Promoting choice and value for all gas and electricity customers

Household energy bills explained

Britain has a highly competitive domestic energy market in which prices are set by energy companies in competition against one another. This factsheet sets out to explain why energy prices have risen, and what factors might influence them in the future.

Why have domestic prices risen?

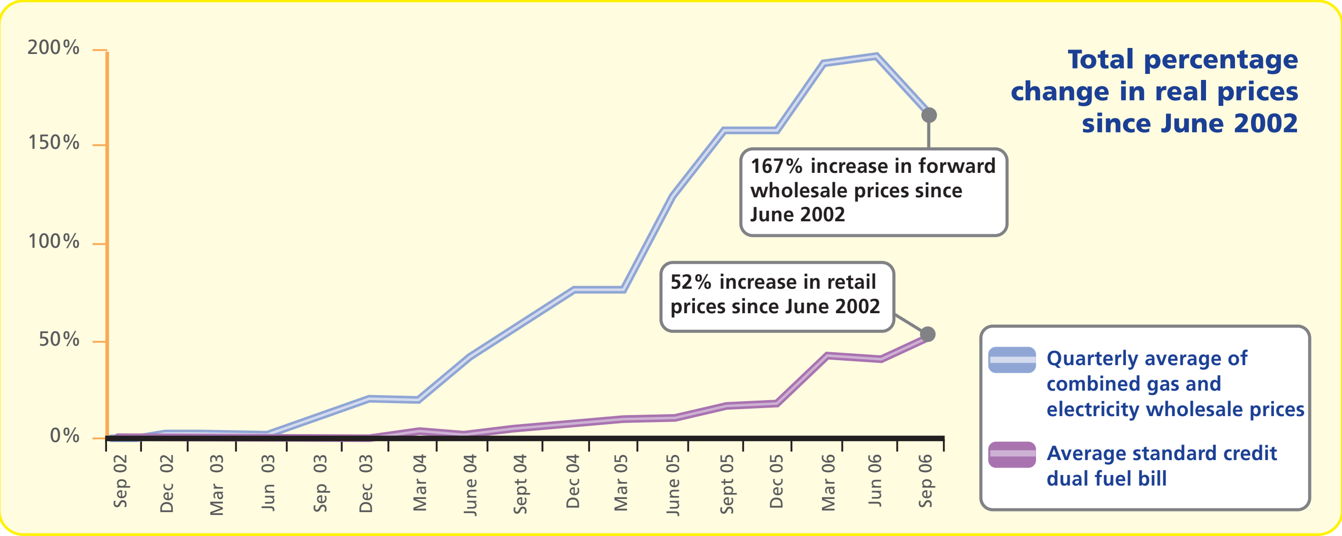
Gas bills have risen by 71 per cent and electricity bills by 45 per cent since 2003*. The main driver behind the increase has been the rise in gas wholesale prices. Higher wholesale gas prices feed through to electricity prices as at present around 33 per cent of Britain's electricity is generated by gas-fired power stations. Electricity prices have also been affected by rising oil and coal prices and the need to cut carbon emissions to tackle global warming.

*Includes all announced price rises even those for 2007

When wholesale gas prices started to rise in 2003 Ofgem investigated why and found that rising oil prices and a faster than anticipated decline in UK gas reserves were the main culprits.

Unlike Britain's competitive market, gas prices in the rest of Europe are linked to oil prices. When oil prices rise European gas prices rise. This is having a much bigger impact on prices in Britain as the North Sea declines and we rely more on imports from Europe – particularly during winter.

What is the relation between wholesale prices and retail prices?



(What is the relation between wholesale prices and retail prices? continued)

Energy suppliers buy much of their gas for domestic customers in advance so domestic prices don't track movements in the price of gas from day to day. This allowed suppliers to delay putting up prices when wholesale gas prices began to increase (see graph on front page).

It also protects customers from sudden spikes in prices such as happened last March when wholesale gas prices rose from around 60 pence a therm to £2.50 a therm.

