

February 2000

**Review of British Gas Trading's  
Price Regulation**

**Final Proposals**

## Contents

	Page
<b>Executive Summary</b>	<b>2</b>
<b>1. Introduction</b>	<b>5</b>
<b>Part I: Setting the Framework</b>	
<b>2. BGT's Performance under the Present Control</b>	<b>7</b>
<b>3. Assessment of Competition</b>	<b>14</b>
<b>Part II: BGT's Costs</b>	
<b>4. Gas Purchase and Storage Costs</b>	<b>24</b>
<b>5. Transportation and Metering Costs</b>	<b>35</b>
<b>6. Supply Costs</b>	<b>40</b>
<b>7. Profit Margin</b>	<b>49</b>
<b>Part III: Ofgem's Final Proposals</b>	
<b>8. Revised Tariff Caps under the Present Structure</b>	<b>52</b>
<b>9. BGT's Proposal to Remove Standing Charges</b>	<b>57</b>
<b>Appendices</b>	
<b>1. Draft Special Licence Condition for BGT's Revised Price Regulation</b>	<b>67</b>
<b>2. Summary of Assessor's Report for Gas Costs in 1997/98 and 1998/99</b>	<b>72</b>
<b>3. Available 'Headroom' Analysis</b>	<b>77</b>
<b>4. BGT's Proposal to Charge for Replacement Electronic Token Meter (ETM) Cards.</b>	<b>81</b>

# Executive Summary

The present controls on prices charged by British Gas Trading (BGT) to customers who consume at or below 73,268<sup>1</sup> kilowatt hours (kWh) of gas a year will expire on 31 March 2000.<sup>2</sup> This document sets out Ofgem's Final Proposals for regulating BGT's prices from 1 April 2000.

Ofgem's Final Proposals reflect its judgement on the most appropriate balance between promoting effective competition; protecting customers' interests where competition is not effective; and ensuring that BGT can finance its licensed activities.

## **1. Scope**

Ofgem believes that competition is sufficiently developed for Direct Debit customers to be removed from the scope of revised price controls. This will remove price controls for about 5 million customers, about 35% of BGT's total customers.

Where competition is not sufficiently developed there is a risk that some customers will face higher prices than might otherwise be the case. Ofgem believes that competition is not yet sufficiently developed to remove price controls from BGT's customers paying by its PromptPay, Standard and PrePayment tariffs. Ofgem therefore intends to set revised controls on BGT's prices to safeguard these customers' interests.

## **2. Duration**

Ofgem intends these revised controls to last for one year only. In this time, Ofgem expects the prices that customers pay increasingly to be determined by more vigorous competition rather than the price control. To encourage this, Ofgem is committed to removing the remaining barriers to entry that prevent all customers benefiting fully from the competitive market. Subject to satisfactory progress in removing these barriers, it is Ofgem's firm intention to remove the price controls in respect of BGT's PromptPay, Standard and PrePayment customers from 1 April 2001. Other safeguards for

---

<sup>1</sup> 73,268 kWh equates to 2,500 therms. From 1 January 2000 for consistency with section 48(2A) of the Gas Act 1986, all Ofgem publications will use metric values. 1 therm equals 29.3071 kilowatt hours.

<sup>2</sup> Formally, 31 March 2000 is not the end of the current control, but the first date from which it could be disapplied.

customers, including those provided by the provisions of the gas suppliers' licences and general competition law will remain beyond 1 April 2000.

### **3. Level**

Ofgem's Final Proposals imply a cut in BGT's revenue in 2000/01 of about 4.5% or about £12 per price controlled customer. This compares to 5.0% or £13 per price controlled customer under Ofgem's Initial Proposals. This change reflects more up to date information on the level of BGT's costs in 2000/01 and consideration of the 'headroom' available to BGT's competitors.

### **4. Removal of BGT's Standing Charges**

On 13 January 2000, BGT announced its intention to remove all standing charges from its domestic gas and electricity tariffs. BGT intends to replace its present tariff structure of a standing charge and a unit charge with a tariff structure that has no standing charge and a two-tier unit charge, similar to the present structure of BGT's PrePayment tariff. Ofgem's initial view is that this does not breach the provisions of BGT's gas suppliers' licence or general competition law. Ofgem invites views on this assessment.

