COMPETITION LAW AND BRITISH NATURAL GAS REGULATION

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British Gas (BG) is a seriously successful monopolist which, since its 1986 privatisation, is facing increased regulation by the Office of Gas Supply (OFGAS). OFGAS is the first public body specifically created to regulate a European gas industry. It employs a rate-capping formula instead of the more labour intensive rate-of-return method favoured in North America. Despite initial criticisms, OFGAS has surprised industry observers with efficacious results. This article succinctly discusses the process of natural gas industry privatisation in the United Kingdom (U.K.) and the development of a British type of "open access."

Contemporary British gas regulation is a distinct paradigm involving the privatisation of a vertically integrated pipeline system coupled with an alternative regulatory method. These regulatory results include lower prices for core customers and the promotion of third party direct sales within the U.K. Since Britain leads the European Community (E.C.) in common carriage provisions, the regulatory régime here provides a benchmark for the other Member States.

I. British Gas: Privatisation

The Conservative Government led by Mr. Edward Heath enacted the 1972 Gas Act, abolishing the previous régime of Area Boards and creating the British Gas Corporation (BGC) with a vertically integrated monopoly[1] over the brokerage and transportation of gas for public supply. From 1948 to 1980 successive Labour and Conservative governments concentrated on economic performance in public utilities which had undergone major restructuring. Criticisms were made of economic inefficiency in the nationalised industries, although in the case of gas, output per employee rose much more quickly than the U.K. norm.[2] Other criticisms were that regulatory processes should recognise the weakness to consumers and provide incentives to industry to treat consumers fairly.[3]

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1. The gas industry has existed in Britain since the 1800's, however, it only really started to mature following the North Sea Petroleum discoveries of the 1960's and 1970's. For instance, in 1847 the U.K. government decided that "... the existence in the same town of two rival gas companies does not appear to us at all calculated to benefit the customers." NATIONAL CONSUMER COUNCIL, IN THE ABSENCE OF COMPETITION, 11-12 (1989).

2. On the question of efficiency, *see* R. Molyneaux and D. Thompson, *Nationalised Industry Performance: Still Third Rate,* FISCAL STUDIES Vol. 8 No. 1, Feb. 1987. *See also* R. Millward, *The Comparative Performance of Public and Private Ownership,* in THE MIXED ECONOMY (E.Roll ed., 1982).

3. IN THE ABSENCE OF COMPETITION, *supra* note 1 at 2.

Government control consisted of statutory obligations to maintain public supply, to avoid so-called "undue preference," and to carry out research and development programmes. Government control was officially limited to monitoring and setting objectives, supposedly on an "arm's length" basis without interference in the day-to-day business. However, the Government effectively intervened in many aspects of the nationalised industries including the natural gas industry.[4]

British Gas avoided much of the polemic public sector criticism since it was profitable, supplied the cheapest domestic fuel, and contributed to the balance of payments. Conversely, it was accused of being inflexible in dealing with servicing small customers and a government-sponsored efficiency study found room for improvement.[5] Governmental regulation began to tighten with the first exercise of government veto over the proposed Gas Gathering Pipeline in 1981. Ostensibly, the veto was over concern for the Public Sector Borrowing Requirement (PSBR). Another veto was exercised over the BGC's 1983 contract to purchase gas from the Norwegian Sleipner field (royalties would otherwise be paid to the Norwegian Government with the attendant loss of U.K. "tax"). The reasons given were concern for the long-term balance of payments, the loss of revenue from the Petroleum Revenue Tax (PRT), and the policy of encouragement for gas exploration on the U.K. Continental Shelf (UKCS).[6] Both vetoes affected BGC's business planning.[7]

Secondly, the Government increased its financial hold over BGC by the 1981 Gas Levy Act which in turn ameliorated the Petroleum Revenue Tax introduced in 1975. In 1980 gas prices were forced up in real terms by thirty-three percent and the BGC was required (like the electricity industry) to give its operating cash surpluses to the Treasury.[8]

More recently, increased intervention was effected by the 1982 Oil and Gas (Enterprise) Act. Following a policy of promoting new British entrants to the UKCS, the Act divested BGC of its oil exploration and exploitation assets. It transferred them to a new private sector company, Enterprise Oil. "The BGC had a stake in 5 offshore oil fields, 20 offshore exploration blocks, and a 50 per cent stake in the onshore Wytch Farm field. It was allowed to retain its offshore gas interests."[9] The Act provided for common carriage, but this was ineffective in the absence of independent adjudication of common carriage terms.[10]

The lack of common carriage terms in the 1982 Oil and Gas Act allowed BGC to dictate the terms. Therefore, BGC could claim that there was no

4. FRANCIS MCGOWAN ET AL., REGULATION OF THE PRIVATISED BRITISH GAS INDUSTRY 6 (1990).

5. *See* Deloitte Haskins and Sells, *British Gas Efficiency Study*, Department of Energy, London and M. Wright, *Government divestments, and the regulation of natural monopolies in the UK: the case of British Gas*, ENERGY POLICY, June 1987.

6. House of Commons Energy Committee, *The British Gas Corporation's Proposed Purchase of Gas from the Sleipner Field*, H.C. 438, HMSO, London, May, 1984.

7. MCGOWAN ET AL. *supra* note 4 at 7.

8. *Id.* at 8.

9. *Id.* at 59.

10. *Id.* at 8.

pipeline capacity,[11] impose onerous back-up supply charges, and it could also use predatory pricing[12] (or discriminatory) practices in the industrial contract market.[13]

> "The 1982 Act ended the BGC's de jure monopsony[14] over the purchase of North Sea gas, but the de facto monopsony continued: the requirement that all gas produced on the UKCS should be landed in the U.K., combined with the absence of new gas suppliers, meant there was no alternative to selling it to the BGC."[15]

Furthermore, producers feared unfair discrimination by BGC against direct sales of the commodity. Stronger common carriage measures might not have altered this outcome without certain unpredicted changes in the industry structure that were affected by privatisation.[16]

Privatisation under the Thatcher government(s) was a mixed bag of policies: "rolling back the frontiers of the state" and promoting private ownership of shares and houses as well as other initiatives such as stringent public expenditure.[17] It occurred around the well-known 1986 world-wide fall in oil prices (and gas prices which were indexed by reference to oil) that had acute ramifications for the petroleum industry. Also, in Eastern Europe, Glasnost had reduced the fears concerning Russian gas supply.

