Energy UK

The voice of the energy industry

Energy UK explainer: why aren't lower wholesale gas prices reducing bills?

January 2023

Key points

- The spot price of gas has fallen from record high levels and is now similar to what it was around 18 months ago, which is still high by historic standards. Energy bills are highly unlikely to immediately fall as a result
- To protect households and businesses from market volatility, energy companies 'hedge' by buying gas and electricity in advance of when it is needed.
- This means that energy bills today reflect the market from many months and years ago and won't reflect today's prices.
- Hedging and the price cap introduce a time lag between shifts in the wholesale market and what consumers pay
- There is still a lot of uncertainty and volatility, making it hard to know what will happen to energy prices in 2023
- The withdrawal of Government support means that the prices paid by households and business will increase before they fall again

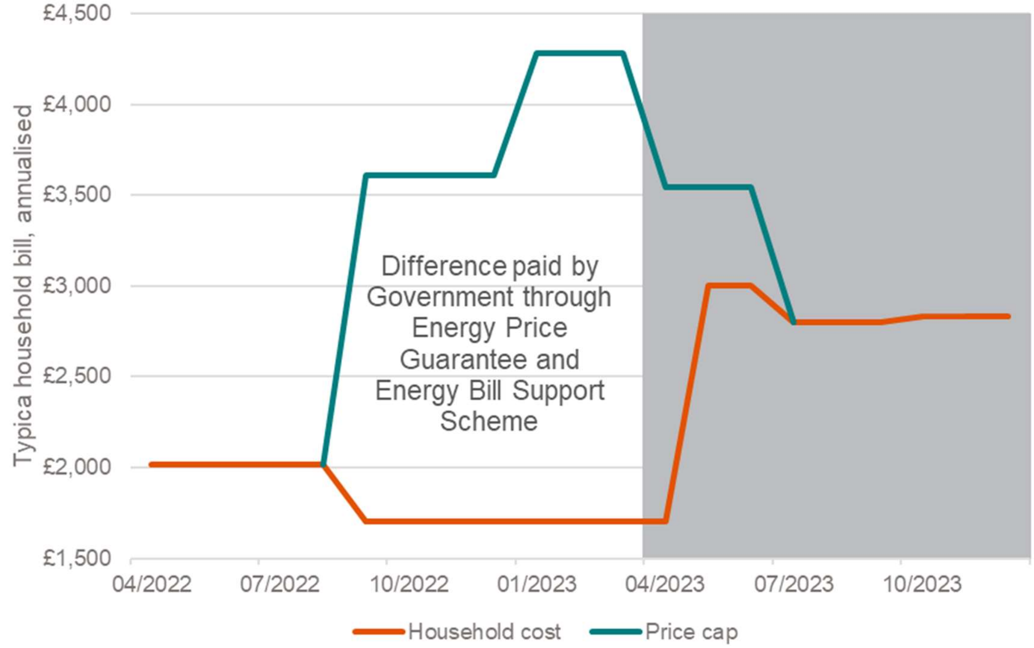
What has been happening?

Wholesale gas prices increased significantly over the course of 2021 and 2022, initially as a result of the economy opening up after Covid and later due to the lead up to invasion of Ukraine and subsequent conflict. Since the invasion, the price of gas has been highly volatile, and significantly more expensive than the historic average. The price of electricity is mostly determined by the price of gas. Energy bills for households and businesses rose in response to the high wholesale costs, despite significant government intervention. However, in the mild autumn of 2022 and once the cold snap in December had abated, wholesale energy prices have returned to pre-invasion levels. These falls will not immediately feed through to cheaper bills.

When will energy bills fall?

Household energy bills will rise from April 2023 as Government support is reduced and are currently forecast to start falling from the summer of 2023, but this depends on trends in the wholesale market which are highly uncertain. For the first half of 2023, savings from falling wholesale energy costs will be felt by the Government, not billpayers.

