

## 14.03.01

### **John Wybrew, Executive Director Lattice Group plc, Speech to The Adam Smith Society 6th Annual Conference on The Future Of Utilities**

#### **The British Gas Market connected to Europe – new forces, new priorities**

Only yesterday, the European Commissioners approved the publication of new proposals to amend the European Gas Directive. This potentially far-reaching initiative stems from the fact that, in spite of its liberalising principles and objectives, the impact of the 1998 European Gas Directive has so far been modest.

Gas-to-gas competition as the principal determinant of gas prices in Continental European markets is no closer to realisation. And with today's high oil prices, the indexing of gas prices to oil prices is causing gas consumers to suffer from market forces which have little to do with the fundamentals of gas supply and demand. The European Union still comprises fifteen largely separate gas supply systems, and the benefits to consumers of a pan-European wholesale market for gas remain as distant as ever.

The European Commission's new proposals have been devised to address these serious shortcomings with practical measures to enforce beneficial change.

1998 European Gas Directive – then and now

One thing is sure. The Commission's proposals will get more careful attention from the British gas industry, its consumer representatives, its Regulator and the British Government than the first European Gas Directive which came into force in 1998.

Three years and more ago, the development and enactment of the European Gas Directive was regarded as largely immaterial to Britain and the British gas industry. Britain was already well ahead of the rest of the world in liberalising its gas market – the largest in the European Union – and in introducing competition and choice to its 20 million consumers. There were ample supplies of UK offshore gas to cover the immediate and foreseen needs of the market. Liberalisation had exposed the producers to competition, with considerable benefits for gas consumers.

In 1998, the Interconnector pipeline to Continental Europe had just been commissioned. This was conceived not so much in terms of the physical and commercial linking of the British market to those of Continental Europe, but as the means of exporting surplus UK gas for a decade or more. In policy terms, it was also seen as the means of bringing the benefits of gas-to-gas competition to other North West European markets – of Britain exporting our radical model of market liberalisation.

How different things look in three short years.

This winter, another comparatively mild one, UK gas producers have been hard pressed to deliver enough gas to the beach, and the Interconnector – operating in reverse flow – has played a not insignificant part in meeting the steadily growing demands of the British market. With oil prices more than double those of three years ago, UK gas producers have understandably been grabbing every opportunity to sell any surplus gas into Continental European markets with their oil-indexed prices. Ironically, the most liberal gas market in the world now finds its wholesale prices largely dictated by those set in much less liberalised Continental markets. In consequence,

wholesale gas prices in Britain have doubled and, like it or not, this will progressively impact on retail prices to millions of gas consumers.

In another twist of irony, the Climate Change Levy on business energy consumers is due to come into effect on 1<sup>st</sup> April. This economic instrument was also conceived about three years ago at the time of low energy prices. It responded to concerns that the liberalisation of Britain's gas and electricity markets had been so successful in driving down consumer prices in real terms that there was little stimulus to greater energy efficiency. Now, of course, it will have the effect of leveraging much higher gas prices – no doubt to the benefit of the environment, but the discomfort of business consumers.

New forces, new priorities – addressing future challenges

The theme of my contribution to the conference is the interplay of new forces and new priorities now that the British gas market is linked physically and commercially to those of Continental Europe. So far, I have sketched a picture of rapid and largely unexpected change.

So where does this leave us as we look to the future and the need, as ever, to adapt the framework of public policy and regulation for the British gas industry to the uncertainties and challenges which lie ahead?

Let me make three points, and then expand on them:

- First, the British gas market – and therefore British energy policy – is now inextricably linked to those of Continental Europe. Gas is already close to supplying half our primary energy, and this proportion is likely to increase. The exploration for gas in UK waters may yet surprise us, but it looks as if we will become increasingly dependent on gas imports to help meet our winter requirements.
- Secondly, this means that we can no longer adopt an isolated position as regards the British approach to gas market liberalisation. Our goal must be to engage with Europe, and to work towards a pan-European wholesale market for gas – a model which is safe, reliable and efficient; which recognises the diversity of Europe; and which delivers to consumers the benefits of gas-to-gas competition and universal access to the transmission networks.
- Finally, in doing so, we must be forward-looking, recognising how rapidly, and often unexpectedly, things can change; and recognising also that secure gas supplies are so essential to our economies and societies that the drive for economic efficiency must be balanced against the attributes of robustness and adequacy.

Britain's gas market inextricably linked to those of Europe

Back then to my first point: the advent of a new stage in the development of Europe's gas markets; a stage in which Britain's large fully-liberalised market is now inextricably linked to those of Continental Europe – and not to forget, to the fast-growing gas markets of Ireland and North Ireland.