Regulation of natural monopolies in the private sector was deemed by the Conservative government, led by Mrs. Thatcher, to be preferable to nationalised utilities.[18] Revenue from privatisation was under £500 million in 1983,

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11. "A pipeline's capacity to carry gas increases roughly with the square of its diameter. A twenty inch diameter pipe, for example, can carry about four times as much gas as a ten inch diameter one. But a twenty inch pipe does not cost four times as much to construct and operate as a ten inch pipe; it does not cost even twice as much. Consequently, it is far cheaper to carry gas through one twenty inch pipe than through four ten inch ones. Economies of scale based on pipeline diameter continue up to the largest standard sized pipe currently produced. The largest pipe commonly planned for new installations in the United States has a diameter of forty-two inches. Most existing transmission pipelines range from twenty-four to thirty-six inches in diameter and reflect the largest sizes commonly available when those systems were constructed." Robert Means and Deborah Cohn, *Common Carriage of Natural Gas,* 59 TUL. L. REV. 529, 534 n.12 (1985).

12. "Predatory pricing can sometimes be discriminatory (i.e., involve some kind of separation of a seller's markets, with differences of economic treatment as between the separated segments). What particularly distinguishes it is systematically pricing below cost to all or some of a seller's customers." BRUCE DUNLOP ET AL., CANADIAN COMPETITION POLICY: A LEGAL AND ECONOMIC ANALYSIS 221 (1987). *See also*: P.L. Joskow and A.K. Klevorick, *A Framework for Analyzing Predatory Pricing Policy*, 89 YALE L. J. 213 (1979-80).

13. J. VICKERS & G. YARROW, PRIVATISATION: AN ECONOMIC ANALYSIS 258 (1988).

14. Monopolists are sole suppliers with no good substitutes, possibly able to maintain a price above that which would prevail in a competitive market. Conversely, a monopsonist is the sole buyer of a product or service that cannot feasibly be transformed into a different service or product for another buyer. Jon Bernhardt, *Is Natural Gas Pipeline Regulation Worth the Fuss?,* 40 STAN. L. REV. 753 at 759 (1988). *See e.g.*, U.S. DEPARTMENT OF JUSTICE, ANTI-TRUST DIVISION, U.S. DEPARTMENT OF JUSTICE MERGER GUIDELINES 2 (1984). British Gas arguably retains a de facto monopsony over the commodity's purchase despite the nascent direct sale experience.

15. MCGOWAN ET AL. *supra* note 4 at 8.

16. *Id.*

17. *Id.* at 9.

18. 1983 Conservative Manifesto p.17 and J. Moore, *The Success of Privatisation* in J. KAY ET. AL., PRIVATISATION AND REGULATION: THE UK EXPERIENCE, (1986).

growing tenfold by 1987, with the sale of utility industries. Despite the windfall North Sea oil revenues, the government still needed to raise income given its pledge to reduce taxes. Thus, nationalised industries with a large monopoly market, such as telecommunications, electricity, water and gas were placed on the public auction block. Gas privatisation netted about £5.6bn, roughly 5 times the annual rate-of-return payable to H.M. Treasury based upon the £16.8bn current cost value of its assets. The sale may have been undervalued and commentators suggest that the motivation was a myopic political attempt to obtain windfall revenue. Genuine concern over the post-privatisation efficiency of these industries was arguably absent.[19]

Given the vertically and horizontally integrated nature of BG, criticisms were voiced by Parliament's Energy Committee. It said that

> ". . . there can be no heavier or more deadening regulation of any market than that exercised by a powerful and ineffectually restrained monopoly."[20]

It recommended that BG publish annually its profits in the tariff market, that the DGGS should have power to investigate BG's internal accounts and to assist BG in setting and publishing performance objectives. Furthermore, it suggested that BG should produce separate accounts for cost and profits between different parts of its activities in order to prevent (undue)[21] cross-subsidization[22] and it should promote greater fuel conservation. The Committee recommended establishing a Regulatory Commission to replace "one-man"[23] (i.e. the DGGS) regulation. But the Government was able to ignore this input because of its commanding Parliamentary majority.

II. 1986 GAS ACT & COMMON CARRIAGE

United Kingdom third party access was first made available under section 17 of the Oil and Gas (Enterprise) Act 1982 during the first Thatcher Government. These were replaced by section 19 of the 1986 Gas Act.[24] It empow-

19. VICKERS & YARROW, *supra* note 13 at 157.

20. House of Commons Energy Committee, *Regulation of the Gas Industry*, H.C. 15, HMSO, London, January 1986.

21. There will always be discrimination of some sort. Corrections must be made by regulators when it becomes too flagrant (or "undue" in public utility law) to accept.

22. The Monopolies and Mergers Commission (MMC) Gas, *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*, C.M. 500, HMSO, London, October 1988. At the time of privatisation, British Gas' corporate structure supplied 61% of the household market (including four-fifths of the domestic central heating market accessible to gas), 35% of the industrial energy market, and 38% of the commercial market (shops, offices, warehouses etc).

23. OFGAS ANNUAL REPORT 86 (1991). OFGAS' staff numbered 28 in 1991, but may expand to around 40 given the new duties of the Competition and Service (Utilities) Bill.

24. Gas Act 1986, § 19 requires that charges should reflect the use of the pipeline system by third-parties in comparison with use by British Gas and others - of the operating, administrative and maintenance costs of the system as well as rate of return on the relevant capital assets equal to the return earned by British Gas on the system generally; Section 4(1)(b) requires the Director General to seek to secure that gas suppliers are able to finance the provision of gas supply services; Section 4(2)(b) imposes a duty on the Director General to exercise his functions in the manner that will best protect the interests of gas consumers, including the prices charged. The Director has a duty to promote efficient use of gas; Section 9(1) obliges BG to comply with any reasonable request for a supply of gas, as far as it is economical to do.

ered the Director General of Gas Supply (appointed by the Government and answerable to Parliament) to give directions to British Gas as to the terms upon which gas is to be carried for a third party. Section 19(5) concerns rate rationale, providing that the pipeline owner (i.e. British Gas) should be entitled: (1) to charge the user for an "appropriate proportion" (of the capital costs of the direct sale in proportion to total system operating costs) incurred in administering, maintaining and operating the pipeline system and (2) to pass on to the user as a cost, a return equal to the "appropriate proportion" of the return received by the pipeline owner on the capital value of the system, including depreciation.

