A VERY BRITISH ENERGY CRISIS – KEEP CALM AND TRANSITION FASTER

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Wider forces have wreaked havoc in global energy markets in 2021 but UK policy has caused additional problems in Blighty

As we set out in our briefing on the global energy crisis here, there has been a crisis around the world with record natural gas, coal and electricity prices. The causes are a combination of post-pandemic recovery, extreme weather events and fractious geopolitics, which have increased demand and compromised supply. We also argued that the underlying cause allowing such events to be decisive is a long-running failure of global policymaking to manage the transition from fossil fuels to clean energy. This is also true of the UK, notwithstanding its reputation as a poster child for decarbonising its economy.

In this briefing, we take a closer look at the peculiar UK perspective on the energy crisis, its impact and potential implications. In particular, with the UK's competitive energy supply business market, we consider the issues raised by the fact that no less than 22 energy suppliers ceased trading this year. Other issues under scrutiny include the role of tariff caps for consumers and back-stop measures to ensure supply when firms fail.

WHAT HAPPENED TO UK WHOLESALE ENERGY PRICES THIS YEAR?

As with much of the world, the UK has seen record prices for natural gas (up six-fold since October 2020) and electricity (day ahead prices reaching near seven times the strike price at the latest round of Contracts for Difference auctions to encourage low-carbon electricity generation).

Global factors have been the overriding forces at play. As set out in more detail in our global energy crisis briefing:

- natural gas prices have reached record highs across Europe, the US and Asia as global competition to secure supplies ahead of winter intensifies. Similar pressures have been seen for coal;

- with natural gas and coal being key to flexible power generation price spikes have translated into record electricity prices;
- a series of aggravating extreme weather and supply events globally have contributed to supplies of natural gas and coal falling short of demand;
- behavioural impacts from the pandemic have also played a role - particularly the shift to hybrid working, and
- geopolitical factors have also been evident, particularly Russia's reluctance to boost gas supply to Europe beyond contracted levels (a move seen by many as aimed at pressing Germany to approve the Nord Stream 2 pipeline).

UK SPECIFIC FACTORS

While this is clearly a global crisis, it is striking that price gyrations have been more extreme in the UK than many comparable nations. The failure of multiple energy supply companies is also peculiar to the UK. Other specific factors include:

- **Greater reliance on wind during a period of low wind**
  Low wind speeds across Europe from April to June led to a greater impact on the UK than most of mainland Europe with the UK's much higher proportion of wind generation.
- **Low levels of natural gas storage**
  The UK has some of the lowest natural gas storage capacity in Europe. Historically, the UK's position as a producer meant storage was less important. However, with UK fields maturing and its main storage facility at Rough closing in 2017, the UK has been left heavily reliant on imported LNG – which has seen prices soar this year.
- **Brexit and leaving the EU internal energy market**
  From 1 January 2021, with the end of the Brexit transition period, the UK left the EU's internal energy market, meaning that electricity trading for UK/EU interconnectors – high voltage cables connecting state grids – were no longer subject to so-called market coupling. This coupling mechanism used an algorithm to ensure coordinated day-ahead price setting and capacity allocation – with interconnector capacity and electricity sold together. This regime ensured efficient allocation to whichever national market had the greatest need. Without that system, market participants must buy interconnector transmission capacity for the day ahead as a first step and then separately buy the electricity they wish to flow. In short, UK/EU electricity trading is less optimised and the UK cannot rely on as efficient response when local offshore generators face low winds. However, the larger impact in 2021 has been the fire on 15 September at the IFA1

interconnector with France, which caused a full outage until late October and will reduce capacity until late 2022.

UK SUPPLIERS - CRISIS AND LAST RESORTS

The UK's energy supply market is one of the world's most liberalised. From 2011 to the start of 2021, the market share of the large legacy electricity and gas supply companies (known then as the 'Big 6') dropped from nearly 100% to 70%, with a peak of 70 energy supply companies in 2018 (down to 53 by Q1 of 2021).

Since January, 22 energy suppliers ceased trading with their customers transferred to alternative suppliers under the UK's Supplier of Last Resort (SoLR) regime. SoLR enables Ofgem to direct another supplier to take on the customers of a failing provider to ensure supply continuity.

One of the reasons for these failures has been the Government's Default Tariff Cap regime in place since 1 January 2019 under which energy watchdog Ofgem sets a cap on the tariff levels suppliers can charge for electricity and gas for a six-month period. The cap is not meant to prevent wholesale costs being passed on or reasonable profits. Its purpose is to deal with what was considered the unfair result of the way suppliers competed, which left many consumers who did not frequently switch suppliers paying considerably more. However, for suppliers with limited balance sheets and lacking sufficient long-term contracts or other hedging strategies, the cash-flow crunch caused by the energy crisis has been terminal.

While the industry jargon of these mechanisms is obtuse, the impact of such policies can be devastating if they get out of step with market realities. As a trainee in our energy group in 2002, this author worked round the clock to sell TXU Europe's retail supply business with its 5.5 million customers for £1.3 billion before it became worthless due to automatic customer transfer. Government policy, in that case new electricity trading arrangements, caused heavy industry losses and ultimately put TXU Europe in administration. In contrast to the current situation, TXU's problems stemmed precisely from having long-term arrangements. The Government's reforms had, almost overnight, made prudent risk management massively loss making. Now we are once again seeing the impact government action and inaction can have on this highly-regulated sector.

It is often the case that being a SoLR is a much sought-after role as it enables the SoLR to add new customers. So prospective SoLRs may offer to absorb much of the costs involved. However, at the current time the energy crisis together with the Default Tariff Cap mean prospective suppliers face losses on supplying energy to any new customers except to the extent that they have longer-term contracts in place or other hedging strategies with sufficient volumes to cover the extra consumers.

OFGEM'S RESPONSE

On 29 October Ofgem wrote to all energy suppliers about actions it would take in response to the current crisis. The agency announced it would issue an expedited approach to making SoLR cost reimbursements to assist with cash flow problems. The regulator also set out measures to bolster financial oversight of suppliers as they increase market share.

It also announced that there would be a consultation on the Default Tariff Cap in November 2021 with a decision in February 2022 in time for the new cap period from 1 April 2022.

Ofgem's letter falls short of the substance and urgency called for by many of the smaller and more exposed energy suppliers, who argue that the regulatory set-up is inadequate in the face of the current crisis and that further support is required even for well-run firms. On the other hand, some of the larger suppliers welcome the approach, which they see as reflecting the reality that risky strategies are to blame for the extraordinary number of supplier failures.

WINTER IS COMING (SO A PLAN WOULD BE GOOD)

Amid such regulatory wrangling, UK industry has been left increasingly concerned at rising energy costs. Many firms in energy intensive industries have already been rationing production, halting operations or making other adaptations. As winter approaches it is increasingly likely that large industrial energy users will be required to cease operating to protect priority end-users like hospitals to balance the UK's gas and electricity transmission systems.

In the short term, aside from hoping for a mild winter, the UK Government will be assessing if and to what extent it should take further steps to mitigate the impact on the most vulnerable consumers and exposed sectors of industry. Longer term the UK needs to look at the regulation of the domestic energy supply business and put the market on a more stable footing, including looking at reform of the Default Tariff Cap.

With recent, more robust support for new nuclear and the announcement of a new finance model to cut the cost of new nuclear power stations, the Government is also moving to address the underlying reason the UK (and many other countries) has been susceptible to 2021's energy crisis: the need to give business the certainty to move ahead with the energy transition. Failure to grasp such challenges risks making the market gyrations of 2021 seem less like crisis and more like the first tilt into an unwelcome new normal.

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