Why have we shifted so suddenly and unexpectedly from being self-contained and independent to being linked to the rest of Europe?

The Lattice Group's principal subsidiary company Transco – the provider of Britain's onshore gas infrastructure – saw the first evidence of the changing supply/demand outlook in 1999. As required under Transco's licence, its planners had consulted widely and updated their supply and

demand projections for the British gas market. Since the development of North Sea gas in the late 1960s, there had always been a 'bow wave' of developed production potential more than sufficient to meet the needs of the growing market some years into the future. Transco's 1999 projections showed the same buoyant growth of gas demand, now driven primarily by the increasing use of gas for power generation. But the outlook for future UK gas production had begun to tighten significantly.

At first this was thought to be a temporary blip – a result of the austerity measures forced on UK producers by the then weakness of oil and gas prices. Yet the same exercise last year showed a further marked tightening in the gas supply outlook, and that picture has not changed more recently in spite of the sharp increase in the wholesale price of gas.

#### Winter dependence on supplementary gas imports

This winter, the outlook of supply tightness has become reality. Transco is required to have enough gas transportation capacity to cover the theoretical worst winter conditions in 20 years based on past temperature statistics. This winter that would equate to a demand level of 520 million cubic metres a day. Thanks to the extra demand-side flexibility in Britain's liberalised gas market, the highest daily volume which the supply side has had to provide is 415 million cubic metres – the same as last winter's record level.

At the start of the winter it was expected that, in total, the producers would be able to deliver at least 400 million cubic metres of gas a day at times of high demand. Yet in practice, the upstream side of the industry has fallen at least 10% short of this level, and the shortfall has been made up from stored gas and imports through the Interconnector.

Even if the economic stimulus of high gas prices is coupled with successful exploration and appraisal to boost the future supply of UK offshore gas, it does not follow that the British gas market will cease to be dependent on winter imports. When we had a comfortable surplus of indigenous gas production on an average annual basis, there was little need to worry about the typical seasonal swing of well over 250% between summer and winter levels of demand. Compared with much of Europe, our development of gas storage to help manage this problem has been limited.

Now our handling of the winter peak becomes more critical, reinforced by new forces and dynamics. Freed from their traditional long-term supply contracts following market liberalisation, UK producers are using every opportunity to sell their surplus summer gas into Continental markets so as to realise high oil-indexed gas prices. This in turn increases the depletion of reserves. So long as gas prices remain high, the electricity industry's use of gas under the New Electricity Trading Arrangements is likely to be more seasonal. And the growing call for gas from the island of Ireland, North and South, is becoming a material new factor.

Like it or not, Britain's self-contained, self-sufficient gas market looks like being a thing of the past. In future, our gas market – and therefore our energy policy – is likely to be inextricably linked to those of the rest of Europe. This is the new reality, which must be squarely addressed. Europe's common goal – a pan-European wholesale market for gas

My second point follows from this new reality. As I said earlier, we can no longer adopt an isolated position as regards the British approach to gas market liberalisation. We must engage constructively with the rest of Europe and work towards the common goal of a truly pan-European wholesale market for gas – a market characterized by universal access to the transmission networks, gas-to-gas competition and proper regard for the diversity and security of supplies of a vital commodity.

Britain's shared pursuit of this goal will need to start with the recognition that our current model of gas market liberalisation was the successful product of circumstances, which no longer exist. In

future the drive for economic efficiency will need to be balanced by the essential robustness and adequacy of the infrastructure – the underpinning of supply diversity and security.

Throughout the 1990s, in the transition from a monopoly structure to full market liberalisation, the British gas market was essentially self-contained. Importantly, there was also an overhang of surplus gas supply potential from the upstream industry. In consequence, the liberalisation of the market, and the dismantling of the long-term take-or-pay contracts between British Gas and the producers created gas-to-gas competition both upstream and downstream. Gas consumers benefitted considerably, with gas prices falling by over a quarter in real terms.

Today, the same principles of liberalisation that forced UK producers into competition to place their gas in the self-contained British market have freed them to export via the Interconnector in pursuit of high oil-indexed Continental gas prices. For gas as for other fossil fuels, Britain is no longer an 'energy island'. The interests of British consumers as regards prices and security of supply are no longer different from those of Europe as a whole.

Advancing the liberalisation of European gas markets – the need to be forward looking

Given this, let me turn to the last of my three key points – the need for the new measures to advance the liberalisation of European gas markets to be forward looking. In this, we must recognise how rapidly, and often unexpectedly, things can change. We must also recognise that secure gas supplies are now so essential to our economies and societies that economic efficiency is no longer the be all and end all; the attributes of robustness and adequacy need to be prime policy objectives; and we will probably need to devise new stakeholder governance arrangements for planning the development of gas infrastructure.