Against this background, Ofgem has adjusted the structure of the revised tariff caps to reflect BGT's proposal to remove standing charges. In doing so, Ofgem has sought to ensure that BGT's new tariff structure allows it the same revenue as Ofgem's Final Proposals under BGT's present tariff structure. As a result, customers at lower volumes<sup>3</sup> will benefit from larger reductions in annual bills.

PromptPay customers at average consumption can expect to see reductions in their annual bill of 3.1% or about £8. Standard and PrePayment customers, at average consumption, can expect to see reductions in their annual bills of 3.6% or about £10.<sup>4</sup>

---

<sup>3</sup> Less than 4,572 kWh a year.

<sup>4</sup> Under the present tariff structure, Ofgem's Final Proposals would imply a cut in annual bills of 4.5% or £11 for an average PromptPay customer and 4.6%, or £12 for an average Standard or PrePayment customer. This compares to Ofgem's Initial Proposals for reductions in bills of 4.8% (£12) for PromptPay customers and 5.2% (£14) for Standard and PrePayment customers.

## **5. Available 'Headroom'**

Ofgem has sought to ensure that the level of its revised tariff caps for BGT do not act to discourage competitors and potential competitors from innovating and competing vigorously. Ofgem's Final Proposals for BGT's revised tariff caps leave substantial headroom for competitors offering 'dual fuel' supplies. Based on Ofgem's analysis of new entrants' costs, competitors could offer discounts ranging from 8% to 20% for PromptPay, Standard and PrePayment customers. There is less headroom available for gas only suppliers. However, gas only new entrants can still offer discounts for PromptPay and Standard customers of between 7% to 15%.

Available headroom is tightest for PrePayment customers. Acquisition costs for PrePayment customers are presently very high. About 70% of PrePayment customers have an outstanding debt with BGT, and therefore, BGT can object to their transfer to a new supplier. Ofgem believes that its proposals to remove the right of suppliers to object to the transfer of customers in debt<sup>5</sup> and work on removing other barriers to entry will help to reduce new entrants' acquisition costs for PrePayment customers and hence increase the available headroom for these customers.

## **6. Next Steps**

Ofgem's Final Proposals are embodied in the proposed new Special Licence Condition for BGT (set out in Appendix 1). These proposals are subject to a 28 day public consultation process. If BGT rejected Ofgem's proposals at that stage, Ofgem would expect to refer the matter to the Competition Commission.

---

<sup>5</sup> "Customers in debt and their access to the competitive market", Ofgem, December 1999.

# 1. Introduction

## *1.1 Purpose of this Document*

This document sets out Ofgem's Final Proposals for continuing regulation on BGT's prices from 1 April 2000. It explains how Ofgem has arrived at these proposals including consideration of issues raised in response to Ofgem's Initial Proposals published in November 1999.<sup>6</sup> This document also invites views on Ofgem's initial assessment of BGT's proposal to remove standing charges.

## *1.2 Consultation*

Ofgem published a consultation document in June 1999<sup>7</sup> on issues to be addressed in its review of BGT's price regulation. In November 1999, Ofgem published its Initial Proposals for BGT's price regulation after 1 April 2000.<sup>8</sup>

Ofgem received sixteen responses to its Initial Proposals document in addition to BGT's. These comprised: nine gas and electricity suppliers, four consumer groups, one energy efficiency organisation, one academic and one customer.

Ofgem has amended its Initial Proposals to take into account these responses and further information from BGT. Ofgem's Final Proposals are embodied in the draft special licence condition attached as Appendix 1. Ofgem's Final Proposals are subject to a 28 day public consultation process. If BGT rejected the proposals at that stage, Ofgem would expect to refer the matter to the Competition Commission.

## *1.3 Structure of this Document*

This document is divided into three parts. Part I, comprising chapters 2 and 3 sets the framework for Ofgem's Final Proposals. Chapter 2 sets out Ofgem's updated view on BGT's performance against its tariff caps over the period of the present price control. Chapter 3 sets out Ofgem's assessment of the development of competition, including issues respondents raised to Ofgem's December 1999 review of the competitive

---

<sup>6</sup> Much of the detail produced in the Initial Proposals document is not reproduced here.

