November 1999

# Review of British Gas Trading's Price Regulation

## Initial Proposals

## Contents

# Executive Summary

## *1. Overview*

The present controls on prices charged by British Gas Trading ("BGT") to customers who consume at or below 2,500 therms[1] of gas a year will expire on 31 March 2000[2]. This document sets out Ofgem's initial proposals for regulating BGT's prices from 1 April 2000.

These proposals have been developed in the context of Ofgem's preliminary conclusions from our review of the development of competition in the domestic gas market[3]. They reflect Ofgem's judgement on the most appropriate balance between securing effective competition, protecting customers' interests where competition is not effective and ensuring that BGT can continue to finance its licensed activities.

These proposals are designed to complement the development of competition in the domestic gas supply market. Ofgem believes that where competition is established price caps are no longer required because competition will generally provide sufficient protection for customers. Additional safeguards will be provided by the Gas Act 1986, the gas suppliers' licences and general competition law, in particular the Competition Act 1998.

The preliminary conclusions from our Domestic Gas Competitive Market Review indicate that competition is established for customers paying by Direct Debit. Specifically, Ofgem believes that competition in the domestic gas market will provide sufficient protection for BGT's Direct Debit customers. Ofgem therefore proposes to remove Direct Debit customers from the scope of continuing controls on BGT's prices. This removes price caps from about 5 million customers, or about 35% of BGT's total customers.

[1] 1 therm approximates to 29.3071 kWh.
[2] Formally, 31 March 2000 is not the end of the current control, but the date from which it could be disapplied.
[3] A summary of the preliminary conclusions of this review is given in Chapter 4. Ofgem's full review will be published in December 1999.

Where competition cannot be relied upon to protect customers' interests there is a risk that customers will face higher prices than might otherwise be the case. Ofgem's preliminary conclusions from our Domestic Gas Competitive Market Review suggest that competition is not yet capable of providing sufficient protection for customers on BGT's PromptPay, Standard and PrePayment tariffs. In these circumstances, Ofgem believes there is a continuing need for caps on BGT's prices to safeguard customers' interests.

Ofgem's initial proposals are that revised tariff cap price controls should continue to apply to BGT's PromptPay, Standard and PrePayment customers. As a result of the initial proposals outlined in this document, PromptPay customers at average consumption can expect to see reductions in their annual bill in 2000/01 of about £12 or 4.8%. Standard and PrePayment customers, at average consumption can expect to see reductions in their annual bill in 2000/01 of about £14 or 5.2%. In setting the level of these revised caps, Ofgem has sought to ensure that they allow room for competition to develop.

Ofgem's preliminary view is that these tariff caps should apply for one year. During this period, Ofgem is fully committed to removing the remaining barriers to entry that prevent all customers benefiting fully from competition. Subject to satisfactory progress in removing these barriers, it is Ofgem's firm intent to remove specific price controls on BGT and move towards full deregulation for all domestic gas customers. Protection for customers would then be provided primarily by the Gas Act 1986, the standard gas suppliers' licences and general competition law, in particular, the Competition Act 1998.

## *2. Process*

Ofgem published a consultation document in June 1999 on matters to be addressed in this review. The initial proposals set out in this document are for further consultation. Ofgem would like comments by no later than 22 December 1999. Ofgem intends to issue its final proposals in February 2000. These final proposals will be subject to a 28 day public consultation process. If BGT was to reject the proposals at that stage, Ofgem would expect to refer the matter to the Competition Commission.

### *3. Structure, Form, and Duration of the Control*

Ofgem proposes to set revised tariff caps on the prices BGT can charge its customers paying by its PromptPay, Standard and PrePayment tariffs. These caps will include an allowance for efficient costs related to serving these customers. The present pass-through regime will be removed. Ofgem proposes to continue with an allowed profit margin of 1.5% on turnover.

Tariff caps will apply to the standing and unit charges in each tariff. Ofgem proposes to continue with the merged tariff cap for Standard and PrePayment customers so as not to distort BGT's debt recovery incentives.

Ofgem proposes that these revised tariff caps should be put in place for a one year period from 1 April 2000, subject to satisfactory progress in removing the remaining barriers to entry that prevent customers from benefiting fully from competition. This progress will be assessed in Ofgem's next annual review of the competitive market.

### *4. Gas Purchase and Storage Costs*

Ofgem proposes to include in the overall tariff cap for 2000/01 an allowance for BGT gas purchase and storage costs. Ofgem proposes that the level of this allowance be set at 19.2 p/th (in 1999/00 prices).

Ofgem has chosen not to continue the present pass-through regime for gas purchase and storage costs for several reasons. One of the problems identified with the present pass-through regime is the time it takes to assess whether BGT's purchases were made economically. This creates uncertainty over the appropriate level for BGT's tariff caps, which makes it difficult to assess BGT's performance against its price control. In these circumstances, it is doubtful whether such a mechanism can satisfactorily protect customers' interests or substitute for competition.

BGT's gas purchase costs are more predictable than at the time of the last review. While further renegotiations are possible, it is unlikely that they will be on the scale seen during 1997/98. In addition, uncertainties relating to the opening up of full competition are no longer as significant as they were during the last review. Moreover, around two-thirds of the escalators that determine BGT's outturn gas costs in 2000/01 will be known by the time the final proposals are published in February 2000. In these circumstances, it seems appropriate to cap gas costs, notwithstanding the natural pressure on these costs brought by the development of competition.

The level of the allowance is based upon Centrica's single gas portfolio of purchase contracts, adjusted to reflect the costs of meeting domestic customers' load profile. It also includes an allowance for the costs of contract renegotation.

## *5. Transportation and Metering Charges*

In the context of a one year control, Ofgem proposes to include in the overall tariff cap an allowance for BGT's level of transportation and metering provision costs. Ofgem proposes to set this allowance at our estimate of Transco's charges for these services in 2000/01. Since these charges are already regulated and BGT has limited influence over how they are incurred, it seems appropriate to enable BGT to recover these costs in full.

Our estimates are taken from work being carried out on splitting Transco's price control into three separate controls[4]. Our initial estimate of the allowance for transportation costs is 14.9 p/th, (in 1999/00 prices). Our initial estimate of the metering costs allowance is £12.33 per PromptPay customer and £16.41 per Standard/PrePayment customer. These estimates will be finalised upon publication of Ofgem's proposals to split Transco's price control.

## *6. Supply Costs*

Ofgem proposes to include in the tariff caps an allowance for BGT's supply costs. This allowance amounts to £20.42 per PromptPay customer at average consumption, and £42.11 per average Standard/PrePayment customer at average consumption (both in 1999/00 prices).

[4] Final proposals for the splitting of Transco's price control are due to be published in December 1999.

In order to derive the allowance for supply costs, Ofgem has attributed costs at several levels. First, Ofgem has attributed costs within Centrica plc between BGT and the rest of Centrica. Second, costs have been attributed within BGT between BGT's domestic gas supply business and the rest of BGT (i.e. its industrial and commercial gas supply business and its electricity supply business). Third, domestic gas supply business supply costs have been attributed between tariff groupings, and subsequently between customer-related and commodity-related costs. Throughout, Ofgem has had regard as to whether the costs in question represent forward-looking avoidable costs.

## *7. Profit Margin*

Ofgem proposes that BGT should be allowed a margin of 1.5% of turnover. This is consistent with Ofgem's initial proposals for the Public Electricity Suppliers' supply price regulation[5]. This reflects Ofgem's view of an appropriate return for supplying gas to customers in parts of the market where competition is not yet capable of providing sufficient protection.

## *8. Correction Factor*

At this stage, the precise amount of the correction factor (or 'K' factor) accumulated during the present price control is not known. This is because the economic purchasing reviews for gas, transportation, metering and storage costs (i.e. the pass-through costs) have yet to be finalised. In particular, Ofgem is awaiting an independent assessment of BGT's 1998/99 gas costs. Preliminary conclusions of this assessment are expected in January 2000.

BGT's preliminary view is that it will under-recover costs by about £247 million over the duration of the present price control. Ofgem's preliminary view, however, is that BGT has under-recovered by about £76 million. The difference mainly results from the 1997/98 economic purchasing review and Ofgem's treatment of renegotiation costs over the period of the present price control.

[5] "Review of Public Electricity Suppliers 1998 to 2000 – Supply Price Control Review: Initial Proposals", Ofgem, October 1999.

On the basis of presently available information including BGT's views, and taking into account the overall effect of Ofgem's initial proposals on customers and competition, Ofgem's initial proposals do not include any provision to reflect previous under- or over- recovery.

Given the proposal for a one-year price cap and the continuing development of competition, Ofgem considers it appropriate  to remove the correction factor mechanism from the revised control for any under or over recovery in 2000/01.

# 1. Introduction

This document sets out Ofgem's initial proposals for continuing regulation on BGT's prices from 1 April 2000. This document explains the reasoning behind these proposals and seeks views from interested parties. It is anticipated that final proposals will be published in February 2000. These proposals will be subject to a 28 day period of public consultation.

This document is divided into two parts. Part I, comprising chapters 1 to 5, sets the framework for Ofgem's initial proposals. Chapter 2 describes BGT's experience under the present controls. A summary of responses to our June consultation is provided in Chapter 3. Chapter 4 summarises Ofgem's preliminary conclusions on its current assessment of competition in the domestic gas market. Options for BGT's price regulation beyond 31 March 2000 are discussed in Chapter 5.

Part II sets out Ofgem's initial proposals. Chapters 6 to 9 address each component of Ofgem's initial proposals: gas purchase and storage costs; transportation and metering charges; supply costs; and profit margin. Chapter 10 summarises the effect on customers' bills.

Ofgem wishes to continue to conduct this review in as open a way as possible and to take account of the views of all interested parties. If you wish to express a view on the initial proposals set out in this document or any related matter, we would like to receive your response by no later than 22 December 1999. Responses should be addressed to:

Nick Fincham
Director, Competition
Office of Gas and Electricity Markets
Stockley House
130 Wilton Road
London SW1V 1LQ

It is open to respondents to mark all or part of their responses as confidential, however, we would prefer, as far as possible that responses were provided in a form that can be placed in Ofgem's library.

If you have any queries concerning issues raised in this document, please contact Richard Moriarty on 0171-932-5901 (or e-mail: moriartyr@ofgas.gov.uk) or Colin Garland on 0171--932-1671 (or e-mail: garlandc@ofgas.gov.uk) who will be pleased to help.

# PART 1: SETTING THE FRAMEWORK

## 2. BGT's Experience under the Present Price Control

### *2.1 BGT's Bills to Customers*

Table 1 shows how BGT's bills to customers have changed over the period of the present price control, based on the average annual consumption over the period of 613 therms. It shows that BGT's average bills have reduced in real terms over the period of the present control by 12% for Direct Debit customers, 12% for PromptPay customers, 6% for Standard customers and 14% for PrePayment customers. BGT's Standard and PrePayment tariffs were merged in January 1999 following Ofgem's review of BGT's request to rebalance its tariffs (see Appendix 1).

**Table 1 – BGT's average annual[1] bills over the present price control, in 1999/00 prices**

| | Direct Debit | Prompt Pay | Standard | PrePayment |
|---|---|---|---|---|
| 1997/98 | £294 | £303 | £316 | £347 |
| 1998/99 | £262 | £276 | £306 | £305 |
| 1999/00 | £258 | £267 | £299 | £297 |
| Cumulative Price Reduction | 12% | 12% | 6% | 14% |

Source: BGT

1. Average annual consumption = 613 therms.

Table 2 shows BGT's bills using the average consumption for each tariff over the period of the price control. It shows that the average Direct Debit customer benefited from a cumulative price reduction of 12%. This compares to 12% for PromptPay; 5% for Standard; and 13% for PrePayment.

**Table 2 – BGT's average annual bills over the present price control, in 1999/00 prices**

| | Direct Debit | Prompt Pay | Standard | PrePayment |
|---|---|---|---|---|
| **Consumption**[1] | **742** | **550** | **569** | **485** |
| 1997/98 | £348 | £275 | £297 | £278 |
| 1998/99 | £311 | £250 | £288 | £250 |
| 1999/00 | £307 | £242 | £281 | £243 |
| Acumulative Price Reduction | 12% | 12% | 5% | 13% |

Source: BGT

1. Average consumption over price control period.

### *2.2. Customer Numbers and Volumes*

Table 3 shows the change in customer numbers on BGT's regulated tariffs over the period of the present price control. It shows that BGT's customer base has declined from about 19 million in 1997/98 to about 15 million in 1999/00. Overall, BGT has lost more PromptPay customers than Standard or Direct Debit. The number of PrePayment customers has increased over the period.

**Table 3 - BGT's Customer Numbers[1] and Volumes over the Present Price Control Period**

| | Direct Debit | Prompt Pay | Standard | PrePayment | Total Customers | Total Volumes Therms (000's) |
|---|---|---|---|---|---|---|
| 1997/98 | 5,681 | 6,828 | 5,266 | 1,163 | 18,938 | 10,993 |
| 1998/99 | 5,486 | 4,939 | 4,843 | 1,272 | 16,540 | 10,628 |
| 1999/00 | 5,293 | 4,087 | 4,901 | 1,402 | 14,873 | 9,340 |

Source: BGT

1. Customer numbers are weighted averages of over the year.

### 2.3. BGT's Performance against its Tariff Caps

The position of BGT's tariffs relative to its tariff caps is one indicator of how BGT has responded to competitive pressures for customers in different tariff groups. Table 4 shows BGT's view of its tariffs and its tariff caps in 1997/98. It shows that BGT under-recovered most on its Direct Debit and Standard tariffs, with a smaller under-recovery for PromptPay. BGT priced to its tariff cap for PrePayment.

**Table 4 - BGT's View of its Average Annual[1] Bills Relative to its Tariff Caps in 1997/98 prices**

| | Direct Debit | Prompt Payment | Standard | PrePayment |
|---|---|---|---|---|
| **Consumption[1]** | **709** | **512** | **559** | **455** |
| **Tariff Cap (£)** | 341 | 257 | 297 | 246 |
| **Average Bill (£)** | 314 | 246 | 279 | 245 |
| **Difference (£)** | 26 | 11 | 18 | 1 |
| **Difference as a % of tariff cap** | 8% | 4% | 6% | 0% |

Source: BGT

1. Average annual consumption.

It should be emphasised that the 1997/98 tariff caps shown in table 4 are based on BGT's view of its allowable costs, including allowable gas costs (22.80 p/th). Under the terms of the existing price control it is for Ofgem to determine the level of gas costs, in the light of recommendations from an appointed Assessor.

Ofgem's preliminary determination of allowable gas costs is 22.72 p/th. This is slightly lower than BGT's view but in line with the recommendations made by the Assessor (see Appendix 2).

In 1998, after Ofgas' tariff rebalancing review, the Standard Credit and PrePayment tariffs were unified into a single tariff. Table 5 shows BGT's view of its bills in 1998/99 relative to its tariff caps for all price controlled tariffs. In monetary terms, the under-recovery was greatest for Direct Debit and smallest for PrePayment.

**Table 5 - BGT's View of its Prices Relative to its Tariff Caps at Average Consumption for each Tariff, 1998/99**

| | Direct Debit | PromptPay | Standard / PrePayment |
|---|---|---|---|
| **Consumption[1]** | **754** | **584** | **562** |
| **Tariff Cap (£)** | 337 | 276 | 293 |
| **Average Bill (£)** | 311 | 260 | 281 |
| **Difference (£)** | 25 | 16 | 12 |
| **Difference as a % of tariff cap** | 8% | 6% | 4% |

Source: BGT

1. Average Annual Consumption.

Table 6 shows BGT's view of its bills in 1999/00, relative to its tariff caps for all price control tariffs. BGT under recovered significantly for Direct Debit. It under recovered to a lesser extent for PromptPay. BGT priced at its tariff cap for Standard/PrePayment.

**Table 6 - BGT's view of its prices relative to its tariff caps for average consumption for each tariff, 1999/00**

| | Direct Debit | PromptPay | Standard / PrePayment |
|---|---|---|---|
| **Consumption[1]** | **728** | **564** | **544** |
| **Tariff Cap (£)** | 337 | 258 | 271 |
| **Average Bill (£)** | 302 | 246 | 270 |
| **Difference (£)** | 36 | 12 | 1 |
| **Difference as a % of tariff cap** | 11% | 5% | 0% |

Source: BGT

1. Average Annual Consumption.

An Assessor has recently been appointed to undertake the economic purchasing review of BGT's gas purchase costs in 1998/99.

BGT's expected performance against its tariff cap in 1999/00 and its cumulative K factor over the period of the present control are discussed in Chapter 10.

