Not so long ago I was invited by my gas supplier to enter into an agreement to fix my unit charge for gas for the next five years. I assume that it was a general invitation to all British Gas customers; possibly competitors were making similar approaches.

This has caused me, and no doubt many fellow consumers, to face up to the dilemma confronting industrial and electricity generating users of gas; do we buy on the spot market or do we buy forward? What is going to be the course of gas prices over the years? And of course it has raised the question in my mind – what does British Gas think about these questions? One might think that British Gas is expecting prices to fall back. But we domestic consumers are offered a break clause in the event of a price fall. So what is British Gas up to? Perhaps it is hoping to lock in customers for the long term back to back with its long-term purchase contracts. But this only works if the price of gas is going to rise. If it falls British Gas is stuck with high prices under its purchase contract and a defecting clientele. So do we conclude that British Gas is taking a gloomy view of the path of future gas prices?

Mercifully as I am no longer a part of government or of the oil and gas industry I do not need to worry unduly about the answers to this conundrum. But if I were in either of those places I would be very perplexed.

Broadly speaking the situation seems to be as follows:

- Gas supplies from the UKCS are declining and at a faster rate than quite recent predictions.
- Imports can come in through the Interconnector (whose capacity has been recently upgraded); as LNG (the Isle of Grain terminal is operating and more capacity is on the way); and in due course through new connections with Norway.
- Until these projects are fully operational a cold winter could see demand exceeding supply.
- We have limited stocks.
- We are experiencing some untypical cold weather.
- The spot price of gas has risen dramatically.
- The one month forward and longer-term forward prices have also risen sharply.

In the face of this situation the gas consuming part of industry is extremely anxious, is talking about suspending production or transferring to lower cost countries, and calling on the government to do something about it. The media are stirring it. And the government is trying to calm things down.

Personal Commentary

Charles Henderson

The key fact to keep in mind in assessing this situation is that the UK gas market is uniquely liberalised. If supply looks like falling below demand, prices will rise to suck in imports whether it be through the Interconnector or as LNG; and demand will fall as industrial users of gas switch or suspend production (something they may well do even if they have long-term supply contracts, since it may be more profitable to sell the gas than to produce). And of course the traded market will become upwardly volatile.

All very good in theory, you might say, but in that case why is the Interconnector not full, delivering gas from Europe sucked in by the higher prices? And why are LNG cargoes destined for the UK being diverted to other destinations? There is a school of thought that the answer to the first question is that European gas suppliers are restricting supplies to the UK in spite of the higher prices because over there the markets are not fully liberalised. It is an odd argument, implying either that a cartel is operating to keep prices below the level that could be achieved, or possibly that governments are leaning on the suppliers to restrict exports. I am not convinced. Another more plausible theory is that third party access into the trans-European pipeline systems is being restricted by operators. This may be the natural consequence of such pipelines being full with gas carried for contracted users. Or it could be that pipeline owners are deliberately keeping utilisation of the system below capacity. This is something that the EU Commission is investigating, egged on by the UK government and the Office of Fair Trading.

The second question (why LNG is going elsewhere) must surely be because the USA (post Katrina) and Spain are seeing higher prices than are being bid by the UK. The problems of third party access to terminals would seem in this case to be fanciful.

Industry can probably understand all this and wants the government to do some thing about it. The government cannot see what it can do in this liberalised market, except to try to dispel any panic about the possibility of interruptions in supply, and to prepare all consumers for higher prices in the medium term. I say this because once the LNG terminals and pipeline connections are in place the UK will be taking its prices from a world market for LNG and from a European market for pipeline gas. The latter market is at the moment driven by prices indexed to oil; but it is surely only a matter of time before the two markets become one. Either way, prices in the UK look set to stay high, and there is nothing the government can do about it. Industry of course can take evasive action by negotiating long-term contracts, by hedging in the forward market, or at the extreme closing or relocating plant.

And what is the answer to my own domestic conundrum in the light of all this? Accept a five-year fixed price.