

**ICIS POWER
INDEX ANALYSIS:
CAP ON UK
HOUSEHOLD
BILLS LIKELY
TO DROP FROM
OCTOBER**

ICIS POWER INDEX ANALYSIS Q4 2018/Q1 2019

CAP ON UK HOUSEHOLD BILLS LIKELY TO DROP FROM OCTOBER

MAIN HIGHLIGHTS

- UK wholesale energy prices plummeted over the past six months, which may mean a lower cap on household bills from October
- Healthy gas supply and a mild winter pressured UK wholesale prices, with Britain seeing an influx of liquefied natural gas (LNG) deliveries
- Weaker trade across global and European commodities markets also weighed on UK gas and power prices this winter
- Outlook for prices this summer points to further weakness

The **ICIS Power Index (IPI)** shows that UK wholesale energy prices fell substantially on the forward market over the 2018/2019 winter, bringing down the underlying costs that make up a large part of the price cap on household energy bills.

This means that wholesale prices, which account for over a third of the retail tariff caps, are almost certain to be significantly lower when they are recalculated by regulator Ofgem later this year than when they were last raised from 1 April. This points to a potentially lower cap from October.

Healthy gas supply meant that prices collapsed from the start of the winter, as energy traders hurried to factor in unseasonably mild weather and muted demand.

Prices had risen sharply over the summer due to low levels of gas in storage and fears that supply shocks similar to last March's 'Beast from the East' event would return this winter.

But as an acutely bearish picture emerged across the market around October, these gains were quickly undone and wholesale prices entered a downward trajectory that would last throughout the winter and beyond.

Weaker trade across European and global energy markets also helped to pressure UK energy prices, with falls on coal and oil offering particular downside.

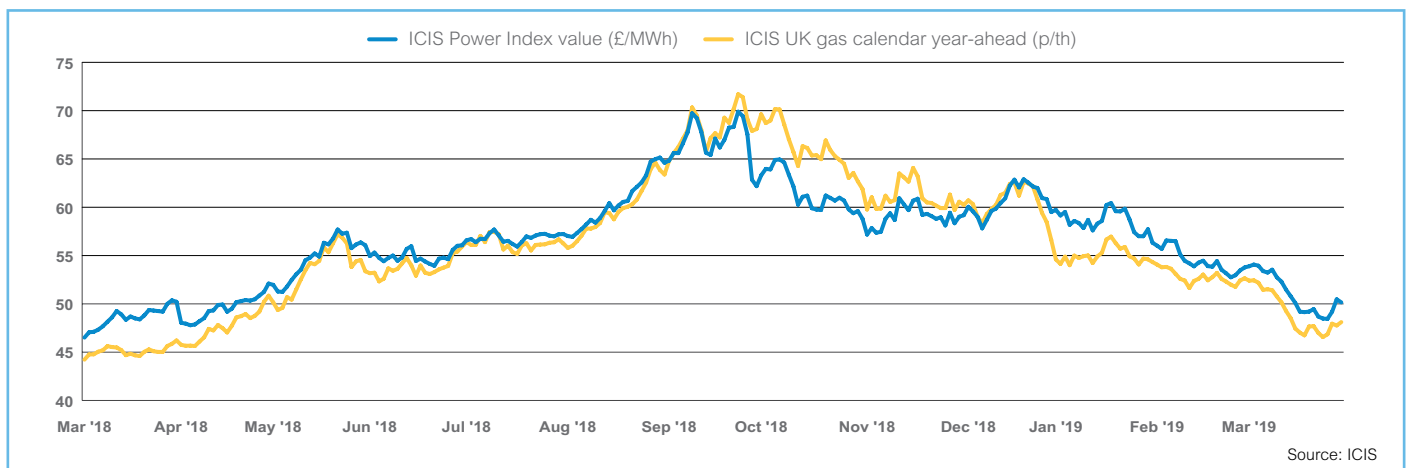
SUPPLY GLUT

The IPI tracks the price of electricity to be consumed in the UK for the 12 months starting from the beginning of the season ahead – in this case summer 2019 into winter 2019-2020. The IPI finished Q1 2019 at a value of just over £50/MWh – marginally higher than the level seen around the start of the summer last year.

