

Sir John Mogg KCMG
Chairman



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value for all customers*

25 November 2005
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Philip Lowe Esq
Competition Directorate General
Rue de la Loi 200
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Belgium

Dear Mr Lowe

EUROPEAN GAS MARKET

Our (albeit brief) conversation last night confirmed that you are well aware of the major concerns there are about recent UK price movements and appreciate our wish urgently to reassure ourselves that this severe price volatility is the result of underlying gas supply and demand conditions and not of any abusive behaviour or distortions in the UK or NW European gas market arrangements.

In the last fortnight, wholesale gas prices in GB and at Zeebrugge have surged and are now at record levels. Although the weather has led to high levels of demand, the level of prices both in absolute terms and relative to reported prices in the Netherlands and Germany would suggest that all or at least the vast majority of available gas supplies from the North Sea, Norway and NW Europe should flow into the UK. It would also suggest that LNG should be diverted to the UK.

The reverse is true. The Zeebrugge interconnector has been operating at between 60% and 75% of capacity and there have been only three shipments of gas to the new LNG terminal at the Isle of Grain since July (a fourth was delivered yesterday).

The impact on customers (and in particular large industrial and commercial customers) has been significant. Higher wholesale spot gas prices have led to significant increases in wholesale electricity prices as generators have had to switch to more expensive fuels (including oil). Several very large manufacturers have had to cut or cease production. Over the past seven days we estimate that large industrial customers in GB who are exposed to the spot prices have seen their daily wholesale gas prices rise by around £55m per day compared with those of last month. They also face significant increases in wholesale electricity prices.

The Gas and Electricity Markets Authority

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INVESTORS IN PEOPLE

There have also been large increases in the forward price of gas and electricity in respect of the remainder of the winter. The considerable uncertainty about whether North Sea, interconnector and LNG supplies can be relied upon is reflected in these very high and volatile forward gas and electricity prices.

We are currently analysing GB gas supplies with the assistance of the Department of Trade and Industry to reassure ourselves that all available gas is flowing to the GB market and that no producer is seeking to withhold gas to drive up prices. We would be happy to share that analysis with your services. We are not, however, able to analyse whether all available gas supplies are being delivered through the interconnector from the NW European markets. You are also aware of our concerns about recent changes to certain national market rules (for example in Spain) that may lead to gas being diverted and thereby distort the operation of the European gas market.

It is very important that a thorough and rapid analysis is carried out at EU level to determine whether supplies are being made available to the market from all sources of supply. Whilst we continually monitor supplies from the North Sea and GB storage for evidence of any anti-competitive behaviour, we are unable to carry out the same analysis in relation to LNG and supplies through the interconnector.

Three of the problems you identified in your recent issues paper on the EU gas markets may be causing real and significant distortions and harm to customers. First, the lack of transparency on gas supplies, storage, gas demand and available transit capacity is leading to uncertainty about whether the Zeebrugge interconnector can be relied upon to deliver gas to the UK and Ireland this winter (which in turn feeds through into prices). Second, the limited liquidity in NW Europe and/or lack of access to transportation is preventing gas flowing to the UK and may continue to do so throughout the winter. And third, the example of the recent decision by the Spanish regulator (to set charges for suppliers who are out of balance at 150% of the higher of two prices in the UK or the US) may be causing LNG to divert to Spain.

There may be legitimate reasons (such as transportation constraints or lack of available gas) to explain why the interconnector has not, or will not, flow at maximum rate. It is also clear that the failure of the interconnector to flow at full rate over the last couple of weeks is not the only reason for high GB wholesale spot gas prices. It is, however, clear that, were the interconnector to flow at full rate, and indeed were LNG deliveries to be on a more frequent basis, there would have been a significant downward effect on GB spot prices and forward prices to the benefit of all consumers.

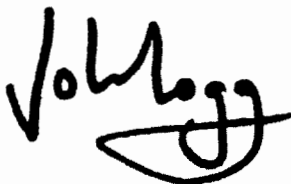
In the present market conditions, and as a follow up to our earlier request to you to examine our concerns following our own gas probe inquiry, I should be grateful if your services would consider as a matter of urgency the current concerns I have raised. There are, at least, three options we have identified where concrete actions could be initiated: first, an

analysis could be undertaken of whether there is gas and transportation capacity available to deliver more gas to the UK both now and for the remainder of the winter. (This could be seen as an integral part of your work on the sectoral review.) Second, there could be an investigation of the various problems, building on the expertise and understanding of the operation of European gas markets that your services have built up over recent months whilst undertaking the gas sectoral inquiry but separate from that inquiry. Third, consideration of whether any recent rule changes in the gas market (including the Spanish market) could result, or could have resulted in the diversion of gas and the dislocation of flows within the European gas market.

On the third of these options you may wish to consider whether any actions taken amount to a breach of the duty contained in Article 86 of the Treaty, (notably, the duty under Article 10 not to jeopardise the attainment of the objectives of the Treaty.¹) This is of particular importance given that in the energy sector there has been substantial efforts to liberalise the market and to create a truly internal energy market.²

I had hoped to discuss these issues with you early next week but I understand that you are on mission. However, my staff are available to discuss with yours our concerns in greater detail. In the meantime it is my intention to inform the market of this request for the co-operation with the European Commission.

I have copied this letter to my regulatory colleagues in Northern Ireland and the Republic of Ireland.

A handwritten signature in black ink, appearing to read 'John Hogg'. The signature is stylized with a large 'J' and 'H'.

¹ *INNO v ATAB* (13/77) [1977] ECR 2115

² Directive 2003/55/EC of the European Parliament and of the Council of 26 June 2003 concerning common rules for the internal market in natural gas; and Directive 2003/54/EC of the European Parliament and of the Council of 26 June 2003 concerning common rules for the internal market in electricity.