<sup>7</sup> "Review of BGT's Price Regulation: A Consultation Document", Ofgem, June 1999.

<sup>8</sup> "Review of BGT's Price Regulation: Initial Proposals", Ofgem, November 1999.

market.<sup>9</sup> It includes Ofgem's Final Proposals for the scope and duration of BGT's revised price control.

Part II sets out Ofgem's allowances for BGT's costs in the calculation of BGT's revised price control. Chapters 4 to 7 set out each component of Ofgem's calculations supporting its Final Proposals: gas purchase and storage costs; transportation and metering costs; supply costs; and profit margin.

Part III sets out Ofgem's Final Proposals. Chapter 8 sets out Ofgem's view of revised tariff caps under the present tariff structure. Chapter 9 sets out Ofgem's assessment of BGT's proposal to remove standing charges from its tariff structure. It also sets out Ofgem's Final Proposals adjusted for BGT's proposal.

#### **1.4 Views Invited**

If you wish to express a view on Ofgem's Final Proposals, we would like to receive your response by no later than 10 March 2000. 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 are provided in a form that can be placed in Ofgem's library.

If you would like to discuss any issue raised in this document, please contact Richard Moriarty on 0171-932-5901 (or e-mail: [Richard.Moriarty@ofgem.gov.uk](mailto:Richard.Moriarty@ofgem.gov.uk)) or Colin Garland on 0171--932-1671 (or e-mail: [Colin.Garland@ofgem.gov.uk](mailto:Colin.Garland@ofgem.gov.uk)) who will be pleased to help.

---

<sup>9</sup> "A Review of the Development of Competition in the Domestic Gas Market", Ofgem, December 1999.

# PART I: Setting the Framework

## 2. BGT's Performance under its Present Control

### 2.1 Introduction

This chapter sets out:

- Ofgem's updated view of BGT's performance against its tariff caps over the period of the present price control; and
- Ofgem's estimate of BGT's cumulative correction factor ('k' factor).

### 2.2 BGT's Performance against its Tariff Caps

#### a) Ofgem's Initial Proposals

Ofgem did not give a view on BGT's tariff caps as it was awaiting the results from the economic purchasing review of gas in 1998/99. Ofgem noted BGT's view of its prices against its tariff caps in each formula year. This is summarised in table 1.

**Table 1 – BGT's View of its Prices Relative to its Tariff Caps (difference as % of tariff cap)<sup>10</sup>**

	Direct Debit	PromptPay	Standard	PrePayment
1997/98	- 8	- 5	- 6	2
1998/99	-11	- 6	- 4	- 4
1999/00	- 11	- 5	-1	-1

#### b) Respondents' Views

Respondents raised no comments.

---

<sup>10</sup> Customers bills based on average annual tariff consumption.



**c) BGT's Views**

Tables 2, 3 and 4 show BGT's updated view of its prices relative to its tariff caps since the publication of Ofgem's Initial Proposals. BGT's revised view mainly reflects more recent estimates of its gas and transportation costs.

Table 2 shows that in 1997/98, BGT over-recovered for PrePayment by about 2%. The under-recovery for the other tariffs was broadly similar to BGT's earlier estimates.

**Table 2 - BGT's View of its Average Annual Bills relative to its Tariff Caps in 1997/98 (nominal prices)**

	Direct Debit	PromptPay	Standard	PrePayment
Consumption (kWh per year)	20,779	15,005	16,383	13,335
Tariff cap (£)	342	258	298	240
Average bill (£)	314	246	279	245
Difference (£)	- 28	- 12	- 19	5
Difference as a % of tariff cap	- 8	- 5	- 6	2

Table 3 shows that for 1998/99, BGT had a larger under-recovery for Direct Debit than its previously forecast.

