

Gas

Volume 1 of reports under the Fair Trading Act 1973 on the supply within Great Britain of gas through pipes to tariff and non-tariff customers, and the supply within Great Britain of the conveyance or storage of gas by public gas suppliers



MONOPOLIES AND MERGERS COMMISSION

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**Presented to Parliament by the Secretary of State for
Trade and Industry by Command of Her Majesty
August 1993**

Members of the Monopolies and Mergers Commission as at 30 July 1993

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¹These members formed the group which was responsible for this report under the chairmanship of Mr D G Goyder.

Note by the Department of Trade and Industry

In accordance with section 83(3) and (3A) of the Fair Trading Act 1973, the Secretary of State has excluded from the copies of the report, as laid before Parliament and as published, certain matters, publication of which appears to the Secretary of State to be against the public interest, or which he considers would not be in the public interest to disclose and which, in his opinion, would seriously and prejudicially affect certain interests. The omission is indicated by a note in the text.

Volume 1 contents

		<i>Page</i>
<i>Chapter</i>	1	Summary of the Fair Trading Act conclusions 1
	2	Conclusions to the Fair Trading Act references..... 5
<i>Appendix</i>	1.1	The references 57

1 Summary of the Fair Trading Act conclusions

1.1. In two references dated 31 July 1992 (see Appendix 1.1) the Secretary of State asked the MMC to investigate two subjects. The first was the supply within Great Britain of gas through pipes to tariff customers and to non-tariff customers. The second was the services of the conveyance, generally referred to in this report as 'transportation', or storage of gas by public gas suppliers. On the same day we were sent a reference by the Director General of Gas Supply (the Director) under the provisions of the Gas Act 1986 (the Gas Act), into the conveyance and storage of gas; and shortly afterwards a further reference by the Director into the fixing of tariffs for the supply of gas. We are required to submit separate reports taking into account the different statutory provisions of the two Acts, in particular the more limited scope of the Gas Act references, but much of the material and of our reasoning applies to both reports, and we have summarized the evidence submitted to us in volumes common to the two reports.

1.2. Gas accounts for nearly one-half of final energy used, excluding transport, in the UK, a significant increase since the mid-1960s when it accounted for less than 10 per cent. In 1992 British Gas plc (BG) supplied over 80 per cent of all gas supplied in Great Britain to non-tariff customers (until August 1992, users of over 25,000 therms a year). It is the only public gas supplier with special rights and obligations including a statutory monopoly in supply to tariff customers using below 2,500 therms a year. It controls almost all facilities for transportation and storage of gas in Great Britain.

1.3. When BG was privatized it retained the integrated structure under which it had operated as a nationalized industry. It was regulated under the terms of the Gas Act, while remaining subject to the general provisions of competition legislation.

1.4. In supply to the non-tariff market (the larger industrial and commercial customers) competition with BG has recently increased. This follows the introduction of a number of measures recommended in a 1988 MMC report¹ and recent undertakings given by BG to the Director General of Fair Trading (DGFT). These included an agreement to limit BG's share of this market to 40 per cent by 1995, to release gas to other shippers to enable them to supply the remaining share of this market, and to establish a separate gas transportation and storage unit. This unit would be subject to regulation and have a transparent pricing system to apply equally and even-handedly to BG and to other shippers. It would also provide transportation of gas and storage and other facilities on the basis of non-discrimination between BG and other shippers.

1.5. Competition in the non-tariff market, created by a number of regulatory measures, has been to the benefit of commercial and industrial users, increasing choice, reducing prices and stimulating BG to lower its costs, but is not evenly distributed. We are not aware of any sale by competitors of interruptible gas (which the supplier is entitled to stop supplying at times of peak

¹Gas: a report on the matter of the existence or possible existence of a monopoly situation in relation to the supply in Great Britain of gas through pipes to persons other than tariff customers, Cm 500, October 1988.

demand). Competition is also weak for large-volume customers. The present situation is moreover artificial, being supported by temporary measures that restrict BG's own ability to compete. BG's competitors are almost completely dependent on BG's transportation and storage facilities, and vulnerable to the prices BG elects to charge and its other terms and conditions for use of the network.

1.6. BG is both a seller of gas, and owner of the transportation system which its competitors have no alternative but to use. In our view, this dual role gives rise to an inherent conflict of interest which makes it impossible to provide the necessary conditions for self-sustaining competition.

1.7. The lack of effective neutrality of the transportation and storage system as well as the perception by users of this absence, and of the required incentives to secure new shippers, may be expected to reduce the effectiveness of competition in supply of gas to the non-tariff market, inhibiting choice, restricting innovation and leading to higher levels of gas prices than would otherwise be the case. Recent problems with the service to independent shippers, and concerns over BG's proposals for charging and future operation of the transportation and storage system, indicate the problems that will arise unless the neutrality of the network is assured. Similar considerations apply to the supply of gas to users of between 2,500 and 25,000 therms a year, where competition has been permitted only since August 1992.