III. TRANSPARENCY: PRICE CONTROL FORMULA

Like the telecommunications industry, regulation of the U.K. gas industry structure has three main elements. The most draconian Government power is the ability to revoke, terminate, or amend British Gas' licence or to sanction imports or exports or the installation of pipelines. More directly, a price control formula distinguishes between tariff customers[25] who use less than 25,000 therms[26] a year, and those who use more, namely the gas contract market. Unlike the regulatory hearing procedures in the U.S. and Canada, price regulation was seen as less troublesome.[27] Admittedly, price control regulation can be seen as rate-of-return regulation in a different guise.

In Britain the formula is set out in British Gas' statutory authorisation. The formula is RPI (retail price index inflation rate) minus (-) X (the independent variable efficiency factor[28] applicable to controllable costs including labour and capital, i.e. non-gas/non-commodity costs) plus (+) Y (uncontrollable costs including the cost of commodity and the Gas Levy).[29] The chief alternative to formula regulation is rate-of-return regulation which is criticised by some[30] as backward looking and failing to encourage cost control.

Competition was arguably fettered by continued price discrimination in

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OFGAS may enforce this obligation pursuant to § 28 via provisional (at short notice) and final (after a full investigation) orders; Section 14(3) provides that tariffs for the domestic market, (i.e. premises using less than 25,000 therms per year) "shall not show undue preference to any person or class of persons, and shall not exercise any undue discrimination against any person or class of persons."

25. North American terminology is different. The "core market" is a term that includes residential, commercial and small industrial customers. "Industrial" (or "contract" customers in Britain) comprise a market category who demand large volumes of gas. Most have dual-fired factories or the ability to switch easily to alternative fuels, and are thus targeted by distributors with discounted prices. This is a controversial form of rate discrimination.

26. OFGAS News Release, *Where Britain Leads Europe Could Follow*, May 21, 1992. OFGAS wants to reduce this provision. It seems probable that the British government may soon lower the threshold gradually to 2500 therms per annum, thereby increasing the size of the competitive market.

27. C. VELJANOWSKI, SELLING THE STATE 159 (1987); M. Wright, *Government Divestments, and the Regulation of Natural Monopolies in the UK: the Case of British Gas*, ENERGY POLICY, June 1987.

28. *See* Greg McGregor, *Gas and the Energy Efficiency Factor: The 'E' Factor*, OFGAS, June 1992.

29. The 1981 Gas Levy Act ameliorated the Petroleum Revenue Tax introduced in 1975. Because Y is estimated in advance, another component allows for retrospective adjustment. The electricity industry regulator "OFFEL" and the telecommunications industry regulator "OFTEL" also use a RPI - X formula.

30. Beesley & S. Littlechild, *The Regulation of Privatised Monopolies in the United Kingdom*, RAND J. ECON. Vol. 10 no. 3, Autumn 1989, at 454-472.

the contract (industrial) market and the price formula was said to have had an undervalued X factor. It also was said to have encouraged average cost pricing as opposed to the more desirable long range marginal cost pricing in the tariff (core-customer) market.[31] The squeeze factor (for non-gas costs) used to be two (2) percent.[32] Following a tariff formula review,[33] British Gas will have to abide by a tough new pricing formula imposed by the regulator OFGAS with an "X" factor of five (5) percent.[34] (RPI - 5% + GPI -Z + E (Allowable Energy Efficiency Cost per therm in Formula year t) + K).[35] The original price cap formula (allowed BG's gas purchase costs to be passed through directly into prices). The new formula has been converted into a "double price cap." The objective of the new gas cap is to foster BG's incentive[36] to buy gas at the lowest prices possible yet protecting BG against price volatility. Since lower gas costs lead to higher profits, the advantage of the new arrangement is similar to the old one, giving BG an incentive to improve its purchasing efficiency.[37]

The price control formulae cap prices are intended to encourage greater efficiency, hence greater profit for shareholders. Prior to its cost disaggregation exercise, OFGAS was ironically foreseen to use rate-of-return calcula-

31. McGowan et al., *supra* note 4 at 15. In order to improve allocative efficiency, long-run marginal cost (LRMC) pricing was implemented in 1967 as the pricing principle for all nationalised industries: The Nationalised Industries: A Review of Economic and Financial Objectives, 1967, Cmnd 3437.

32. David Thomas, *A Surge of New Customers*, in *The Gas Industry*, Financial Times, April 20, 1990, at 5. "Combined with the impact of weak oil prices on gas purchase costs, this has delivered a ten percent cut in real gas prices since 1986."

33. The review concerned overall tariff prices rather than tariff structure. OFGAS normally exercises tariff structure regulation under § 14(3) of the Gas Act 1986, which prohibits "undue preference" or the exercise of "undue discrimination". Discussions with British Gas have altered the tariff structure to recognise the costs of supply to particular classes of customer including standing charges, larger tariff customers and "high load factor" customers (whose demand is fairly even throughout the year rather than displaying a peak in winter). OFGAS Annual Report 1991, *supra* note 23 at 15, 39. OFGAS considered removing any incentive for BG to sell more gas because of environmental reasons, publishing: *OFGAS Gas Regulation and the Environment*. Basically, OFGAS believes the expanded gas use is beneficial for the environment compared to other fossil fuels. The structure of the present formula was retained (although the X factor was increased). In *OFGAS Least Cost Planning in the Gas Industry*, 1990, it was realised that the passing through of gas costs might be an artificial distortion that gives incentive to increase gas sales as opposed to investing in more cost effective energy efficiency. Supplying new demand requires expansion of supply capacity ("supply-side" investment) as compared with energy efficiency investment which elicits reduced demand ("demand-side" investment). BG never had an incentive to conduct such a comparative analysis but now the new tariff formula contains an "E" factor concerning allowable energy efficiency costs, giving an incentive for BG to consider energy efficiency on the same basis as energy supply.