Household bills are set to rise as Government support is withdrawn before they are forecast to fall in the summer



Source: Energy UK analysis of Ofgem and Cornwall Insights

Why aren't energy bills reducing immediately?

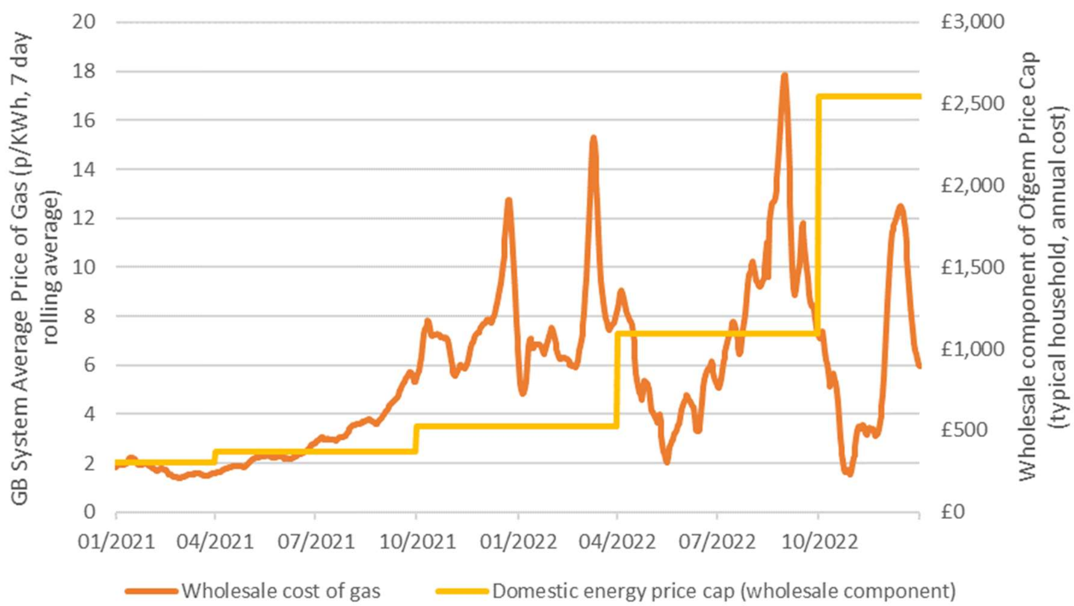
Energy bills are not immediately falling in response to lower wholesale costs for a combination of reasons:

- **Hedging:** most energy suppliers buy their gas and electricity in advance on long-term contracts with a fixed price. This helps them keep the price consumers pay steady when costs of the wholesale market change dramatically. This means that most of the gas and electricity households are using now will have been bought many months if not years ago, when energy was more expensive. It took some time for higher wholesale prices to feed into higher costs for consumers and it will take some time for falling prices to reduce bills away. This is a good thing for consumers – if households were exposed to all of the volatility in the energy market, they would face much higher costs when energy is expensive, such as in the recent cold weather.
- **The price cap:** the price cap limits how much suppliers can charge domestic customers on a Standard Variable Tariff. It is set by assessing the costs suppliers face, including the wholesale price of the energy they buy. The wholesale cost of energy allowed in the price cap is based on the market cost of electricity in the months prior to the period the price cap applies to. This means that what consumers are paying for electricity and gas today is partly determined by wholesale prices in the autumn. There is, therefore, a time lag between changes in wholesale prices and changes in retail costs – although this has been reduced by the price cap moving from being changed quarterly, rather than every 6 months
- **Government support:** In January 2023, the price cap is the annual equivalent of £4,279 for a typical household, but £1,779 will be paid by the Government because of the Energy Price Guarantee which limits typical bills to £2,500. Additionally, households are receiving £400 between October 2022 and March 2023. The Energy

Price Guarantee will increase to £3,000 a year for a typical household in April. This means two things:

1. In the short term, energy bills will rise as the level of Government support reduces – regardless of what is happening in the wholesale markets
2. Initially, falls in prices will reduce the cost to the Government, not consumers. It is not until the price cap falls below the equivalent of £3,000 for a typical household that consumers will feel the benefit. Indeed, falling energy prices are expected to save taxpayers billions of pounds in the coming months, creating much needed fiscal headroom for the Government – possibly up to £13bn according to latest estimates[1]

The price cap and hedging insulate consumers from volatility in the wholesale market and creates a lag between wholesale energy costs and what households pay



Source: National Grid via ONS and Ofgem

Why is there uncertainty about bills falling?

It is unclear when wholesale energy prices will be at the sustained, low levels that would allow for significant falls in the price paid for gas and electricity by households and businesses. There are several sources of uncertainty and causes to think that prices will not fall significantly in the short-term:

- **Energy is still expensive:** Although wholesale gas prices in Europe are now below what they were before the Russian invasion of Ukraine, they are still high by historic standards and prices for energy in the future do not return to historic levels in the next few years.
- **Energy prices are still highly volatile:** We are not in a period of steadily falling wholesale prices. Rather, tight supply conditions are causing prices to swing wildly according to external events. For example, wholesale gas prices more than doubled then halved again over the past two months of 2022 as the unseasonably mild autumn

[1] CEBR

gave way to a cold snap before Christmas. This volatility is reflected in the hedges bought by suppliers and the costs set by the price cap.

- **No one knows what will happen this year:** we are in turbulent economic and geopolitical times, creating uncertainty about how much gas and electricity will cost in the coming months and years.
    - **Replacing Russian gas:** Significant quantities of Russian gas was still flowing to Europe until the closure of the Nord Stream 1 pipeline in August 2022 – six months after the invasion. This meant Europe could still fill its storage for this winter partly using Russian gas. That will not be possible in summer 2023, meaning it may be harder to find gas for next winter.
    - **Recovery in China:** after an initial period of disruption, the end of the "Zero Covid" policy in China is expected to lead to a significant increase in economic activity. In turn, this will increase demand for gas in China – raising prices and making it harder for the UK and Europe to attract LNG shipments

Why does the price of gas affect my electricity bill?

Electricity prices are currently set by the cost of the last generating unit to be turned on to meet demand – which is mostly a gas power plant with high marginal costs. Renewable energy is around nine times cheaper than gas, and the price cap is already seeing reductions thanks to newer renewable projects.

The energy industry plans to invest £100bn over the course of this decade in new energy sources, and Energy UK has put forward ideas to Government to ensure consumers benefit from cheap, clean homegrown low carbon electricity.

Where can people get support if they are struggling to pay their bills?

Energy UK has produced a detailed FAQ for households and businesses which can be found here and wider support for winter found here.

What about businesses?

The Energy Bill Relief Scheme (EBRS) will provide a discount on the business' unit price for gas and electricity. It applies to fixed contracts agreed on or after 1 December 2021, deemed, variable and flexible tariffs and contracts. It applies to energy usage from 1 October 2022 to 31 March 2023, running for an initial six-month period for all non-domestic energy users. It will be replaced by the Energy Bills Discount Scheme from April, a less extensive scheme offering non-domestic consumers a discount on the unit rates they pay for gas and electricity.

Businesses may be able to access additional support and help to reduce energy usage include:

- the Industrial Energy Transformation Fund (IETF), which consists of £315 million live grant funding that supports manufacturers with high energy use to cut their energy bills and carbon emissions by investing in energy efficiency and low-carbon technologies
- a number of advice and support schemes that businesses may be eligible for, to help to improve the energy performance of buildings and processes and lower their energy bills. Search for local schemes that provide advice and grants
- the UK Business Climate Hub which provides practical steps on cutting emissions and saving money. If businesses are based in England, they may also be able to access support via local Growth Hubs, who they can get in touch with to find out more