## *2.4. BGT's Non-Price Controlled Tariffs and Other Offers*

### *a) BGT's Non-Price Controlled Tariffs*

The four regulated tariffs categories, discussed above are not the only basis on which BGT supplies gas to domestic customers. BGT's other tariffs include:

- ValuePlus. In response to competition in the South West of England BGT introduced the ValuePlus tariff in March 1997. At the time, it offered a 5½% discount for Direct Debit customers. After BGT reduced the Direct Debit tariff by 9% on 12 January 1998, The ValuePlus tariff was reduced by a further 3½% to ensure that ValuePlus customers would be no worse off than other customers paying by Direct Debit. Hence, from that date, the ValuePlus tariff did not offer a price advantage over BGT's price controlled national Direct Debit tariff. BGT presently supplies about 35,000 customers on its ValuePlus tariff;

- AdvancePay. Introduced in May 1999, AdvancePay offers a 2% discount against BGT's Direct Debit tariff for customers who pay for at least 12 months' supply in advance. BGT presently supplies over 53,000 customers on its Advance Pay tariff; and

- LPG/LNG. Since British Gas was privatised in 1986, BGT (and its predecessors) has supplied customers on separate Liquefied Natural Gas/Liquefied Petroleum Gas tariffs.

### *b) BGT's Dual Fuel Offer*

In April 1998, BGT began to offer 'dual fuel' energy supplies. BGT offers separate contracts for gas and electricity rather a single 'dual fuel' contract, where the gas contract is typically one of the regulated tariffs. BGT gas customers who take electricity from BGT receive a discount on the electricity standing charge of about £14 a year

(£3.50 per quarter).[6] In addition, BGT offers domestic customers who purchase both its gas and electricity a guarantee that its 'electricity' prices will be cheaper than those of the local PES supplier until 2002. At present, BGT has 2 million electricity customers, of which about 90% had taken up its 'dual fuel' offer.

Ofgem has previously written[7] that, although BGT's 'dual fuel' discount applies to the electricity bill, it is a principal term of gas supply since it affects a customer's reasonable evaluation of BGT's gas tariffs. In July 1999 Ofgem published its assessment of BGT's 'dual fuel' offer[8]. It found that BGT's 'dual fuel' offer did not appear to be predatory and a breach of Standard Condition 13 of BGT's Gas Suppliers' Licence. BGT's 'dual fuel' bills generally covered attributable costs and where they did not the difference was relatively small.

### *(c) Other Offers*

Over the period of the present price control BGT has developed a number of non-tariff offers and 'affinity' offers. These include:

– Goldfish credit card. A joint-venture with HFC Bank. Cardholders receive 1 'Goldfish' point for every £1 spent using the credit card. Each point is worth one pence towards their BGT gas bill. Points can also be redeemed against a variety of other products and redemption partners, e.g. Boots and Asda;

– Home insurance. A joint-venture with Privilege Insurance, which offers one third off the first year's premium back in rebates. BGT has said that the average rebate is worth £71. The rebates are offered as credits towards BGT's gas bills; credits towards BGT's electricity bills; savings on 3 star service cover; savings on appliances sold at British Gas Energy Centres; or as Goldfish points;

[6] No such discount is available to electricity only customers or electricity customers with gas PrePayment meters.
[7] "Review of the Domestic Competition Market", Ofgem, October 1998.
[8] Review of British Gas Trading's Behaviour in the Domestic Gas Market – A Follow-up Document", Ofgem, July 1999.

– Sainsbury's Reward Points – electricity customers are offered 1000 Sainsbury's Reward Points, equivalent to a £10 credit towards purchases at Sainsbury's stores; and

– a mobile phone offer with Vodafone. This is open to all of BGT's customers, whether gas or electricity. Customers are offered a Vodafone mobile phone for £69.99. Customers receive a telephone and £35 worth of 'Pay as you Talk' call time. BGT gives £25 worth of call time, Vodafone gives the remaining £10.

# 3. Summary of Responses

## 3.1. Introduction

Ofgem invited views from interested parties on the main issues raised in its June consultation document. Respondents commented on several areas:

– classes of customers that require continued protection;

– objectives and approach for the price control review;

– option 1 – revised tariff caps;

– option 2 – relative price regulation;

– option 3 – removal of specific price regulation;

– energy efficiency; and

– standards of service.

## 3.2 Customers that Require Continued Protection

BGT said that price controls were no longer necessary as competition provided strong enough incentives for it to reduce its costs to all customers. BGT said that all customers would receive sufficient protection from the Competition Act 1998 and the standard conditions of BGT's gas supplier's licence.

However, in its response to the issue of relative price regulation, BGT said that there were certain customers who may not be benefiting fully from competition and might therefore be included in the target group for continued price control protection, including customers:

- in debt;
- paying by PrePayment meters;
- on low consumption levels;
- paying by frequent payment methods such as weekly magnetic cards; and
- paying through deductions in their DSS benefits.

PESs had mixed views about the extent to which BGT's customers required continued protection. Four PESs said that Ofgem could regulate BGT with the standard conditions of BGT's licence and general competition law rather than explicit controls on BGT's prices. However, four PESs said that BGT's price controls should continue in order to protect the interests of some customers, especially those on PrePayment meters and paying by standard credit. Three PESs argued that all customers should be covered by a continuing price control. One PES believed that the scope of the price control could be reduced, with controls being removed for Direct Debit.

Consumer groups generally said competition was not sufficient to remove price controls. Some said that all classes of customers required continued protection from price controls. Others said that Standard credit customers and especially PrePayment customers required continued protection. One respondent said that any control should aim to protect the interests of low income customers. One consumer group believed there could be valid grounds allowing customers who pay by Direct Debit to be removed from explicit controls. This view was based on the range of attractive offers and switching behaviour.

### *3.3 Objectives and Approach*

BGT said that simplicity and transparency were important objectives whereas present control was complex and opaque. BGT said that the revision process was cumbersome, preventing it from responding rapidly to market developments. BGT agreed with Ofgem's objectives[9] but identified several others in addition. These were:

- flexibility to adapt to changing circumstances;
- a lighter regulatory burden;
- consistency with the Competition Act 1998;
- removal of additional standards of service on BGT; and
- consistency in approach to price regulation between gas and electricity.

PESs generally supported Ofgem's approach and objectives. Most stressed the need for consistency between the gas and electricity supply reviews.

Consumer groups generally supported Ofgem's objectives. Some added that more emphasis should be placed on standards of service, those on low income and the fuel poor.

Energy efficiency groups generally welcomed our objectives, but said that energy efficiency should be recognised as one of the main objectives for the review.

### *3.4 Option 1 - Revised Tariff Caps*

BGT said that revised tariff caps under the existing form of control were not appropriate for dealing with the transition to a fully competitive market. BGT believes that it has sufficient incentives from competition to reduce its cost base. BGT said that if gas costs were to be capped then there would need to be an increase in the allowed margin.

Four PESs said that a revision of the present price control was required. Two PESs said that BGT's allowed supply costs should not be greater than the PESs given BGT's economies of scale and scope. Six PESs responded that if there was a continuation of

[9] These are summarised in Chapter 5.

the present form of control, the current pass-through arrangements should be replaced with a cap on all costs. PESs believed that the removal of the pass-through regime would increase certainty in the market and send clearer cost/price signals to BGT's competitors. Five PESs said that the duration of revised controls should be either one or two years.

Consumer groups were supportive of the continuation of the present form of regulation. Some said that all customers should continue to be covered by the control, while others said that there may be scope to exclude Direct Debit customers. Consumer groups generally believed that price caps were a transparent form of control.

### *3.5 Option 2 - Relative Price Regulation*

BGT welcomed the concept of relative price regulation as a transitional measure where competition is developing but not effective. BGT said that relative price regulation would allow some customers to be protected by the market while providing adequate protection for those customers for whom competition is not yet effective.

BGT proposed that its Direct Debit and PromptPay tariffs could act as the marker group while its Standard and PrePayment tariffs could act as the target group. It said the initial price differential could be based on present tariffs.

PESs had mixed views about whether relative price regulation would be effective in practice. Four PESs thought relative price regulation was the most appropriate way to regulate BGT's prices from 1 April 2000. Most PESs, however, expressed concern about competitive responses being linked to prices in less competitive parts of the market. This could result in reduced aggression for marker customers resulting in target customers not receiving sufficient protection.

Consumer groups generally welcomed relative price regulation as a way in which the benefits of competition could be spread more evenly among BGT's customers. However, four consumer groups expressed concern about the ability of relative price regulation to protect customers' interests, while not distorting the development of competition. These concerns included:

– that the marker and target groups would need to be defined carefully and evolve in response to the changing relative intensity of competition for different customers; and

– that the initial price differential should be based on robust cost differences for the period of the control.

Two consumer groups said that there should be a mechanism to ensure that the control could respond to these developments in order to prevent such developments adversely affecting customers' interests.  Another respondent said that relative price regulation was an attractive form of control.  It would not allow the differential in prices between different payment methods to increase.  However, this respondent said that fuel poverty was caused not so much by expensive gas, but by low incomes.  Relative price regulation would not reduce income inequality.

### *3.6 Option 3 – Removing Price Controls*

BGT said that removing price controls was the most effective and efficient option for the protection of domestic customers in the increasingly competitive marketplace.  BGT said that additional safeguards were provided by BGT's gas suppliers' licence and by the Competition Act 1998.

Four PESs said that the best way to protect the interests of BGT's customers was by removing price controls.  These PESs believed that the combined disciplines of competition, the Competition Act 1998 and strict enforcement of the non-discrimination licence conditions would adequately protect customers.

However, most PESs preferred revised price controls or relative price regulation to complete removal of controls.  Four PESs said that the removal of controls would be premature as BGT had significant scope to abuse its dominant position while competition was not effective.  These PESs said that although the fines for breaching the prohibitions of the Competition Act 1998 were a deterrent, any investigation would take time to process.  These PESs expressed concern that BGT's abuse could have damaged the development of competition before any investigation was complete.

All consumer groups said that removing additional controls on BGT's prices for all customers was premature, given that competition was not fully effective.

### *3.7 Energy Efficiency*

BGT made no specific comment on this issue.

Some PESs commented that treatment of energy efficiency funding should be consistent across gas and electricity supply markets.

Consumer groups were in favour of increasing the role of BGT in the promotion of energy efficiency schemes.  One respondent said that energy efficiency funding in the gas and electricity markets should be treated in a consistent manner.

Energy efficiency groups believed that increasing funding for energy efficiency schemes and increasing customers' awareness of measures that could be taken to improve energy efficiency could have a direct effect on customers' bills.  According to these respondents, energy efficiency was an integral part of helping to alleviate the problem of fuel poverty.  By cutting bills, energy efficiency would make it easier for customers to clear any debt, which would free customers to take full advantage of the competitive market.

### *3.8 Standards of Service*

BGT said that the increasing maturity of the competitive gas market meant it was now no longer appropriate for them to have to operate under additional standards of service obligations over and above those obligations in which apply to all gas suppliers in the domestic market.  In practice, customers will determine standards of service and price.

Two PESs said that the additional standards should apply to BGT as long as they remained dominant in the gas or 'dual fuel' market.  Three PESs said that the introduction of competition meant that customers were adequately protected in terms of standards of service.

All consumer groups said that the market was not sufficiently competitive to protect customers in terms of the standard of service.  Consumer groups therefore believed that BGT's present additional standards of service obligations should remain.  Two consumer groups said that these additional obligations should be extended to all suppliers.

# 4. Assessment of the Development of Competition

## 4.1 Background

Over the course of the last three months, Ofgem has carried out a review of competition in the domestic gas market. The main reason for the review was to inform Ofgem as to which customers will continue to need protection by means of price controls on BGT beyond April 2000.

As part of the review, Ofgem has drawn information from three sources:

– the 1999 Domestic Gas Market Survey. The quantitative element of this survey requested information from domestic gas shippers and suppliers for the period from October 1997 to September 1999 on:

  - suppliers' ownership structure;
  - tariffs and related products, split by volume bands;
  - customers supplied, split by volume bands, tariffs offered and PES areas;
  - volumes supplied, split by volume band, tariffs offered and PES areas;
  - customers in debt and the average level of their debt, split by volume band, tariffs offered and PES areas;
  - customers who are also supplied with electricity, split by volume band, tariffs offered and PES areas;

- customer gains and losses, split by payment methods[10];

- customer movements between tariffs, split by payment methods; and

- expenditure, split between gas, storage, transportation, metering, supply and other costs;

– the 1999 MORI survey. Ofgem recently commissioned MORI to undertake a survey of customer attitudes and experiences of competition in the domestic gas and electricity markets. Interviews with customers were conducted in September and October 1999, and the results forwarded to Ofgem earlier in November 1999; and

– information on switching levels provided by Transco.

Ofgem has looked at the evidence available in a number of different ways in order to develop as comprehensive a picture of competition in the market as possible. Ofgem's analysis covers the following areas:

– customer awareness;

– entry and exit;

– market shares;

– switching behaviour;

– price and related offers;

– barriers to entry; and

[10] Payment methods were split into three groups, direct debit, PrePayment and other, which included mainly credit payment methods, such as cheque, cash or postal order.

- assessment of available 'head room'.

A summary of Ofgem's preliminary findings in each of these areas is provided below (section 4.2). This is followed by a summary of Ofgem's preliminary conclusions, including the implications for the scope and duration of future supply price regulation (section 4.3). A full analysis together with Ofgem's conclusions is to be published in December 1999.

## *4.2 Preliminary Analysis*

### *a) Customer Awareness*

Evidence on customer awareness has been drawn from the responses to the MORI survey mentioned in section 4.1. Three key preliminary findings are that:

- 96% of gas customers are aware of their ability to choose alternative gas and electricity suppliers;

- customer responses suggest that they would switch supplier during the next twelve months at a similar rate to the previous year; and

- 60% of customers who had not so far switched gas supplier said they would need a price saving of at least 10% to be persuaded to switch supplier.

Ofgem is currently analysing the responses to the MORI survey to see whether customers' views differ for each payment method.

### *b) Entry and Exit*

There are 26 competitors to BGT in the domestic gas supply market, including 1 new entrant during the last year. There has been some consolidation of suppliers and changes of ownership through mergers and acquisitions, but this has not reduced the net number of suppliers.

### c) *Market Share*

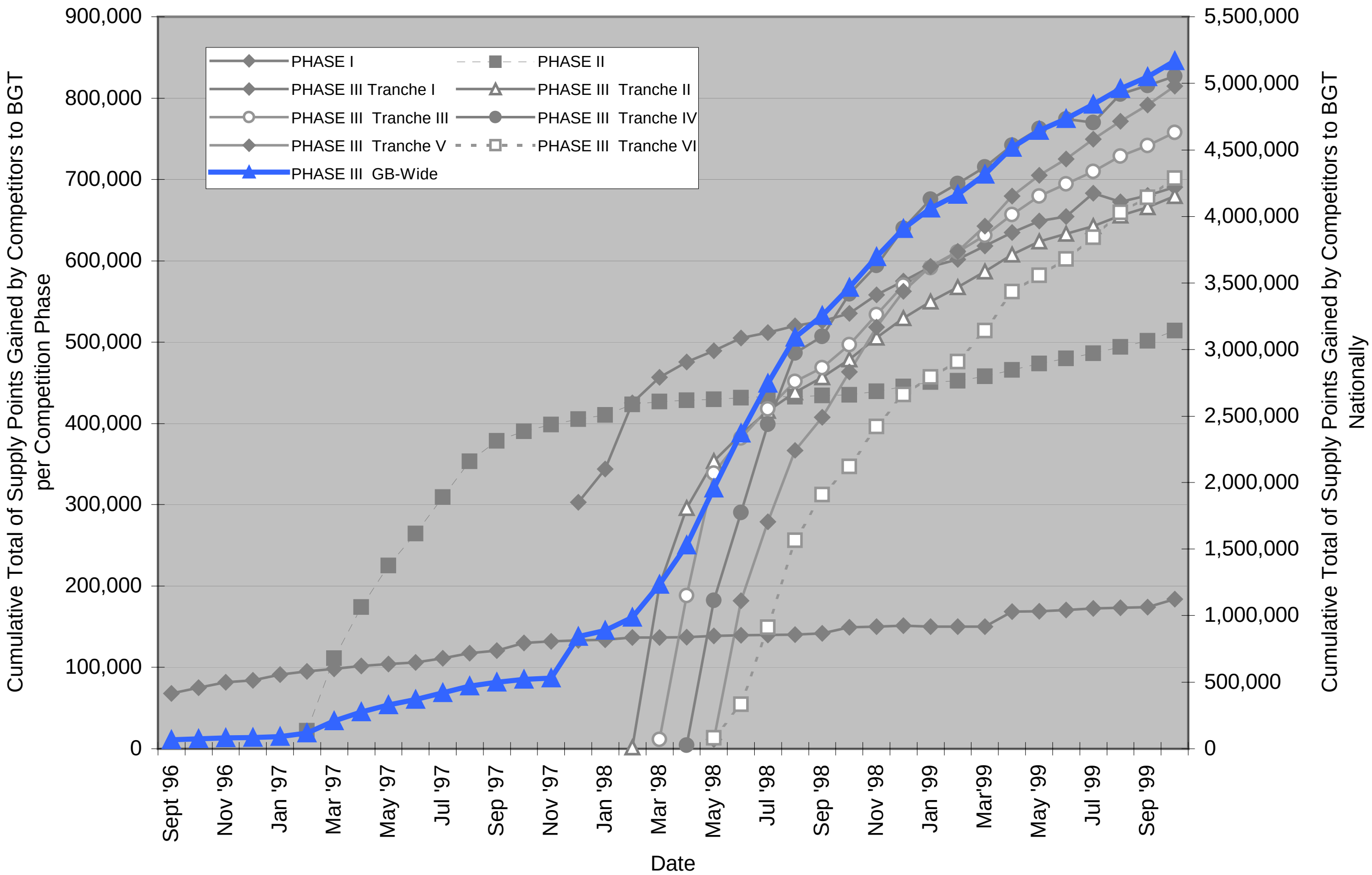
BGT supplies about 75% of the customers in the domestic gas market in Great Britain. By payment method, BGT supplies 70% of direct debit customers, 80% of other credit customers, and 94% of PrePayment customers. There is some evidence to suggest that BGT has lost more customers consuming higher volumes than those consuming lower volumes. Also, from the evidence available, BGT appears to have a disproportionately large share of customers in debt.

