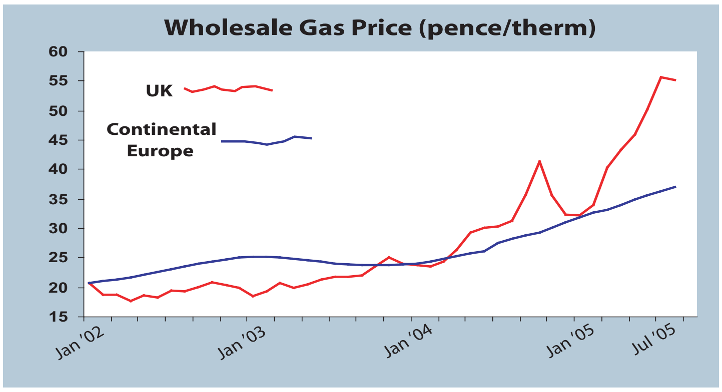
Rising energy prices

energywatch
your gas and electricity watchdog

The facts

Since October 2003 UK consumers have experienced rapidly rising energy prices. The effects of these rises on businesses, the public sector and domestic consumers have been dramatic. The cause has been an unprecedented increase in the wholesale price of gas paid by UK suppliers.

Ofgem estimated that over the winter of 2004/5 alone consumers in the UK paid £5.2 billion more for their gas and electricity than they had the previous year.



Wholesale gas prices in the UK and Europe since January 2002
(Source: Patrick Heren/Energy Intensive Users' Group)

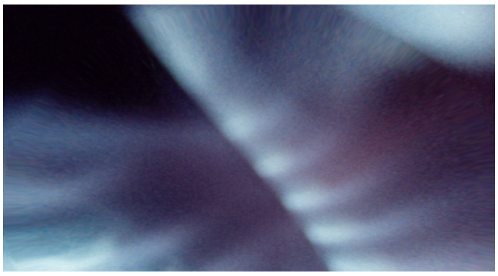
- ***70% – average gas price increases for chemicals industry over the last two years***
- ***40-50% – average gas and electricity price increases in the retail sector over the same period***
- ***£41 million – increase in NHS gas bill between November 2003 and November 2004***
- ***£100 million – combined increase in local authorities' gas and electricity bills in 2004***
- ***£327 – average annual domestic gas bill in 2003***
- ***£445 – average annual domestic gas bill in 2005***
- ***4th – the UK was the fourth largest gas producer in the world in 2004***

The 'reasons'

A number of explanations have been put forward as to why the wholesale price has risen so steeply.

- gas supplies from the North Sea have declined faster than expected, though there are still significant reserves
- the price of oil has soared in recent years and, with the price of gas in Continental Europe still linked to oil, this has had a knock-on effect on the price of gas in the UK
- import and storage capacity in the UK is inadequate, and has therefore not been able to offset declining North Sea production

In addition, gas is used to produce 40% of our electricity, and so the price of electricity has also rocketed.



"Staggering"

Lord Browne, chief executive of BP, on his company's cashflow, January 2005

The impact

This briefing looks at some of the impact of rising energy prices on UK businesses, the public sector and households over the last two years.

Manufacturing

Across the UK, businesses have been hit hard by the rises in energy costs over the last two years. However, it is industry, and in particular those sectors that are the most energy intensive, that have been hit hardest. Whatever these businesses produce, they play a vital role in ensuring the UK is competitive and they are now finding it impossible to secure competitive energy contracts in the forward market.

Industry is now facing hard choices as to how to mitigate rising energy prices. Companies can cut back production or lay workers off to reduce some of their costs. Alternatively, they can shift production overseas.

Chemicals

The chemicals industry accounts for 2% of the UK's GDP, supports 230,000 highly skilled jobs and consumes 22% of the energy used by UK manufacturing. With companies in the sector experiencing average price increases of 70% for their gas and 60% for their electricity, the UK chemicals industry is now seeing its competitiveness eroded by cheaper imports. INEOS Chlor, based in Runcorn and the UK's largest producer of chlorine and caustic soda, faces an annual increase in its bills of £2.5 million for every pence per therm the price of gas increases, adding tens of millions of pounds in costs each year.

