



House of Commons  
Trade and Industry Committee

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**Security of Gas Supply:  
Ofgem Response to the  
Committee's First  
Report of Session  
2005–06**

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

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## 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.

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### Committee staff

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

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# Twelfth Special Report

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The Committee published its First Report<sup>1</sup> of Session 2005–06 on 13 December 2005. Ofgem's Response was received on 22 February 2006 and is published as an appendix to this Report.<sup>2</sup>

## Ofgem response

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### Introduction

Ofgem welcomes the opportunity to respond to the Trade and Industry Committee's report into security of supply in the British gas market. This document also sets out how prices and the supply and demand position have changed since Ofgem gave evidence to the Committee in October 2005 and outlines Ofgem's view of prices and the supply and demand position for the remainder of this winter.

### *The benefits of early liberalisation in Britain*

The recent price increases should, however, be set against the context of the 14 years of low prices that preceded them. We provide more detail on the benefits of liberalisation to British customers in the response to paragraph 7.

Business and domestic customers are facing higher prices this winter as Britain makes the transition from being self-sufficient in gas to becoming a net importer.

We therefore disagree with the Committee's suggestion that it is far from clear that all energy users have derived continuing and sustainable benefits from the early liberalisation of the energy market in the UK.

### *Development of infrastructure*

The Committee asserts that there is a legacy of slow development of infrastructure. Around £6 billion is being invested in gas import infrastructure projects and several of these are scheduled for completion for winter 2006–07. If these projects are delivered on time gas supply capacity will have increased by around 10 per cent for next winter.

It is worth noting that the market did deliver enough new import capacity to cover the decline in North Sea supplies that had been forecast originally. It was not until 2003–2004 that the offshore industry was able to forecast that the decline in UK gas supplies was going to be greater than previously forecast. Given the long lead times needed to obtain planning permission and to build new import and storage facilities, this revised warning came too late to allow the market to 'fast forward' its construction programme. There is, however, no reason to believe that Government or any instrument of central planning would have been in a better position to forecast supplies accurately.

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<sup>1</sup> First Report from the Trade and Industry Committee, *Security of Gas Supply*, Session 2005–06, HC 632

<sup>2</sup> The Government's Response, received on 12 January 2006, was published in the Tenth Special Report from the Trade and Industry Committee of Session 2005–06, HC 833

Over the next two to three years, the market will deliver over 100 billion cubic metres (bcm) of new import facilities, which is nearly the same amount of gas that Britain currently uses in a year (around 100–120 bcm). The market is also investing to double Britain's storage capacity by 2008.

### **Wholesale prices**

During late November and early December wholesale energy prices rose sharply, for several reasons:

- higher gas demand due to cooler than average weather for that time of year;
- less gas was available through the interconnector than expected. An upgrade to the pipeline allowing it to import higher volumes had been completed, but only 60 to 75 per cent of the full capacity was being used. This occurred even though Britain was experiencing the highest wholesale gas prices in Europe during November, meaning that exporting gas to Britain through the pipeline would have been commercially attractive to European suppliers;
- the Isle of Grain liquefied natural gas (LNG) terminal in Kent did not receive as many shipments as expected. As with the interconnector, high wholesale prices in Britain should have attracted more LNG cargoes; and
- supplies of gas from the North Sea were lower than expected because of maintenance work that was being carried out on certain fields.

Ofgem took immediate action in response to the lower than expected interconnector and LNG volumes. With DTI we put in place new arrangements to allow us jointly to monitor North Sea gas production to make sure that reduced beach flows were the result of genuine production problems and not of companies withholding gas to drive up prices.

We asked the European Commission to investigate why the interconnector has not been flowing gas at full capacity during periods when British prices are much higher than in Europe. We also asked them to look into market arrangements in other countries, such as Spain, that may be distorting trade in LNG and leading to LNG not being delivered to Britain even though our gas prices were higher than other EU countries. The Commission agreed to investigate both these matters urgently.

Ofgem also asked Interconnector UK to provide us with information about who holds import capacity this winter to assist our ongoing analysis. We also asked National Grid to make sure that arrangements are in place to allow other companies to deliver LNG through the Isle of Grain if the companies who bought capacity at the terminal are not using it, and quickly secured improvements to these arrangements.

Storage gas was used to make up the shortfall of supplies. The cost of withdrawing gas from storage earlier in the winter than usual increased prices as storage users will seek to sell their gas at, or above, the prices they would expect to get during periods of high gas demand, typically in January and February.

