

THE EARLY STAGES OF LIBERALISATION: THE CASE OF GAS

Eileen Marshall

Clare couldn't be here today so I have been asked to relay her views, and I shall return to these again tomorrow during the discussion on Organisational Cultures and Governance.

Clare Spottiswoode's views

What has worked well:

" Limited clear objectives, relatively small expert teams, independence (from political influences primarily, but more generally from any outside interest that would seek deviations from the limited clear objectives) "

What has not worked well:

"Proliferation of objectives, larger bureaucratic organisations, erosions of independence and, most importantly, an associated involvement of the regulators in making what are in effect 'tax and spend' decisions".

What have we learnt:

" That it would be better to cull the objectives and bureaucracies and seek stronger checks and protections against a repetition of the cycle".

Clare's views on what worked well accurately describe the situation when she was Director General of Gas Supply(DDGS) from November 1993 -1998, when the government committed to the rapid introduction of domestic supply competition and when the Gas Act 1995 strengthened and widened the Regulator's pro- competition duties.

The proliferation of the things that Clare considers hasn't worked well was first facilitated by the Utilities Act 2000. The Act provided for the merger of Ofgas and Offer to become Ofgem, required Ofgem to have particular regard to

customers on low income and to follow government -issued guidance on social and environmental policies, and introduced a Board to replace the individual regulators.

But the period of gas liberalisation and market opening began in the earlier period before Clare was appointed, and it was lessons learned in that period which laid the foundation for the rapid progress towards liberalisation which was initiated when Clare was Director General.

The early years 1986-93: attempts to liberalise the industrial and commercial markets

When it comes to deciding what didn't work in terms of liberalising the gas markets the provisions of the Gas Act 1986 has to come top of the list.

The Act provided for British Gas (BG) to be privatised with its vertically integrated monopoly of the on-shore gas industry intact.

The arrangement was heavily criticised at the time, including within government, as being unhelpful to the development of gas-on-gas competition. But the views of the Secretary of State and BG prevailed.

At the time of privatisation BG was given a 25 year franchise monopoly of supply to some 16.5 million tariff customers (accounting for about 70% of gas sales). In addition there were a small number of very large industrial users comprising the contract market.

The Gas Act 1986 allowed potential competitors to negotiate with BG to use its pipelines in order to supply the contract customers, and gave the DGGS the power to set terms for access if the parties could not agree them, but only if help was requested.

Even though the DGGS had a duty to promote competition in the contract market, a late addition to the Gas Act, the regulator had no further role in the contract market, or in the regulation of the gas transportation network, except to the extent that the costs had to be taken into account when re-setting the tariff market price control.

In principle the contract market was opened to competition in 1982 under the Oil and Enterprise Act, on a similar negotiated access basis, but competition didn't develop.

Even with the help of the DGGS it took until 1990, 8 years after negotiated third party access was introduced, for the first agreement to be put in place, and according to the regulator it was not used because by the time it was finally sorted out the potential supplier had lost its source of gas.

This system of network access was doomed to fail. Not only was it protracted, giving BG ample time to alert its supply business to the potential loss of a customer, there was also no attempt or incentive to charge competitors or provide access to them on the same terms as BG's own supply business, so competitors were always likely to be at a competitive disadvantage.

Because the DGGS did not have concurrent competition powers, it was the Director General of Fair Trading who, within a year of privatisation, had referred BG to the Monopolies and Mergers Commission (MMC) under the Fair Trading Act 1973, after complaints from large consumers.

The 1988 MMC report sought to address all the three main obstacles to competition that were present at privatisation.

- In relation to anti-competitive practices, it found that BG had engaged in extensive price discrimination and recommended BG be required to price against published price schedules.

- In relation to gas availability, where all gas from existing fields was contracted to BG on the basis of long term contracts, the MMC recommended that BG be able to contract for only 90% of gas from new fields so the remaining gas would be available for competitors.

- And in relation to pipeline access, the MMC recommended that BG should publish further information on common carriage terms, and said if competition in gas supply failed to develop over the next five years, further consideration should be given to the industry structure.

In 1991, a follow-up report by the Office of Fair Trading (OFT) found that competition had still not developed well, with BG retaining 95% of the market. Most of the gas released under the MMC's 90:10 rule had been diverted to the new power station market, and more plentiful supplies were not expected to come on stream until 1995. Also third party access to the gas network was not working.

The OFT put in place a series of undertakings:

- These included the drastic step of requiring BG to limit its share of the contract market to 40% by 1995, and to release gas to other suppliers to enable them to supply the rest of the market.
- To help solve the access problems, BG was to establish a separate gas transportation and storage unit with separate accounts. This unit was to be regulated and have a transparent pricing system to apply equally to BG's own supply business and to other suppliers.

However matters came to a head in July and August 1992, when there were 4 references to the MMC, two from the Secretary of State under the Fair Trading Act, after discussions with BG, and two from the DGGS under the Gas Act 1986.

Also in August 1992, following enabling legislation, the Government expanded the competitive market to include all industrial and commercial customers, reducing BG's retail supply monopoly to the domestic market.

The MMC reported in August 1993. It said that competition had increased in the contract market with BG's market share falling to 70%.

But it also said that the situation was artificial, being supported by temporary measures that restricted BG's own ability to compete.

All in all, the MMC concluded that BG's dual role as gas supplier and owner of the gas transportation system that competitors had to use to compete with BG, gave rise to "an inherent conflict of interest", which made it impossible to

provide the necessary conditions for self-sustaining competition.