**Table 3 - BGT's View of its Average Annual Bills Relative to its Tariff Caps in 1998/99 (nominal prices)**

	Direct Debit	PromptPay	Standard	PrePayment
Consumption (kWh per year)	22,096	17,115	16,787	15,133
Tariff cap (£)	351	276	298	274
Average bill (£)	311	260	286	263
Difference (£)	- 40	- 16	- 12	- 11
Difference as a % of tariff cap	- 11	- 6	- 4	- 4

Table 4 shows that for 1999/00, BGT under-recovered significantly on Direct Debit and to a lesser extent for PromptPay. BGT priced just below its cap for Standard/PrePayment.

It should be noted that gas costs in this year have not been assessed by the Assessor. Under the terms of the present licence condition the Assessor is appointed eight months after the end of the tariff year.

**Table 4 - BGT's View of its Average Annual Bills Relative to its Tariff Caps in 1999/00 (nominal prices)**

	<b>Direct Debit</b>	<b>PromptPay</b>	<b>Standard/PrePayment</b>
Consumption (kWh per year)	21,394	16,760	15,943
Tariff cap (£)	340	261	272
Average bill (£)	303	249	270
Difference (£)	-37	-12	-2
Difference as a % of tariff cap	-11	-5	-1

**d) Ofgem's View**

Tables 5, 6 and 7 show Ofgem's view of BGT's prices relative to their tariff caps over the period of the present price control.

Ofgem's view is broadly similar to BGT's for 1997/98 and 1998/99. The difference between Ofgem and BGT's views results from different views on the level of allowable gas costs. The Assessor disagreed with BGT over some items that have been included in the level of gas costs to be passed through to domestic customers. Ofgem's view on the Assessor's recommendations is set out in Appendix 2.

**Table 5 – Ofgem’s View of BGT’s Average Annual Bills relative to its Tariff Caps in 1997/98 (nominal prices)**

	<b>Direct Debit</b>	<b>PromptPay</b>	<b>Standard</b>	<b>PrePayment</b>
Consumption (kWh per year)	20,779	15,005	16,383	13,335
Tariff cap (£)	341	258	297	238
Average bill (£)	314	246	279	245
Difference (£)	- 27	- 12	- 18	7
Difference as a % of tariff cap	- 8	-5	- 6	3

**Table 6 – Ofgem’s View of BGT’s Average Annual Bills Relative to its Tariff Caps in 1998/99 (nominal prices)**

	<b>Direct Debit</b>	<b>PromptPay</b>	<b>Standard</b>	<b>PrePayment</b>
Consumption (kWh per year)	22,096	17,115	16,787	15,133
Tariff cap (£)	350	275	298	274
Average bill (£)	311	260	286	263
Difference (£)	- 39	- 15	- 12	-11
Difference as a % of tariff cap	- 11	- 5	- 4	-4

The largest difference between BGT’s and Ofgem’s view is for the tariff year 1999/00. As the economic purchasing review for 1990/00 has not been completed, Ofgem has used information from its review of BGT’s price control to estimate a level for allowable costs. Ofgem has also used information from its price control review to estimate BGT’s allowable transportation costs. This is based on Transco’s estimate of average transportation charges for domestic shippers in 1999/00. Ofgem estimates that BGT’s allowable transportation costs should be 0.524 pence per kWh, compared to BGT’s estimate of 0.549 pence per kWh.

Ofgem estimated BGT's gas costs on a contract by contract basis. Ofgem estimates that BGT's allowable gas costs should be 0.631 pence per kWh, compared to BGT's estimate of 0.640 pence per kWh.

On this basis, Ofgem estimates that BGT over-recovered for the merged Standard and PrePayment tariff by about 3%, compared to BGT's view of an under-recovery of 1%.

**Table 7 – Ofgem's View of BGT's Average Annual Bills Relative to its Tariff Caps in 1999/00 (nominal prices)**

	Direct Debit	PromptPay	Standard/PrePayment
Consumption (kWh per year)	21,394	16,760	15,943
Tariff cap (£)	326	251	264
Average bill (£)	303	250	270
Difference (£)	-23	-1	6
Difference as a % of tariff cap	-7	0	3

Chapter 3 discusses BGT's pricing relative to its tariff caps in the context of the development of competition for different classes of customers.