In January however prices fell back to levels of between 40 to 65 pence per therm. This was due to milder weather during December and January reducing gas demand and because of

greater availability of gas from North Sea fields after maintenance work had been completed. As a result, gas was put back into storage in preparation for colder weather during February and March.

### **Supply/demand balance**

Since the high prices in November, gas flows from the North Sea have been in line with National Grid's expectations as set out in its Winter Outlook Report. Flows through the Isle of Grain have also improved. Sonatrach has consistently delivered gas throughout the winter as it stated it would. BP has not used all of its capacity rights but now expects to bring gas in for the rest of the winter. Storage has delivered as expected and companies have behaved responsibly and put gas back into store when warmer weather and lower gas demand has allowed.

However, a continuing concern for Ofgem for both the remainder of this winter and next winter is the performance of the Bacton–Zeebrugge interconnector. Despite the fact that gas prices in Britain over much of this winter have been at higher levels than in Europe, and despite the fact that the interconnector capacity has been available, this has not resulted in increased imports through the terminal until very recently. In the last two to three weeks utilisation has exceeded 90 per cent despite much lower prices in GB than in November and only a small premium to reported prices in Germany and Holland. This clearly shows that more gas could flow through the interconnector and that there are no significant infrastructure constraints in Europe preventing gas flowing. Ofgem hopes that the Commission's ongoing investigation will shed light on the important question of why more gas did not flow earlier in the winter.

**1. Gas supplies this coming winter are likely to be tighter than was anticipated in February, principally because of the continued faster-than-expected decline in production from the UKCS. New import and storage facilities are coming into operation roughly at the rate predicted. The difficulty in predicting actual import rates has grown because of the effects of the hurricanes in the Gulf of Mexico this year: the uncertainty about the extent and duration of the damage to the USA's gas production facilities, with the resulting unpredictability of demands for LNG imports to the United States. We note National Grid's assessment of the security of supply this winter, and the Meteorological Office's suggestion that there is about a 66 per cent chance of this winter being a '1 in 10'. Although it is extremely unlikely that domestic customers and the majority of businesses will suffer any interruptions to their gas or electricity supply because of the tight gas supply, it is very likely that the largest I&C customers will, if they have the relevant contracts, suffer interruptions, or, if they purchase gas on the spot market, have to pay very high prices for that gas, or both. It is, unfortunately, impossible to do anything to change this situation now, although some mitigating actions can be taken. However, we believe that the Government needs to pay closer attention to the consequences of this situation and to demonstrate greater urgency in pursuing a single market within the EU. (Paragraph 10) <sup>3</sup>**

The Committee rightly noted that domestic and most business customers would be extremely unlikely to suffer any interruptions to their energy supply as a result of the gas

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<sup>3</sup> Paragraphs in bold type are quotations from the Committee's First Report.

supply/demand balance. This has been borne out by events. Ofgem acknowledges that some very large gas customers such as power stations and chemical companies have had to switch to other fuels or reduce or halt production in response to high prices.

Ofgem has given a special focus to helping industrial and commercial users engage more effectively with the market. Ofgem has hosted a series of events around the country to bring market participants together to help customers improve their buying options for the winter.

We agree with the Committee that it is vital to do all that we can to pursue a truly competitive single European energy market. To this end, we have been very active on this front. We have supported the Commission in its sectoral investigation since it began last year. More recently, as stated above, we have secured the agreement of the Commission to investigate the reasons for lower than expected interconnector and LNG volumes.

**2. Although the effect of peaks in prices on the wholesale gas market is moderated for domestic consumers by the averaging effect of their billing mechanisms and by the fact that wholesale prices form only about 50 per cent of the retail cost of their gas, rising fuel prices will mean that more people fall into fuel poverty. Although greater energy efficiency is the most effective means of reducing the number of those in fuel poverty absolutely and permanently, it is not—as the Minister acknowledged—an immediate response for those suffering now from higher energy prices. If fuel prices continue to rise it will be essential to provide further assistance to the elderly. However, we are particularly disappointed that little progress has been made in dealing with the plight of some non-elderly vulnerable groups, particularly disabled people, whose difficulties in relation to fuel poverty have been known for a long time. (Paragraph 12)**

Ofgem believes that competition in the retail sector has kept pressure on prices and has led to the development of social tariffs, capped prices and special arrangements in particular for energy suppliers' most vulnerable customers.

There is a requirement on energy suppliers to focus 50 per cent of energy savings under the Energy Efficiency Commitment on households on income and disability-related benefits (known as the 'Priority Group', eligibility for which is similar to Defra's Warm Front scheme). In order to help customers check their eligibility for special support schemes, and ensure that they are maximising their entitlement to benefits, many energy suppliers are offering benefits entitlement checks as part of their programmes of support for vulnerable customers.