Based on sample information from the 1999 Domestic Gas Market Survey, Ofgem estimates that about 3 million of the 5 million customers who have switched from BGT to another gas supplier are supplied on 'dual fuel' deals. A further 1 million customers who have switched from their local PES to another electricity supplier are also supplied on 'dual fuel' deals. Ofgem has noted that very few suppliers offer PrePayment customers an additional discount for taking both fuels from the same supplier.

### d) *Customer Switching*

Switching levels during the last year have averaged about 32,000 per week. From December 1998, once the initial impact of the roll-out of competition had subsided, the switching rate has remained broadly constant. This is shown in figure 1.

**Figure 1 – Switching Rates in the Domestic Gas Supply Market**




There is also evidence that some customers have switched more than once. Moreover, there is some evidence suggesting that there is more switching among customers paying by direct debit than customers paying by other payment methods.

Based on returns from the 1999 Domestic Gas Market Survey, Ofgem estimates that around 70% of PrePayment and 12% of prompt or late payment customers are unable to switch supplier because they have a level of debt that allows their supplier (usually BGT) to block their transfer to another supplier under Standard Condition 7(4) of the gas suppliers' licence. About 60,000 customers[11] on non-Transco PGT networks are either unable to switch or face very limited choice of alternative gas suppliers as BGT have not signed the network codes of non-Transco PGTs.

[11] This figure is approximate.

### e) *Price and Related Offers*

Ofgem has examined the extent to which customers have the opportunity to switch to cheaper gas suppliers while continuing to pay by a comparable method. The broad picture is as follows:

– Direct Debit customers are able to make a significant saving when transferring from BGT to any of its 25 competitors (up to 10%);

– Quarterly credit customers (including PromptPay customers) can benefit from a range of competitive price offers, with discounts of up to 20% available. However, customers paying by a frequent payment method[12] have a limited range of competitive offers to choose from, with some suppliers either not offering a frequent payment method or offering a price higher than BGT; and

– PrePayment customers presently encounter a limited range of competitive offers. It is possible, at certain volume levels, for domestic PrePayment customers who switch from BGT (and wish to retain their PrePayment meter) to obtain a discount. However, at average PrePayment consumption levels (i.e. 480 therms) BGT's PrePayment offer is presently the most competitive in terms of price. In addition, some of the complementary products offered by suppliers are not available to PrePayment customers.

### f) *Barriers to Entry*

In July 1999, Ofgem published a follow-up document to the 1998 domestic competitive gas market review setting out its conclusions on BGT's behaviour in the domestic gas supply market. This document considered the effect on the development of competition of four aspects of BGT's behaviour:

- its 'dual fuel' offer;

[12] This includes customers who pay their bill in weekly, fortnightly or monthly instalments, but do not use a direct debit.

- its complementary products, and in particular, whether they are in accordance with the requirements of Standard Condition 13 and competition law;

- its advertising, and in particular, the effect on competition of misleading advertising by BGT as the dominant supplier; and

- BGT's role in the customer transfer process, and in particular, its failure with regard to the agreed reads[13] process for customer transfers, which Ofgem is investigating under the Competition Act 1980.

BGT's role in the transfer process continues to give Ofgem concern. This will be discussed further in the domestic competitive market review. Ofgem is continuing to monitor BGT's 'dual fuel' offer, its complementary products and its advertising to ensure that it does not restrict, distort or prevent the development of competition.

Specifically for PrePayment customers, Ofgem is concerned that there remain significant barriers to entry, including:

- suppliers' right to object to customer transfers under Standard Condition 7(4) of the gas suppliers' licence, if a customer is in debt;

- uncertainty about the future level of Transco's PrePayment meter charge; and

- the lack of competition in the provision of gas metering services.

[13] An agreed read is required where no actual meter read has been obtained at the time of a customer transfer and the new and old suppliers do not agree with the estimated meter read produced by Transco.

Ofgem intends to consult on proposals to remove the suppliers' right to object to customer transfers because of debt as soon as practically possible. Ofgem will be publishing proposals to address PrePayment metering issues in general in December 1999.

Given the level of market activity in 'dual fuel' supply (see section 4.2(c)), together with evidence that the 'head room' available to 'dual fuel' suppliers entering the gas market is significantly greater than that available to suppliers solely entering the gas supply market (see section 4.2(g) below), Ofgem has also considered barriers to entry in electricity supply.

Bearing in mind the growth in the number of available 'dual fuel' offers, Ofgem plans to consider, and if necessary act to remove, a number of the remaining barriers to entry in the electricity supply market in the next eighteen months, including:

- access to competitive wholesale electricity supplies;
- the lack of robust separation of electricity supply and distribution functions;
- the lack of competition in electricity metering and meter reading services;
- concerns associated with the current transmission charging regime; and
- PESs behaviour in supplying electricity and related products within their own areas.

The removal of these barriers to entry should reduce the costs for potential new entrants to the electricity supply market.

### g) *Assessment of Available 'Head Room'*

In addition to considering the evidence of customer and supplier behaviour set out in sections 4.2(a) to 4.2(e), Ofgem has considered the position of a potential entrant deciding whether or not to enter the domestic gas supply market. Ofgem's analysis considers the position of a supplier entering the market to provide gas and electricity, and gas only assuming the price cap proposals outlined in Chapters 6 to 10 of this document take effect from 1 April 2000.

It is assumed that entrants would face gas costs of 16p/th and supply costs of £20 per customer for credit customers who pay promptly or customers who pay by Direct Debit, and £40 per customer for other credit customers and PrePayment customers. Ofgem has assumed acquisition costs of £40 per customer which it is assumed are recovered over 5 years. Suppliers offering 'dual fuel' deals are assumed to face additional supply costs of £4 per customer for all payment methods and another £4 of acquisition costs per customer, again for all payment methods although in assessing the headroom available beneath BGT's forecast prices, it has been estimated that 50% of acquisition costs and combined supply costs may be attributed to electricity supply. On the basis of these assumptions, Ofgem has estimated the size of the discounts that could be offered relative to BGT's tariffs.

The analysis suggests that the price cap proposals set out in this document leave substantial head room for entrants supplying both gas and electricity. On the basis of the assumptions set out above, new entrants could offer discounts for prompt pay, standard and PrePayment of between 8 and 13%. There is less head room available to suppliers entering the gas supply market only. However, based on assumptions set out above, it would be possible for such new entrants to offer discounts to prompt pay, standard and PrePayment customers in the order of 3 to 5%.

It should be noted that these assumptions are based on discussions with a number of suppliers. Ofgem welcomes views on the assumptions used, particularly in relation to PrePayment supply and acquisition costs, in view of the disparity between the conclusions suggested by this analysis and observed market behaviour.

## *4.3 Preliminary Conclusions*

Overall, Ofgem believes that competition in the gas supply market is developing well. 96% of customers are aware of their ability to choose an alternative gas supplier, 25% of customers have switched gas supplier, the level of customer switching is continuing at about 32,000 per week, the number of rival suppliers to BGT is well in excess of that required for competition most customers are able to obtain competitive offers, with discounts of up to 20% compared to BGT's tariffs available.

Increasingly the gas and electricity supply markets are being characterised by 'dual fuel' offers, with almost half of electricity and gas switchers supplied on 'dual fuel' contracts. Ofgem remains concerned about the barriers to entry in the electricity supply market, many of which it plans to address over the next eighteen months.

Ofgem's initial view is that competition for direct debit customers is sufficiently well developed to enable price controls to be removed. Direct Debit customers are able to obtain a range of competitive offers from BGT's rivals, with discounts of up to 10% available. BGT's market share for this payment method is about 70%, showing that a significant proportion of direct debit customers have been able to take advantage of the competitive offers. Direct Debit customers are also able to take advantage of a range of complementary products offered by gas suppliers, including 'dual fuel' and other discounts.

Ofgem is of the view that competition is not yet sufficiently well developed to remove price controls for PromptPay, Standard and PrePayment customers at this time. BGT has not lost as much market share for credit and PrePayment customers as for direct debit. Some PromptPay, standard and PrePayment customers have a limited range of competitive offers available from other suppliers and a significant proportion of PrePayment and credit customers are effectively unable to switch supplier because they are in debt. If satisfactory progress is made towards removing the barriers to entry discussed in section 4.2(f), it is Ofgem's firm intention to remove price controls from these customers from April 2001.

# 5. Options For Continuing Price Regulation

## 5.1 Introduction

Chapter 4 concluded that there is a continuing need for protection for PromptPay, Standard and PrePayment customers. This chapter discusses Ofgem's initial proposals on the most appropriate way to provide that protection. It also discusses how Ofgem would like to see regulation evolve in the future, in particular a movement from specific supply price controls to protection under general competition legislation and the Competition Act 1998, which comes into effect on 1 March 2000.

## 5.2 Objectives for the Review

Ofgem has considered carefully comments raised on the objectives set for the review. In essence these comments fall into four categories:

- consistency of approach across electricity and gas supply reviews;
- a desire for greater practicality and simplicity;
- comments on the need for continuing standards of service, obligations specific to BGT; and
- comments on the need for greater emphasis on energy efficiency alternatives.

Ofgem shares the desire for consistency of approach between electricity and gas reviews. As far as practicable, Ofgem has adopted this objective in carrying out this review.

Transparency is an objective of the review. Part of satisfying this objective will be developing proposals that are as simple and straightforward as possible.

Ensuring that domestic gas customers are properly protected in terms of standards of service is also an objective of the review. However, it is not in itself an objective either to remove or to retain standards of service. Whether to retain specific standards of service obligations on BGT over and above those applicable to other domestic gas suppliers will depend on whether customers can be adequately protected by competition in their absence.

The objective to provide incentives to efficiency in effect spans both the efficient *supply* of and the efficient *use* of gas. However, allowances specifically designed to be used to meet energy efficiency standards of service have been included within the proposed price caps. These are discussed in Chapter 10.

Against this background, Ofgem has retained the objectives set out in the June Consultation Document. Briefly, any form of continued price regulation should:

– not distort the development of competition;

– protect customers' interests where competition is not yet effective;

– provide incentives to efficiency;

– protect customers in respect of standards of service; and

– be transparent.

In addition to these principles, Ofgem has considered each of the options in the light of respondents' views and the findings of our recent review of the domestic gas supply market.. Each of the options outlined in the June Consultation Document is assessed against these objectives in section 5.3.

### *5.3 Discussion of the Options*

#### *a) Option 1 - Revised Price Control*

Revising the present price control for PromptPay, Standard, and PrePayment customers would involve re-setting appropriate tariff caps. The structure would be similar to the present price control with price caps on the standing charge and commodity charge elements of customers' bills. The principal advantage of revised caps is the certainty that they give that consumer interests will be protected in circumstances where competition is weak or where its likely effectiveness is questionable.

One of the main issues in revising the present controls is the extent to which BGT's costs should be subject to a cap or alternatively whether these should be passed through to customers. The present price control only sets a cap on supply costs, which account for 14% of BGT's total costs of serving domestic gas customers. The remaining costs are passed through subject to an economic purchasing requirement. This is designed to ensure that customers are protected from BGT purchasing these costs inefficiently.

The decision to pass-through gas costs related to the circumstances that prevailed at the time of the last review. The future level of gas costs was subject to a high degree of uncertainty due to the impending renegotiation process and the opening of domestic competition. Transportation, metering and storage costs were subject to pass-through because of BGT's limited ability to influence these costs.

One of the problems identified with the present pass-through regime is the time it takes to assess whether BGT's purchases were made economically. This creates uncertainty over the appropriate level for BGT's tariff caps, which makes it difficult to assess BGT's performance against its price control. In these circumstances it is doubtful whether such a mechanism can satisfactorily protect customers' interests where competition is not effective. It provides neither certainty nor transparency.

One option to overcome these problems is to include the current pass-through costs in a revised cap. In doing so, Ofgem would need to be comfortable that the uncertainty over the level of these costs and BGT's lack of discretion over how they are incurred are no longer significant within the proposed duration of the price control.

By including a greater share of BGT's costs in a revised price cap it is important to consider how this would impact upon the development of competition. If set at an appropriate level, a price cap should not prevent, restrict, or distort the development of competition. In practice this means that a revised price cap should provide adequate protection for customers where competition cannot be relied upon, but should not reduce BGT's prices to such a level as to dissuade competitors, actual or potential, from continuing to compete or enter the market. In setting the level of price caps judgement is required on the appropriate balance between these objectives.

### *b) Option 2 - Relative Price Regulation*

In Chapter 4, Ofgem concluded that competition is more effective for some customers than others. In these circumstances, relative price regulation could act so as to link the prices charged to customers where competition is less effective (the "target" group) to the prices charged to customers who are afforded sufficient protection by competition (the "marker" group).

In principle, relative price regulation would bring down prices to target customers to the extent that competition continues to develop for marker customers. In this sense, relative price regulation acts to ensures that the benefits of competition are widely distributed among different classes of BGT's customers. It also gives BGT an incentive not to discriminate in its search for efficiency savings and innovation.

An appropriate price differential between the marker and target groups could be predetermined for a specified period. The differential could be fixed. Alternatively, Ofgem could set guidance on the appropriate tolerance for price differentials that would act as triggers for further investigation, under BGT's licence conditions or the Competition Act 1998, in which case relative price regulation would differ little from the approach under Option 3 below.

Relative price regulation could give customers and BGT greater certainty as to what is and what is not acceptable pricing conduct. It could reduce, and to a large extent replace, the regulatory burden associated with monitoring and enforcing non-discrimination provisions. Provided the pre-determined price differentials were reasonably related to relative attributable costs, this approach is also fully consistent with the principles of general competition law.

One of the issues raised by respondents against this form of regulation was the potential for it to introduce distortions in BGT's behaviour. In particular, BGT may be less inclined to cut prices to marker customers if they must be matched by price reductions to target customers. The strength of this effect would depend on many factors, including the degree of competition for marker customers, the relative importance BGT places on the expected profit streams from both groups, and the degree of rigidity imposed on relative prices.

Chapter 2 explained that the potential target customers, PromptPay, Standard and PrePayment, represent about 65% of BGT's customers in 1999/00. Under these circumstances, there is a possibility that BGT might be inclined to reduce its aggressiveness in responding to competition for Direct Debit customers. If, in addition, the degree of competition for Direct Debit customers was significantly dependent on BGT's conduct (for example, if changes in BGT's prices have significant effects on the prices of rivals), this might in turn risk denying Direct Debit customers the full benefits of competition and reduce the protection provided to those customers who cannot rely on competition.

On the other hand, if relative price regulation were restricted only to giving guidance on acceptable ranges of price differentials, with some flexibility in deciding how to proceed if differentials moved outside these ranges, then the potentially negative effects of the approach would be mitigated. Moreover, in circumstances where there might be a concern that BGT could behave in a predatory way in certain segments of the market, introducing constraints on relative prices is one way of reducing incentives to price in a predatory manner.

#### ***c) Option 3 – Removal of Additional Price Regulation on BGT***

Where competition can be expected to protect customers' interests it is preferable to withdraw from specific additional regulatory requirements on BGT's pricing behaviour and to rely on safeguards contained in all domestic suppliers' licences together with general competition legislation. The main regulatory safeguards governing suppliers' behaviour would be Standard Condition 13 of the gas suppliers' licence preventing discrimination and the provisions of the Competition Act 1998.

In terms of the Competition Act 1998, the Chapter II prohibition that prevents abuse of a dominant position could be used instead of additional price regulation on BGT. This prohibits abuse a dominant position by BGT through excessive, predatory, or discriminatory pricing levels or structures.

The Competition Act 1998 will give Ofgem new powers in the event that BGT abuses a its dominant position. The Act allows Ofgem to impose interim measure directions during an investigation into a potential breach of the prohibitions. An interim measure direction may require BGT to cease an agreement or conduct until Ofgem completes its investigation. Ofgem can also impose financial penalties of up to 10% of BGT's UK turnover for infringement of the prohibitions.[14]

Removing additional regulation on BGT and relying on Standard Condition 13 and the Competition Act 1998 potentially offers significant benefits to both BGT and customers. It would mark a withdrawal from specific prescriptive regulation and a move towards full deregulation, allowing customers to benefit fully from the competitive process. It would remove regulatory distortions and allow BGT to compete on an equal footing with other suppliers.

Removing all additional regulation at the current time could however have drawbacks for those customers who do not yet enjoy vigorous competition. Chapter 4 explained that there are some remaining barriers to entry that imply that customers paying by BGT's PromptPay, Standard, and PrePayment tariffs may not yet be receiving the full benefits of competition.

