

The Energy White Paper: The Regulator's Role

**UKBCSE NATIONAL CONFERENCE
The Energy White Paper – One Year on ...**

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This is Alistair Buchanan's speech on the Energy White Paper - one year on.

When I asked my colleagues in preparation for this speech their views on what I should talk about, a number of them asked me to play it safe. I could outline for 20 minutes our statutory duties in detail, and whilst undoubtedly important, it's probably as interesting before lunch as watching paint dry. So rather than read out my section 3 responsibilities, my focus in the next 20 minutes is to outline how we are seeking to live within this new agenda. We felt privileged as an organisation to have an input into the White Paper process, out of which Ofgem has two flags, to which we can rally: 1) The firm belief in markets, 2) an environmental and social guidance, a simpler format to which we seek to aspire. So with these two flags let me seek to address firstly the climate change agenda and secondly the security of supply agenda. By focusing on these two issues I will encompass the four goals of the White Paper. One; to reduce carbon emissions, inline with Kyoto, two; to maintain reliability of security of supply, three; to promote competitive markets and four; to ensure every home has adequate and affordable heating. Finally, I will seek to make this speech as up to date as possible by drawing your attention to our Renewable Obligations Annual Report published last week, our three year corporate plan published yesterday. I will also try to draw key elements from our December consultation paper on this year's Distribution Price Review, much of which will be updated in tomorrow's March price review paper.

So, what is Ofgem doing on the climate control agenda? Four things: one; we are central to the administration, two; we act positively within our remit, three; we must be seen to be a listening organisation and four; we need to have a role that is one of encouragement for change.

Let me start with our first role, that of administrator. It sounds nice and dull, and that's what we intend it to be. As my audit partner once said to me; "our clients don't want film stars to audit their books, dull can be good". But there is an importance to doing our administrative duties well, it gives confidence to the markets and gives confidence to the users. So what do we administer? We administer the non-fossil fuel obligation, the CCL and most high profile is with regard to the renewables obligation. It is this which is Ofgem's linkage to the government's main policy measure to encourage renewables in the UK, as outlined in the White Paper. Such as the commitment that, as you know, in December 2003 the Government expanded the deadline for this scheme, from 2010 to 2015. Now our job includes issuing the certificates and their Scottish cousins, monitoring compliance, receiving buyout payments and redistributing the buyout fund, and accrediting power stations. Let's put some colour in here from our recent report. 23 suppliers last year received £79 m in England and Wales and £11 m in Scotland. 5.6 m ROCs were issued or looked another way, 9.3 TWh hours and 431 stations got Ofgem accreditation at the beginning of the year and that was up 505 by the end of the year. This is a heavy responsibility which we take very seriously. A loss of confidence in the process, could be wounding to the policy.

Let me move on to our second point, acting positively. Now internal to Ofgem, we have carried out a corporate restructuring in February. Within this you will see that the Environmental division now sits within the Strategy function. That I think is encouraging, because we find that so much of what we do, in terms of strategy, has an environmental element to it. We are also very committed to supplying, at the most senior level; input onto key committees such like the Environmental Advisory Group.

But what of the impact on policy? There are a number of areas here but in the time I have this morning I want to focus on some areas related to the Distribution Price Control Papers; issued in December 2003. In response to the Government's renewables plans, Ofgem has been reviewing the development of distributive generation and more recently this has included the innovative funding initiative and regional power zone concepts. As you will see, we are keen to, and be seen to, balance incentives with our primary role for customers. As you will appreciate, there is a two way pull for Ofgem and I hope that you feel that when you read the document tomorrow, that we have got it right. I believe that we have.

Let me move on to the third area; that of listening. In my 20 years as investment analysis in London and New York, I'm not ashamed to say that many of my best ideas came from others. Fortunately, I was never accused of "doing a Handel" or plagiarism, but what I am trying to illustrate is the power of listening. Both Sir John Mogg and I are committed to making Ofgem a listening organisation. May I give just one example that has relevance to the white paper goals? You will see in our corporate plan published today, that we are evaluating the feedback on our 28 day pilot scheme. Having listened carefully, we believe the scheme will balance the appropriate safe guards to consumers with the need to allow the companies sufficient encouragement to offer energy services. Watch this space, on further details on the pilot scheme over the next few weeks.

