KEY ISSUES FACING UK BUSINESS ENERGY USERS
Price Forecasts and Volatility in EU Wholesale Energy Markets and Impact on Major Business Energy Users.

Clive Moffatt, Managing Partner, Moffatt Associates

Briefly, I would like to share with you some highlights from our recent market research and my own thoughts on four key questions:

- **What's going to happen to gas, power and CO_2 prices**
- **Will markets be less or more volatile?**
- **Can regulation help mitigate the impact of rising prices?**
- **How are UK businesses responding to the challenge?**

1. Future gas and power prices?

Our latest quarterly EU market trends survey sponsored by APX reveals that 70% of EU market traders believe both wholesale power and gas prices could rise between 50/60% in the next 12/18 months.

Why? – our recent EC study amongst some 150 market players has confirmed that the key drivers are:

- much firmer CO_2 in Phase Two of ETS – average price of 40 euros/p/t forecast with every euro rise in CO_2 adding 74 cents per MWh to power price.

- gas prices up due to rising oil price and generation switch from coal and the need to reserve more gas power to support intermittent wind generation – these higher gas prices will drive further CO_2 increases

- sustained higher coal prices – which have doubled from $70t to $140t in the last 12 months due to rapid increase in Asian demand

- rising capital costs of power generation – which have increased by 30-40% in the last 4 years

In terms of future power prices 65% of respondents to our recent EU survey said that gas prices will be the dominant driver behind rising power prices closely followed by C02 prices. And 72% say the oil price will
be the dominant driver of the gas price.

2. More or less volatility?

So no sign of an immediate end to rising wholesale energy prices but will the market be more or less volatile?

The answer is more volatile with more frequent price spikes.

The vast bulk of wholesale electricity, gas and CO2 trading takes place in the opaque OTC market where financial investors are very active. Speculative activity here spills onto the energy exchanges, which sets a benchmark for further rounds of index driven financial trading.

Do current oil and gas prices reflect fundamental supply and demand conditions? Opinions vary with some pundits citing a long term supply deficit in oil. However, in the case of gas, there is no evidence yet that demand exceeds available supply but unfortunately the market is dominated by long term pipeline supply contracts and those who export to us (e.g. Russia) are very unlikely to break the link to oil prices.

But it's not all speculation – the EU is very short of new generation capacity. Higher prices should help encourage more investment – but meantime as we saw last week sudden outages can cause short term spikes. Volatility will also increase because of fluctuations in the C02 price (and here the future beyond 2012 is uncertain) and the intermittent nature of wind power generation.

3. Can market regulation mitigate the impact of rising prices?

The EU Commission's latest attempt at market reform (Third Package) is now winding its way through the European parliament but the short term impact on market competition and liquidity and energy prices will at best be neutral.

- it does not address political control over regulation – who controls the regulator is more important that who controls network assets

- it does not address the market implications of unrealistic renewable and efficiency targets

- it does not recognise the strategic importance of creating a sustainable investment in clean/relatively inexpensive nuclear generation

- it does not address long term gas contracts and downstream access and it cannot remove the EU's growing dependency on imported gas

- it does not mean network tariffs will fall – they will in fact have to increase to fund what is a much needed improvement in electricity grids across the EU.

This is not to say that the Third Package is a waste of time – on the contrary, if passed as intended it will facilitate more competitive markets. What the process needs is more political support in France, Germany and elsewhere.

The real danger to the evolution of more effective markets in the short term is the threat that governments will try to intervene in some way to try to control or mitigate the impact of rapidly rising energy prices. History shows that attempts to try and identify market abuse or excessive speculation are doomed to failure.

What we can probably expect is that the market will correct itself – some investment banks will catch a cold and may go down – but EU politicians should not take their eye off the main goal of structural reform.

4. How are UK businesses responding?

Back in January, for the fifth time in three years, we surveyed 100 UK major energy users.

- On efficiency 90% of MEUs have already taken some action – plucked low hanging fruit – to reduce their energy consumption. Further gains are considered feasible but more expensive to implement. With higher power prices, more projects become viable.

- 88% supported political commitment to reducing carbon emissions.

- 56% also said they thought compliance with climate change agreements had resulted in energy savings or process improvements.

- 36% said they believed there were commercial advantages to be had from a small carbon footprint.

However, there is some concern about the proposed Carbon Reduction Commitment (CRC).

- 71% of intensive energy users said they believed the scheme would make the UK uncompetitive.

- When asked about the implementation or such regulation, 63% said they thought the costs of doing so would out-weigh the benefits.

- Less than half (48%) believed that the CRC would achieve its target ore removing 1.2 million tonnes if carbon dioxide from the atmosphere by 2020.

Looking ahead, MEUs (if they have not already done so) are going to have to get more involved, directly or indirectly, in wholesale markets to manage price risk as well as be more creative in reducing carbon emissions. And 70% of MEUs said they need extra help and advice on carbon management.

Moffatt Associates
June 2008