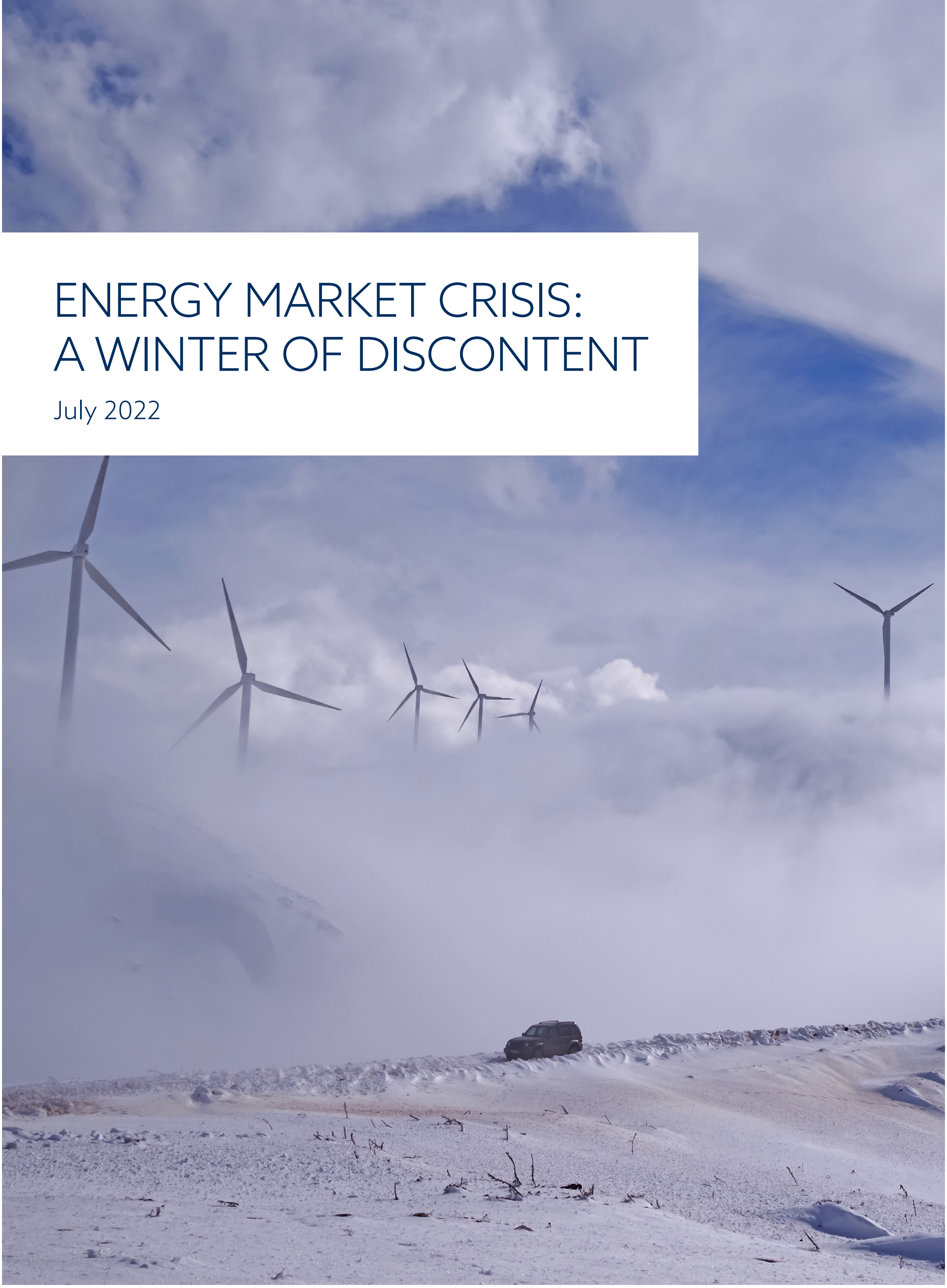
ENERGY MARKET CRISIS: A WINTER OF DISCONTENT

July 2022



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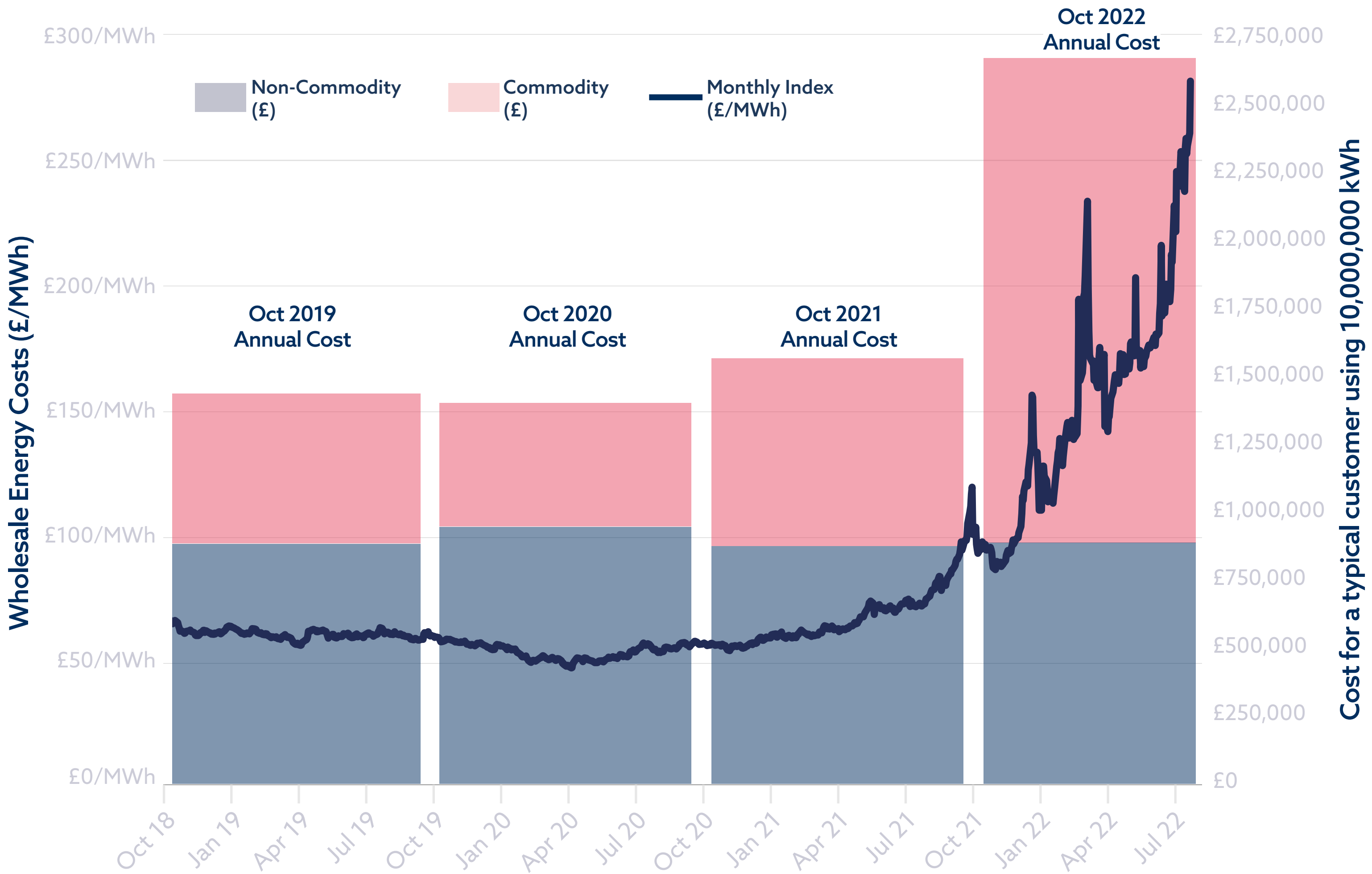
A broken market, but why?

In our [Energy Market Crisis: A UK Perspective report]() published in April this year, we reflected on how the UK retail energy market was broken and the current chaos was an unfortunate, but very real, "new norm". Fast forward to summer '22 and the market is still broken, in fact – it's rapidly got much worse in a very short period of time.

Europe and many countries across the globe are finding themselves in a deep energy crisis with energy supplies tighter than they have been in decades and prices skyrocketing, a situation compounded by slowing economic growth and the threat of a full-blown recession. European governments must work towards a resolution that avoids excessive intervention in energy markets which might exacerbate the energy crisis. The consequences of Russia's invasion of Ukraine have created a security of energy supply stress test that has stimulated UK and European Government intervention not seen in recent memory.