[14] In December Ofgem will publish draft sector specific guidance which, together with the guidelines published by the Office of Fair Trading, will set out the general principles to be applied when exercising powers under the Competition Act 1998 in the gas and electricity markets.

These barriers arise as a result of certain aspects of the current gas regime, which Ofgem intends for address over the course of the next year, and the immature state of development of competition in metering. Determining whether or not an abuse of dominant position has actually occurred, may therefore be particularly difficult in circumstances where competitive conditions are being substantially altered by past and present regulatory decisions. Such complexities surrounding the immediate enforcement of the Competition Act may also create uncertainty among market participants, which itself could adversely affect entry conditions.

It can be argued therefore that Ofgem should seek first to address the remaining entry barriers, before relying *solely* on Competition Act powers to promote competition and protect consumers.

### *5.4 Ofgem's Position*

Where there is evidence of relatively vigorous competition for certain classes of customers, Ofgem believes that removing specific additional regulation and relying on the standard licence provisions and the Competition Act 1998 is the most appropriate safeguard for the customers concerned.

Ofgem is of the view that this position has been reached in relation to Direct Debit customers and therefore proposes to remove Direct Debit customers from the scope of continuing price regulation beyond 1 April 2000. This introduces full deregulation for about 5 million domestic gas customers, about 35% of BGT's total customers. It also enables BGT to compete for these customers on an equal footing with other suppliers, subject to the provisions of the gas suppliers' licences and the Competition Act 1998.

Where competition appears to be relatively weak, Ofgem believes that removing additional specific regulation would leave customers without sufficient protection. The Competition Act 1998 will offer a means of dealing with such situations by prohibiting any abuse of a dominant position. Initially, however, there will be some uncertainty as to its operation, and there may be some (albeit relatively short) delay before its impact is fully felt. Remaining barriers to entry mean that there is a risk that, in the short term, some customers will pay higher prices than would be the case if an alternative approach were taken.

Of the remaining options, Ofgem believes that, at the present time, there could be significant drawbacks to relative price regulation based on rigidly fixed price differentials. The importance of PromptPay, Standard, and PrePayment customers to BGT's total revenue and profits means that relative price regulation based on such fixed price differentials may not provide sufficient protection for these customers and may distort BGT's competitive responses for Direct Debit customers.

Ofgem therefore proposes to revise the current tariff caps for PromptPay, Standard and PrePayment customers. In doing so, Ofgem has made a judgement on the most appropriate balance between securing effective competition, and protecting customers' interest where competition is not effective.

This judgement has been informed by a detailed assessment of BGT's costs of serving its domestic gas customers. Ofgem's initial proposals on the treatment of BGT's costs are set out in Chapters 6 to 9. These are summarised in Chapter 10, which contains Ofgem's initial proposals for revised tariff caps to commence from 1 April 2000. This judgement has also been informed by the analysis of available margins for BGT's competitors set out in our Domestic Gas Competitive Market Review[15].

Ofgem proposes that the duration of these revised tariff caps should complement the development of competition. In this regard, Ofgem is fully committed to identify and remove the remaining barriers in gas and electricity, as discussed in Chapter 4, that prevent competition being established for BGT's PromptPay, Standard, and PrePayment customers. Major initiatives during the next year include the New Electricity Trading Arrangements (NETA) and a consultation on the right of suppliers to object to the transfer of customers in debt.

[15] This is summarised in section 4.2. A more detailed description of this analysis will be published in December 1999.

Once competition becomes more clearly established for all BGT's customers then Ofgem intends to remove additional regulation on BGT's pricing behaviour and rely on the safeguards contained within the gas suppliers' licences and the Competition Act 1998.

Ofgem therefore proposes to set the revised tariff caps for one year only. Subject to satisfactory progress being made in removing remaining barriers to entry, it is Ofgem's firm intent that price controls should be removed completely from the domestic gas supply market from April 2001. Limiting the duration of the control to a one year period will also have the advantage that it will, without significant risk to BGT allow the cost pass-through regime to be abandoned, thereby eliminating a number of the current complexities of price control discussed in section 5.3(a) above.

# 6. Gas Purchase and Storage Costs

## 6.1 Introduction

Gas purchase and storage costs account for 45% of BGT's total costs in 1999/00, or approximately £1,781 million equating to 19.5p/th[16]. Under the present price control these costs are passed through to customers subject to an economic purchasing requirement.

This chapter considers:

- the treatment of gas and storage costs in continuing controls;
- Centrica's gas purchase portfolio;
- gas purchase contract renegotiations;
- BGT's overall weighted average cost of gas (WACOG);
- BGT's domestic WACOG; and
- BGT's storage costs.

## 6.2 Treatment of Gas and Storage Costs in Continuing Controls

Ofgem's June 1999 consultation document outlined three principal options:

- continuing the present pass-through regime;
- setting a cap with reference to market values; and
- setting a cap based on forecast costs.

[16] These figures are BGT's view of its 1999/00 costs, submitted during the price control review.

### a) *Continuing with the Pass-through Regime*

Chapter 5 discussed the drawbacks of the current pass-through regime. In moving from a pass-through to a cap, Ofgem needs to be comfortable that the reasons for the present pass-through are no longer applicable.

One of the main uncertainties at the time of the last review was the outcome of impending contract renegotiations[17]. During the period covered by the current price control, Centrica has succeeded in renegotiating many of its long-term contracts (discussed in more detail in section 6.4). Future gas purchase costs are now more predictable than at the time of the last review. Ofgem recognises that there may be further contract renegotiations, although that such renegotiations are unlikely to be on the same scale as those already undertaken.

Another significant uncertainty at the time of the last review was the potential impact on BGT's demand of the full introduction of domestic competition. During the last review a range of market share loss scenarios was considered of between 3% and 37% by 2000. After eighteen months of the full opening of competition, there is now far less uncertainty about its impact on BGT's domestic supply business. A one year duration for continuing controls further limits this uncertainty.

Storage costs were subject to pass-through because of BGT's limited ability to influence these costs. However, since the last review, competition in the provision of storage services and related products has developed significantly. While Ofgem accepts that the introduction of competition in storage services may bring a degree of uncertainty over future costs, setting a cap on storage is unlikely to be onerous because the introduction of competition is likely to reduce prices rather than increase them. This means setting a cap should not generate a financial risk to BGT and it may pass the benefit of reducing costs through to customers.

[17] Renegotiations were required for a number of reasons including a general over-supply position and the cost of these contracts being much higher than the prevailing market rate. For a full discussion, see Appendix 6, "Review of British Gas Trading's Domestic Gas Supply Price Regulation: A Consultation Document", Ofgem, June 1999

These changes in the environment surrounding BGT's gas and storage purchases together with the experience of the present pass-through regime (discussed in Chapter 5) indicate that continuing with a pass-through regime is no longer appropriate.

### *b) Market Based Control*

One of the purposes of continuing controls on BGT's prices to domestic gas customers is to protect their interests where competition cannot be relied upon to do so. This could be taken to mean that customers should pay only as much for their gas and storage costs as could be charged in a competitive market. In practice this would mean a cap on gas and storage costs based on the market prices for their purchase.

However, Ofgem considers that there could be serious shortcomings associated with setting a market-based cap in present circumstances. Although there is now a healthy market for gas and storage in the UK, BGT still dominates the segment of that market which meets the particular requirements of domestic gas consumers. Any attempt to link the prices chargeable by the dominant participant in that segment to those experienced by minority participants would be highly problematic. It would be difficult to ascertain market prices in such circumstances with sufficient reliability, and perhaps more importantly would distort BGT's incentives to influence those prices. Moreover, to the extent that BGT's purchase price of gas remains above its competitors, then capping BGT's gas costs with reference to market rates would lessen the gap between competitors and BGT, and thus potentially damage the continued development of competition.

### *c) Gas and Storage Forecast Cost Cap*

The present pass-through regime for gas purchase costs allows BGT to reflect in its prices to domestic customers the costs associated with its portfolio of long-term contracts.

For the reasons outlined above, Ofgem believes that it is appropriate to set a cap on BGT's gas and storage purchase costs for the one year period of the price control which reflects the costs associated with Centrica's single portfolio of gas purchases (including its long-term gas purchase contracts). Ofgem considers that a cap on this basis would overcome the problems associated with the present pass-through regime and would strengthen BGT's incentive to reduce its gas and storage costs. Moreover, since Ofgem proposes a control period of only one year, many of the uncertainties associated with gas costs for that year will have been removed before the control comes into place, particularly in relation to contract escalators.

In assessing the level of this cap for the year 2000/01 Ofgem has been assisted by Arthur Andersen. The calculation and risks associated with this cap are discussed below.

### *6.3 Centrica's Single Gas Portfolio*

#### *a) The Single Portfolio*

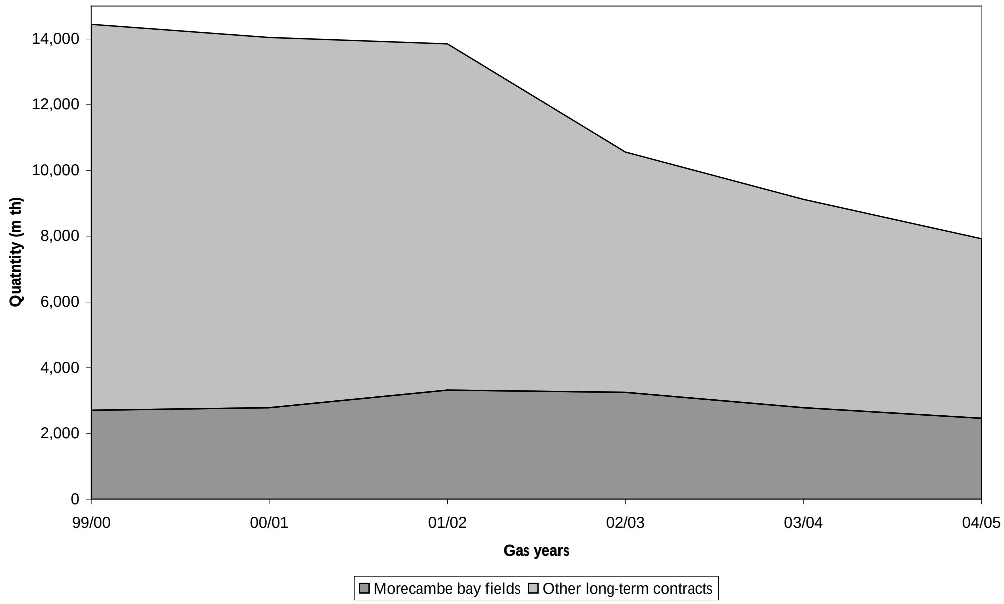
Ofgem has treated all Centrica's gas purchases as one single portfolio of gas (excluding those which fall outside of the definition of regulated gas[18]). This is to ensure that domestic customers are not discriminated against by bearing the cost of expensive gas from long-term supply contracts when Centrica might be purchasing gas more cheaply from other sources and passing this to customers in parts of the gas market that are more competitive, such as the industrial and commercial sector.

#### *b) BGT's Long Term Contract Commitments*

BGT has 34 long-term gas purchase contracts with third party gas producers. Over the next nine years it is committed to buying a minimum of 63 billion therms of gas under these contracts. BGT also sources, under internal contracts, gas from the North and South Morecambe fields which are owned by Hydrocarbon Resources Limited (HRL), a wholly-owned subsidiary of Centrica, with minimum volumes over the next nine years of 23 billion therms. Between the current year and the 2004/05 gas year[19], the projections of BGT's contract purchases are shown in the diagram below.

[18] Broadly speaking, 'regulated gas' excludes gas purchased under contracts of less than six months' duration (or of less than one year's duration in the case of purchases from a related person) as well as gas traded outside Great Britain.
[19] A gas year ends on 30 September.

Figure 2 – Centrica's Long-Term Contract Commitments




For the proposed price control year of 2000/01, demand from domestic and industrial and commercial customers is forecast to be approximately 14.6 bn therms so almost all of this demand will be met through long-term gas purchase contracts. Purchases from uncontracted sources are not projected to become a significant proportion of the portfolio until after the period of the price control.

### *c) Centrica's Wholesaling Purchases*

The present price control excludes from the definition of the single gas portfolio any gas purchases which were made for the purposes of wholesale gas trading. These are defined as being "*a contract for the purchase of gas for enabling a particular contract for the sale of gas during a period not exceeding six months (or, in the case, of a contract for the sale of gas by a Related Person, not exceeding twelve months)"*[20]. This aims to ensure that Centrica is not discouraged from operating a separate gas wholesale trading business through its subsidiary Accord Energy.

The Assessor appointed to review 1997/98 gas costs examined the activities of Accord Energy. The Assessor examined whether there was evidence of discrimination between regulated and unregulated gas; whether any unregulated gas could reasonably have

[20] "BGT Price Control Review: Final Proposals", Ofgem, November 1996.

been made available to the regulated gas portfolio; and whether BGT's purchases met their economic purchasing obligation. The Assessor found that a small number of sales from Accord to BGT fell into the definition of regulated gas. The Assessor did not find any systematic evidence of other Centrica gas purchases that should have been included.

In light of these factors, for the purposes of setting a cap on gas costs for 2000/01, Ofgem proposes to continue with the present exemption from Centrica's single portfolio of wholesaling purchases of less than one year in duration.

#### *d) "Take or Pay"*

A significant issue at the time of the last price control review was the degree to which BGT faced a problem of 'oversupply' in terms of its volume commitments under long-term contracts exceeding demand for gas from its customers. Under the terms of its long-term contracts, BGT was committed to paying for gas regardless of whether it took it from suppliers. This led to the accumulation of significant "take or pay banks". By October 1995, BGT had a total of about 4.2 billion therms in its take or pay banks. Since that time, Centrica has renegotiated many of its long-term contracts and, while it still has take or pay banks, they are at a much smaller level and are depleting rapidly. By October 2000, BGT's take or pay banks are expected to be about 535 million therms and are projected to be completely depleted by 2003.

The costs of financing the take or pay banks are forecast to account for around 1.2% of BGT's total gas costs in 2000/01. These are split between domestic and non-domestic customers in the same way as other gas costs.

### *6.4 BGT's Contract Renegotiations*

At the time of the last price control review, BGT[22] was about to enter a process of renegotiation of its long-term gas supply contracts. BGT entered into this process because its long-term contracts were presenting a significant financial liability in terms of its obligation to pay for gas it could not take at prices that were significantly above the

[22] Or Centrica on behalf of BGT.

prevailing market price. Between late 1996 and October 1999, BGT succeeded in renegotiating 20 deals with third party suppliers. BGT also renegotiated one of its internal contracts with HRL relating to the South Morecambe field.

#### *a) Ofgem Guidance*

Ofgem issued guidance notes for the economic purchasing requirement[23]. Ofgem's view was that the costs and benefits of renegotiation should be passed through to domestic customers in a non-discriminatory way. Ofgem noted that while the benefits pass through automatically under the allowable gas cost methodology, this may not always be the case for the costs. Ofgem envisaged at this time that the costs of contract renegotiation would be passed through in proportion to the benefits.

#### *b) External Contract Renegotiations*

Most of the renegotiations with third party suppliers involved an up-front payment in return for reduced prices and / or reduced volumes under the long-term contracts. Payments made to external suppliers total £1.2bn[24]. These may be compared to the present value of benefits totalling £1.8bn[25], calculated as the reduction in BGT's forward looking gas costs.

Counterparties own shares in different gas fields, therefore BGT's renegotiations tended to be on a party-by-party basis not a contract by contract basis. A significant factor in encouraging producers and BGT to renegotiate was the fact that one-off payments in return for revised contractual terms were not subject to Petroleum Revenue Tax. This allowed BGT and producers to generate a 'win-win' deal from the renegotiations.

To recover the costs of renegotiations from customers over time, BGT allocated the costs to future years in proportion to when the benefits accrue in its long term contracts, stated in money of the day or Net Present Value (NPV) terms. BGT used a nominal discount rate of 12% to calculate benefits in NPV terms which it has said is its weighted average cost of capital (WACC)[26], equivalent to 9.3% in real terms.

[23] Appendix 2 of "BGT Price Control Review: Licence Modification", Ofgem, May 1997
[24] The costs and benefits given in this paragraph are as provided by BGT and are in 1 April 1997 prices.
[25] Benefits are converted into 1 April 1997 values using real pre-tax discount rate of 8% (see Chapter 9)
[26] Ofgem notes this discount rate is inconsistent with BGT's submission on its WACC (see Chapter 9)

Ofgem is concerned to ensure that the benefits of renegotiation are not skewed in such a way as to discriminate between customers over time. Ofgem's initial view is that the distribution of benefits from renegotiation does not discriminate between customers[27]. BGT has recently provided Ofgem with more detailed information than was used for the 1997/98 economic purchasing review. Ofgem is currently reviewing this information to determine whether its initial views hold.

Subject to the above, Ofgem accepts BGT's method of profiling the costs of renegotiation. However, Ofgem disagrees with the discount rate used by BGT. Ofgem's view on BGT's cost of capital is discussed in Chapter 9. It concludes that BGT's real, pre-tax cost of capital is 8%. Ofgem has therefore applied a real discount factor of 8% to external renegotiation benefits and costs. The effect of this on the allowance for gas costs under the present control and the proposed continuing control in 2000/01 is set out in table 7.

