

Energy Market Report: September 2022

Without wanting to either sensationalise or exaggerate current global issues, we have to acknowledge that the world is in the midst of an energy crisis. The reasons behind this have been a hot topic for many months and started with the end of covid stimulating a significant rebound in consumption and a sector that was not ready to meet this increased demand. This situation then developed into a full-blown crisis when Putin invaded Ukraine and the western world applied sanctions on Russian oil and gas. These issues are widely understood, but many have been caught off guard by the corresponding huge rises in the cost of electricity, which now threatens economies just as much as spiraling oil and gas prices.

In Europe, the Americas and not least, the UK, electricity pricing is “complex”. Over many years, power generation and transmission has been nationalised, privatised, renationalised, quasi-privatised, rationalised, taken over, split apart, legislated against, legislated for and in general, morphed (year after year) into extremely complex entities and if you want evidence of this, just look at your latest electricity bill and try and make any sense of it! Electricity costs are made up of several different charges (in the UK there are 11!) and broadly speaking these can be split into four different categories; generation, transmission, distribution and taxes. This report is too short to satisfactorily explore transmission, distribution and tax charges in detail. Suffice to say that transmission charges cover the cost of operating the grid infrastructure, distribution covers all the bits that take electricity from the grid to the end-user, whilst taxes are set by government (and in recent times, have been used to penalise fossil-fuel generation and oblige the generation of renewable energy).

All of these costs may be high or low, but at least they are consistent, which is not a word that can be used to describe the final “killer” price factor; the cost of power generation. This charge (calculated per kilowatt hour) is now so high that many British businesses are facing five or sixfold electricity bill increases and much of this is due to the problematic way that the cost of power is calculated. Basically, instead of looking at actual generation costs, the electricity price in Britain directly correlates with the marginal cost of gas (ie, the current global spot price). On the surface this seems scandalous as not only does the majority of gas generation emanate from long-term (non-spot) North Sea contracts, but up to 50% of UK electricity actually comes from nuclear and / or renewables!

There are however a number of reasons behind gas indexed prices and the first is to ensure that generators who are having to pay the market price for gas (for whatever reason) have an incentive to produce UK electricity. Otherwise, why would they – as private companies – bother generating power at all? The logical response to this might be to ask why any well-run generator would have to buy gas at spot prices at all - surely that is where competitive long term supply contracts come into play? This should be true, but the nature of electricity generation from gas is that it is not only used for day-to-day capacity, but also as a back-up for when there is no renewable generation. How much gas has to be bought as renewable back-up and for how long, entirely depends on how long the wind doesn't blow and the sun doesn't shine. Which in turn means that a limited number of advance gas supply contracts can be entered into and thus, the spot gas price must be paid...

The second reason behind gas indexed electricity prices is to incentivise and reimburse the nuclear and renewables generators, who incur significant investment costs to build the generation in the first place. Over the last 10 years, gas prices have generally been so low (because of plentiful supply) that nuclear and renewables have all lost money – or as a minimum, failed to cover their original capital investment. Now that gas prices are so high, the nuclear and renewable players are finally beginning to make money on their electricity, so it is controversial (to say the least) for the government to turn round and tell them that they must reduce their prices!

This though is easily the most logical measure if we are to take control of soaring electricity costs. Far better than simply borrowing further billions to reimburse end-users, and also better than windfall taxes, where the money is rarely (if ever) ringfenced to directly reduce bills. On the other hand, diminished electricity tariffs on both renewable and domestically produced gas supply would immediately bring costs down (without borrowing), whilst still generating more than satisfactory returns for the generators. Naysayers will point out that any revised rates will still be higher than anything we have seen over the last 25 years, plus they will have to be fixed for a long period to appease the power generators. But at least today's immediate economic challenge of sky-high power prices will be addressed, as we move away from the stratospherically high cost of gas.

At this juncture, there are no good options and such is the depth of the current crisis that we have little choice but to deal with the most pressing problems. Over complexity of the generating system, years of cheap energy (lots of it from Russia), a lack of understanding of how fast decarbonisation could take place, the undoubted upheaval of Covid and now the war in Ukraine, have all contributed to the current energy meltdown and in due course, governments may want to reflect on these issues - many of which have been self-inflicted failures. But here and now, we have an immediate requirement for a solution and moving electricity tariffs away from the spot gas price is the logical action.