34. The new pricing formula went into effect as of April, 1992.

35. GPI-Z means that British gas can increase its gas costs in accordance with the movement in a special gas price index minus an efficiency factor, Z, set at one (1) percent. The second new element, E, pertains to certain energy efficient expenditures. The K factor is the same as before - allowing an undershoot or over-shoot in any particular year to be corrected in subsequent years.

36. Under the previous formula, U.K. consumers benefitted from the world-wide collapse of oil price in 1986 which fed through into bulk gas contracts and passed through to customers. However, the original price control formula (X factor two (2) percent) provided that gas costs could be passed straight through to consumers making British Gas' purchasing decisions virtually risk free. In the Absence of Competition, *supra* note 1 at 58.

37. OFGAS Annual Report 1991, *supra* note 23 at 13-15.

tions so as to recommend changes in the tariff formula.[38]

Cost disaggregation was needed because British Gas refused to separately account for its costs in using its own pipeline system as opposed to the relevant costs of third party carriage. Arguably, the tariffs based on disaggregation were not cost reflective. BG distorted them as between different tiers of the system, and independent shippers sought more flexible common carriage contracts. These include umbrella contracts which will enable the swapping of capacity between different terminals and contracts enabling interruptible supply and gas storage. Yet British Gas refuses to clearly define its underlying methodology in calculating individual quotations.

> "[I]t was difficult, if not impossible for independent shippers to understand the pricing philosophy and apply that philosophy to particular costings for the routes and volumes that they were interested in."[39]

Two years after first requesting a fundamental review of the common carriage system, OFGAS reiterated the request (to a dilatory BG) to devise a system of charging "as if BG had to pay itself for transporting its own gas through its pipeline system." BG responded by publishing a complicated, if not incomprehensible formula, the effect of which has been "to obscure as much as clarify pipeline tariffs."[40]

However, a public utility regulator's access to accurate data is needed to promote the public interest. Yet there was an "asymmetry in the availability of information."[41] Because gas prices are indexed with relation to oil prices, the 1986 slump in world crude prices meant that these lower prices had to be passed on to the tariff (core-customers) according to the Y component in the formula. Citing commercial sensitivity, British Gas refused to provide details of its upstream supply contracts, after reducing tariff prices by 4.5 percent in June 1987. Eventually it made concessions after the DGGS threatened legal action.[42] Neither the Government authorisation nor the 1986 Gas Act required British gas to provide such information. This deficiency was a potential hamstring on OFGAS' ability to glean information about competition in the contract market.[43]

IV. 1988 MMC REPORT

British gas regulation is personified by the Director General of Gas Supplies (DGGS), head of the Office of Gas Supply (OFGAS) which is Parliamentary accountable to the Energy Committee. The regulatory process interacts with the help of the Monopolies and Mergers Commission (MMC), which investigates and makes recommendations on the cases referred to it, and the Office of Fair Trading (OFT) which adjudicates on monopolistic practices within the ambit of British and E.C. competition policy. The DGGS has the ability to refer directly to the MMC any matter relating to the tariff market.

38. MCGOWAN ET AL., *supra* note 4 at 49.
39. OFGAS ANNUAL REPORT 1991, *supra* note 23 at 22.
40. *Id.*
41. J. Kay & J. Vickers, *Regulatory Reform in Britain*, in ECONOMIC POLICY, No. 7, 1988, at 330-331.
42. VICKERS & YARROW, *supra* note 13 at 279.
43. MCGOWAN ET AL., *supra* note 4 at 19.

Specifically, he is required to monitor gas and non-gas costs. He may also apply to the MMC for an amendment to the maximum price formula.[44]

Pursuant to the Gas Act 1986, the assets of the British Gas (Crown) Corporation were privatised intact via transfer to British Gas plc. Section 3 of the Gas Act abolished the de jure monopoly of U.K. gas supply. The Act enabled the Secretary of State for Energy to grant an authorization (equivalent to British Telecom's license) to operate a "public gas supplier" company. Section 19 stipulates that a public gas supplier (such as British Gas) must facilitate third party carriage for value provided, inter alia, that the arrangement doesn't interfere with British Gas duties as public gas supplier, nor its contractual commitments.[45]

Regulatory responsibility at OFGAS rests with the Director General of Gas Supplies (DGGS) who is obliged to adjudicate upon common carriage matters. Vis á vis the contract (industrial) market, in the absence of formal powers he cannot refer gas supply matters to the MMC. Rather complaints are dealt with by the OFT and Gas Consumers' Council (GCC). This latter body was created under the 1986 Gas Act and was thought to be a superfluous continuation of previous consumer interest groups.[46] The GCC in turn can refer complaints to the OFT and British Gas concurrently is obligated to publish maximum prices for contract customers including pricing policy and common carriage arrangements.

The natural gas industry referral to the MMC was made pursuant to the 1973 Fair Trading Act whose general ambit pertains to monopolistic practices and competition. But the regulatory régime of the DGGS was unable to cope with a particular type of conflict, namely matters concerning the gas contract (i.e. industrial) market. Certain industrial users complained to the GCC, OFT and the European Commission that BG's prices were higher than those set by Continental competitors and that its prices were unduly discriminatory between contract customers.[47] Dissatisfaction among customers with British Gas' monopoly of this market was echoed by OFGAS, the industry's regulatory body, who complained that British industry was having to pay more for its gas than its counterparts on the Continent.[48]

General British competition law provisions induced the 1988 MMC report,[49] not the more leonine regulatory provisions found in other jurisdictions.[50] The MMC found extensive price and transportation discrimination[51]

44. *Id.* at 13-14.

45. The Gas Act 1986 § 19, set parameters for defining the third party carriage charge: "Such charges should cover an appropriate portion - reflecting the use of the pipeline system by the third-party compared with use by British Gas and others - of the operating, administrative and maintenance costs of the system as well as rate of return on the relevant capital assets equal to the return earned by British Gas on the system generally."

