

Dear Mr Harris

Please forgive the late submission of my response to Review. I have the following comments

Question 1: Have we used an appropriate level of aggregation for customer bills, i.e. wholesale energy cost, other costs and VAT? If not, what other splits would you suggest?

The costs should reflect the kWh price reflected in customers bill and avoid generalities that are meaningless in making effective comparisons.

Question 2: Do you think the 18 month hedging model provides a reasonable indication of suppliers' wholesale energy costs?

No. I refer here to the gas market alone. Ofgem appears not to have heard of derivatives. A supplier is more likely to have contracted 18 months in the past for actual volumes of gas with the price set at delivery. Any idea that they would have carved the gas price into stone at that point is, being polite, unlikely. It is much more likely that the price of gas delivered was linked to any number of market price discovery indices (ICE, SAP, Heren etc). The idea that the big six simultaneously decided in July 2008 that \$140+ oil presented a buying opportunity for 100% of their domestic volumes is again, unlikely.

Question 3: Do you have any comments on the assumptions and methodology outlined in appendix 4 of the document?

Appendix 4 is simply an attempt to reverse engineer a rationale for high prices.

A significant number of business energy end users simply buy gas as delivered and used according to day ahead indices. Ofgem assumes that everyone is so scared of volatility that they spend massive sums avoiding it, via hedging, as opposed to simply dealing the consequences of volatility as and when it surfaces. Volatility is always a short term problem. An SAP price has ended up being 70% lower than fixed in October 2008/09 and 41% lower from October 2009 despite the severe winter.

End users are exhorted by the Third Party Intermediary industry to insure against energy risk. A transparent SAP ensures buyers can see what the premium for the security was on historical basis.

Ofgem should use National Grid System Average Price commonly used on commercial contracts as a simple, and extremely transparent, benchmark of actual energy costs incurred by both end users and suppliers who do not wish to hedge anything.

There is an entire "energy risk" industry which is being inappropriately targeted on end users with minimal actual exposure to energy prices. Anyone who does not spend at least 30% of turnover in energy costs, i.e. almost everyone, is ill served by those who are simple scaremongers. Sadly, Ofgem appears to act as enablers to the risk industry by over emphasising risks and avoiding publicising SAP prices.

A comparison of the SAP prices against the hedging models, would be most helpful for future reports. While price insurance is a noble objective, it is increasingly futile. It is increasingly obvious that curve prices at any particular point in time, especially 18 months ahead of actual use, have been an abject failure.

For example at one point in summer 2008 gas for January 2010 delivery was over £1.10 a therm. Those unwise enough to have bought at that price, did so on the feeling that the price would outturn even higher.

The average SAP at time of writing for January is in the area of 37 pence. I need not mention the historically high demand of this month. Similarly, January 2010 was over 70 pence as recently as last winter and over 50 in June 2010. It appears that using curve markets to predict future outcomes is worthless. This is particular problem in the the UK with low curve liquidity. The only people who would appear to actually buy that far in advance, are the very suppliers with a vested interest in high prices, but who know from past behaviour that Ofgem will give them a free pass.

Even in the much more liquid US forward markets this is a problem, as the California State Energy Commission recently noted:

The uncertainty associated with predicting major input variables and the resulting natural gas price forecasts bring into question the value of producing date-specific, single-point natural gas price forecasts.

I don't presume to tell end-users how to buy gas. But they would be better served if they were made aware of all options, and I trust that future reviews will add the one choice that Ofgem is not publicising of the true cost of wholesale gas.

Obviously in the spirit of transparency and openness, I have no objection to my submission being part of the public record.

Kind Regard

Nick Grealy

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