant referral to the Competition Commission. We accept that such an increase in activity may require greater staff resources within the DTI; we would expect extra resources to be made available, if required. (Paragraph 98)**

This is a matter for the DTI.

## Vertical integration in the gas and electricity industries

**23. It is clear that company mergers are creating gas and electricity markets dominated by a few, vertically integrated companies. We know that Ofgem monitors this situation closely to ensure that no anti-competitive behaviour emerges. However, we detect increasing unease among consumer groups, I&C customers and some companies within the industry about the possible effects of such integration. (Paragraph 102)**

Ofgem takes these concerns very seriously and continues to monitor actively the competitiveness of the wholesale and retail gas and electricity markets. We would not hesitate to take enforcement action if there was evidence of anti-competitive behaviour. In terms of the structure of the industry, it is open to us to advise OFT to make a merger reference to the Competition Commission if a merger would, in our view, lead to a substantial lessening of competition. It is also open to Ofgem to make a market

investigation reference to the Competition Commission under the Enterprise Act if Ofgem has reasonable grounds for suspecting that any feature, or combination of features, of the market prevents, restricts or distorts competition.

## Electricity market

24. Although some individuals who wrote to us felt that the electricity price rises for consumers were unjustified, the vast majority of our witnesses accepted that they were a direct result of the increase in the cost of the main generating fuels, coal and—especially—gas. We, too, believe that electricity producers have not been profiteering. The variations in price rises from company to company can be explained in part by the differences in their portfolios of generating plant and the degree to which they have been able to offset the gas price rises by changing to cheaper fuels; and in part by the different commercial approaches they have adopted (whether they have chosen to increase prices across the board or to shelter some customers from the full effects of the price rises, for example). (Paragraph 108)

25. However, the effect of the price increases on customers has been significant, and further increases are inevitable, given that the cost of environmental legislation has yet to be passed through to customers. We note that the cost of the Large Combustion Plant Directive and the EU Emissions Trading Scheme will add to the existing cost of the Renewables Obligation and the Climate Change Levy. Although fluctuations in fuel costs will occur, over the medium to long-term electricity is unlikely to be as cheap in real terms as it has been over the last six years. I&C customers have considerable incentives to reduce their energy use. As a result, we think that it is now time for the Government to re-examine the operation of the Climate Change Levy, and in particular to consider the scope for reducing it to help UK industry during its present difficulties. (Paragraph 109)

Ofgem will continue to urge Government to develop flexible market-based mechanisms which are effective in reducing carbon and efficient in terms of their cost to the consumer. Ofgem would also note that as new gas import infrastructure puts downward pressure on gas prices, this will act to reduce electricity prices.

## New infrastructure projects

26. We have no doubt that the UK will shortly have significant extra import capacity, but we cannot predict when construction of this capacity will be completed. We note that, between UKOOA's submission of its original Memorandum to us in late November 2004 and the production of its Supplementary Memorandum in mid February 2005, the target dates for completion of three facilities had been put back, and there had been a reduction in the expected capacity of two facilities (including Phase 1 of the Isle of Grain LNG facility, which is likely to be the first to come into operation). This is in the nature of large infrastructure projects. However, this does prolong the uncertainty to which the wholesale gas market is prey. Government departments should ensure they are well placed to facilitate these developments where they have a regulatory or planning function. (Paragraph 112)

Planning matters are for the Government. However, as explained above, Ofgem has an important role in developing a regulatory framework that attracts timely and efficient infrastructure investment. The volume of investment so far made (and still to come) is clear evidence that the market can respond effectively.

## Future of gas prices

**27. We cannot take the Panglossian view of the gas wholesale market that the DTI and Ofgem appear to hold. There are failures in the market which arise from significant problems with physical supply, the lack of information about supply available to participants, the difficulties caused by operating a liberalised market (the UK) alongside a relatively unliberalised market (Continental Europe), and the dearth of traders willing to sell gas into the forward market. These problems are serious enough for us to conclude that the autumn 2004 price spike, and the recent spike in late February, will be repeated over the next two years. We urge Ofgem and the DTI to keep a close watch to ensure that the market is responding to all the proposed developments likely to make it function efficiently (extra infrastructure and storage capacity, the provision of more information, and so on). If there continue to be well-founded concerns over the operation of the market after these changes have taken effect, then we conclude that the market must be considered to be failing. (Para 116)**

Ofgem takes these issues extremely seriously and is taking action on a number of fronts to ensure that British energy markets remain competitive and efficient. In particular, Ofgem:

- routinely monitors the wholesale markets and investigates price movements where necessary;
- is taking steps to improve the arrangements for publishing gas production data;
- is adopting, where appropriate, a ‘light touch’ approach to the regulation of proposed new infrastructure projects; and
- is working with the European Commission, national regulators and National Competition Authorities to promote full and effective liberalisation of the European energy markets and to shape the regulatory agenda going forward.

We will keep a close watch to ensure that the market is responding appropriately to these developments. Ofgem continues to believe that the current market-based framework provides appropriate incentives for new investment in both the gas and electricity industries, and ensures that market participants respond as effectively as possible to changing circumstances, delivering secure energy supplies at least cost.

**28. Although all the problems with the market could, and probably will, be solved eventually, customers—and especially I&C customers—will face serious disadvantages in the meantime. The DTI is placing heavy reliance on customers changing their buying practices: avoiding the October bunching, and purchasing gas on short-term markets when forward prices seem excessive. We think that this is going to be difficult for companies, especially the SMEs whose interests the DTI has pledged itself to take particularly into account. (Paragraph 117)**

We welcome the DTI's initiative in this area.