**Table 7 – Effect of Using an 8% Discount Factor for External Renegotiation Costs (1999/00 prices)**

| | **1997/98** | **1998/99** | **1999/00** | **2000/01** |
|---|---|---|---|---|
| Renegotiation costs at 9.3%(£m) | 34 | 160 | 220 | 238 |
| Renegotiation costs at 8% (£m) | 32 | 149 | 205 | 221 |
| Reduction in WACOG of adjusting from 9.3% to 8% (P/th) | 0.0 | 0.1 | 0.1 | 0.2 |

***c) Internal Contract Renegotiations***

As well as renegotiating its gas purchase contracts with third parties, BGT also renegotiated its internal contract with HRL for gas sourced from Centrica's South Morecambe field, effective from 1 January 1998. The Morecambe fields are particularly

[27] It should be noted however, that Ofgem's view is based on projections to 2007.

valuable because of their high swing capability. This internal renegotiation was conducted in a different way from the external renegotiations.

The renegotiation was agreed by the Oil Taxation Office (OTO) and, instead of a one-off payment in return for future benefits, the payments are made over time. The renegotiated price is the market price multiplied by a factor of 1.31. The Assessor was satisfied with the level of these payments for the economic purchasing review and Ofgem is considering whether the level of these payments is at arms length and consistent with the proper protection of domestic customers.

#### *d) Ofgem's Initial Conclusions*

Ofgem agrees with BGT's cost allocation methodology. However, it disagrees with the discount rate BGT used to inflate the costs. Ofgem has adjusted BGT's allowable renegotiation costs to take account of this. On internal renegotiations, Ofgem is considering whether the level of the compensation payments is at arms length.

### *6.5 BGT's Weighted Average Cost of Gas (WACOG)*

#### *a) Ofgem's Approach*

BGT provided Ofgem with a gas cost model that aggregated its single portfolio contracts. Ofgem's preferred approach is to calculate BGT's WACOG using a "bottom-up" approach, considering the single portfolio on a contract by contract basis. Ofgem's analysis of the single portfolio takes into account the minimum contracted volumes and outstanding take or pay balances. Table 8 shows the differences between the two approaches.

**Table 8 - Ofgem's view of BGT's overall WACOG (p/th), 1999/00 prices**

| | **1999/00** | **2000/01** |
|---|---|---|
| BGT's view from BGT's model | 17.4 | 18.3 |
| BGT's view from Ofgem's model[29] | 17.1 | 17.8 |
| Difference | (0.3) | (0.5) |

### *b) Escalators*

The prices of gas purchased under long-term contracts are inflated according to movements in various external indices, known as contract escalators. In considering BGT's gas purchase portfolio on a contract by contract basis, Ofgem has examined the escalators in detail.

The main contract escalators for 2000/01 are indices relating to the Producer Price Index (PPI), gasoil prices, heavy fuel oil prices and gas prices. BGT has provided Ofgem with its projections of prices of the main escalator indices. Ofgem has tested the key escalators against independent estimates and is satisfied that they are broadly consistent with those forecasts.

Ofgem is considering whether it is appropriate to use the forward price of commodities rather than direct forecasts. Ofgem welcomes views on this alternative approach.

### *c) Risk from a Gas Cost Cap*

Since the majority of gas purchases are from long-term contracts, the prices of which are not fixed and dependent upon escalators, Ofgem has considered the risks of BGT over- or under-recovering its actual gas costs.

The main uncertainty relates to the prices for gasoil and fuel oil. These are largely affected by changes in the price of crude oil. The crude oil price has fluctuated widely over the past year, from $9.6/bbl in December 1998 to $25.1/bbl in November 1999, which causes gasoil and fuel oil prices to fluctuate generating some uncertainty. Ofgem

[29] BGT's key assumptions have been applied

estimates that if the crude oil price immediately rose to over $32/bbl and sustained that level until June 2000, WACOG for 2000/01 would increase by approximately 0.3 p/th.[32]

Ofgem's preliminary view is that, although there is a degree of oil price risk, its significance is limited because:

- by the time Ofgem publishes its final proposals, over two thirds of BGT's gas costs in the year of the price control will be subject to historical prices, thereby eliminating the risk for that proportion of costs;
- the oil price may fall, which would reduce BGT's gas costs;
- BGT could undertake further contract renegotiations; and
- the duration of the control is limited to one year.

Under the 1992-1997 domestic gas supply price control, a gas cost index was applied. Prices to customers were based on an index that took into account movements in certain escalators. The National Audit Office reviewed the operation of the gas cost index and found that while it encouraged BGT to purchase efficiently, the index itself was higher than BGT's WACOG over the period. This was because the index escalators did not fully match the composition of BGT's contract escalators.

In setting the level of the gas cost cap for the year of this control, Ofgem has taken into account actual and projected movements in all of the escalators impacting BGT's gas purchase portfolio. This is aimed at overcoming the shortcomings of the gas cost index.

## *6.6 BGT's Domestic WACOG*

### *a) Domestic Demand*

Since the portfolio of gas purchases is used to supply both the domestic and industrial and commercial markets, there is no meaningful way to distinguish between physical gas purchases in terms of the markets they serve. However, daily demand in the

[32] The provisional crude oil (North Sea Brent) price on 9 November 1999 was $25.07/bbl.

domestic market is significantly more variable across and within seasons and this makes serving these customers more expensive.

BGT can meet this volatility in demand through the use of storage facilities, through the use of swing in gas purchase contracts, or through purchasing gas on the wholesale market at times of high demand. Gas purchased to provide a high degree of swing will typically be more expensive than that purchased for less swing. In considering BGT's WACOG for the domestic market, some account needs to be taken of this.

BGT plans for a level of domestic swing of 278%. That is, it provides a degree of flexibility that allows for a level of consumption in its domestic market on the peak day in any year equal to 278% of the average daily consumption in a year[33]. The relative amounts of swing to be efficiently provided by gas contracts, storage or the wholesale market will depend on the relative cost of these alternatives.

### *b) Contracted Swing*

The present price control caps contracted swing[34] (mainly met through long-term contracts in the year of the control) at 230%, leaving the remaining 48% to be covered through storage. Ofgem would like to incentivise BGT to purchase peak gas from the cheapest source, whether this is from its long-term contracts, storage, the wholesale market, or through interruptions.

BGT said that in the first instance it will always take peak gas from its long-term contracts. This is because if it did not it would incur potentially punitive take or pay surpluses. Ofgem's assessment of BGT's take or pay costs and balances supports this assertion. Ofgem has modelled BGT's actual contract swing against its market requirements and found that BGT's domestic swing met from its gas purchase portfolio is in the range 230% to 238% in 1999/00 to 2001/02.

[33] This level of flexibility is only likely to be necessary for 1 peak day in every 20 years; nevertheless, BGT and other suppliers are required by the terms of their licences to allow for such flexibility in every year.
[34] Defined as the flexibility that exists in gas contracts to vary daily volumes in response to volatility in end-user demand.

In calculating a gas cost cap for the control period, Ofgem accepts that BGT will purchase significant amounts of gas from its long-term contracts and has therefore continued to assume that 230% of the peak requirement comes from BGT's gas purchase portfolio.

### *c) Cost of Peak*

The cost of providing capacity to rapidly increase the amount of gas provided to meet demand on the peak day in a year is difficult to estimate. The cost is expressed in £ per peak day therm (£ppdt). In essence, two broad approaches may be used in calculating the value of swing, one based on the price of swing in contracts, the other based on the market value of swing.

At the time of the last price control review a contract-based approach to the price of swing was adopted. However, the cost of swing British Gas was paying in its gas contract portfolio could not be explicitly identified, so the price of swing had to be estimated on the basis of other indicators. British Gas advised Ofgem that its historical assumption for the cost of swing, used as a benchmark in negotiating gas contracts, was £10ppdt, reflecting the effective costs at the time of providing medium-term gas storage as an alternative to swing in the gas contracts. Ofgem accepted that figure for calculating the WACOG of British Gas' gas contract portfolio.

Ofgem has reconsidered this position following BGT's gas contract renegotiations. The renegotiations generated more favourable terms, meaning that the price of peak should be closer to the market than in BGT's old long-term gas contract portfolio.

#### *i) Contractual Cost*

BGT has stated that the price of peak might have fallen by around 10 to 20 per cent as a result of contract renegotiation. This would reduce £10ppdt to £8ppdt or £9ppdt. BGT has also confirmed that it uses £8ppdt for long-term planning.

Ofgem has performed analysis to ascertain the value of peak inherent in BGT's long-term contract portfolio by comparing the actual 1998/99 prices paid (i.e. post renegotiation prices where relevant) for each contract with the swing in each contract.

While there is a low correlation between price and swing, the analysis indicates the contract value of swing may be in the region of £8ppdt.

*ii) Market Value*

Owing to the introduction of competition in the provision of storage services, the price of storage has fallen which, as one of the alternatives to beach peak, indicates that the price of peak may also have fallen.

BGT has stated that the market value of peak is in the region of £6ppdt to £7ppdt between now and the end of the control period. Ofgem has independently verified this, using a variety of methods including the following:

- analysing summer/winter market-based price differentials by comparing forward spot gas prices; and

- obtaining market quotes for the cost of swing.

On this basis, Ofgem's initial view is that the market value of peak could be as low as £5ppdt to £7ppdt.

*iii) Ofgem's Initial Conclusion*

Ofgem has considered whether it is appropriate to use the market value of peak as opposed to the contractual value. Recognising that BGT still sources virtually all of its gas from its long-term contract portfolio, the contractual value should still apply. Ofgem therefore proposes the contractual approach at £8ppdt. Views are invited on whether this is preferable to an approach based on the market value of swing.

On the basis of a charge for swing of £8ppdt and a level of contract swing of 230%, the premium for domestic flexibility is around 1.2 p/th over the average WACOG for Centrica's entire gas purchase portfolio in 2000/01. Table 9 shows Ofgem's view of BGT's overall WACOG, the premium for swing and Ofgem's view of BGT's domestic market WACOG.

**Table 9 - Ofgem's view of BGT's overall and domestic WACOG (p/th) – 1999/00 prices**

| | 1999/00 | 2000/01 |
|---|---|---|
| Average WACOG | 17.0 | 17.7 |
| Premium for swing | 1.1 | 1.2 |
| Domestic WACOG | 18.1 | 18.9 |

### *6.7 Storage Costs*

Most of the swing demanded by BGT's customers is provided through gas purchase contracts. For the purposes of the gas and storage cost calculations, 230% of swing on the peak day is treated as being provided by the gas purchase portfolio and the remainder through storage. Ofgem has found that the removal of the 230% cap has a minimal impact on the overall costs of gas and storage.

During the period covered by the current price control, competition has been introduced into the provision of storage services. BG Storage's services at Rough and Hornsea are subject to auction, BG Storage's LNG services are open to fixed price tender and competitors, such as Enron, have introduced a "virtual" storage service.

BGT said that non-domestic customers require no storage because they are accommodated by the interruption of non-domestic customers, storage bookings should be charged to the domestic market. This is because the domestic supply business is required to plan for a level of deliverability and availability of gas sufficient to meet demand on a one in twenty year peak day and a one in fifty year winter.

Ofgem does not accept this view. Demand on the peak day is not limited to domestic customers and therefore the costs of satisfying the peak requirement should be attributed to both domestic and non-domestic customers in proportion to their share of the peak requirement.

Ofgem has adjusted BGT's storage cost forecasts to reflect the respective shares of peak demanded by domestic and non-domestic customers. Ofgem made similar adjustments to BGT's storage projections during the last price control review and the 1998 tariff rebalancing review.

Table 10 sets out BGT's and Ofgem's forecasts of storage costs.

**Table 10 - Ofgem's view of BGT's storage costs p/th (1999/00 prices)**

| | 1999/00 | 2000/01 |
|---|---|---|
| BGT's view | 0.37 | 0.35 |
| Ofgem's view | 0.30 | 0.28 |

While Ofgem accepts that the introduction of competition in storage services will bring uncertainty over future costs, setting a cap on storage services is unlikely to be onerous because the introduction of competition is likely to reduce prices rather than increase them. Ofgem concludes this cap should be at 0.28 p/th for the year of the revised price control.

### *6.8 Ofgem's Initial Proposals*

Ofgem considers that a cap based on BGT's single gas purchase portfolio is appropriate for the continued control in 2000/01. Ofgem proposes to set a combined cap for gas and storage. Ofgem proposes that the level of this cap should be set at 19.2 p/th in 1999/00 prices.

In calculating this level, Ofgem's projections differ from BGT's projections in four main respects. These are:

– modelling approach. The key differences between Ofgem and BGT's model is that Ofgem's gas cost model has been constructed on a contract by contract basis whereas BGT's model aggregates contracts into groups. The difference in domestic WACOG from the two modelling approaches is 0.7 p/th in 2000/01.

– renegotiation costs. BGT's WACOG is based on recovering these costs from customers over time by inflating by a real rate of 9.3% per year. Ofgem believes a more appropriate discount factor is BGT's weighted average cost of capital, which Ofgem estimates to be a real rate of 8%. The difference between Ofgem and BGT's position amounts to 0.2 p/th in 2000/01.

– cost of peak. Ofgem believes that the cost of peak gas has fallen reflecting BGT's contract renegotiations, increasing competition in storage services, and the development of the wholesale gas market. Ofgem has therefore changed this value from £10ppdt to £8ppdt. The difference between Ofgem and BGT's position amounts to 0.3 p/th in 2000/01; and

– storage costs. Ofgem disagrees with BGT that all its storage costs should be allocated to the domestic customers. Ofgem has allocated storage costs in proportion to domestic and industrial and commercial customers' share of total peak day demand. The difference between Ofgem and BGT's position amounts to 0.1 p/th in 2000/01.

Ofgem recognises that there is a risk that BGT could over- or under-recover its actual gas and storage costs. However, Ofgem considers that this risk is mitigated by several factors. These include: the fact that by the time we publish our final proposals, the majority of the data on gas purchase contract escalators for the year of the price control will be historical; the possibility that the oil price might fall; and the duration of the cap being limited to one year.

***Views are requested on Ofgem's proposed treatment of gas and storage costs in the forthcoming price control. In particular, Ofgem would welcome views on the main adjustments we have made to BGT's projections.***

# 7. Transportation and Metering Costs

## *7.1 Introduction*

Transco's charges for gas transportation and metering for BGT are approximately £1,659 million in tariff year 1999/00, about 42% of BGT's total costs, equating to 16.1p/th[35]. Under BGT's current price control, these charges are passed through to customers subject to an economic purchasing obligation. Transco's charges for transportation and metering services are regulated through its price control. BGT's costs therefore depend on the regulation of these charges.

Presently there is a single revenue cap on Transco covering transportation, metering and meter reading. As part of Ofgem's policy for metering competition, it is planned to change this. In December 1999, Ofgem will be publishing final proposals to split Transco's price control into three individual revenue caps from April 2000. While the proposals will maintain the overall level of revenue, they could be expected to impact on the relative charges for transportation, metering and meter reading services. Ofgem considered the treatment of BGT's transportation and metering costs in the light of these proposals.

## *7.2 Transportation Charges*

Transco's charges are regulated through its price control. The price control sets a total level of allowable revenue which increases by RPI-2 each year. The revenue cap is also scaled up or down to allow for year-on-year changes in the amount of gas being transported through Transco's pipeline system Transco is not allowed to discriminate between shippers in its charges. This means that all domestic shippers can expect to face the same level of Transco charges as BGT for transporting gas to domestic customers with identical profile characteristics.

Ofgem's initial estimates are pending the final proposals for splitting Transco's price control. As noted above, it is expected that Ofgem will finalise these estimates by the time it publishes final proposals for BGT's continuing price regulation.

Table 11 below shows BGT's and Ofgem's transportation charge forecasts.

**Table 11 - Comparison of transportation charge forecasts (1999/00 prices, p/th)**

| | **1999/00** | **2000/01** |
|---|---|---|
| BGT's view | 16.1 | 15.2 |
| Ofgem's view | 15.3 | 14.9 |
| Difference | -0.8 | -0.3 |

Ofgem's initial views of transportation costs in 1999/00 are based on Transco's view of domestic transportation charges from 1 October 1999 (15.2 p/th), adjusted to reflect higher transportation charges in the period 1 October 1998 to 30 September 1999.

The initial estimate of the transportation costs for 2000/01 of 14.9 p/th has been derived by:

- identifying the level of costs relating solely to Transco's transportation activities (excluding metering and meter reading); and

- estimating the proportion of these costs which Transco would be expected to recover from the domestic and non-domestic market.

BGT's forecasts are based on Transco's current published charging structure, adjusted for BGT's view of the likely outcome of Ofgem's proposals to split Transco's price control. Therefore, the difference between Ofgem's forecasts and those supplied by BGT may be due to:

[35] These figures are BGT's view of its tariffs for 1999/00.

- Ofgem’s estimate of costs to be included with the transportation element of the split price control; and

- potential differences in underlying assumptions, such as gas consumption and customer numbers on Transco’s systems.