Because suppliers buy their gas in advance, recent falls in the wholesale price of gas, if sustained, will not immediately feed through to customers' bills as suppliers are still locked into the higher prices they paid for gas this winter.

Volatility of wholesale gas prices over the last few years has also made it harder for suppliers to predict when is the best time to buy gas for winter.

In 2005 those firms who bought gas 12 months in advance paid much less than those who bought their gas later in the year. However, the opposite has been true in 2006, when those companies who bought their gas in advance will have paid more for their gas, as since May wholesale gas prices for delivery in January 2007 have declined by a third. Those suppliers who have had the most successful buying strategies this year will be in a better position to compete effectively on price.

Suppliers have also offered customers capped and fixed price deals to help avoid price rises. Over four million customers who have signed up to these deals have not been affected by recent price rises.

In the long-term, competition will lead to lower prices if wholesale prices continue to fall. New competitors may also enter the market to compete against the existing big six suppliers if they have locked themselves into high priced contracts.

What action will Ofgem take if prices do not fall?

As companies have competed keenly as prices have gone up Ofgem expects them to compete just as hard as wholesale prices fall. However, if suppliers stopped competing on price or domestic prices did not respond to a sustained fall in wholesale prices, Ofgem has said it will look closely at the market.

If Ofgem found evidence of anti-competitive behaviour it has powers to fine companies up to 10 per cent of annual worldwide turnover. It can also refer the market to the Competition Commission if it finds evidence that competition is not working.

However, there is no guarantee that wholesale gas prices will continue to fall this winter. While uncertainty about some of the new gas import projects has reduced, there are many other factors that could affect wholesale gas prices, including how much gas arrives through the new importation projects, oil prices and how severe the winter is.

Other pressures on energy prices

The need to tackle climate change has led to several government policies to help reduce greenhouse gas emissions from the energy sector. This requires investment in renewable generation, energy efficiency and in ensuring that Britain's electricity network can support more sustainable forms of generation.

Ofgem fully supports this drive to a more sustainable energy industry, but wants to ensure that customers are protected by reducing carbon emissions in the most cost effective way possible.

- **Renewables Obligation** – Electricity suppliers are obliged by government to source an ever increasing amount of electricity from renewable sources. This currently adds £7 to customers' annual electricity bills and is set to increase to around £20 a year by 2015.
- **Energy Efficiency Scheme** – This government scheme places an obligation on suppliers to support energy efficiency measures in customers' homes. This scheme costs £9 per customer, per fuel.
- **Emissions Trading** – The European emissions trading scheme has also increased electricity generation costs, which feeds through to customers.
- **Investment in energy networks** – Over £10 billion is also to be spent on ensuring the electricity networks continue to deliver a reliable service and can expand to meet the demands of renewable energy. Transmission and distribution costs are therefore rising. This equates to £5.50 per year on the average electricity bill.

What effect have higher prices had on the competitive market?

