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**SPEECH TO IEA  
PARIS 26 JANUARY 2006**

- **FACING THE LNG CHALLENGE IN GB**
- **MASSIVE NETWORK AND MARKETS INVESTMENT POST LIBERALISATION IN 1986**

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### 1. Facing the LNG challenge in GB

A leading German business man recently visited me and commented that he thought that the UK's gas and electricity markets bust and more, so the model a busted flush. I thought this conveniently forgot three things. Firstly the past benefits from the UK market model where we have had price leadership for most of the past 15 years across Europe, secondly, the fact that the UK has the most and leading investment into new gas infrastructure (£10 billion in the next 3 years) and finally I thought to myself that attack is clearly that company's best form of defence. Now this morning I am going to address primarily LNG related questions but I shall also take the opportunity to discuss investment in UK markets.

The first question that you asked me to address is “will the LNG market control the UK market for security of supply and gas?”.

We need to look at this in three phases: firstly when we look to the past the answer is clearly no. The 100 BCM's of demand in the UK was met by the North Sea with five small short term storage facilities on the mainland. However now even though LNG only provides 30 MCM's per day it has become of critical importance if we have a very cold winter with a demand of around 450 MCM's a day. I should reiterate that it is critical only if we have a Siberian style weather system and only if that occurs either in the next few weeks of this year and arguably for the next winter as well, should pipeline infrastructure development not arrive on time. If you don't believe how important it is look at this newspaper cutting from the Daily Mail that I am showing you where they have actually sent their journalists to sit on “tanker watch” in the Thames Estuary.

Finally if we look to the future we do have some massive facilities for LNG being built in the UK both at Grain and two facilities at Milford Haven. More recently a Canvey Island project has been announced. In total 35 BCM's of LNG will be delivered against a potential demand of 110 BCM's. You may well think therefore that LNG will dominate the UK market going forward but this is not the case because at the same time as we have the LNG effect we also have the new infrastructure build of 60 BCM's of pipeline facility (the phases 2&3 of the interconnector between Bacton and Zeebrugge the Ormand Langer line from Norway and the BBL line from the Netherlands).

So LNG will be an important—not dominant—part of the UK gas mix going forward representing about 30 to 40 BCM's of 180 BCM's potentially available rather than 4 BCM's out of 100 as we have today.

**The second question which you invited me to address was “Is the UK a better market for this LNG infrastructure?”.**

My answer to this is fairly straightforward: yes I believe it is and there are 5 factors that support this. Firstly, it enhances security of supply as quite clearly 30–40 BCM's of LNG facility on a demand of 110 is a very important. We have also use or lose it provisions so that should the current parties not be able to utilise the facility it will be made available to third parties. Secondly, LNG provides a diversity of supply both in fuel mix but also in the geography of where it comes. If we look at the LNG supplies in 2002–03 to Europe they come from a range of countries, Trinidad, Algeria, Nigeria, Qatar, Australia and indeed it is very feasible to consider LNG will come from Russia in due course. Yamal peninsular gas may come to the UK by sea rather than pipeline.

Thirdly, the arrival of LNG provides a competition on product and price in the local market. Fourthly, and here with 20 years as an Investment Banker I start to lick my lips with this element of infrastructure development. With the Bunde Emden hub developing poorly and Zeebrugge only developing itself by another 4.5 BCM's there is a very real opportunity for the UK to develop as a major LNG hub, especially if the EU goes slow on liberating and liberalising

its old contracts. And finally LNG quite clearly utilises our geography: Milford Haven is a fantastic deep sea port.

**The third question which you asked me Chairman was “Have the markets delivered in the UK?”**

My answer is a resounding yes! If we look at the long term gas market in the UK we see £10 billion worth of investment in the UK, that is a development of 100 BCM's of additional gas. LNG represents 30–40 BCM's of that and we should point out that some of these LNG projects are ground breaking in terms of size. The Exxon Mobil/Qatar project at Milford Haven has a total cost of \$12billion with \$7.6 billion refinancing this includes liquification plant as well as train development in Qatar as well as a fleet of tankers. Secondly, we see the market responding in the short term only a few days ago Conoco Phillips announced that they would be delivering LNG into their Teesside terminal for October 2006 to take advantage of the current supply demand ratio in the UK. This latter development if any of them shows that markets deliver entrepreneurial solutions and that, markets deliver.

To conclude I believe we have very healthy markets in our gas business. Currently we have massive new investment, we see many new major players either entering, or wanting to enter, the market (GazProm, Dong of Denmark and Gaz de France to name but three major players), Sonatrach have

also entered the market and we also see the development of new products.