Given that there is one main provider of transportation services and that this provider is regulated, it is possible to predict the level of BGT’s transportation charges with a degree of certainty. However, this is subject to the possibility that Transco might seek to rebalance its charges. Any such rebalancing request would need to be approved by Ofgem.

This may lead to different charges to BGT’s domestic gas supply business after a cap has been set. The direction of the change will depend upon how Transco rebalances its charges in the price control year. For example, if it increases fixed elements and decreases volume driven elements, then transportation charges for domestic customers could rise. Conversely, a decrease in fixed elements and a rise in volume driven elements would see transportation charges for domestic customers fall.

Ofgem‘s initial proposals are to cap the level of BGT’s transportation costs. In the context of a one year control; Ofgem does not believe a pass-through mechanism to be appropriate. An over or under recovery of transportation costs in the price control period could distort prices in a fully competitive market if they are allowed to be carried forward. In addition, Ofgem believes that transportation costs can be determined with a high degree of accuracy.

### *7.3 Metering*

This review is taking place against a background of emerging competition in the provision of metering services. In October 1998, Transco separately identified its metering charges from its transportation charges. Transco currently offers a rebate of £10 per year per Domestic Credit Meter (DCM) and levies a surcharge of £10 a year per PrePayment Meter (PPM). A rebate against transportation charges for a DCM has been available to shippers since April 1999[36].

Shippers continue to have an incentive to seek out alternative, more cost-effective metering service providers. In particular, to the extent that all these factors help to make the gas metering market more open and competitive, this gives BGT greater discretion over how it meets its metering needs. It should help to reduce BGT's metering costs and improve the range of services on offer.

In the light of these developments, Ofgem proposes to set a cap on BGT's metering costs, the level of which will be set with reference to Ofgem's projections of Transco's charges. Table 12 sets out Ofgem's and BGT's views on metering costs.

**Table 12 - Forecast metering customer charges (£ per customer (1999/00 prices))**

| | 1999/00 | | 2000/01 | |
|---|---|---|---|---|
| | DCM | PPM | DCM | PPM |
| BGT's view | 10.00 | 20.00 | 10.24 | 25.85 |
| Ofgem's projection | 10.00 | 20.00 | 12.33 | 24.66 |

Ofgem's preliminary conclusion is to set a cap on BGT's metering charges at the level of Ofgem's forecast of Transco's metering charges. Ofgem's initial estimate of these costs in 2000/01 is £12.33 per DCM customer and £24.66 per PPM customer, in 1999/00 prices. These estimates will be finalised pending the publication in December 1999 of Ofgem's proposal to split Transco's price control.

[36] However, it should be noted that Transco places a restriction (of 150 meters per day) on the rate at which any shipper can switch meter provider.

Projections made by Ofgem for transportation and meter provision combined give a very similar level of total revenue to BGT's combined projections.

***Views are requested on Ofgem's proposed treatment of BGT's transportation and metering costs for the revised price control in 2000/01.***

# 8. Supply Costs

## 8.1 Introduction

BGT has identified supply costs[37] of serving the domestic gas market in 1999/00 of £557.3 million[38], an average of 6.1 p/th or £38.1 per customer. This equates to just over 14% of BGT's total costs of serving domestic gas customers.

Arthur Andersen has undertaken a detailed review of BGT's supply costs. This has involved:

- a review of BGT's supply costs in order to arrive at an appropriate opening level of supply costs in 1999/00;
- an assessment of cost determinants to attribute costs to different classes of customer and to assess how the opening level of supply costs will change in response to changes in customer numbers and consumption; and
- a review of potential efficiencies.

Ofgem's conclusions in light of this review are set out below.

## 8.2 The Opening Level of BGT's Supply Costs

In assessing the level for domestic gas supply costs Ofgem considered the following factors:

- whether costs associated with other Centrica business units, such as Services, Accord Energy, Financial Services, and the Automobile Association ("AA"), were included in the supply cost base; and

[37] Supply costs include the cost of customer contact, customer enquiries, bad debts, meter reading, remittance processing, marketing, support costs and corporate overheads.
[38] BGT Table 2 submission – central scenario version two.

– whether costs associated with BGT's non-domestic gas supply business units, such as electricity and Business Gas, were included in the supply cost base.

In doing so, Ofgem considered whether costs represented forward-looking avoidable costs.

***a) Defining the Scope of BGT's activities within Centrica***

Centrica and BGT provided information on non-BGT business units' operating costs. BGT's view was that, with the exception of corporate overheads, there were no shared costs between BGT and other Centrica business units. BGT argued that most costs were directly attributable to business units.

Ofgem's initial view is that certain activities, such as call centres, IT and joint marketing, could be shared between business units. Combining activities could result in cost savings. This has been well covered by industry commentators, particularly with Centrica's acquisition of the AA. Centrica itself has made public statements about potential future synergies. For instance, Centrica's proposal to acquire the AA said that "the combined business has the opportunity to achieve greater efficiency and cost savings through synergies"[39].

Ofgem has considered the existence of benefits across Centrica's business units, in areas such as IT, call centres and joint marketing. Ofgem does not accept BGT's view that benefits will not exist in the future. However, Ofgem considers that with the exception of marketing, it may take longer than the one year envisaged for the revised control for synergies to materialise that have a significant impact on BGT's supply costs.

With respect to marketing, Ofgem believes that there are shared benefits and costs between BGT and other Centrica business units. For example, BGT benefits from British Gas Services' marketing under the British Gas brand. Given the paucity of information from BGT in respect of these shared activities, it is difficult to assess an appropriate cost attribution between business units for these sorts of marketing activities. Ofgem does

[39] Proposal to Acquire the AA, Centrica, 5 July 1999

not at this stage propose to make an adjustment for these factors. However, we have made adjustments to the overall level of BGT's marketing costs (see section 8.2(b)).

Ofgem has adjusted BGT's allocation of corporate overheads. BGT allocates corporate overheads between business units in proportion to turnover. This results in business units with low turnover, such as new businesses, being attributed a disproportionately low level of corporate overheads. Ofgem does not consider this to be appropriate. Instead, Ofgem proposes to attribute overheads on the basis of operating costs.

Adjusting the allocation of corporate overhead lowers the attribution of costs to BGT's domestic supply business by £2.8 million or 19 pence per customer.

***b) Defining the Scope of Domestic Gas activities within BGT***

BGT has provided Ofgem with information about how supply costs at an activity level are allocated across BGT's business units. After a detailed review of this information, Ofgem proposes to make a number of adjustments.

*i) Marketing*

There are two striking features of BGT's approach to allocating marketing costs. First, BGT's forecast 1999/2000 domestic gas marketing costs are 41% higher than the equivalent 1998/1999 figure. Second, BGT's methodology allocates a much higher proportion of marketing costs per customer to its domestic gas supply business than to its electricity business. Given that electricity is a relatively new business, Ofgem would expect a much higher proportion of marketing spend on electricity customers.

During the tariff rebalancing review, Ofgem estimated BGT marketing costs in the order of £1 per customer. This allowance included costs associated with BGT's marketing responses to the full introduction of competition. It also represented the costs of marketing solely to gas customers, rather than to potential 'dual fuel' customers.

Ofgem's initial view is that marketing costs for the domestic gas supply business should be based on the level of costs allowed during tariff rebalancing. Ofgem has therefore reduced BGT's allowable costs for marketing from £[ ][40] million to £24.1 million. This allowance is similar to the average that PESs reported in their business plans for the purposes of reviewing electricity supply price controls.

*ii) Business Development*

This mostly relates to specific business projects, such as systems development, which can be directly attributed to BGT's business units. There are some projects that cannot be attributed in this way. BGT allocates all costs associated with these projects to the domestic gas market. Ofgem does not agree with this treatment and proposes to attribute these costs across business units on an equi-proportional mark-up basis.[41] Ofgem has therefore reduced business development costs from £26.6 million to £23.5 million.

*iii) Depreciation*

Ofgem has reduced BGT's depreciation costs from £20.0 million to £13.1 million. During the last price control review, Ofgem concluded that depreciation was a suitable proxy for capital expenditure and allowed a charge of £13.3 million. At tariff rebalancing, BGT's depreciation costs were approximately £13 million. Ofgem is concerned that the significant increase in depreciation over the period of the present price control could be related to:

- changes in accounting policy. Ofgem notes that BGT's fixed assets over the period have remained fairly constant. It is therefore not clear why the depreciation charge should have increased;

- the possibility that depreciation may no longer be a suitable proxy for capital expenditure; or

- capital expenditure supporting the growth of the electricity business.

[40] This figure has been removed at the request of BGT on the grounds of commercial confidentiality.

[41] The equi-proportional mark-up method allocates costs in the proportion to directly attributable supply costs.

Given the level of fixed assets employed by BGT's domestic supply business has remained stable since rebalancing, Ofgem proposes to maintain a depreciation charge of £13.1 million.

*iv) IT costs*

During the 1997 price control review, Ofgem adjusted IT spend to reflect costs that were not related to the domestic gas supply business. However, costs were still considered to be high and reflected an allowance to update legacy systems prior to the introduction to competition. High levels of efficiency saving were anticipated during the present price control period.

Ofgem wishes to ensure costs relating to non-gas businesses are not allocated to gas customers. Ofgem's initial conclusion is that the actual level of expenditure submitted during tariff rebalancing represents a more appropriate allowance as it excluded both legacy and 'dual fuel' systems expenditure. On this basis, Ofgem has reduced BGT's IT costs from £71.9 million to £58.9 million.

*v) Call Centres*

Ofgem has reduced call centre costs from £39.2 million to £31.7 million. This adjustment is based on a review of call duration and cost profiles across tariff type. It also takes account of 'dual fuel' calls.

The deductions in sections (i) to (v) above total £61.9 million or £4.16 per customer.

### *c) Forward-Looking Level of Domestic Supply Costs*

Ofgem has made a number of adjustments to the 1999/00 forecast levels of cost where these do not appear to be representative of forward-looking avoidable costs. Avoidable costs are considered to be those which would be avoided if the supply business as a whole did not continue[42].

BGT's 1999/00 forecasts were based on customer numbers of 14.6 million. BGT have subsequently revised their customer numbers forecast to 14.9 million and have

[42] Defined as costs avoided within 1 year.

indicated that their cost forecasts are understated. Ofgem has, therefore, adjusted BGT's 1999/00 forecasts to reflect this change in customer numbers. The effect is to increase domestic supply costs by £7 million.

*i) Bad Debt*

Ofgem has reduced BGT's debt provision from £69.9 million to £37.9 million. During the last price control period, BGT indicated that an efficient level of debt was approximately £50 million. Ofgem concluded that this level represented a significant decrease from their actual level of bad debts and believed that any reduction should be phased in over the period of the price control. Ofgem therefore allowed a figure of 1% of sales. This conclusion was maintained in the 1998 Rebalancing review.

BGT's current level of bad debt is still significantly higher than what Ofgem considers an efficient level. Ofgem considers that the reasons for allowing 1% in the last price control review and the rebalancing review are still valid. On this basis Ofgem's initial conclusion is that bad debts should remain at 1% of turnover. This broadly compares to the allowance for bad debts in initial proposals for the PESs.

*ii) Business Development*

Ofgem has reduced business development costs further, from £23.5 million above to £13.7 million. Business development costs in 1999/00 include a number of large one-off and non-recurring projects such as systems changes for "Y2K". Such expenditure will not be incurred again during 2000/01. Ofgem has therefore excluded this expenditure from calculations for the 1999/00 base year.

*iii) Finance Charges*

Ofgem has excluded financing charges totalling £10.9 million. BGT has indicated that the amount of working capital required to serve different types of customers varies, because the time taken for different types of customer to pay a bill varies. BGT has, therefore, included an element for working capital in its submission. Ofgem does not agree that interest on working capital should be included as an attributable supply cost as it is already allowed for within the profit level, which is currently set at 1.5% of turnover (see chapter 9 for a discussion on BGT's profit margin).

The deductions in sections (i) to (iii) above total £52.7 million or £3.54 per customer.

### *d) Resulting Opening Level of Supply Costs*

Table 13 below shows the total adjustments to the base year 1999/00 outlined above.

**Table 13 – Adjusted Opening Level of Supply Costs (1999/00 Prices)**

| | BGT 1998/99 | BGT 1999/00 | Ofgem 1999/00 |
|---|---|---|---|
| Supply cost total (£m) | 578.3 | 557.3 | 439.3 |
| Average cost per therm at 650 therms (p/th) | 5.4 | 5.9 | 4.5 |
| Average cost per customer (£/customer) | £34.81 | £38.09 | £29.5 |

### *e) Comparison of per Customer Supply Costs*

To assess the reasonableness of our conclusions above, table 14 compares Ofgem's initial view of average supply costs per customer with forecasts for 1999/00 made during the 1997 price control review and the 1998 tariff rebalancing review. It also shows how Ofgem's initial estimates compare to the allowance given for the PESs in Ofgem's initial proposals and British Gas' projections for supply costs for 1999/00 at the time of the transfer of its gas supply business from British Gas plc into British Gas Trading Ltd in December 1995.

**Table 14 – Comparison of supply costs per customer forecast for 1999/00 (in1999/00 prices)**

| Forecast and Date | £/Customer |
|---|---|
| BG Transfer Scheme[1] (Dec 1995) | 23.1 |
| Ofgem's 1997 price control review (Nov 1996) | 29.2 |
| Ofgem's initial conclusions (Nov 1999) | 29.5 |
| Ofgem's 1998 tariff rebalancing (July 1998) | 31.4 |
| Average for PES[2,3] > 2 million customers (Oct 1999) | 32.3 |
| Average PES[2,3] (Oct 1999) | 34.1 |
| BGT (Nov 1999) | 38.1 |

Notes

1. Sources: BGT's proposals at the time British Gas Trading Ltd was established as a separate subsidiary of British Gas plc.
2. Source: Review of Public Electricity Suppliers 1998 to 2000 - Initial Proposals
3. PES averages exclude separation costs, exceptional items and energy efficiency charges

Table 14 suggests that the results presented in this chapter are broadly comparable with forecasts made in prior years. Ofgem notes that five PESs have unit supply costs below £30 per customer. In addition, BGT's supply costs can reasonably be expected to be below those of the PESs because of its ability to benefit from significant economies of scale and scope.

### *8.3 The Determinants of Supply Costs*

Establishing the determinants of supply costs helps to determine how costs should be attributed to different classes of customer and how they are likely to change over time in response to changes in BGT's customer base. Ofgem can therefore project from the base year derived above to the price control period of 2000/01.

Cost determinants also allow supply costs to be attributed to different customer segments. In 1998 BGT applied to rebalance its tariffs. At that time BGT provided significant amounts of information on cost determinants (i.e. how costs should be attributed between payment types). In the current review BGT has, by and large, relied upon this information to allocate costs between tariffs. In 1998 Ofgem concluded on the reasonableness of BGT's application and in a number of places, adjustments were made to BGT's cost determinants. Ofgem has reviewed BGT's analysis and has considered the conclusions previously reached. Where appropriate, Ofgem has adjusted BGT's view to reflect the conclusions of the tariff rebalancing review.

#### *a) Constant and Linear Costs*

For each activity BGT has estimated:

- the degree to which the activities are dependent on customer numbers or gas volumes (the 'linear' element); and

- the degree to which the activities do not change as a result of a change in customer numbers or gas volumes ( the 'constant' element).

For the base year, BGT estimates that 59% of its supply costs are linear and 41% constant. Ofgem reviewed this analysis at an activity level. Ofgem's preliminary conclusion is that the proportion of costs which BGT's deems to be linear appears very low. During the rebalancing review, Ofgem estimated that 82% of BGT's costs were linear and 18% were constant. Ofgem accepts that the proportion of linear costs may have fallen since then in response to a fall in total customer numbers. Ofgem's initial view is that a more appropriate linear and constant split is 75:25.

In addition to the activity level review, Ofgem also believes that the proportion of linear costs would in any case be greater than the average PES due to the existence of economies of scale and scope. Different comparisons for the linear constant split are set out in table 15.

**Table 15 – Comparison of Linear/Constant Split**

| | **Linear** | **Constant** |
|---|---|---|
| BGT (Nov 1999) | 59% | 41% |
| Ofgem's initial proposals for PESs (Oct 1999) | 72-93% | 7-28% |
| Ofgem's initial proposals for BGT (Nov 1999) | 75% | 25% |
| Ofgem's price control review[1, 2] (Nov 1996) | 85% | 15% |
| Ofgem's tariff rebalancing review[1] (July 1998) | 82% | 18% |

Notes:

1. The linear/constant split has been determined assuming BGT's current market share.
2. BGT assumed that 17% of these costs were avoidable within 2 years. For simplicity it is assumed that 50% of these costs are linear and 50% are constant.

***b) Attributable and Joint Costs***

Costs can be said to be attributable to particular customers or classes of customers to the extent that those costs are avoided if the customers are no longer with BGT. Costs which are not attributable to particular customers are termed 'joint'.

BGT has allocated the costs that it believes are joint in proportion to directly attributable supply costs. Ofgem has previously said that there is room for some discretion in this area. That said, Ofgem believes that no class of customer should bear an undue proportion of these costs.