1.8. BG has a monopoly of supply to users of less than 2,500 therms a year, who are mainly domestic users. The Government has announced that it is likely to abolish this monopoly. BG and a number of user bodies argued that the monopoly should be retained: a number of shippers argued for its abolition. We have noted that most tariff customers now have a perception that BG's quality of service is high following recent improvements. Nevertheless, we believe that eventual removal of the monopoly would be beneficial to users and that an interim reduction in the threshold should be made to 1,500 therms in 1997.

1.9. In our view, no decision should be taken as to the timing of the complete removal of the tariff monopoly except after a most careful assessment of the consequences. The date for its removal should depend on the progress of legislative change, so as to impose obligations for safety and security of supply and social obligations on all competitors to the domestic market, and on experience of the balancing of supply and demand by competing shippers in other sectors of the market, including developments of information and control systems such as metering. Some shippers argued that removal of the tariff monopoly was a priority, of more importance than any changes to the structure of transportation and storage. The removal of the monopoly should in our view follow measures to ensure the neutrality of the transportation and storage system, which we regard as the principal condition for effective competition in all sectors of the market.

1.10. We have concluded in respect of both references under the Fair Trading Act 1973 (the Fair Trading Act) that BG's conduct in undertaking its business as an integrated business, and its failure to provide for neutrality as between its trading and transportation interests, may be expected to reduce the effectiveness of competition and to operate against the public interest by inhibiting choice, restricting innovation, and leading to higher levels of gas prices than would otherwise be the case. In our view, BG's proposals to establish separate trading and transportation units still under the ownership of BG would not be sufficient fully to remedy these adverse effects even though they represent the most that can be achieved in our report made under the Gas Act. If such a limited remedy were introduced, we see a wide spectrum of decisions relating to transportation and storage that would still be influenced by the interests of BG's trading activities.

1.11. We recommend that the adverse effects identified should be remedied by divestment of BG's trading activities no later than 31 March 1997.

1.12. Such a measure would not, in our view, put at risk security of supply or safety. It would involve considerably less cost and organizational change than many other remedies put to us. Although some increase in costs in the short term may result, the development of self-sustaining competition would bring significant benefits to users. We regard separation of the businesses as essential to ensure that transportation and storage can be made available to all shippers, including the trading activity currently carried out by BG, without undue discrimination. Such a measure would remove the existing conflicts of interest, provide the incentives necessary to ensure the neutrality of transportation and storage, and bring about the transparency necessary for the regulation of the system. Divestment would require, among other measures, changes to the Gas Act. At least until divestment, we also believe it necessary to maintain the other constraints on BG's performance, such as a modified limit on its share of the non-tariff market.

1.13. BG argued that the current tariff formula should be relaxed, to allow higher prices to tariff users, following the recent series of regulatory changes which, it claimed, would result in inadequate profits. It also argued, on a related issue, that the rate of return (ROR) currently used in setting third party transportation charges was inadequate. In BG's view, a current cost rate of return of 10.8 per cent on new investment, and 6.7 per cent on existing assets, was necessary if it were to maintain its proposed investment in the system.

1.14. In considering these issues we have taken a number of factors into account: the interests of consumers, the need to ensure that BG's UK gas supply activities can attract capital to finance new investment, whether the cash flows are adequate to sustain the business, and the requirement that any system of regulation should continue to provide the incentive to improve performance. In our view a real rate of return of between 6.5 and 7.5 per cent on new investment would be reasonable under current conditions to attract capital to the industry. After allowing for the difference between the amounts realized from the sale of BG in 1986 and the value of its current cost assets at the time, and for subsequent differentials between the ratio of the stock market valuation and its current cost assets, this would be equivalent to a return on current cost assets at the end of 1991 of between 4 and 4.5 per cent.

1.15. We accept that following the reduction in the monopoly threshold from 25,000 to 2,500 therms the current tariff formula is likely to produce inadequate profits and adversely affect the supply of capital to the industry, particularly for the financing of new investment. Taking into account the factors listed above, we have proposed a modification to the tariff formula from 1 April 1994 from the present RPI-5 to RPI-4, and that the formula be confined to supply to users of 2,500 therms and below. The additional income generated by such a modification of the formula would be similar to the loss of profit to BG from reducing the tariff threshold.

1.16. During the course of the inquiry, a range of technical issues relating to gas supply was raised with us, including the structure of transportation charges and the operation of the network, which can in our view be better pursued by the Director. Resolution of these issues will be affected by the recommendations of this report and the decision as to how they will be implemented. We also received a number of criticisms of the current regulatory system. In our view, the system itself is fundamentally sound. We suggest extending the powers of the Director to provide him with full concurrent jurisdiction with the DGFT, including the power to make references to the MMC under the Fair Trading Act relating to the supply of gas to the non-tariff market.

1.17. We have noted and accept the emphasis placed by many witnesses and BG itself on the need for stability and certainty. We believe that a time-scale for the adoption of our recommendations should be established and adhered to. This would involve:

- the establishment of transportation and storage as a separate unit of BG no later than 31 March 1994;
- the revision of the tariff formula as from 1 April 1994; and
- necessary changes to the Gas Act, the divestment of BG Trading and an interim reduction in the monopoly threshold to 1,500 therms by 31 March 1997.

We would expect full removal of the monopoly some three to five years after the divestment of BG's trading activities.