46. MCGOWAN ET AL. *supra* note 4 at 13.

47. VICKERS & YARROW, *supra* note 13 at 281.

48. OFGAS, THE EEC INDUSTRIAL GAS MARKET, 18-21 January 1989. David Thomas, *Market Revolution*, in *The Gas Industry*, FINANCIAL TIMES, Friday April 20, 1990, at 5.

49. MMC, *supra* note 22.

50. *See ante* Canadian National Energy Board and U.S. Federal Energy Regulatory Commission (FERC) provisions.

by British Gas. In particular, captive customers had to absorb higher costs. By indexing gas prices to alternative fuels,[52] BG effectively undercut potential competitors. These prices lacked transparency,[53] a fact which was found to increase economic uncertainty among customers. Also, BG has repeatedly refused interruptible transmission or particular terms to various customers. In addition to price discrimination, market entry by newcomers was precluded by BG's inadequate and non-transparent information concerning common carriage.[54] For example, the United Kingdom,[55] Portugal and the Netherlands have adopted legislation combining public service duties with common carrier obligations. Since 1982, statutory provisions in Britain have mandated common carriage for third party "private suppliers" through British Gas, the monopoly supplier.

The MMC found that there was no gas available, since virtually all the gas coming out of the British sector of the North Sea was contracted to British Gas. The gas producers were found to be dependent on British Gas who ensured that new fields were exploited, because it guaranteed the continuous acceptance of all gas produced through life of the field contracts as well as financing via take-or-pay obligations.[56]

Neither was there an obvious point for newcomers to enter into a market which British Gas had sown up by negotiating individual contracts with its customers. As a result, British Gas can contract for no more than ninety percent of the gas from new gas fields. The resulting so-called "90/10" rule[57] forced big North Sea producers to consider fresh markets for the ten percent of gas which they could not sell to British Gas. Indeed, the ten percent was forecast to vanish via contracts for power stations. If the demand predictions for power station gas hold true, then the regulator may have to facilitate imports of gas. This would mean favouring the public supply obligation over extra common carriage.[58]

Statistically, over thirty percent of gas contracted since 1989 has in fact been sold to non-BG purchasers. But this is a qualified success, since most of this gas has been sold to the new power generation market plus the fact that these volumes will not start to flow until 1993. Indeed, new gas availability in the competitive market remains constrained until 1995.[59]

So-called swap arrangements help avoid having ten percent of a field's

51. MMC, *supra* note 22.

52. Prices set at the maximum determined by the alternative fuel, rather than by competition among suppliers, are a characteristic of the monopolistic gas industry.

53. In an October 1991 interview with the author, an official of British Gas refused to admit that the Tariff (i.e. core customers) market did not cross-subsidise the Contract (i.e. industrial) market, proudly proclaiming that British Gas' prices were the "most transparent" in Europe!

54. Spence, *Entry, Capacity, Investment and Oligopolistic Pricing*, 8 BELL J. ECON. 534 (1977). The average cost of constructing the standard 36-inch diameter pipeline was $1,144,937 per mile in 1981. Seaton, *U.S. Pipelines Keep Energy Moving*, OIL & GAS J., Nov. 22, 1982, at 73, 80.

55. Gas Act 1986, § 17.

56. OFGAS, COMPETITION IN THE GAS INDUSTRY ¶ 27 (1987).

57. The 90/10 rule would presumably provide "significant but not unmanageable tranches of gas for potential competitors," MMC, *supra* note 22 at 111.

58. MCGOWAN ET AL., *supra* note 4 at 57.

59. OFGAS ANNUAL REPORT 1991, *supra* note 23 at 20.

reserves being without a contract, facilitate third party carriage by renegotiation of contracts both among field owners and operators and with BG.[60] That is to say, swaps involve the release of gas from BG gas supply contracts, allowing new volumes into the competitive market in the short term. Yet British Gas has onerously conditioned these swaps requiring that they be repaid from October 1992, counter-productively reducing the amount available to independent shippers. Another condition made the gas available only to producers, effectively restricting the available gas to established oil companies. Nonetheless, swap-arrangement related gas has significantly boosted independent sales which, at December 1991, totalled approximately 7 percent of the Contract (i.e. non-core customer) market.[61]

Government plans to privatise the electricity industry resulted in cancellation of all plans to build coal-fired and nuclear powered generators.[62] These have been replaced by co-generation plants.[63] However, electricity is presently generated at a cost of 1.8 to 2.2 pence per unit whereas gas costs 2.9 pence per unit . The gas contracts are backed by long-term contracts to sell electricity to the regional electricity distribution companies. Yet, questions have arisen in the House of Commons Select Committee on Energy. Despite the environmental attractiveness of gas, the Conservative Government's attempt to create a sensible national energy policy may be an attempt to facilitate the privatisation of the coal industry. A leaked report by N.M. Rothchild, the government's adviser on coal privatisation, predicted that only 14 collieries would remain in Britain.[64] To concentrate the nation's energy supply on one fuel jeopardises security.

From a broader policy perspective, the MMC interpreted "effective competition" as meaning gas-to-gas competition. Previously, the regulatory emphasis on competition was made with reference to the price of alternative fuels. According to commentators, this amounted to an about face in the last twenty years of U.K. and thirteen years of E.C. energy policy respectively.[65]

Besides the purchase of life-of-the-field contracts, British Gas' purchasing practice required applicants for common carriage to disclose their source of gas. The MMC found that the dominant position of BG had inhibited competition including its undercutting of potential competitors through use of information received in negotiation with others. So-called "Chinese Walls" were ordered by the MMC to prevent British Gas from receiving confidential infor-

60. *International Gas Report*, April 27 & May 11, 1990. Proposed swaps do not involve only fields where the marketing company has an interest. McGowan et al., *supra* note 4 at 38.

61. OFGAS Annual Report 1991, *supra* note 22 at 21.

62. Maurice Samuelson, *A Dramatic Comeback: Gas is the favoured fuel in electricity generation*, in *The Gas Industry*, Financial Times, April 20, 1990, at 5. "In Britain, it is electricity privatisation which has most dramatically transformed gas's prospects as a power station fuel. Until two years ago, both the Government and the monolithic Central Electricity Generating Board were contemplating building two or three large conventional large coal stations and three more PWR nuclear plants like that taking shape at Sizewell."