Rise in energy wholesale energy costs, and the impact on a typical customer consuming 10,000,000 kWh per year



Security of supply

The media headlines are all about energy costs, and rightly so, but once winter hits, security of supply will potentially be a bigger issue. Natural gas is arguably the most sought-after commodity in the world at present. The war in Ukraine has catalysed the gas crisis to a new level, by significantly reducing Russian gas supplies to Europe. There is now a desperate scramble to fill that gap which is turning into a worldwide stampede as countries race to secure scarce supplies ahead of winter. Unchecked gas prices are driving global inflation that is pushing Europe to the brink of recession. In short, natural gas is now the fuel that shapes geopolitics.

> **//** Gas is now a scarce commodity in Germany
>
> Robert Habeck, Vice Chancellor of Germany,
> Federal Minister for Economic Affairs and Climate Action

Energy 'as a weapon'

Surging wholesale gas prices are a global issue driven through a perfect storm of market forces, affecting the price of energy for both domestic and commercial customers. Russia's war on Ukraine, a key geopolitical factor, in combination with the global energy crisis are propelling a worldwide transformation of the energy market.

The global outcry of the invasion of Ukraine has led Russia to instigate an energy power play, weaponizing gas supply to Europe, using it as a political pawn in response to western sanctions, testing resilience and political will. The tit-for-tat situation has only worsened the supply shortfall in energy markets that were already tight.

> **//** Russia is blackmailing us. Russia is using energy as a weapon.
>
> Ursula von der Leyen,
> European Commission President

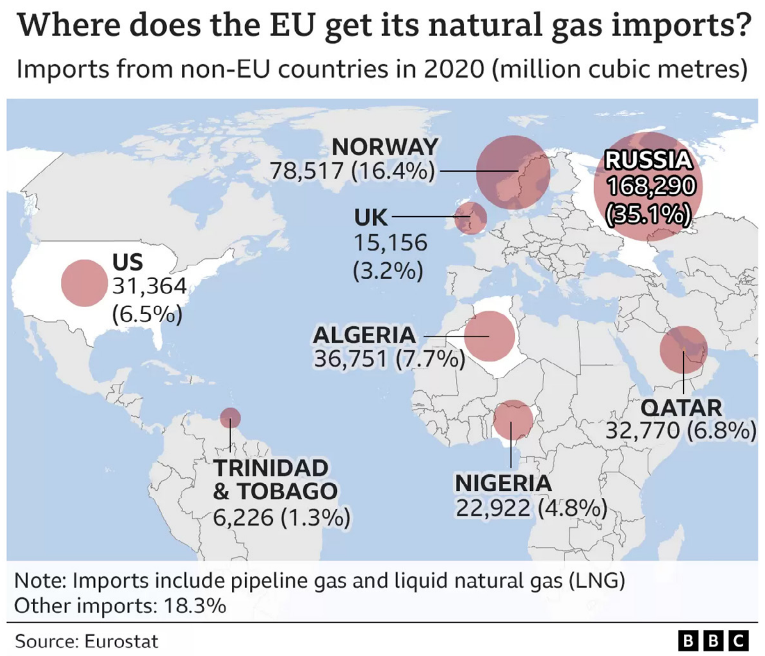
The gas tap: Nord Stream 1

Nord Stream 1, the 759-mile natural gas pipeline that runs from Russia to Germany is Germany's main source of gas with 58% of their annual supply[1] procured via the pipeline, but the UK's reliance on Russian Gas is far less significant at just 3%.[2] Benchmark contracts are trading around 350-400% higher than this time last year.[3]

With annual maintenance halting exports for 10 days until July 21st testing Europe's resolve, many were concerned that the gas tap wouldn't be turned back on at all, with Russia deliberating delaying it to keep Europe in a state of uncertainty.

> Europe will need to ration natural gas to meet winter heating demand if the Nord Stream pipeline doesn't restart after planned maintenance
>
> Brian Gilvary,
> INEOS Energy, Executive Chairman

Despite coming back online there are still numerous significant hurdles to navigate, which only adds to the fragility of the current energy market landscape. For one, the state-controlled energy giant Gazprom cut supplies to 40%, so in spite of the Nord Stream 1 pipeline returning, it is only at reduced levels, which leaves 12 European countries, including Germany, vulnerable due to their dependence on Russian-supplied energy.