Finally, Ofgem seeks to encourage. Now anybody who follows regulation knows well that regulators have formal and informal powers. The formal powers are clear, but the informal powers are often just as important. For example, when I worked in the USA, States regulators often gave their local companies boundaries. For example a 10-15 % allowed return on equity. A clever company understood the formal rules of 10-15% but watched the informal side like a hawk. For example if you go above 13 % return on equity it would trigger regulatory interest, if not outright intervention. So, how does Ofgem use this informal power positively and carefully but stay within our formal remit? Our encouragement in the fuel poor area is a good example. We encourage switching, where 51% of the population have now tasted the benefits of such. We support companies to be imaginative over developing tariffs and we encourage best practice, particularly in areas such as energy efficiency. Some of these initiatives are on the edge of our formal and informal powers and I'm alive to the possibility of creating an unfulfilled expectation and therefore and disappointment in Ofgem's performance.

So we believe that we can assist the climate change agenda through good administration, positive action, listening and encouragement of best practice.

Now let me turn to the second agenda item and that of security of supply. Now firstly, Ofgem clearly believes in markets and is encouraged by the government's comments within the white paper. The electricity market has been tested over the winter, for the first time since meter was introduced. The response has been encouraging with 16 % reserve margin on my first day on office on 1 October 2003 to over 21% recently before

some plants started to close for the summer. Also encouraging, was the fact that prices rose in response to straight forward market dynamics. However, we do not want to give the impression that Ofgem is complacent and over the next few weeks, we will review the winter of 2003/04 and look towards 2004/05. Why should do this? We should do it to see if there are lessons to be learnt and to see if we can signal earlier our views for 2004/05. Now what might this review include? It might include incremental reform, gas information improvement, such as scheduling charges based on nomination at the end of the gas day; it might include short term mechanisms, reserved auctions, maxgen modification, demand side management mechanisms. We will review of shipper's delivery performance of flexibility of CCGTs. Further out, we know of other 'mothball' plants, a new hydro scheme and a few new gas fire plants. But what about the old coal fire plants coming to the end of its days and Magnox and AGR plants starting to wear down? We believe that the prospects in the short term are good, but there could be a possible pinch point toward 2010. The LCP directive for one will have an impact. Our answer currently, is that we believe that markets will respond and that this market is largely mature and that we need to be vigilant over few year to ensure that the market does in fact work properly. If no plant has been commissioned, by let's say 2006, and prices are substantially above new entrant price, then Ofgem will have to think carefully about its situation. Should that be the situation, then unless something very odd happens, I'm sure a market base solution will be the response. Clearly, and we have seen it **very** overtly this winter, no electricity security of supply situation can be seen in isolation from that of gas. Indeed, in NGT's Winter Operations Report in October 2003, they highlighted the impact of gas being shipped at 80 % to beachhead potentially wiping out 2 GW of availability of the 5-6 GW cushion. So when we peer ahead to gas, what do we see? Transco has warned us of a 21 bcm shortfall by 2008/09 in its recent year report. Other commentators point to a pinch point as soon as 2006/07 and yet others look at a much bigger shortfall than that National Grid Transco. Again, without sounding complacent, the answers based on market based solutions can be grouped on a number of fronts: Interconnector enhancement, new pipe lines, LNG, further storage developments, near continent storage, swing field behaviour and interruptability or DSM. In my opinion the market signals are stronger in gas. We are seeing 10 times traded over physical versus 2 times in electricity and formal forward auction and price curves whereas electricity tends to die out after two to three years. Now security of supply is not just about markets it's also about networks and Ofgem was very pleased with much of the Trade and Industry Select Committee reports of early March. They did not want Ofgem to micromanage, nor did they want gold plating of the system and no complaint had been made by any of the parties about underinvestment in the 13 years post vesting. Tomorrow we publish the Distribution Price Review and ask you look very carefully at the submissions of the companies on Capex. We are in consultation at this time and we welcome your response to I think you'll find an interesting read. On the back we will seek to balance wired development with customer's prices properly and fairly as we should.

To conclude, there are some commentators who argue that the white paper missed the opportunity to re-organise the regulation of the energy sector. As a former investment banker, I am always ready to discuss Corporate Structure and therefore the shape of energy regulation and Ofgem going forward. However, my immediate concern is that these views suggest that Ofgem today is not up to the tasks in the White Paper. I hope I have shown in the last few minutes that nothing is further from the truth. Indeed, we believe that we are in an organisation set on operating in an efficient way to achieve these goals. We have recently undergone a major reorganisation to enable us to meet the challenges ahead. We have also set ourselves the target of living under our own

regulatory assessment test laid down under better regulation guide line. From next April, we shall operate under a RPI-X budget regime.

So, to conclude, I hope I have illustrated that both in our policy responses and in our organisation we are well positioned to handle the changes of the White Paper.

Thank you very much.