63. Co-generation: the production of electricity and another energy form such as steam or heat through the sequential use of energy. It is typically used for industrial, commercial, or cooling purposes.

64. Ray Hudson, *A Waste of Energy Deposing King Coal*, Times Higher Education Supplement, March 13, 1992, at 14.

65. McGowan et al., *supra* note 4 at 24.

mation in one branch of its operations and using it in another. Upstream, UKCS producers feared lower prices and did not have much incentive for gas-to-gas competition.[66]

British Gas had been refusing to provide interruptible service to some customers and has only recently published a schedule of prices for contract customers (i.e. large industrial). Following the MMC's report in January 1989, British Gas' authorisation was altered. Hence, the MMC effectively compelled British Gas to publish a fixed schedule of prices for large industrial users and to stop discriminating (in an anti-competitive manner) against contract customers. BG was also ordered to negotiate a single contract (aggregation)[67] for multiple premises of an individual customer. Some users who were below the 25,000 therm per year threshold started flaring gas to cross into a higher-volume (and comparatively lower unit) price band. These users included commercial users in the tariff market who sought access to the lower priced contract (industrial) market. New schedules were elicited by OFGAS which have eased but not eliminated the problem.

Pursuant to its authorisation as a "Public Gas Supplier," it has to supply gas on scheduled terms to all customers (including firm and interruptible) of the "same class or description." It recommended that the pricing of "common carriage" over the trunk line be made transparent. Previously, individual and confidential agreements were concluded on an ad hoc basis according to a customers "individual circumstances."

The British record so far shows that only a few dozen "direct sales" had been effected by the end of 1991 although this may hopefully exponentiate.[68] Likewise, the amount of pipeline bypass projects (some involving joint ventures) remains small despite a noticeable increase trend.[69] On the first day of March 1990, Quadrant Gas, a Shell-Esso joint venture, became the first concern other than British Gas to sell gas directly to industrial customers, using British Gas' pipelines.[70] British Petroleum followed Quadrant with a similar announcement a month later creating BP Gas Marketing, followed by the incorporation of Associated Gas Supplies (AGAS) - a joint venture between

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66. *Id.* at 33.

67. BG's first price schedule set eleven volume bands for firm gas supplies, with a decreasing unit charge. Qualified consumers with more than one premise (comprising common ownership, common activities, sites, establishments and load factors altogether consuming above 25,000 therms a year) could aggregate their consumption to move into a higher volume band. Interruptible service comprised six volume bands, including a minimum of 250,000 therms per year and different charges for different periods. McGowan et al., *supra* note 4 at 28.

68. British Gas, The Competitive Market Takes Off, 7 (May 31, 1991). *See Gas Transportation Services from British Gas* (Sept. 1990), *Contract Gas - Responding to Customers*, (1990); Gas Transportation Services, British Gas PLC, 100 Rochester Row, London SW1P 1JP. OFGAS News Release, *supra* note 24. OFGAS Director General Sir James McKinnon said "There is no doubt that self-sustaining competition will become established in Britain by 1995." For instance, a large competitor, Alliance Gas (formed by BP and Statoil) and a smaller one, North Sea Gas, were formed in May 1992 to challenge British Gas. However, British Gas is expected to retain retail margins of up to 40% of the industrial market.

69. Joint ventures have been struck to carry UKCS gas from the offshore to industrial customers in England, i.e., *PowerGen and Conoco Form Gas Transport Joint Venture*, IGR 8 December 1989, at IV.

70. *Quadrant Starts Supplying UK Industry*, IGR 2 March 1990, at 1-2.

Associated Heat Services and Elf, Mobil Gas Marketing and Kinetica (a joint venture between Conoco and Powergen).

OFGAS has gone through a period of regulatory learning, developing its own agenda such as the cost disaggregation exercise used in the first tariff formula review. Regulation in the U.K. has proven to be more resilient, stricter, unpredictable and less fragmented than expected from a reading of the 1986 Gas Act. For instance, the MMC investigation interpreted "competition" differently than the Government at the time of nationalisation.[71] Privatisation of BG with its dominant position intact remains a salient feature of the British natural gas regulatory régime. Despite the ostensible constraints of statute, regulation spread further than was foreseen.[72]

An extensive tariff formula review was started in the summer of 1990. It involved disaggregation of costs, separating those covered by the pricing formula (costs incurred in supplying household and commercial customers) from those in the unregulated industrial or contract sector. OFGAS' proposals were put to British Gas in February 1991, and were not negotiable. British Gas could either accept (which it did in April 1991) or be referred to the MMC pursuant to Section 24 of the Gas Act 1986.[73]

British Gas intends to expand its overseas developments so that its exploration and production division contributes forty percent of its profit by the end of the decade. Mr. Robert Evans, its Chairman, said that the group will take advantage of acquisition opportunities in the petroleum industry where share prices were severely depressed by low oil prices.

British Gas had decided to enter the market for long-term (up to fifteen years) contracts (rather than the previous annual contracts) for interruptible supplies to the power generation market. Under the 90/10 rule it appeared to be losing market share to competitors, so it reduced (significantly below its competitors) its Long Term Interruptible schedule (LTI2) to 16.1 pence per therm deliverable anywhere in Britain. By February 1991, BG realised that it had "pitched the LTI2 price too low," that it had misjudged power station demand and that this extra supply exposure could jeopardise contract market supplies.[74]

British Gas then, at short notice, attempted to impose a thirty-five percent price increase on the LTI2 gas. It discriminated against customers by offering the pre-increase price to selected customers who signed before a short deadline. Complaints from potential LTI2 customers stated that BG was frustrating contract requests with a last minute request for parent company financial guarantees upon closing of respective deals (instead of within three months following signing of the contracts as was the previous practice). Two

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71. McGowan et al., *supra* note 4 at 43,46,56. Sir James McKinnon, Director General of Gas Supply said that 1991 was a "fulcrum" year. "Perhaps it is time for those who have regularly complained about the alleged shortcomings of the 1986 privatisation methodology to admit that it did contain all the ingredients necessary to bring about a self-sustaining competitive market in gas supply. What may not have been fully realised is that the regulatory framework used in 1986 for the gas industry had inbuilt corrective mechanisms.": OFGAS Annual Report 1991, *supra* note 23 at iv.