Plastics

There are 200,000 jobs in the UK plastics industry, which provides £4.5 billion of exports each year and accounts for just over 2% of the UK's GDP. Companies in this sector have seen average rises of 58% for their gas and 56% for their electricity. As these increases are higher than those of their mainland European competitors, and as mainland Europe is the major trading partner for the industry, these rises have devastating potential for the industry in the UK.

Paper

The UK paper industry employs 16,000 people. For every additional pence per them added to the price of gas, the industry has to find £6 million and rises in the last two years have added £90 million to their annual bills. Half of the 12.5 million tonnes of paper we use in the UK every year is imported from Western Europe. This figure is set to rise now that paper manufacturers here are paying at least 35% more for their gas than their European competitors, putting jobs in the sector at serious risk.

Glass

Things are little better for the glass industry in the UK, which uses gas to fire its high temperature furnaces. There are 7,000 people directly employed in the glass manufacturing industry in the UK, with another 160,000 in converting, glazing and support services. Companies in the industry have seen energy costs rise by 55%. With other raw material costs also rising, this is having a disastrous effect on the viability of the glass industry in the UK.

Construction products

Then there are the companies that manufacture or supply the materials we use to build our homes, schools, hospitals, factories, offices, roads and railways, which account for 4% of the UK's GDP and employ over 650,000 people in nearly 30,000 companies. Their gas bills have risen by up to 80% and their electricity bills by up to 60%. Some of these companies are now paying almost 50% more for their gas than their competitors in France and Germany, and double that of their competition in Spain. Some can pass on their increased costs to their customers but this has led, for example, to an increase of 15% in the cost of cement.

"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 alongside a relatively unliberalised market, and the dearth of traders willing to sell gas on 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."

Trade and Industry Select Committee Fuel Prices report, March 2005

Retail and leisure

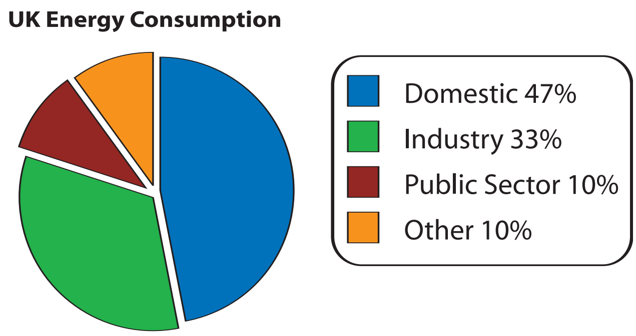
But it is not just manufacturing that has been suffering as a result of rising energy prices. Over the last twelve months retailers in the UK have seen hikes in their energy bills, with average increases of 40-50%. With consumer spending slowing down, retailers are grappling with tougher trading conditions, as ever-increasing operating costs such as energy threaten to drain the vitality of the retail sector and jeopardise jobs in the UK economy.

One chain of department stores operating throughout the UK and employing in excess of 50,000 people is expecting its energy contract prices to double in 2005, leaving the group with the stark options of settling for much-reduced margins or cutting back on staffing levels.

Both pub chain J D Wetherspoon and holiday village operators Center Parcs have commented when issuing financial results on the effect that large energy price rises are having on their operations and the mitigation measures they are having to take as a result.

Small and medium-sized Enterprises

Many UK companies spend millions of pounds each year on energy, and so the sums involved are dramatic. However, smaller businesses have also been affected by rising energy prices. Small and medium-sized enterprises, which contribute more than half of our GDP, spent an estimated £2.9 billion on energy in 2004. Price rises can hit smaller businesses just as hard as larger ones, particularly if they are energy intensive, such as printing companies or food producers, but rising prices affect every shop, restaurant, pub and post office across the country. This compounds many of the problems small businesses already face in the energy market.



Public sector

If you are a taxpayer, you are already paying at least twice, as more of the money that should be going on essential public services is being diverted to meet the rising cost of energy. Between November 2003 and November 2004 the NHS saw its gas bills go up by £41 million – an additional 57%. Individual NHS Trusts are also finding money has to be taken away from patient care – in North Glamorgan the Trust saw its energy bills rise by £450,000 between 2003/4 and 2004/5. This is the equivalent of eighty hip replacements or over six hundred cataract operations.