Source: BBC, bbc.co.uk/news/business-60871601

The European Commission encouraged a united front by urging members to "reduce their gas use from August by 15%" to ensure they can cope in the event of a total gas cut-off from Russia. One thing is clear, the return of gas flows through Nord Stream 1 is expected to do little to help Europe stockpile enough gas ahead of the winter season.

Those feeling the suffocating effects of Russia as gas flows are curbed, is the German-headquartered, energy giant Uniper. Germany responded to a bailout application for government support, after the company faced huge losses due to soaring energy prices. The company had already started using gas it was storing for winter after Russia cut deliveries. Uniper only received a fraction of its contracted gas volumes from Gazprom since mid-June and was forced to enter the open market and procure gas at much higher spot market prices, without the ability to pass on additional costs to customers.

Germany's gas shortfall may trigger a 'Lehman Brothers-like' collapse as Europe's economic powerhouse faces a real and unprecedented danger of businesses and consumers running out of energy. If Germany collapses, the rest of Europe may well be next.

North Sea oil and gas rig

1. brookings.edu/blog/order-from-chaos/2022/07/18/a-german-gas-crisis-will-cause-jitters-across-europe/
2. inews.co.uk/news/uk-gas-where-from-how-much-russia-import-britain-supplies-explained-1504257
3. reuters.com/business/energy/why-russia-drives-european-british-gas-prices-2022-07-10/

Freeport LNG facility puts strain on energy crisis

The current energy crisis isn't limited to one commodity which is one of the many factors that has made the fragility of the market so apparent.

> **"** We have an oil crisis, a gas crisis and an electricity crisis at the same time
>
> Faith Birol,
> Head of the International Energy Agency Watchdog Group

Europe's appetite for LNG is pushing the world towards the brink. The global economy has by and large stood firm and remained resolute enough to withstand surging energy prices thus far. However, it is inevitable, if it hasn't occurred for some already, that we are rising beyond sustainable levels as the continent attempts to wean itself off Russian supplied oil and gas. All of this was only further compounded by a fire at the Freeport LNG plant in Texas, USA, which led to a shutdown of the facility on 8th June, which is now expected to last longer than initially expected, now potentially up until October 23. The impact was an immediate 30% and sustained increase to wholesale prices on the front curve. The output from the facility makes up 20% of US LNG exports[4]. Roughly 70% of Freeport monthly supplies in the past few months went to Europe and Britain. The European and UK commodity markets are now sensitive to US energy factors as a result of moving away from Russian gas and substituting it with LNG.

Pre-pandemic, US factors wouldn't have really impacted the European/UK markets at all, which only reinforces the global impact of the energy crisis. This is further compounded by the disruption and reduced gas export levels with the Nord Stream 1 pipeline, which is the largest source of Russia gas for Europe. High prices are expected to continue to rise and hit European in gas demand this winter.

UK Government introduces Energy Security Bill

The Energy Security Bill was presented to Parliament on 6th July as the UK Government finally recognised the damaging effect that our over reliance on imported energy over the past 20 years has had. 26 new measures have been set up to put the UK on a path to a cleaner, domestic energy market, propelling the biggest reform of the country's energy system in a decade.

The 26 measures contained in the Bill are intended to achieve the following three broad aims:

- Leveraging private investment in clean technologies and promote the building of a homegrown energy system
- Protecting consumers from unfair pricing
- Ensuring the safety, security and resilience of the energy system.[5]

With immediate supply fears now an ever-present threat, the bill is designed to "bolster Britain's energy independence and security" and thrust the UK forward with its transition to "cleaner, affordable, home grown energy system". In a time of energy market volatility, the UK Government finds itself in a period of political leadership uncertainty since the resignation of Conservative Party leader, Boris Johnson. Given the tumultuous state of UK politics, there are concerns whether the Bill will make it through the parliamentary process, but one thing is for sure, this is a long-term strategy, and the Energy Security Bill will not help consumers in the short term. It is important to keep the government's feet to the fire and recognise that fuel poverty is not limited to domestic, but also commercial consumers too. Should the Bill be passed, it will represent a significant step in decarbonising the UK's energy supply to achieve its net zero goals, but there's still a long way to go.