**3. The Government cannot directly affect the price of gas. However, it can ensure that there are no regulatory or economic barriers to maximising gas supplies and storage facilities, and improving the functioning of the gas market. It can also encourage energy liberalisation in the European Union, and help I&C customers to share best practice on how to cope with high prices and a volatile market. We are pleased to note that the Government has been pursuing all these. However, in the area where the Government can take direct action—ensuring no-one is penalised because, with gas interruptions looming, they have temporarily breached emissions limits as the only alternative to suspending operations—the Minister seemed reluctant to do anything at all. We accept the enormous importance of tackling climate change, but we cannot see**

**that giving temporary derogations in extremis (and both Ofgem and the DTI believe that the tight supply situation is likely to last for only another couple of years, and that this winter is likely to be the most problematic) would seriously undermine the Government's long term climate change programme. We look forward to receiving the Minister's assurance that the Government would be willing to give temporary derogations this winter and in the next two winters if prolonged cold spells make large scale gas interruptions inevitable, at the same time as his making it abundantly clear that such derogations in the years thereafter would not be forthcoming except in a case of grave national emergency. (Paragraph 14)**

Ofgem notes the recent correspondence between the Minister and the Environment Agency on the subject of power stations switching to oil-fired production this winter.

**4. Financial institutions that might have been expected to take part in or finance trading in the forward market for gas are not interested in doing so: the UK market is not big enough, and they are unlikely to become involved unless there is a Europe-wide forward wholesale gas market. This is depressing, but not surprising. It supports our predecessors' conclusion that the forward market was too illiquid to be considered functioning, and it underlines the fact that the operation of the liberalised UK market is heavily dependent—and becoming ever more so—on the unliberalised Continental European one. (Paragraph 16)**

Ofgem welcomes the recent announcement by the European Commission that identifies barriers to competition.

**5. The reports published by DG Transport and Energy and DG Competition on 15 November seem to us to provide a comprehensive, rigorous analysis of the failure to achieve real liberalisation in the European market to date and of the obstacles remaining to electricity and gas companies seeking to trade in, buy from, or use transit or storage capacity in, Continental Europe. These obstacles will not be overcome quickly or easily—the Commission has noted that many of the legacy contracts that make purchasing or transporting gas through Europe so difficult have a decade or more to run—with the result that we risk having a malfunctioning forward gas market for a decade. Although LNG imports will alleviate some of the problems of liquidity, the UK will be competing for those with not only some European countries (such as Spain) but also the Far East and the USA. (Paragraph 17)**

Ofgem agrees that the European Commission's reports provide a good analysis of the impediments to effective competition in European energy markets. We will continue to work closely with the Commission.

We agree that LNG imports will improve market liquidity to some extent. These LNG projects are major developments which will add about 30–40 billion cubic metres of import capacity. Ofgem considers that there exists a real opportunity for Britain to develop as a major hub for LNG supplies, especially if liberalisation of continental energy markets remains patchy and certain long term legacy contracts remain in place.

**6. We expect the UK Government to give its full backing to the Commission in its attempts to enforce existing legislation, and to introduce any amendments designed to close any loopholes. (Paragraph 18)**

Ofgem also expects the Government to back the Commission fully in relation to ensuring that European energy markets are properly liberalised. For our part, we will continue to work closely with the Commission towards stronger competition in the continental energy markets with which Britain closely interacts.

**7. It is far from clear that all energy users have derived continuing and sustainable benefits from the early liberalisation of the energy market in the UK. The gas supply problem this winter will affect—whether through high prices of gas and electricity, or through actual supply interruptions—all domestic and I&C customers. The problem is caused not only by matters outside the control of government, but also by a legacy of slow development of infrastructure, and the lack of a true European market for gas. These are matters that do lie, at least partially, under the control of the UK Government. It is therefore right to expect Government to take steps to mitigate the impact of problems this—and probably for the next two—winters. (Paragraph 19)**

### *Benefits of early liberalisation*

Since privatisation of the gas and electricity industries British businesses have paid less for their gas and electricity than most of their European counterparts. Between 1990 and 2004 British industry paid £7.9 billion less for their energy than their German competitors, £5.8 billion less than Italian companies, £4.3 billion less than the French, £3.6 billion less than in Spain and £2.6 billion less than Dutch businesses. Effective regulation by Ofgem means that Britain has some of the lowest transportation charges in Europe, and this has meant that prices for many industrial and commercial businesses were still below average European levels in July 2005 (the latest period for which data is available).