And councils the length and breadth of the country are having to find more money to pay their energy bills. The combined increase in energy costs for local authorities has been estimated at £100 million, enough to pay for 5,000 teachers, social workers or policemen or ten new school buildings. In Kent – one of the largest local authorities in England – the increase was £2.1 million. This means tough decisions have to be taken to cut back on services or to raise council tax.

The public sector has also been hit by rising energy costs in less immediately obvious ways. The bill for street lighting in the UK has gone up by more than 50%, meaning that essential repairs are having to be delayed to meet the rising cost of electricity. Meanwhile, even the British Library has seen its energy bills rise by more than 20%, swallowing up money that could have been more productively spent on buying books.

Domestic consumers

With domestic gas and electricity bills rising by 38% and 30% respectively since October 2003 it is no surprise that the progress on combating fuel poverty is being threatened. In that time, the average annual household gas bill has risen from £327 to £445. The number of people living in fuel poverty fell from 5.5 million in 1996 to 2.25 million in 2002. However, the contribution made by low energy costs to this fall has been well-documented. The most conservative estimate says that the number of households in England that have been pushed back into fuel poverty over 2004 and 2005 is 200,000. With no immediate end in sight to energy price rises the effect will be increased levels of debt, fuel poverty and the possibility of disconnection. The achievements of the last decade in reducing fuel poverty could be lost.

Reform of UK and European Gas Markets

This winter will be tough for UK consumers. They are already paying high prices which are likely to rise still further. There is growing consensus that fundamental characteristics of the UK and the wider European gas market inflict artificially high prices on UK consumers and are in need of urgent reform.

Government, regulators and the European Commission must ensure that wholesale gas markets are open, competitive and transparent. If not, UK businesses will face ever greater input costs, public sector budgets will be even more tightly stretched and more households will be at risk of debt or even fuel poverty.

energywatch believes the root of the problem lies in uncompetitive wholesale gas markets. We are calling for actions to deliver:

1 Liberalised European energy markets

EU energy markets are characterised by dominant, vertically integrated operators which hold equity positions in transmission, storage and the Interconnector and can exercise market power to the detriment of consumers. Unless there is unbundling of the equity and operational links between production, transmission and storage, as well as a concerted approach to refreshing third party access schemes and a thorough review of anti-competitive long-term supply contracts, the actions of major European operators will continue to cause serious damage to all UK consumers.

2 Greater import and storage capacity

There are a number of new infrastructure projects being developed that will increase the UK's gas import and storage capacity, but it is not certain when these will be completed. Already, the target dates for completing three of these facilities have been delayed, and the expected capacity for another two has been reduced. The Government must make these projects a priority, to offset the impact of the reduction of supplies from the UK Continental Shelf.

3 More liquid markets

A lack of liquidity in the forward energy market has contributed to volatile prices and rapidly rising costs for end users. Traders are unwilling to take positions against the market trend and as a consequence trades have become unduly influenced by fear, uncertainty and doubt instead of sound information about supply and demand.

4 Fair provision of information

In the UK wholesale gas market, buyers are at a serious disadvantage with regard to information about market conditions and production issues, compared with producers. In such circumstances it is the demand-side that suffers. energywatch submitted a proposal to amend the Network Code that would have provided information on gas flows from the UKCS. A decision on whether or not to implement this modification has been delayed until the Spring of 2006. Real-time information on gas flows is essential if the problems caused by the information imbalance are to be rectified.

5 Active monitoring of the upstream sector

In the UK, the regulatory arrangements for the gas industry are split between Ofgem, the regulator for the downstream energy market, and the DTI which is responsible for upstream issues. Despite these regulatory arrangements, UK consumers have been exposed to significant price spikes which, because of a lack of transparency in the operations of the UK wholesale market, have been explained by market sentiment rather than market fundamentals. Government needs to take a greater role in monitoring activities on the UKCS to ensure the industry operates in an open and transparent fashion.

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