**Let me now move on to your fourth question which is “How does regulation fit into the gas and LNG equation?”.**

Now in the UK Ofgem does not regulate offshore instead those players in the market and indeed players outside the market look to the actions of Ofgem to gain an understanding of the rules of how a market will behave and to see whether there is transparent and clear information available for those either in or wanting to join this market.

Ofgem essentially has 5 roles.

Firstly it can provide clarity on market rules and this was most recently proven by our rulings on the use or lose it provisions at the Isle of Grain LNG facility where we forced BP and Sonatrach to make their intentions clear.

Secondly we can examine markets where price movement warrant, it as in our 2004 gas probe or whether contracts look strange as in our more recent Sean Field enquiry.

Thirdly we are consistent in our demand from both the UK and Europe that markets will only work if we have full information. Indeed only in November we were forced to write to the Commission to seek redress for the bizarre movements in price and the lack of volume following price in the near Continent as well as the behaviour of Spain in the LNG market. Markets get very frightened by lack of information particularly when strange events occur.

Fourthly we obviously will support and are a keen advocate of the EU road map initiative indeed the Chairman of Ofgem is now the Chair of both ERGEG and CEER, the regulatory bodies central to Europe. Finally we will act in our primary role which is as a regulator of pipes and wires where we have a responsibility, and an example of this with reference to LNG is the development of the pipelines to Milford Haven and the development of the trans pennine pipeline within the UK.

In conclusion Ofgem wants to be part of and wants to ensure sure that there is a creation of a stable, fair, light handed regulatory approach so that investment which is what to today conference have met for can flourish.

## 2. UK: A model of investment 1986–2006?

Now in order to respond directly to the challenge that since 1986 and the gas privatisation there has barely been any investment in the UK and indeed the UK as a liberalised market has sweated its assets to the position that we are in great danger. This is the thesis that Dr Helm outlined to you in his presentation which I now have to unravel with fact.

Let me firstly deal with power and gas markets and the investment that has incurred in the UK in last 20 years. Firstly, in electricity generation during the 1990's we have seen 20 GW's invested in gas fired power stations providing the UK with modern, flexible, and for the most of the time

cheap fuel from new stations which now represent 40% of Great Britain's requirements.

Secondly we have seen 11 GW's of our 27 GW's of coal fired plant retro-fitted with FDG and also those plants have had nitrous oxide burners put on to them.

Thirdly for environmental performance as the recent UK Government energy review paper published by Minister Wicks outlined the energy sector has been the star performer in helping to meet our 1990 emission targets and the report was also honest enough to outline that the public sector has performed dismally.

Fourthly on investment in wholesale electricity markets I must comment on the fact that there has been no new power stations built since the year 2000. This is primarily because at the end of the 1990's we were in the position of having over 30% reserve margin, and no system that has been well constructed and is well run needs that level of reserve capacity, and consequently that surplus capacity was run out of the system. The good news is that the market has worked properly because when those reserve margins fell from 30% to 16% in the two years before October 2003, with a consequent decline in the price, it then rose and power plants came back onto the system to deliver a reserve margin of around 20-23% consistently for the last two years and looking forward to the next 3-5 years.

Finally with regard to generation you may think that listening to others commentaries on the UK that there is no plan to build new plant, again it doesn't appear to be

supported by the facts: Electricity de France has recently announced that it would like to build a 1.2 GW's facility at Sutton Bridge and a 2 GW's at West Burton. E.ON has announced major plans Drakelow, Grain and possibly a new coal fired plant. Similarly, RWE at Pembroke and Centrica at Langage near Plymouth. These are serious projects following up behind the ESB of Ireland's new plant at Marchwood.

Enough said on the generation side of the business in terms of investment I hope that a few facts have put some issues here to rights.

For the gas business I have outlined in my LNG comments on the massive investment that is occurring. This investment is provided by the markets but Ofgem has done its part by allowing a £2 billion spend in the last gas price review – a level unchallenged by Transco. The Competition Commission challenge is particular relevant in gas because of the health and safety implications associated with under investment.

Now let me move on to the defacto market or the market which Ofgem regulates: the market of the wires and the pipes. There has been massive investment since privatisation. I calculate that we have supported £20–£24 billion worth of investment in our infrastructure. That includes £16 billion alone in the local electricity distribution network and £4 billion for the National Grid high voltage network. As two of the utility companies asserted to the Trade and Industry Select Committee in 2003 they had seen

respectively 30% and 80% more capex spent in the 13 years post privatisation than the 13 years before privatisation.