Ofgem's initial conclusion is to adopt the same approach as used for the tariff rebalancing review. This is a 'nested' approach to cost attribution. Joint costs which are directly related to core activities, or which are closely related to a sub set of core processes, are allocated in proportion to the directly attributable costs for those activities. The joint costs, which are more closely related to a sub-set of core activities, are allocated in proportion to all the costs already attributed or allocated. On this basis, attributable costs account for 75% of supply costs and joint costs account for 25%.

Ofgem's initial proposals are that joint costs should be allocated using an equi-proportional mark-up. This means that the remaining costs are allocated to tariffs in proportion to all the costs that have been directly or indirectly attributed during the nesting approach.

Table 16 shows the results of this approach.

**Table 16 – 1999/00 Costs Attributed by Tariff, Plus Joint Costs (1999/00 Prices)**

| £ per customer | Overall | Direct Debit | Prompt Pay | Standard | PrePayment |
|---|---|---|---|---|---|
| Attributable | 22.29 | 13.98 | 16.26 | 33.96 | 37.21 |
| Joint costs | 7.25 | 5.08 | 5.55 | 10.40 | 11.17 |
| Total | 29.54 | 19.06 | 21.81 | 44.36 | 48.38 |

An alternative approach to recovering the joint cost element would be attributing joint costs to particular tariffs in proportion to the total of all attributable costs (including attributable supply costs, gas and storage costs, and transportation and metering costs). The result of this approach would be to allocate a lower proportion of joint costs to PrePayment and Standard customers. Ofgem would welcome views on this approach to recovering joint supply costs.

***c) Customer and Commodity Related Costs***

BGT estimates that the great majority of its costs are driven by the number of customers it serves, rather than the volume of gas sold to those customers. In reaching initial proposals, a review of each activity has taken place. Ofgem's initial conclusions are that volume related costs account for approximately 9% of total supply costs.

## *8.4 Efficiencies*

BGT has forecast efficiencies of 6.3% in 2000/01. BGT's specific efficiencies forecast were reviewed on an activity basis in light of the adjustments outlined above. Ofgem's initial conclusion is that a target of 8% would represent a more challenging but achievable level of efficiencies. In arriving at this conclusion Ofgem has paid particular attention to:

– potential economies of scope (e.g. electricity). For example, Ofgem believes that over the period, significant efficiencies will result from a further move towards dual fuel processes and systems for example, dual fuel meter reading and billing; and

– British Gas' Transfer Scheme, which projected efficiency targets of up to 6%, even with relatively high losses of customer numbers. In addition, the transfer scheme did not incorporate economies of scope resulting from the introduction of electricity supply.

### *8.5 Ofgem's Initial Proposals*

Ofgem's initial conclusions result in a level of supply costs of £382.4 million in 2000/01. This equates to £27.3 per customer or 4.36 p/th (in average 1999/00 prices). Table 17 shows how this is attributed to the four principal tariff types for the customer and commodity related charges.

**Table 17 – Ofgem's view of BGT's supply costs 2000/01 (1999/00 Prices)**

| | Direct Debit | PromptPay | Standard | PrePayment | Overall |
|---|---|---|---|---|---|
| £ per customer | 17.64 | 18.87 | 32.69 | 40.46 | 24.36 |
| Pence per Therm | 0.02 | 0.28 | 1.52 | 0.74 | 0.47 |

***Views are requested on Ofgem's treatment of BGT's supply costs. In particular, Ofgem would welcome views on its treatment of joint supply costs and whether an alternative method, based on recovering joint costs over total costs, would be more appropriate.***

# 9. Profit Margin

## 9.1 Introduction

The current price control was set so as to allow BGT a return on turnover of 1.5% for supplying gas to regulated customers. The allowed profit margin was set at this level to ensure that under a wide range of market share assumptions the value of BGT's domestic gas supply business would be at, or above, the value of its balance sheet net assets at the start of the price control period.

In assessing an appropriate level of return for BGT for the revised price control, Ofgem has considered several factors, including BGT's risk profile and the initial proposals for the PES's supply businesses. Ofgem has also considered how the overall level of return on turnover should be attributed to particular tariffs.

This chapter also outlines Ofgem's initial view on BGT's weighted average cost of capital ("WACC"). Chapter 6 sets out how Ofgem proposes to allow BGT to recover incurred costs of contract renegotiations over future time periods. Ofgem's initial view on WACC is used in that calculation.

## 9.2 Allowed Margin on Turnover

### a) Level of allowed return

During the last price control review, Ofgem concluded that an llowed margin of 1.5% on turnover was necessary to provide a value close to the opening balance sheet net assets at the start of the price control[43].

In setting an allowable return for BGT, Ofgas wishes to ensure consistency of approach across gas and electricity supply. Ofgem's initial proposals for the PESs' electricity supply businesses was to allow a margin at 1.5% of turnover[44]. The initial proposals also included an overall cap indicating an allowance for generation and other costs with a price control duration of two years.

[43] BGT's opening net assets as at 31 March 1997 were forecast to be £750 million. Net assets excluded intangible assets, cash, short term debt and take or pay liabilities.
[44] "Review of PES's Price Regulation, Initial Proposals", Ofgem, October 1999.

BGT has said that it requires an allowed margin in excess of 1.5%. BGT indicates that the development of competition has increased the level of market risk faced by the company. BGT has also argued that if the revised price control should remove the present pass-through of gas costs BGT will be exposed to significantly more risk and that should be reflected in an increase to the allowed margin.

Ofgem accepts that BGT faces risks from the development of competition. However, the level of this risk has declined significantly since the last price control review. During the last review, the impact of the full opening of competition was uncertain and a range of market share loss scenarios were taken into account when setting the 1.5% allowed return. This included a market share loss scenario of up to 40% by 31 March 2000. This level of loss has not materialised over the course of the current price control. After eighteen months of the full opening up of domestic competition, the uncertainty about BGT's market share and volume risk is considerably less than at the time of the last review.

Ofgem accepts that moving from a pass-through regime to a cap involves an element of risk for BGT. However, as discussed in Chapter 6, Ofgem does not believe this risk to be significant. During the present price control, BGT has succeeded in renegotiating many of its long-term contracts. Further renegotiations are possible but unlikely to be on the same scale as those during 1997/98. Renegotiations are likely to reduce BGT's WACOG on an NPV basis. As a result, future gas purchase costs are now more predictable than at the time of the last review. In addition, most of the contract escalators, that drive BGT's gas costs in 2000/01 should be known by the time Ofgem publishes final proposals. A one year duration for continuing controls further limits the risk to BGT.

As indicated above, one approach to estimating margins is by reference to a return on net assets. During the last review, Ofgas estimated BGT's net assets, excluding cash and short term debt, to be £750 million. BGT's net assets as at 31 March 2000 are forecast to be £775 million, but include cash balances and treasury loans[45]. After adjusting for these balances, BGT's net assets are predicted to be lower in 2000/01 than over the period of the current price control, suggesting that a return of 1.5% is still appropriate.

In light of these factors, Ofgem proposes to continue to allow BGT a return on turnover of 1.5%. It should be noted that this is not Ofgem's view of what BGT should earn in a competitive market. Rather, it reflects Ofgem's view of an appropriate return for BGT for supplying gas to customers in parts of the market where competition is not yet effective.

***b) Attribution of profit margin to tariffs***

BGT's present price control allows it to make a 1.5% margin on each tariff type. This profit element was intended to cover the costs of all interest paid by the business including the cost of working capital, i.e. the cost to the company of paying for goods and services before receiving payment relating to those goods and services from its own customers.

BGT has indicated that the amount of working capital required to serve different types of customers varies, because the time taken for different types of customer to pay a bill varies. BGT has, therefore, included an element for the cost of working capital as an attributable supply cost in its submission.

Ofgem recognises that different tariffs have different financing costs. Payment in advance reduces costs and payment in arrears implies additional costs. However, Ofgem does not agree that interest on working capital should be included as an attributable supply cost as it is already allowed for within the 1.5% profit level. Including it in supply costs would therefore amount to double counting.

Ofgem considers it more appropriate to reflect different financing costs in the profit allowance. Based on a review of monthly working capital balances for each tariff type

[45] The Treasury Loan Account is a balance with Corporate Treasury section, and is effectively in lieu of cash/bank balances

Ofgem's initial conclusions are that total profits of 1.5% should be recovered as shown in table 18.

**Table 18 – Breakdown of attributable and joint profit margin**

| | Direct Debit | Prompt Pay | Standard | PrePayment | Average |
|---|---|---|---|---|---|
| Allowed Margin | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 |
| Attributable Margin | 0.00 | 0.34 | 1.09 | -0.64 | 0.23 |
| Joint Margin | 1.27 | 1.27 | 1.27 | 1.27 | 1.27 |
| Margin adjusted for working capital | 1.26 | 1.61 | 2.35 | 0.63 | 1.50 |

Under this approach, the profit margin would differ by tariff type. The attributable element reflects a return on working capital. PrePayment customers result in a positive cash flow for BGT, since customers pay for their gas in advance. This positive cash flow could be invested at BGT's cost of capital. The negative margin for PrePayment customers reflects this benefit to BGT. The joint element is calculated as the difference between the total allowed margin of 1.5% and total attributable margin. The joint margin has been allocated evenly across payment types.

### *9.3 BGT's Cost of Capital*

As discussed in chapter 6, an estimate of BGT's weighted average cost of capital (WACC) is required to profile renegotiation benefits.

Ofgem has used the Capital Asset Pricing Model ("CAPM") as the basis of estimating a cost of capital for BGT's domestic supply business. This is consistent with Ofgas' approach during the last gas price control review. In the CAPM approach, a company's cost of capital is the weighted average of its cost of equity (adjusted for the effects of taxation) and it's cost of debt.[46]

Using this methodology Ofgas' view during the 1997 Price Control Review was that BGT's real pre-tax weighted average cost of capital was in the range 7.5% to 10.3%,

[46] For a more detailed description of the cost of capital, see "Review of Public Electricity Suppliers 1998 to 2000, Distribution Price Control Review, Draft Proposals", Ofgem, August 1999.

with a mid point of 9%. During this review Ofgem took into account arguments raised on the cost of capital in the 1993 MMC Gas report and the 1995 MMC Scottish Hydro-Electric plc report.

BGT estimates its real pre-tax current WACC to be in the range 11.6% to 13.6% with a mid-point of 12.6%. This compares to BGT's estimate of 10.2% to 12.1% during the 1997 Price Control Review.

Ofgem has reconsidered BGT's WACC in light of developments since the last review. Since the 1997 review, the UK economy has benefited from lower interest rates and lower levels of inflation. This has reduced the cost of borrowing, which in turn lowers the cost of debt capital. Taking this and other factors into account, Ofgem's initial conclusions are that BGT's real pre-tax WACC now lies in the range 7.0% to 8.8%. Ofgem proposes to adopt a WACC of 8.0% for BGT.

### *9.4 Ofgem's Initial Proposals*

Ofgem proposes to continue with a profit margin based on a return on turnover of 1.5%. This level of return is consistent with the allowed return for the PES supply businesses in their initial proposals. It reflects Ofgem's view of an appropriate return for BGT on supplying gas to customers in parts of the market where competition is not yet effective. Ofgem believes that this return provides an appropriate balance between the interests of BGT and regulated gas customers.

Ofgem's preferred approach is that margins on individual tariffs should reflect differences in attributable working capital balances.

Ofgem's preliminary view on the cost of capital is that BGT should be allowed a real pre-tax cost of capital of 8%.

***Views are invited on Ofgem's initial proposals for BGT's allowed profit margin and cost of capital.***

# 10. Ofgem's Initial Proposals

### 10.1 Introduction

Chapter 5 sets out the reasons for Ofgem's initial proposals on the form of continuing regulation for BGT's domestic gas customers from April 2000. Ofgem's initial proposals are to remove price controls on Direct Debit customers. It is expected that the non-discrimination provisions in the gas suppliers' licence and general competition legislation will provide sufficient safeguards for these customers.

For PromptPay, Standard and PrePayment customers, Ofgem proposes to set revised tariff caps. Ofgem expects these revised tariff caps to last for one year only, pending satisfactory progress in removing the remaining barriers to entry preventing reliance on competition by all domestic gas customers.

Chapters 6 to 9 set out how Ofgem has calculated these revised tariff caps. This chapter draws Ofgem's initial conclusions together and sets out our proposed changes to BGT's charges to domestic customers for the year 2000/01.

### 10.2 Ofgem's Initial View of BGT's Costs in 2000/01

Ofgem's initial proposals for BGT's costs of serving domestic gas customers, calculated in chapters 6 to 9 and stated in 2000/01 prices, are summarised in table 19. This gives Ofgem's view of the costs associated with Direct Debit, PromptPay, Standard Credit and PrePayment for the year 2000/01.

**Table 19 – Ofgem's Initial View of Costs 2000/01 (in nominal prices)[1]**

| | **Direct Debit** | | **PromptPay** | | **Standard Credit** | | **PrePayment[4]** | |
|---|---|---|---|---|---|---|---|---|
| | £/C | p/th | £/C | p/th | £/C | p/th | £/C | p/th |
| Gas costs | | 19.35 | | 19.35 | | 19.35 | | 19.35 |
| Transportation | | 15.23 | | 15.23 | | 15.23 | | 15.23 |
| Meter provision | 12.64 | | 12.64 | | 12.64 | | 25.28 | |
| Storage | | 0.28 | | 0.28 | | 0.28 | | 0.28 |
| Supply costs | 18.08 | 0.03 | 19.34 | 0.28 | 33.51 | 1.56 | 41.47 | 0.76 |
| EESOP[2] | 1.20 | | 1.20 | | 1.20 | | 1.20 | |
| Allowed profit margin | 0.39 | 0.45 | 0.52 | 0.58 | 1.11 | 0.88 | 0.42 | 0.23 |
| PromptPay adjustment [3] | | | -8.85 | 1.57 | | | | |
| **Total costs** | **32.31** | **35.34** | **24.85** | **37.30** | **48.46** | **37.30** | **68.38** | **35.85** |
| Total at ave. consumption | 299.43 | | 234.40 | | 256.12 | | 243.79 | |
| Total at 650 therms | 262.00 | | 267.30 | | 290.91 | | 301.39 | |

Notes:

1 Appendix 3 states this table in 1999/00 prices and is directly comparable with the tables in chapters 6 to 9.
2 "Energy Efficiency Standards of Performance" – see section 10.4.
3 This adjustment is required to equalises the PromptPay unit charge with the Standard/ PrePayment unit charge.
4 For the purposes of this comparison, the PrePayment standing charge includes the surcharge on the first 39 units consumed each quarter.
5 No adjustment has been made for the 'Skt factor' which sets a maximum upper limit on the standing charge (equating to 1986 prices plus inflation) of all tariffs. The PrePayment tariff exceeds this upper limit.

## *10.3 Ofgem's Initial View of BGT's Tariff Caps in 2000/01*

As indicated above, it is part of Ofgem's initial proposals to remove Direct Debit customers from the price control. Views are invited on the abolition of the Direct Debit cap.

Ofgem has considered whether to separate tariff caps for Standard and PrePayment. Separate caps existed prior to 1998/99. These caps were combined, during the tariff rebalancing review, to create an incentive for BGT to choose the most efficient form of debt recovery.  Options for dealing with customers in debt were discussed in Ofgas' conclusions[47] to that review.

Ofgem has considered the options for dealing with customers in debt and concludes that a merged cap still creates the best incentive for BGT to choose the most efficient form of debt recovery.  This approach is appropriate because the differentials between costs attributed to the Standard and PrePayment tariffs are small in comparison to the range of costs relating to customers on each tariff.

On this basis, Ofgem's initial proposals for regulated tariff caps are given in table 20.

[47] Review of British Gas Trading's Domestic Supply Tariffs, A Decision Document, July 1998.

**Table 20 - Ofgem's Initial Proposals for Tariff Caps in 2000/01 (in nominal prices)**

| | PromptPay | | Standard/PrePayment | |
|---|---|---|---|---|
| | £/C | p/th | £/C | p/th |
| Gas costs | | 19.35 | | 19.35 |
| Transportation | | 15.23 | | 15.23 |
| Meter provision | 12.64 | | 16.82 | |
| Storage | | 0.28 | | 0.28 |
| Supply | 19.34 | 0.28 | 36.14 | 1.31 |
| EESOP's | 1.20 | | 1.20 | |
| Profit margin | 0.52 | 0.58 | 0.88 | 0.68 |
| Total | 33.70 | 35.72 | 55.04 | 36.86 |
| Skt Factor[1] | | | -1.55 | 0.29 |
| D Factor[2] | | | | 0.10 |
| PromptPay adjustment [3] | -8.59 | 1.53 | | |
| **Tariff Cap** | **25.11** | **37.25** | **53.49** | **37.25** |
| Total at average consumption | 234.40 | | 252.60 | |
| Total at 650 therms | 267.26 | | 295.64 | |

Notes:

1. Skt factor sets a maximum upper limit on the standing charge of all tariffs.
2. D factor allows for the recovery of the PrePayment standard that is not recovered from customers burning less than 156 therms per annum.
3. This adjustment is required to equalise the PromptPay unit charge with the Standard/PrePayment unit charge.