Talking of the need for public policy and regulation to be forward looking and robust against unexpected change, we have only to look at California's current electricity supply problems to see how badly things can go wrong. California's current problems are a classic case of well-intentioned but ill-judged decisions made in the collective expectation of a scenario which did not pan out.

Opinion on how best to advance the liberalisation of European gas markets is still widely divided. It ranges from the adoption of the fully-competitive British model to those who argue, on grounds of supply security, that nothing must impair the capability of the big vertically-integrated gas companies from using their buying power to underwrite long term take-or-pay contracts with the major exporters to Western Europe. In our view, neither alternative would be the right approach to the challenges of the future.

The British model of gas market liberalisation was uniquely appropriate to our circumstances throughout the 1990s – an essentially self-contained gas market consistently overhung with surplus supply potential. Given the prospect of tighter UK supplies and the likelihood of growing dependence on gas imports, we would in any case need to address the balancing of supply diversity and security against the drive for efficiency.

Equally, while the role of Europe's big vertically-integrated downstream gas companies in underwriting major gas import schemes and related infrastructure projects has contributed greatly to the development of the European gas industry, the priorities going forward are different. Europe now has a highly-developed gas transportation infrastructure and mature sophisticated gas markets.

Meanwhile, the British gas industry has demonstrated both the feasibility and the considerable benefits – in terms of sharply focused specialisation – of carrying out the gas transportation and supply functions in different companies, each under separate ownership.

Future challenges – the need for supply diversity

Looking ahead, the big challenge facing Europe and its gas consumers is the increasing proportion of gas in the overall energy mix, and Europe's growing dependence on gas imports, most notably from Russia. Conventional forecasts indicate that by 2030 about 70% of gas demand in the European Union will be met by imports.

With 5% of the world's population, Western Europe is fortunate in having potential pipeline access to about half the world's gas reserves, as well as LNG from locations such as Nigeria, the Middle East, and prospectively Egypt. It follows that our prime policy objectives must be supply diversity as well as supply security. Over dependence on one major source, however important, is a hostage to fortune.

Earlier this week we had the good news that the Norwegians are preparing to liberalise their gas industry and open up their large offshore gas reserves to European customers on a competitive basis. The thrust of liberalisation from Norway will be vitally important to the creation of a truly pan-European wholesale market for gas.

Another important factor is the maturing of the international trade in LNG. Imports of LNG to Europe will have an important part to play in providing supply diversity – in counterbalancing the scale of Russian imports with competitive pressures. Further afield, countries like Kazakhstan have the potential to provide further supply diversity and competitive pressure.

A pan-European wholesale market – prime policy objectives

But supply diversity will have little practical benefit in delivering supply security and competitive benefits to Europe's consumers if the multiple flows of imported gas cannot freely be moved throughout a pan-European wholesale market. Our prime policy objectives are therefore clear:

- first, universal access to Europe's gas transmission networks;
- second, easy and practicable connectivity between the national transmission networks to create a coherent user-friendly network of networks;
- third, a common carriage commercial regime which conceptually treats the European transmission networks as a series of connected 'tanks';
- and finally, specialist unbundled transmission companies and system operators to ensure that the networks are developed and operated efficiently, reliably and even-handedly for the benefit of all users.

With supply security as a prime objective, gas storage also has a key part to play in the efficient and dynamic balancing of supply and demand. As with transmission, gas storage needs to be accessible to the market on an open, competitive basis. Arguably, there could also be a case to impose a defined minimum requirement on gas suppliers to safeguard some classes of their customers with gas storage.

Gas storage apart, the transmission networks themselves must be robustly adequate, providing sufficient flexibility to accommodate future change and uncertainty. Evaluating and weighing the trade-offs in this regard will require the development of new stakeholder governance arrangements. These in turn will need to be conducive to investment and the fair treatment of the problem of 'asset stranding' where it arises.

Earlier, I have argued that the British model of gas market liberalisation would in any case need to be adapted to the challenges of the future. Nonetheless, our experience in Britain has demonstrated that there are no over-riding practical or economic constraints to the achievement of the prime policy objectives, which I have outlined.

## Conclusions

To sum up, yesterday's proposals from the European Commission are soundly based. Successfully implemented, they will advance the progress of gas liberalisation to the benefit of Europe's consumers. Importantly, the proposals seek to address the challenges of the future – the balancing of the drive for economic efficiency against the need for supply diversity and security.

As regards implementation, the devil will lie in the detail, but there are no practical obstacles which cannot be overcome. Here, the experience of the British gas industry - and not least the Lattice Group, and particularly Transco – has a potentially valuable part to play. We will certainly be making a strong and constructive contribution.