Energy Security Bill will not help consumers in the short term

Stainburn wind turbine farm, Cumbria

4. reuters.com/markets/commodities/freeport-lng-extends-outage-after-fire-targets-year-end-full-operations-2022-06-14/
5. osborneclarke.com/insights/energy-security-bill-introduced-uk-parliament

Market conditions propel consumers further into a state of uncertainty

There is a very real prospect of the lights going out this winter if the UK cannot source instantaneous capacity from baseload generators which are in short supply.

The UK Government is scrambling towards coal as a backup as have Germany, the latter reactivating coal power plants to preserve supplies as a short-term crisis management option. The UK energy regulator Ofgem are also seriously considering incentivisation payments to UK domestic consumers with smart meters to stop using energy between 4-7pm on weekdays and it will be interesting to how this develops in industry. We are already starting to see various market design initiatives being considered, (for example, local wholesale pricing, decoupling renewable power from market prices etc.,) but these will take time to implement. A likely course of action would be direct financial support from the UK Government. The current market pricing should be sufficient incentive enough to implement demand side response and voluntary load management rather than wait for our turbulent political situation, which is enduring uncertainty of its own.

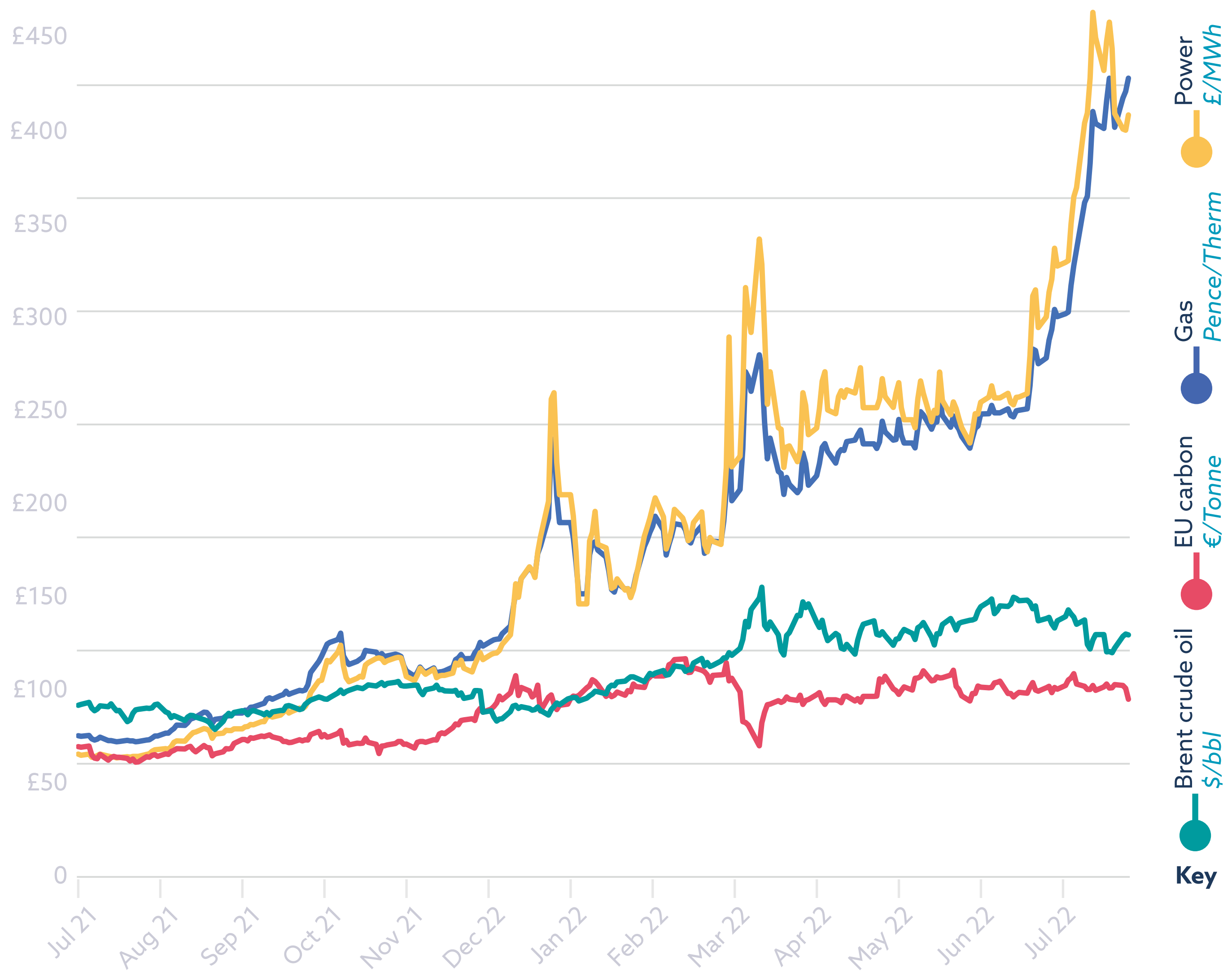
- 41% of the UK's generation fuel source for June 2022 was Gas. The country's reliance on gas continues to increase despite exceptionally high gas prices which are now again pushing record highs
- Wholesale prices. Winter '22 now trading up at £550+/MWh and this is becoming a real issue of affordability now that may force businesses who are exposed to the markets from Oct 2022 to stop production or temporarily close at certain times
- Npower recently announced that they are temporarily suspending all pricing for new business due to the ongoing volatility and unpredictability.