My second point on investment in networks is that we have mandated a significant increase in capital expenditure in the local distribution networks as recently as December 2004 to take effect from 2005. In that review we supported an increase of 48% in the capital expenditure with a potential spend above that which if the companies utilise all allowances which could take the 5 years 2005–2010 versus the previous 5 years to an increase of 57% in capital expenditure. This is clearly not a regulatory regime seeking to deny the fact that assets have a working life and must be replaced at the end of that working life, and consequently we recognise that wire systems that were put up in the 1950's and 1960's have reached the end of their useful lives and need replacement.

We have also fully funded and facilitated the funding of the investment needed for the renewables project. This network investment has so far yielded an initial allowance of £560million to be invested in upgrading the network.

Finally on new spend looking forward to the high level voltage price reviews of 2006 for the electricity and gas networks we are fully expecting to see substantial increases in the capital expenditure asked for and allowed in these reviews. The energy review quotes a figure of 165% increase in capex as an initial expectation.

My next point on networks infrastructure investment must focus on the benefit that consumers have had because

clearly one of the criticisms launched by Dr Helm at the UK market is the sweating of UK assets with the implication possibly that we have been running the assets to the point that there is danger. Customers enjoy one of the best performing grid companies in the world indeed the DTI recently analysed that only Holland betters the UK performance. We assess that National Grid to be operating at 99.9% performance levels and more recently it has attained some of the finest performance in its history. But what about the impact for the man in the street? In the GB the industry delivered from 1990 to 2004 a 30% reduction in outages and at the same time the length of those outages fell by 11%. In the last year the figures for both duration and length of outage have been down by a further 16%. **It is quite clear that we are allowing new investment and the customer is getting an extremely good deal.**

May I finally come to my last point on network investment and that is that we must ensure as sensible regulators with a remit to protect consumers and to ensure that they do not have to pay an amount that is unreasonable that **“we have a gold system but not at a platinum price”**, indeed I have been told by the Trade and Industry Select Committee of the UK Parliament in November 2004, that we must not go down the route of overspending on a system which is performing at a very high level. The best example of this was the Trade and Industry Select Committee instruction to Ofgem was that we should not move to the N2 standard from the N1 which would have cost consumers another £450 million because it was not justified.

We cannot discuss investment without acknowledging cost of capital. One of the significant achievements of Ofgem since 1994 has been to create an orderly approach to cost of capital: this creates confidence and stability in the capital markets. In 2004 we had to set the cost of capital for the local distribution electricity network companies. Our approach was to balance the needs of providing the right incentive to encourage investment (as we were setting 50% increase in capital expenditure), while acknowledging the long term nature of the business, and ensuring that the consumer got the most competitive deal possible. Although it might have been tempting to go for a short term “political win” by focusing on collapsing debt markets – especially as prices were rising due to oil/coal/gas wholesale movements – Ofgem took learned academic advice on a long term rate for cost of capital. Consequently we set a cost of capital well above the cost of debt (4.8% versus 4.1%), and since then debt markets have continued to fall. The companies may make short term gains but we expect them to meet their capital expenditure commitments, and they know that we are monitoring this very carefully.

I hope in the last few comments and yes – my speech has included some facts I have been able to outline that there has been massive investment in the UK in the last 20 years either by the market or by the defacto markets in the shape of Ofgem, Offer and Ofgas.

Now having disagreed fundamentally with Dr Helm’s proposition that the UK is a busted flush in terms of investment I must now address where we do agree with Dr Helm and where we do agree with him is that we are faced

with new pressures, new pressures emanating from a focus on carbon, on a focus on sustainability, and from renewed concerns on security of supply. Whilst we agree on these new challenges **what we would say at Ofgem is that you don't have to rubbish the past in order to handle the future!**, and what we need to do is to work out how we can evolve what we have with the new challenges that we must meet rather than to seek to create a revolution by throwing every thing out that has been developed. **What we must not do is allow ourselves to believe that it is markets that have created these new challenges and that a country that opts not to go for a market model does not face these new pressures, they do.**

If I may conclude therefore we believe that a market structure which is seeking to address these new challenges is a healthy way forward and the Government in its energy paper on 23 January which has started the government's review of energy policy outlined its commitment to the four pillars of the 2003 white paper, and one of

those pillars, was markets. In this 2006 energy review the Government rightly points out that we should seek competition where desirable and regulation where necessary.

Thank you very much for allowing me to speak at this very august meeting.