72. McGowan et al., *supra* note 4 at 53.

73. OFGAS Annual Report 1991, *supra* note 23 at 11.

74. *Id.* at 29.

provisional orders were issued by OFGAS against BG requiring it to contract with two power station projects at the pre-increase price.[75]

British Gas considered this to be a supply/demand crisis. OFGAS opined that BG was violating Section 9(1) of the Gas Act, Condition 5 of its authorisation,[76] that it discriminated by giving prior notice of price increases to some customers but not to all and in the requests for parent company financial guarantees. The Director General of OFGAS threatened a final order concerning breach of statutory duties against the company unless BG established a new long term interruptible schedule.[77] In September 1991, BG proposed a new schedule that halved the original price increase, changed the onerous and discriminatory provisions and proposed a cap of 1.1 billion therms of gas available. OFGAS gauged the market reaction to "see if the price and other terms could be regarded as a proper response to requests for an economic supply of gas." Protracted legal action was avoided as OFGAS accepted the new changes and BG negotiated settlements for damages with the two power station projects (Barking in East London and Coryton) which were refused service at the pre-increase price.[78]

These tough measures have to be seen in light of British Gas' phenomenal performance. British Gas has reacted to previous regulatory pressure by diversifying its profits, which have recently reached approximately £1 billion per year. It is also altering its "corporate culture" into three divisions: gas business in the U.K., exploration and production, and "global gas."

Gas business in the U.K. covers not only sales to tariff and contract customers, but also the company's activities in the area of gas transmission (a transportation services department has been established) and power generation (both in terms of sales to power producers and its own Utiligen joint venture). Exploration and production covers activities in the UKCS, elsewhere in Europe and the rest of the world. A number of ventures are under way. The global gas division covers consultancy and technology transfer activities as well as interests in gas distribution companies in other countries.

Global Gas is the name British Gas gives to its desire to develop an overseas gas distribution and supply operation. Its proposal to acquire Consumers Gas, Canada's largest natural gas distributor, for C$1.1bn (£563m) is the clearest example to date of this strategy. Announced in March 1991, the Consumers Gas acquisition still has successfully faced several tough regulatory hurdles in Canada. This diversification process can be seen as a clever corporate strategy by the once vertically integrated, state-owned system.

V. 1991 Office of Fair Trading Report

The 1991 Office of Fair Trading Report[79] was authorised by the Parlia-

75. *Id.* at 29-30.

76. *Id.* at 30.

77. *Id.* at 31.

78. *Id.* at 32.

79. Office of Fair Trading (OFT), The Gas Review: A Review by OFT Officials in Conjunction with OFGAS of the Industrial and Commercial Market for Gas and Developments since the MMC Report: (Summary Version, October 1991). The report saw no likely

mentary Under Secretary of State at the Department of Trade and Industry and was published in October 1991. It found, inter alia, that insufficient competition had taken place since the MMC report and doubted British Gas' incentive to change the situation. New gas supplies to the contract market were unlikely to exceed a 4-5 percent market share in 1992. Lack of gas supplies not already contracted to British Gas was the fundamental reason. Under the 90/10 rule, shippers faced major problems in getting replacements for gas originally obtained via swaps. British Gas' ownership of the entire on-shore storage and transmission system was found to inhibit market entry.

More competition in the gas market was the principle OFT requirement. Substantial BG contracted gas needed to be released to competitors. The OFT recommended abolishing the BG monopoly to supply tariff customers (i.e. those taking less than 25,000 therms a year). The previous wide BG exemption from normal planning requirements concerning construction and operation of pipelines must end in order to create a level playing field for competitors who, hitherto, faced a considerable disadvantage.

In particular, the OFT decided to recommend another MMC inquiry unless British Gas relinquished (auctioned off) 60 percent of the contract market by 1995. While this is not the dismemberment of British Gas that was called for by some during privatisation, it is indeed a momentous chapter in the monopolist's history. Furthermore, this gas would have to be released to competitors, and the pipeline and storage operations would have to be hived off into a separate affiliate, which will conduct business on a non-discriminatory basis with the brokerage arm of the company.[80]

Initially, BG accepted the OFT requirements but then added a new condition that tariff prices would have to rise. Recently, British Gas agreed with the Office of Fair Trading to halve its share of the industrial gas market by 1995 and to split off its pipeline and storage division into a separate subsidiary.[81] Although the first gas sales are due to begin in October, observers suggest that the sale of such large volumes is doubtful due to the lack of adequate regulation. The company made an after-tax profit of £1.16bn in the year ending March 1991.[82]

The Government announced in 1991 that the monopoly affecting gas tariff users (and the monopoly affecting electricity users) would end in 1998.

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change in competition since the MMC report, indicating that it will recommend another MMC inquiry unless BG undertakes to: relinquish 60% of the contract market by 1995 by releasing gas to competitors and disaggregate pipeline/storage operations into a separate affiliate dealing with the rest of the company on a non-discriminatory basis. *See*, Charlotte Villiers, *Increasing Competition for British Gas?*, 3 UTIL. L. REV. at 7-10 (1992), who concludes at p.10 that "the formal regulatory process, with its thin procedural protections, has been replaced by a looser system of private bargaining between the major players, with little opportunity for intervention by other parties."

80. *See also* OFGAS ANNUAL REPORT 1991, *supra* note 23 at 23.

81. British Gas tactics include "filibustering." The Director General of Gas Supply, Sir James MacKinnon commented on discussions with British Gas about a pricing mechanism for gas transportation and storage: "I am increasingly concerned about British Gas' failure to provide the information necessary to meet the timetable agreed as part of its undertaking to the Office of Fair Trading." OFGAS News Release, *Unblocking the Gas Pipeline System*, June 25, 1992.