The position with regard to domestic customers is similar: from 1990 to 2004 prices to domestic customers in Britain were among the lowest in Europe. For example, in gas between 1990 and 2004 British domestic customers paid £75 billion less than in Italy, £67 billion less than in Spain, £35 billion less than in France, £28 billion less than in Germany, £27 billion less than in Belgium and £25 billion less than in the Netherlands.

### *Development of infrastructure*

Around £6 billion is being invested in gas import infrastructure projects and several of these are scheduled for completion for winter 2006–7:

- The second phase of the upgrade to the Bacton–Zeebrugge interconnector will give a total import capacity of 68 million cubic metres (mcm) per day from December 2006;
- the new Bacton–Balgzand interconnector linking Britain with the Netherlands will bring 27 mcm per day of import capacity from December 2006; and
- the Langed pipeline, which will bring gas from Norway’s Ormen Lange gas field, will have an import capacity of 48 mcm per day from January 2007.

If these projects are delivered on time, gas supply capacity will have increased by around 10 per cent for next winter, with a subsequent effect on prices.

The developers of all three projects have confirmed that they are on schedule. However, market sentiment is mixed. Generally, gas forward prices for next winter have been trading at higher levels than forward prices for this winter a year ago. This could reflect market fears that the new import facilities either will not be ready in time or will not be used to their full capacity to import gas into Britain. However, a different picture is emerging in the Netherlands where gas forward prices for 2006–7 have increased, bringing Dutch prices more in line with Britain's. This might be an indication that the Dutch market believes that the new interconnector pipeline between our two countries will be completed in time for next winter and that companies are planning to use it to export gas to Britain.

The other crucial issue in determining next winter's prices will of course be the extent to which the new capacity is actually used to flow gas to Britain. As stated above, we cannot at present explain why interconnector imports have not reflected the price differential between Britain and Europe. This is why we are, along with other European regulators, seeking to promote as a matter of urgency much greater transparency in the major European gas markets. Ofgem's Chairman, Sir John Mogg, currently chairs the Council of European Energy Regulators (CEER) and holds the Presidency of the European Regulators Group for Electricity and Gas (ERGEG). Ofgem is also supporting the European Commission's investigations, with three senior staff seconded to the Commission, for example.

Over the next two to three years, the market will deliver over 100 bcm of new import facilities, which is nearly the same amount of gas that Britain currently uses in a year (around 100–120 bcm). This includes some major investments in LNG import terminals at Isle of Grain and Milford Haven. These LNG projects will improve Britain's security of supply position as the market will be able to purchase gas from a more diverse range of sources. In addition, the Committee will be aware that the market is investing to double Britain's storage capacity by 2008.

### *Ofgem's role in facilitating investment*

This investment is being provided by the markets but Ofgem has helped create an investment-friendly climate both by supporting a light touch approach to the regulation of new infrastructure providers and by allowing a £2 billion spend for National Grid Transco in the last gas price control review—a level of expenditure that NGT accepted.

Since privatisation there has been major investment in the gas and electricity networks. In April 2002 the National Audit Office reported that there was “no evidence that investment has been inadequate or that the networks have deteriorated. For example, investment in the gas and electricity networks has been high—over £31 billion since privatisation”.<sup>4</sup>

Since that report, Ofgem has provided for a significant increase in capital expenditure in the electricity distribution networks. In the distribution price control agreement that took effect in April 2005, Ofgem allowed a 48 per cent increase in capital expenditure—with a

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4 *Pipes and wires*, National Audit Office, April 2002, p.6. On the same page the NAO noted that “customers have seen lower prices and higher quality of service, and regulated companies have been able to cut costs and invest in their networks, while continuing to finance their functions.” Since that report customer service has continued to improve. From 1990–2004, the industry delivered a 30 per cent reduction in outages and an 11 per cent reduction in the length of those outages.

potential spend above that which could, if the companies utilise their allowances to the full, result in a 57 per cent capital spending increase from 2005 to 2010.

On the transmission side, transmission companies are facing several key challenges, including the need for significant investment in the transmission system to replace ageing networks and to accommodate new energy sources—for example, new gas entry terminals as well as renewable generation. Consequently, the transmission companies are also seeking significant increases in capital expenditure (capex) in the forthcoming transmission price control review, which will set capex allowances for the period 2007–2012.

On 1 February, we sent an open letter to interested parties inviting views on how best to respond to these challenges in the price control review. We have, within the present price control period, fully facilitated new investment for connecting renewable generation projects to the electricity transmission network—to the tune of £560 million so far. We aim to design the price controls to continue to provide the right incentives for efficient and timely investment throughout the relevant period.