Blackpool Tower and sea front

Market change over 12 months

Increases

	Cumulative 12 months	Jul 21 vs Jul 22
Power	196%	28%
Gas	221%	9%
Carbon	54%	-4%
Oil	44%	-5%



Protecting your business and mitigating the risk

The volatile nature of increasing energy prices continues to test the stability of the market and resilience of businesses and suppliers alike. If the current crisis hasn't prompted businesses already to think about their energy portfolio, it is critical that they address their approach to risk management now. Engaging the expertise of a risk manager, having regular strategic conversations and being proactive is key and should include such things as:

1. **Extend supply contracts where possible to protect against further volatility**

   Having a long trading window gives businesses the defence of proactively protecting against market volatility. Contract prices for winter '23 onwards although higher in comparison to historical prices, are still cheaper than the coming winter '22 so should be secured because if the new norm persists, they will only go higher. Winter '23 has increased from £200 to £300 in the past month, and winter '24 from £150 to £220. With suppliers going out of business, if your current supplier is offering an extension, take advantage and explore this opportunity.

2. **Explore reliance away from the wholesale market with renewable energy options (CPPAs)**

   With price hikes and volatility, corporate power purchase agreements are a more attractive long-term, sustainable hedge to optimise your energy portfolio. Accessing renewable volumes via CPPAs protects businesses against volatility and provides security of supply with budget certainty. Companies are using CPPAs strategically to manoeuvre some, or all, of their energy to renewable energy sources to reduce their environmental footprint.

3. **Employ demand side response and cut usage where possible no matter how marginal**

   The current crisis is supply-led but given how long it will take to resolve supply issues, we all have a duty to manage demand more responsibly. Germany has already 'dimmed the lights' to cope with the supply crunch and have taken a step closer to gas rationing after supplies in Russia were reduced. The country is already rationing hot water and turning off the lights to reduce LNG consumption. Businesses need to explore their systems and processes and consider if options such as shift changes from day to night and energy efficient alternatives (e.g. alternatives to incandescent lightbulbs with LEDs) are a possibility.

Conclusion

It was mentioned in our April edition of this report, but energy security and energy costs are now clearly a board room issue once more and it is essential for boards to recognise what happened in the past is gone forever. It is unrealistic to expect that any government intervention will have a meaningful impact on the short-term crisis, other than to sure up some market participants (possible including Gazprom), albeit at a cost. Similarly, whilst UK energy policy clearly needs an overhaul, it will take many years for this to feed through to price.

The energy crisis, uncertain state of British politics coincided with the geopolitical climate has wide-reaching consequences, which have the potential to threaten economic recovery from the pandemic, exacerbate inflation, fuel social unrest, and undermine efforts to save the planet from global warming. Nobody was predicting it, but it is likely to get worse before it gets better.

We are already helping many existing and new customers to navigate the challenging market conditions, please do not hesitate to contact us should you need support.

Palace of Westminster, Big Ben and Westminster Bridge

Optimising
energy costs
sustainably

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