A stronger summer 2018 for energy prices was then followed by significant losses for a prolonged period from the start of the winter. Sharp losses in the value of wholesale gas were the primary driver behind the plummeting electricity prices.

Moves at Britain's NBP gas market strongly influence wholesale power prices because, despite rapid proliferation of renewables in the UK's power mix, the fuel continues to play a significant role in meeting end user electricity demand.

Gas prices came under significant pressure over the winter,



with a glut of LNG cargoes meaning that supply to the market outweighed demand for gas from both domestic heating and for burning to generate power.

ICIS data shows that British LNG terminals received over 12 billion cubic metres (bcm) of LNG over the course of the winter – almost six times as much as during the same period in 2018.

An unseasonably mild winter reduced British demand for gas, with National Grid data indicating that temperatures across the country averaged over 0.5°C above normal over the course of the season.

As a result, consumption of gas for domestic heating averaged just below 250 million cubic meters per day (mcm/day), which was around 20mcm/day lower than the previous year.

Losses led by supply and demand in wholesale energy prices were tracked lower by the IPI, dragging the index down throughout the winter.

RETAIL PRICE CAP

Price caps on default and pre-payment retail gas and electricity tariffs came into force in the UK on 1 January 2019, limiting the maximum price suppliers can charge energy consumers.

In February, regulator Ofgem announced that the default cap would rise by £117 or 10% from 1 April after being in place for just three months. The new cap is set at £1,254. Similarly, the pre-payment cap rose by £106 to £1,242 per year.

Ofgem cited rising underlying energy costs as the main reason for the hike, with the regulator taking a snapshot of wholesale energy prices over the summer when the UK market was in a firm uptrend.

As part of its methodology, the regulator uses a '6-2-12 semi-annual' rule to calculate a weighted average of wholesale energy costs.

This model involves a six-month observation period of daily index values in the lead up to the cap period, a two-month lag to allow the level to be announced and a forward view of contracts delivering during the 12 months from the start of the cap.

The value of the cap is updated every six months, meaning that the next reassessment will take place in time for October of this year.

The wholesale energy costs are expected to be markedly lower when this reassessment occurs.

To put it into context, for the calculation of the latest cap, Ofgem would have looked at wholesale prices over the six-month period between 1 August 2018 and 31 January 2019. The IPI values averaged £61.15/MWh in that period.

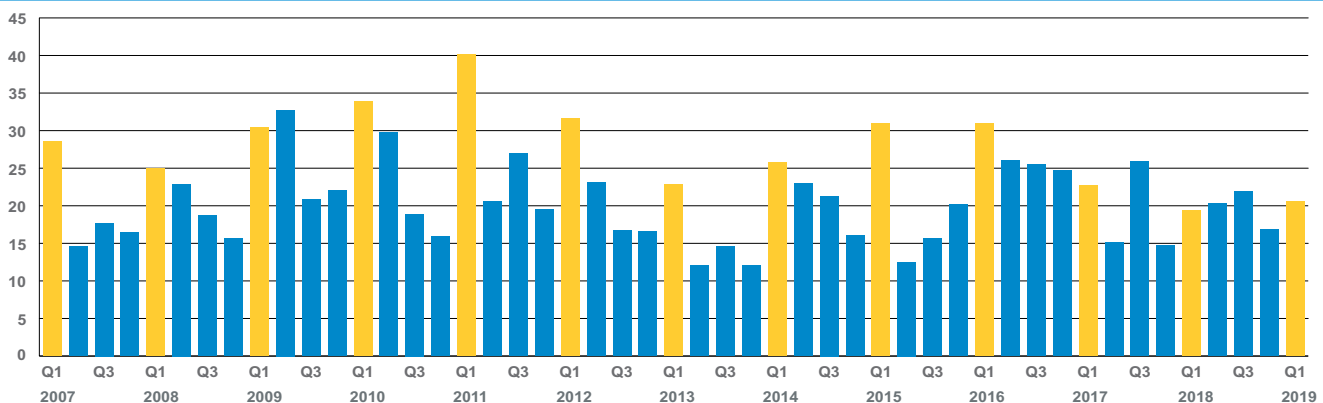
The next reassessment will take place in August with a new cap to come into effect from 1 October and will look at wholesale prices between 1 February and 31 July 2019. The average IPI stood much lower at £52.71/MWh between 1 February – 31 March 2019, a significant downward shift in the price expectations going forward. Despite the bearish price drivers over the winter being essentially short term in nature, they brought down forward contracts across the market.