82. Deborah Hargreaves, *British Gas Agrees to Terms With OFT*, FINANCIAL TIMES, Feb. 28, 1992, at 19.

OFGAS ambitiously hopes that the number of competitors will effectively end the concept of a "natural monopoly" in the U.K. gas industry,[83] although this seems doubtful. Now British Gas is saying that the recent OFT agreement changes its operating conditions so much[84] that the "tough" new domestic formula needs to be eased.[85]

Following acceptance of the new pricing formula, in March 1992, British Gas said that it would freeze residential prices with a view to cutting them later in the year. OFGAS threatened legal action unless BG complied with its request. OFGAS said that since inflation was forecast to remain at 4 percent this year, BG should cut prices now by up to 2p a therm (trimming pre-tax profits £250m), averaging £15 a year in households.[86] Subsequently, on July 31, 1992, OFGAS referred the issue to the MMC.[87]

In January 1991, a statement of intent (and the British Gas Code of Practice on Energy Efficiency) was agreed upon between OFGAS and British Gas confirming their commitment to efficient use of the fuel. It allows the Director General of OFGAS to determine efficient gas performance standards that ought to be achieved by BG. The Citizen's Charter was also published in 1991. It sets out, somewhat ambitiously, a comprehensive litany of principles governing the provision of services throughout the public sector. Based upon this intiative, stronger powers for regulators were incorporated in the Competition and Service (Utilities) Act.[88] The new Act empowers OFGAS, with the

83. OFGAS ANNUAL REPORT 1991, *supra* note 23 at 4.

84. "In the 18th & 19th century the concept of contract was founded on the freedom of contract principle, which assumed the bargaining power of the parties, and the sanctity of contract (Pacta Sunt Servanda)." This should be contrasted with the principle that the circumstances surrounding agreements may change necessitating variation in the agreements rebus sic stantibus). The equal bargaining power concept reflected the economic laissez-faire thinking of the 18th & 19th centuries. CLIVE M. SCHMITTHOFF, COMMERCIAL LAW IN A CHANGING ECONOMIC CLIMATE, 8-12 (2nd ed. 1981). While these maxims are conceptually helpful, they oversimplify the myriad of factors affecting contractual performance.

85. Deborah Hargreaves, *Clash of the Wills Over Power for the People*, FINANCIAL TIMES, May 7, 1992, at 23. "Lower UK gas prices are, however, more a historical accident than a regulatory triumph."

86. Deborah Hargreaves, *British Gas Told to Cut Prices*, FINANCIAL TIMES, May 7, 1992, at 24. Sir James McKinnon, OFGAS' Director-General, said that "It looks like they're trying to hold on to their money as long as they possibly can."

87. OFGAS News Release, July 31, 1992. McKinnon said that "Discussions about appropriate arrangements have been dogged with difficulty and delays which make it impossible to implement a fair system from the originally agreed target date of this October. Reluctantly, I have decided on a revised target date of October 1993 for the introduction of such a system." The President of the Board of Trade, Mr. Michael Heseltine has concurrently exercised his powers to refer the tariff market to the MMC.

88. Competition and Service (Utilities) Act 1992, ch.43 § 56 provides for commencement on such date as may be appointed by order of the Secretary of State. The Gas Act 1986 is amended (§§ 11-19, 37-38), providing a new § 33A (Standards of Performance in Individual Cases), which allows disputes (§ 33A(6)) to be referred to the Director General of Gas Supply. Section 33B provides that the Director may determine overall standards of performance in gas supply, and § 33C enables him to collect relevant information. Public gas suppliers are required to provide information to customers about overall performance (§ 33D). New provision is made for complaints (§ 33E). The Director is empowered to determine standards of performance in connection with the efficient use of gas (§ 15B). Those wishing to become tariff customers now enjoy a new mechanism for determination of disputes (§ 14A) and likewise the Director has new adjudicatory powers over billing disputes (§ 15A) with the Gas Consumers' Council being empowered to make investigations of certain (i.e. core customer) gas supply disputes. The 25,000 therm limit may be

Secretary of State for Energy's consent, to make regulations prescribing performance standards in individual cases as well as performance standards to be implemented by BG. It requires BG to establish and publish a complaint handling procedure.

It also enables greater information collection by OFGAS and prescribes a duty to BG to publish performance information to its customers complete with methodology. OFGAS is discretionally empowered to determine standards of performance on energy efficiency and to resolve disputes, including billing disputes arising under OFGAS' enforceable duties under the Gas Act, as well as power to intervene through enforcement in disconnection disputes.

VI. British Gas Regulation: Conclusion

Regulatory organizations in the U.K. lack the wide-ranging power of U.S. public utility commissions to make rules, to judicially decide tariff cases, audit accounts or give input to investment decisions. In the late 1980's, doubt was expressed whether OFTEL and OFGAS (both are nonministerial departments largely staffed by seconded civil servants) really qualified as regulatory organizations. Their powers appeared to be primarily administrative (in a business, not a public law sense), verifying whether the regulated industry conformed to conditions which they, as regulators, did not set. Real regulatory power arguably lay with the MMC[89] Some legislative powers will, however, increase under the Competition and Service (Utilities) Bill.[90]

Accordingly, these regulatory reforms compliment the third party access program within the U.K.. The efficient pace of one-man, price-formula regulation in the public interest has increased in the U.K. Admittedly, provisions in the 1986 Gas Act concerning third party carriage took four years to be effectively implemented. This pace is remarkable given the intransigence of British Gas to facilitate regulated competition. The British experience suggests that it is possible to have effective regulation without using the rate-of-return hearing system employed in Canada and the U.S.A. Given the challenges ahead, including the E.C. intiatives on transit rights, the price-control formula method cannot be dismissed as a potential regulatory tool for the Community.

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amended by the Secretary of State by Order (§ 8A). Section 4(1A) makes new miscellaneous provision for the conveyance and storage of gas. Miscellaneous provision is also made for Compliance orders against public gas suppliers (§ 48 of the 1992 Act). *See also* OFGAS ANNUAL REPORT 1991, *supra note 23.* Section 15, on the efficient use of gas largely follows the Electricity Act 1989. The bill incorporates the OFT recommendation enabling the tariff threshold to be reduced or abolished, and to allow small consumers to take advantage of direct purchase.

89. IN THE ABSENCE OF COMPETITION, *supra* note 1 at 19. Fair Trading Act § 84(1) provides that the test employed by the MMC is the "Public Interest."

90. OFGAS ANNUAL REPORT 1991, *supra* note 23.