The 1993 MMC report therefore made the historic recommendation under the Fair Trading Act reference, that BG be required to divest its supply business by 1997, to overcome an important deficiency in the industry structure at privatisation, and that the removal of BG's remaining retail supply monopoly should take place after divestment. In the meantime, under the Gas Act reference, the MMC recommended that divestment should be preceded by rigorous regulatory separation between BG's supply business and its pipeline network and storage facilities.

It can be seen that Clare became Director General at a crucial time.

The MMC's report had been published in August 1993, Clare became DGGS on the 1st November and the government responded to the MMC's recommendations on 21 December 1993.

The Government rejected the MMC's recommendation of compulsory divestment in favour of regulatory separation between BG's supply business and its transportation and storage business. However it went further than the MMC in committing to an early opening of the domestic market to competition.

Consequently, overseen by Ofgas, and in line with the MMC's Gas Act recommendations, BG restructured in 1994, creating a separate transportation and storage unit called Transco. This separation between BG's supply business and its network and storage business involved full physical as well as financial separation, with no shared costs or services and no shared buildings or facilities. This regulatory separation was accompanied by a split of the price controls and the introduction of a regulated structure of charges applicable to all users of the transportation network and storage facilities. Taken together these reforms were an important step towards establishing the neutral gas network, which the MMC had said was necessary for self-sustaining competition.

As far as the industrial and commercial markets are concerned, by 1995 the gas release scheme finished, wholesale gas became readily available and trading began in a new spot market. Competition developed rapidly and the requirement on BG to price according to published schedules began to be unnecessarily

restrictive. Ofgas first suspended the requirement for a year and removed the requirement permanently soon after.

In February 1997, BG voluntarily divested its trading arm, including its supply business, creating Centrica. So, as the MMC had hoped, divestment finally removed the “inherent conflict of interest” that it identified in 1993, and to the same timetable as the MMC had recommended.

Liberalising the domestic market and wholesale market reform

a) The introduction of Domestic Market competition

The Gas Act 1995 paved the way for the phased introduction of domestic competition between April 1996 and May 1998.

The DGGS was given the responsibility for issuing new supply licences. The new licences included a set of standard licence conditions. These embodied the principle of equal obligations on all suppliers which was an important feature of the new competitive market, and consistent with the MMC’s concept of self-sustaining competition.

A lesson from the opening of the industrial sector to competition was the importance of preventing anti-competitive behaviour by a dominant supplier. The new supply licence therefore included a condition which was designed to prevent predatory pricing and other related forms of anti-competitive behaviour. This condition was used by Ofgas to investigate potential predatory pricing several times in the early stages of domestic market opening.

In setting BG’s new supply price control, which would span the period of market opening Ofgas put in place transitional tariff caps, on both the standing charge and the per unit charge for each of BG’s tariffs for an initial 3 year period to April 2000. With customers safeguarded from unjustifiably higher prices, BG was free to introduce additional tariffs in response to market developments, subject to the licence condition which prevented predatory pricing.

Competition developed well with significant new entry and helped by a large reduction in wholesale gas prices. The transitional price caps were removed in stages between April 2000 to April 2002 in favour of ex-post regulation, influenced by the fact that the 1998 Competition Act came into effect in March 2000.

Between 1995, when BG first started to rebalance its domestic tariffs soon after the announcement that competition was to be introduced and 2002, when the final price control was removed, Ofgas reviewed the structure of BG's tariffs nine times. It was a lesson in how difficult it is to protect customers with price controls, guard against predatory pricing and make sure that the prices are not restricting competition, all at the same time.

b) Unbundling to promote competition

The 1995 Gas Act did not only provide for the opening of the domestic gas market. It also expanded the scope of the competition duty to include securing competition in pipeline extensions and connections and in the ancillary services of gas storage, meter reading and meter provision, all of which were at the time included in BG's transportation and storage price control.

These new competition duties meant that over time Ofgas was able to 'unbundle' these potentially competitive services over which BG had a de facto monopoly and separate them from its natural monopoly pipeline network, to make it easier for competition to develop in them.

The separation of gas storage from the transportation price control in 1997, with a three year transitional revenue cap, was the first step taken towards the deregulation of gas storage. Later price regulation was removed and replaced by undertakings given by BG to auction all of the capacity instead, with the first auctions taking place in 1999.

In May 2000, the first step towards the deregulation of gas metering and meter reading began, with the disaggregation of the existing transportation price control and the creation of three separate controls.

c) New Gas Trading Arrangements

The final step in gas industry reform in this period was the establishment of new market-based gas trading arrangements, the first phase of which was introduced in 1999, which included an independently operated, screen-based "on-the-day" market (OCM) which the gas shippers could use to fine tune their own balance of gas inputs and off-takes, and which Transco could use in its role as residual gas balancer of its transmission system.

Active forward and futures markets and a before-the -day spot market developed alongside the trading arrangements.

The 1986 Gas Act had established a wholly inadequate industry structure and regulatory framework for the development of gas liberalisation. But learning from the difficulties this caused, the Gas Act 1995 provided a legal background which enabled great strides to be made in liberalising the gas market in a relatively short space of time.

In 1991 BG was still supplying 95% of the large industrial contract market, and the rest of the industrial and commercial and the domestic market had yet to be opened to competition. But by 2002 the market was fully liberalised and significant complementary wholesale reforms had been undertaken.

In summary, in terms of gas liberalisation, the Gas Act 1986 didn't work, the Gas Act 1995 did work, while the 1993 MMC report had an important influence on the essential transition between the two.