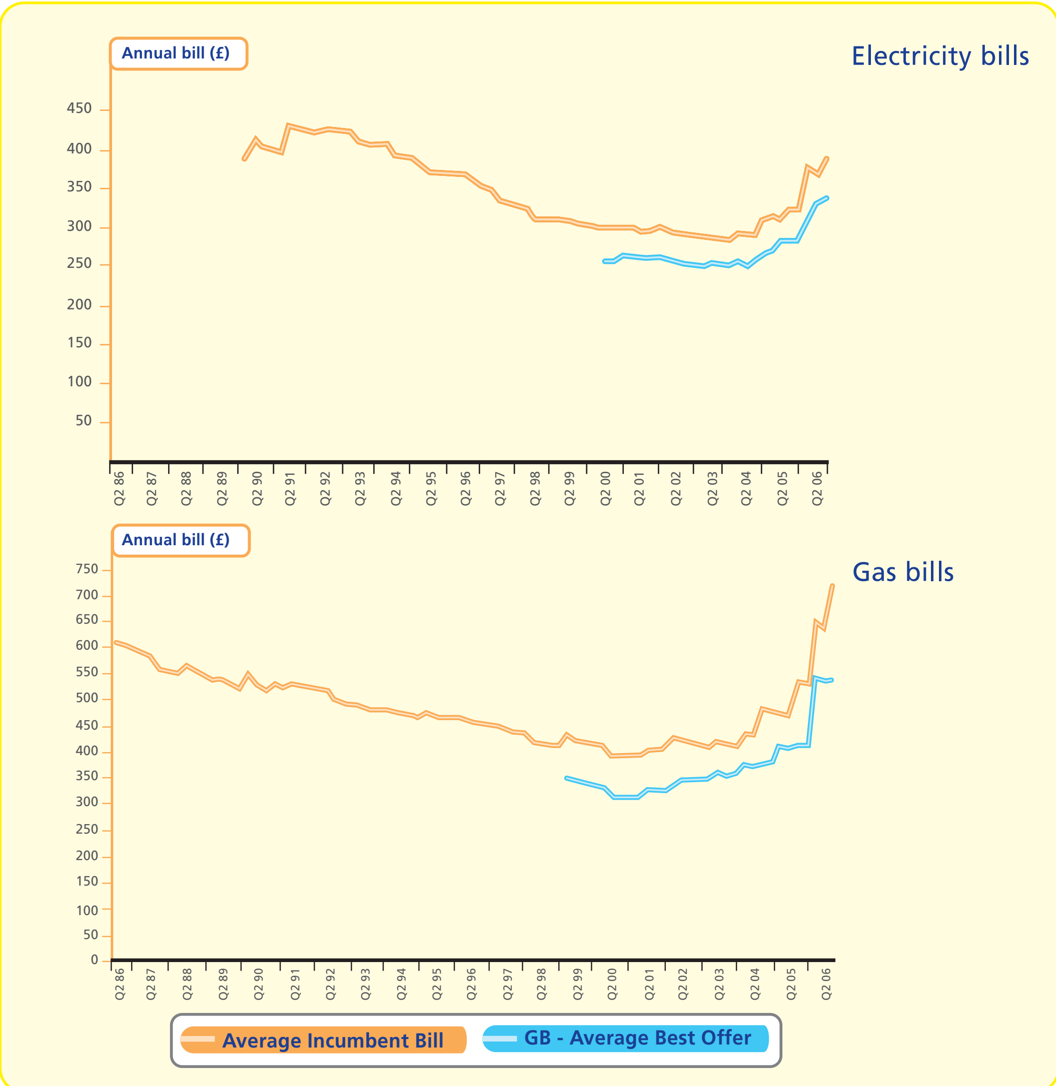
- Suppliers have not put their prices up by the same amount because some suppliers have been more effective at buying cheaper supplies of gas or are willing to cut their profits to gain market share and retain customer loyalty.
- Competition has remained vigorous with price differences between energy suppliers of around £125 on dual fuel deals.
- More expensive gas suppliers are being punished by customers who are leaving them at a rate of half a million a year. Other companies who have priced more competitively, have gained customers.
- Energy suppliers have responded to rising prices by offering customers more fixed-term contracts and have stepped up the help they provide the fuel poor.
- Competition in the supply market and effective regulation by Ofgem of the energy networks means Britain still has the cheapest domestic gas prices in Europe and our domestic electricity prices are below the European average.
- Switching rates remain high with 900,000 customers changing supplier in March 2006.
- Half of all energy customers have yet to change energy supplier and are missing out on over £1 billions of savings

Britain vs European prices

Prices for domestic customers have remained among the lowest in Europe. For example, in gas between 1990-2004 British customers paid:

- £75 billion less than Italy
- £67 billion less than Spain
- £35 billion less than France
- £28 billion less than Germany
- £27 billion less than Belgium, and
- £25 billion less than Holland.

Domestic gas and electricity prices in real terms



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