### 10.4 Energy Efficiency

Ofgem has announced a two year £100 million programme of energy efficiency measures targeted at the fuel poor[48]. Under the programme, which will run from April 2000 until March 2002, Ofgem will set efficiency targets for gas and electricity suppliers to achieve. Targets will vary according to the size of the customer base, and type of fuel, and will be set in January 2000 following advice from the Energy Savings Trust. Suppliers with a combined customer base of less than 50,000 customers will not be set an efficiency target.

It is Ofgem's initial view that BGT should be allowed an indicative charge of £1.20 per customer to enable them to fund the schemes necessary to achieve their energy efficiency targets.

### 10.5 Correction Factor

The current price control includes a correction factor, the "K factor" mechanism, which allows BGT's domestic supply business to recover in subsequent years any allowed revenue not recovered in previous years and vice versa. This was intended to ensure that BGT has not been penalised for differences between its forecasts of costs for the year ahead (which form the basis for its tariffs) and its outturn costs (which determine the precise level of allowed revenue).

At this stage, the precise amount of the K factor accumulated during the period of the last price control is not known. This is because the economic purchasing reviews for gas, transportation, metering and storage costs (i.e. the pass-through costs) incurred during the last price review have yet to be finalised.

BGT's preliminary view is that it has under-recovered these costs by approximately £247m over the duration of the previous price control. Ofgem's initial view is that there has been an under-recovery of £76 million.

[48] Energy Efficiency: Standards of Performance 2000-2002. Initial Decisions. Published October 1999.

Table 21 compares Ofgem's initial views on the level of the K factor with BGT's submission:

**Table 21 – K factor - £million**

| | Direct Debit | PromptPay | Standard/ PrePayment | Total |
|---|---|---|---|---|
| BGT | 190 | 51 | 6 | 247 |
| Ofgem | 60 | 20 | (4) | 76 |

Table 21 indicates that approximately 80% of the under recovery is generated by Direct Debit. Ofgem's initial proposals are to remove direct debit from continuing regulation. Ofgem believes that it is inappropriate for the K factor generated by Direct Debit to be recovered over the remaining regulated tariffs.

Ofgem views the remaining level of K to be small. Ofgem's initial proposal is not to allow K factor pass-through in 2000/01. Ofgem expects to finalise the economic purchasing review before final proposals are published. At this stage Ofgem will consider the options for the recovery of K.

Given the proposal for a one year price control with caps for all elements of the total bill, it is Ofgem's proposal to remove the correction factor mechanism from the revised control.

### *10.6 Price Reduction*

Table 22 sets out Ofgem's initial proposals for price reductions that will apply to each of the PromptPay and Standard/PrePayment tariffs in 2000/01.

**Table 22 – Ofgem's Proposed Tariff Caps and Price Reductions in 2000/01 (nominal prices)**

| | **PromptPay** | | **Standard/PrePayment** | |
|---|---|---|---|---|
| | £/C | p/th | £/C | p/th |
| Proposed tariff caps<br>Total at average consumption | 25.11<br>234.40 | 37.25 | 53.49<br>252.60 | 37.25 |
| Current tariffs<br>Total at average consumption | 17.47<br>246.17 | 40.71 | 48.87<br>266.45 | 40.71 |
| Price reduction | 4.8% | | 5.2% | |

As a result of Ofgem's initial proposals, average bills for PromptPay and Standard/PrePayment can be expected to fall by about 5% in nominal terms in 2000/01.

Ofgem does not envisage controlling BGT's prices beyond 2000/01. However, in considering whether to remove caps after one year, Ofgem has considered the potential impact on prices for these customers. Ofgem's view based on current information indicates that these price reductions are sustainable in the year 2001/02.

### *10.7 Standards of Performance*

Competitive pressures are, as expected, leading to improvement in the services offered by BGT and its competitors. The standards of service BGT has previously agreed with Ofgem should be viewed as the minimum performance the company will wish to achieve in a competitive environment. In the circumstances it does not seem appropriate to make futher adjustments to the agreed Standards of Performance.

***Views are invited on the issues covered in this Chapter and in particular the level of price caps, the removal of the Direct Debit cap, the merged cap for Standard Credit and PrePayment customers and the treatment of correction factors.***

# Appendix 1: Regulatory Background

## A1 Background

### A1.1 BGT's Present Supply Price Control

BGT's price control, which set in place the tariff caps discussed in chapter 2, is set out in Special Condition 3 of BGT's Gas Suppliers' Licence. It takes the form of an RPI-X price control for supply and meter reading costs (i.e. the cap rises by the retail price index minus a specified percentage X each year – for the duration of the present price control X has been set at 4). Transportation, storage, meter provision, and gas purchase costs are passed through to customers, subject to an economic purchasing condition (the "Economic Purchasing Objective"). A profit margin of 1.5% is allowed in the price control for each of these elements.

As noted above, the price control sets caps on four categories of BGT's national tariffs: Direct Debit, PromptPay, Standard and PrePayment. BGT is required to continue to offer these four regulated tariff categories to all its customers in Great Britain for the duration of the price control. BGT changed the names of its tariffs to reflect their payment method, but maintained the four different tariffs.

The price control includes a correction mechanism (the 'K-factor' mechanism). Over-recovery against the price cap results in a reduction in the cap in the following year of the control; under-recovery in any year results in a relaxation of the control in the following year. In both cases, an interest rate is applied. For under-recovery the interest rate is the Barclays Bank base rate and for over-recovery 1% is added to this base rate.

The tariff cap form of price control was put in place by Ofgas to seek to ensure that all BGT's customers were protected from unduly high prices in the new competitive environment. If Ofgas had maintained the previous form of the price control based on average revenue or total revenue, BGT could have compensated for price cuts to one class of customers by increasing prices to other classes of customer. For example, price reductions for Direct Debit customers could have been offset by price increases to PrePayment customers.

Provided that BGT continues to offer what were the four regulated tariffs to all its customers in Great Britain, it is free to introduce additional tariffs as an option for particular customer categories. These would represent additional choices for BGT's customers, over and above the regulated tariffs. The tariff flexibility does not, however, permit BGT to behave anti-competitively, for example, through predatory pricing. Limitations on pricing by a dominant gas supplier are contained in Standard Condition 13 of the Gas Suppliers' Licences.

The present price control was intended to cover the period from 1 April 1997 to 31 March 2000. It cannot be disapplied before 31 March 2000. BGT can give 11 months' (or more) notice to disapply from 30 April 1999. The DGGS may either accept BGT's disapplication request or refer it to the Competition Commission. To date, no such request has been made.

### *A1.2 Change Procedures*

The present price control gives BGT the opportunity to seek to rebalance the level of its tariff caps in the light of new cost information (a 'full rebalancing request'). BGT can also seek to separate any of the regulated tariffs into two or more cost-reflective tariffs (a 'partial rebalancing request'). In these circumstances, any change must not increase BGT's overall revenue from its regulated tariffs. The new caps remain subject to RPI-4. Moreover, any rebalancing of the tariffs requires a licence modification.

On 28 July 1997 BGT applied to Ofgas to have its tariff caps rebalanced (i.e. BGT issued Ofgas with a Full RPI Adjustment Request). Broadly, BGT proposed that the RPI-X elements of the Direct Debit and PromptPay tariff caps should be reduced, and that the RPI-X elements of the Standard and PrePayment tariffs should be increased.

Although BGT formally withdrew its application on 19 May 1998, Ofgas took the view, following its investigation, that the existing tariff caps were no longer cost reflective. To address this, new tariff caps for the 1998/99 formula year were introduced. There were three principal changes:

- Ofgas reduced the supply cost tariff cap for Direct Debit customers from £23.66 to £20.33 for the standing charge element and from 0.06 p/th to 0.05 p/th for the unit charge;

- Ofgas reduced the standing charge element of the PromptPay tariff cap from £17.56 to £13.87, whilst raising the cap on the unit charge from 1.62 p/th to 1.74 p/th; and

- Ofgas unified the Standard and PrePayment tariff caps into a single tariff cap. The idea behind this proposal was to remove any artificial incentive on BGT to use PrePayment meters rather than alternative and less costly ways of providing budgeting assistance, or means of debt prevention and recovery.

There is also a provision for BGT to propose more minor changes to its regulated terms and conditions (an ‘accepted variation’). BGT used this provision to change the names of its regulated tariffs to reflect individual payment methods.

### *A1.3 Standing Charges*

In addition to the individual caps, under Special Condition 4 of its Gas Suppliers’ Licence, BGT must ensure that any increases in standing charges do not exceed the cumulative change in the Retail Price Index since December 1985. This also applies where there are charges that have a similar effect to a standing charge.

### *A1.4 Standards of Service*

Special Condition 13A, which was put in place as part of BGT’s price control, requires BGT to establish a set of service standards and record its performance against these standards. It also requires BGT to operate a compensation scheme for service failures. The additional service standards relate to general customer service, administration and metering.

### *A1.5 Gas Act 1986*

The DGGS must exercise the functions assigned to him under the Gas Act 1986 (as amended by the Gas Act 1995) in the manner that is best calculated to fulfil the duties described in Section 4 of that Act. These duties include a duty to protect the interest of customers in respect of the prices charged and the other terms of supply, and a duty to secure effective competition in the supply of gas.

### *A1.6 Gas Suppliers' Licence*

The Gas Act 1986 (as amended by the Gas Act 1995) provides for the licensing of gas suppliers. The licence comprises a number of standard conditions that apply to all domestic gas suppliers including BGT.

*a) General Obligations*

All suppliers are required to supply (and continue to supply) gas in the areas covered by their licences to every domestic customer who requests such a supply at premises connected to the system. In addition, each supplier must make available its terms of supply on request.

Suppliers are required to accept payment by a range of methods, including cash, cheque or postal order. Suppliers must offer a PrePayment meter as an alternative to a cash deposit, and as an option prior to disconnection.

*b) Social Obligations*

Gas suppliers serving domestic customers are required to make arrangements to meet a number of social obligations. These obligations include:

- providing energy efficiency advice on request;
- providing special controls, adapters and advice on gas use, appliances and fittings to pensioners and to the disabled and chronically sick on request, and facilities for blind and deaf people, and to keep a register of such customers (the Gas Care Register); and

- providing credit terms for the supply of gas to those customers who are in debt through misfortune or inability to meet bills for gas supplied on credit. This includes offering the facility to discharge their debt by instalments or a PrePayment meter and general advice as to how future bills may be reduced through the more efficient use of gas.

*c) Non-Discrimination*

Under Standard Condition 13 of the Gas Suppliers' Licence, a dominant gas supplier is prohibited from showing undue preference or exercising undue discrimination against any person or class of persons. Standard Condition 13 becomes less restrictive after competition is established. When competition is established, a dominant supplier is able to set terms in a way that is reasonably necessary to meet established competition, but not in a way that is predatory.

Standard Condition 13 deals only with undue discrimination and undue preference in the terms it sets for gas supply including the charges set. It does not address all aspects of anti-competitive behaviour. It complements and does not substitute for the normal operation of UK competition law.

### *A1.7 Competition Legislation*

The DGGS has concurrent powers with the Director General of Fair Trading under the Fair Trading Act 1973 and the Competition Act 1980. In relation to these concurrent powers Ofgem works in conjunction with the Office of Fair Trading (OFT) under the terms of the Ofgem/OFT Concordat.[49] In exercising his functions under the competition legislation, the DGGS must act in accordance with his section 4 duties under the Gas Act 1986 (as amended by the Gas Act 1995).

The Competition Act 1998 received Royal Assent on 9 November 1998 (and comes into force on 1 March 2000). The new Act replaces or amends existing competition legislation, including the Restrictive Trade Practices Act 1976; the Resale Prices Act 1976 the Competition Act 1980; and parts of the Fair Trading Act 1973. It will apply

[49] The terms of the Ofgem/OFT Concordat are available from the OFGAS library.

European Union competition law principles to domestic gas supply competition in the United Kingdom.

The Competition Act 1998 introduces two prohibitions: the Chapter I and Chapter II prohibitions. The Chapter I prohibition covers agreements between undertakings that have the object or effect of preventing, restricting or distorting competition. The Chapter II prohibition covers conduct by one or more undertakings, which amounts to the abuse of a dominant position. Companies can be fined up to 10% of their UK turnover for breaches of these prohibitions.

### *A1.8 The Proposed Utility Bill*

In March 1998, the Government published a Green Paper[50] outlining proposals to modernise the framework for utility regulation. The subsequent White Paper[51] set out a number of conclusions that will influence gas regulation in the future. These include:

- the merger of Ofgas and Offer into a new regulatory authority for gas and electricity;
- that the new authority should have a single primary duty to exercise the functions assigned to it in a manner that best promotes the interests of the consumer, wherever practical and cost efficient, through facilitating competition;
- that the new authority should have a separate duty to pay due regard to social and environmental guidance from Government; and
- proposes the establishment of an independent Consumer Council dealing with customer complaints.

[50] "A Fair Deal for Consumers: Modernising the Framework for Utility Regulation", DTI, March 1998.
[51] "A Fair Deal for Consumers: Modernising the Framework for Utility Regulation; the Response to the Consultation", DTI, July 1998.

# Appendix 2 – Economic Purchasing Obligation

Under Special Condition 3 of its gas suppliers' licence, BGT is required to purchase gas in the most economically advantageous manner possible. This is to ensure that BGT's dominance of the gas supply market does not lead to customers paying unnecessarily high prices. In accordance with Special Condition 3, BGT appointed Deloitte & Touche (the Assessor) to assess its purchase of gas in the formula year 1997/98.

No later than seven months after the end of the formula year BGT is required to submit to the Director General of Gas Supply an audited statement of its gas costs for the formula year (the total gas cost notice (TGCN)). For 1997/98 BGT submitted a TGCN of £3,847.5 million, relating to 17,953 million therms. This gave a per therm TGCN of 21.43 p/th.

The Assessor recommended certain alterations to BGT's TGCN. These included altering the discount factor used in the calculation of renegotiation costs to BGT's WACC as determined by the regulator. Ofgem agrees that the WACC is the appropriate discount factor, although Ofgem's view of BGT's WACC is 8% in real terms. The effect of the alterations proposed by the Assessor are detailed in table A1 and result in a TGCN of 21.41p/th.

In determining BGT's domestic gas supply tariff caps, its single portfolio is adjusted for increased peak and capacity requirements of domestic customers. This adjustment means that the allowable domestic rate is higher than TGCN. See section 6.6.

**Table A1 - Total gas costs for 1997/98 as adjusted by the Assessor's findings:**

| | Costs | Therms | TGCN | Allowable domestic rate |
|---|---|---|---|---|
| | **£ million** | **million** | **p/th** | **p/th** |
| Total gas cost per TGCN | 3,847.5 | 17,953 | 21.43 | 22.80[2] |
| Stored gas injected into the system | (107.8) | (521) | | |
| Take or pay adjustment | 24.9 | | | |
| Over-accrual of disputes | (17.5) | | | |
| Re-negotiation expenses pre 1 April 1997 | (9.0) | | | |
| Accord margin | (2.8) | | | |
| Using real discount rate of 8% for renegotiations | (2.4)[1] | | | |
| Total gas cost to be allowed by Ofgem | 3,732.8 | 17,432 | 21.41p | 22.72[1] |

1. As calculated by Ofgem.
2. As submitted by BGT.

# Appendix 3 – Ofgem's Initial View of BGT's Costs

## Table A2 – Ofgem's Initial View of BGT's costs in 2000/01 (in 1999/00 prices)

| | **Direct Debit** | | **PromptPay** | | **Standard** | | **PrePayment[3]** | |
|---|---|---|---|---|---|---|---|---|
| | £/C | p/th | £/C | p/th | £/C | p/th | £/C | p/th |
| Gas costs | | 18.88 | | 18.88 | | 18.88 | | 18.88 |
| Transportation | | 14.86 | | 14.86 | | 14.86 | | 14.86 |
| Meter provision | 12.33 | | 12.33 | | 12.33 | | 24.66 | |
| Storage | | 0.28 | | 0.28 | | 0.28 | | 0.28 |
| Supply costs | 17.64 | 0.02 | 18.87 | 0.28 | 32.69 | 1.52 | 40.46 | 0.74 |
| EESOP[1] | 1.17 | | 1.17 | | 1.17 | | 1.17 | |
| Allowed profit margin | 0.38 | 0.44 | 0.51 | 0.56 | 1.08 | 0.86 | 0.41 | 0.22 |
| PromptPay adjustment[2] | | | -8.63 | 1.54 | | | | |
| **Total Costs** | **31.52** | **34.48** | **24.25** | **36.36** | **47.28** | **36.39** | **66.71** | **34.97** |
| Total at ave. consumption | 292.13 | | 228.68 | | 249.88 | | 237.85 | |
| Total at 650 therms | 255.61 | | 260.78 | | 283.81 | | 294.04 | |

Notes:

1. "Energy Efficiency Standards of Performance" – see section 10.4.
2. This adjustment is required to equalise the PromptPay unit charge with the Standard/PrePayment unit charge.
3. For the purposes of this comparison, the PrePayment standing charge includes the surcharge on the first 39 units consumed each quarter.