This is because higher supply and lower demand mean that more energy is kept in storage for use during the coming months. Energy can be stored in a number of ways including gas storage facilities and hydropower reserves.

Higher storage stocks heading into the summer will in turn reduce demand for stores to be refilled ahead of the following winter.

The cap calculation also includes allowances for network costs for transporting power and gas to homes, as well as costs associated with environmental and social schemes.

UK POWER TRADED VOLUME IN GW



Source: ICIS

INTERNATIONAL ENERGY COMMODITIES

Carbon

- European carbon prices remained at a similar level coming out of winter as they were going into winter, trading around €22.00/tCO₂e despite large fluctuations recorded at times
- Mild weather depressed fuel burn over this period, reducing EU allowance (EUA) demand
- Brexit-driven volatility continues to grip the market with the price spiking above €24.00/tCO₂e on 5 April
- Separately, a policy instrument designed to combat chronic oversupply started to cut auction volumes short from the start of 2019

Coal

- European coal prices have fallen fairly steadily since the start of October
- A supply-demand imbalance in the gas market is the main factor behind the decline. Coal sellers were forced to drop their offers or lose out in the power mix
- Chinese import restrictions have also contributed, flooding the market with Australian coal

Oil

- After climbing to four-year highs at the start of Q4 2018, oil prices entered a downtrend, tracking a sell-off in wider equity markets and fading concerns surrounding the impact of US sanctions on Iran
- Prices in 2019 were propped up by OPEC and its allies agreeing to remove 1.2m bbl/day from the market, effective from January. Additional upside came from the US imposing sanctions on Venezuela's oil exports
- The protracted trade war between the US and China continued to stunt growth

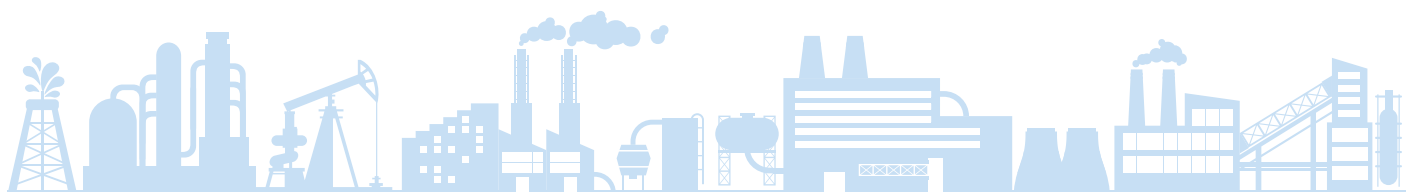
- US production and exports have hit record levels in 2019, keeping a lid on prices

LNG

- UK LNG imports rose more than three times year on year to 5.7m tonnes in winter 2018-2019 due to rising supply in the Atlantic and falling global prices
- The diversity of suppliers also increased. In Q1 2019, Trinidad & Tobago, Peru, Nigeria, Algeria, Equatorial Guinea and Cameroon all added to supply from Russia, Qatar, Norway and the US
- East Asian spot LNG prices fell 51% from Q4 2018 to Q1 2019, plunging to a 19-month low of \$5.60/MMBtu as of 13 March
- High supply from storage combined with low demand due to a mild winter drove the bearish moves

OUTLOOK

- Wholesale energy prices are set to fall further heading into the warmest part of the year, as demand for gas from domestic heating is greatly reduced
- The gas market is likely to remain well supplied, with Britain remaining an attractive destination for LNG cargoes
- ICIS data shows that British terminals are expected to receive seven cargoes by the end of April
- Forward prices indicate downside, with the Summer '19 Baseload wholesale electricity contract expiring at a value of £43.10/MWh, according to ICIS assessments. The Summer '18 equivalent was valued at £47.58/MWh



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