### **2.3 Implied Level of 'k' Factor**

#### **a) Ofgem's Initial Proposals**

BGT's current price control includes a correction factor, the "k factor" mechanism, which allows BGT to recover in subsequent years any allowed revenue not recovered in previous years and vice versa. This ensures that BGT is not 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).

Table 8 sets out BGT's and Ofgem's initial estimates for the level of cumulative correction factor for each tariff and overall. Ofgem's view of BGT's under-recovery was smaller than BGT's, with most of the difference on Direct Debit.

**Table 8 – BGT’s Cumulative k Factor over its Present Control, £ Million (nominal prices)**

	Direct Debit	PromptPay	Standard/ PrePayment	Total
BGT’s view	190	51	6	247
Ofgem’s view	60	20	(4)	76

**b) Respondents’ Views**

Respondents raised no comments.

**c) BGT’s Views**

Table 9 shows BGT’s revised view of its cumulative correction factor. It has not changed significantly from BGT’s estimate in the Initial Proposals.

**Table 9 – BGT’s View of its Cumulative K Factor over its Present Control, £ Million (nominal prices)**

	Direct Debit	PromptPay	Standard/ PrePayment	Total
BGT’s view	198	52	10	260

**d) Ofgem’s View**

Estimating BGT’s cumulative correction factor is subject to a high degree of uncertainty because an economic purchasing review for 1999/00 has not been completed. In addition, relatively small differences in estimates for the pass-through costs can lead to relatively large differences in estimates for the cumulative correction factor.

Table 10 shows Ofgem’s latest view of BGT’s cumulative correction factor. It shows that Ofgem’s estimate of the total under-recovery is far lower than BGT’s. Ofgem estimates that BGT has over-recovered for Standard and PrePayment.

**Table 10 – Ofgem’s View of BGT’s Cumulative k Factor over its Present Control, £ Million (nominal prices)**

	<b>Direct Debit</b>	<b>PromptPay</b>	<b>Standard/ PrePayment</b>	<b>Total</b>
Ofgem’s view	130	1	(39)	92

Ofgem’s final proposals for the allowance in the revised control for the cumulative k factor over the present control is discussed in chapter 8.

## 3. Assessment of Competition

### 3.1 Introduction

Ofgem's Initial Proposals document summarised the conclusions of its review of the development of domestic gas supply competition. It explained how Ofgem's assessment of competition determined its proposals for the scope and duration of revised price regulation for BGT from 1 April 2000. In December 1999, Ofgem published its detailed review of the competitive domestic gas supply market.<sup>11</sup>

This chapter sets out Ofgem's position on issues raised in response to Ofgem's assessment of competition. It goes on to set out Ofgem's Final Proposals on the scope and duration of revised controls on BGT's prices.

### 3.2 Ofgem's Assessment of Competition

#### a) Ofgem's Initial Proposals

Overall, Ofgem believed that competition in the domestic gas supply market was developing well. A range of evidence supported this view including:

- 96% of customers being aware of their ability to choose an alternative gas supplier;
- 25% of customers having switched gas supplier and a level of customer switching of about 32,000 per week;
- the number of rival suppliers to BGT and their continuing innovations in terms of price, service and related products; and
- most customers' ability to obtain competitive offers, with discounts of up to 20% available compared to BGT's tariffs.

---

<sup>11</sup> "A Review of the Development of Competition in the Domestic Gas Market", Ofgem December 1999.

Ofgem found that competition was developing more quickly for direct debit customers than other payment methods. Direct debit customers were able to obtain a range of competitive offers from BGT's rivals, with discounts of up to 10% available. BGT's market share for direct debit customers was about 70%, showing that a significant proportion of direct debit customers had been able to take advantage of competitive offers. Direct debit customers were also able to take advantage of a range of complementary products offered by gas suppliers. BGT had priced significantly below its tariff cap for direct debit customers over the period of the present control.

BGT's role in the transfer process continued to give Ofgem concern. Ofgem also stated that it was continuing to monitor BGT's 'dual fuel' offer, its complementary products and its advertising to ensure that BGT did not restrict, distort or prevent the development of competition.

A key conclusion of Ofgem's assessment was that the gas and electricity supply markets were increasingly being characterised by 'dual fuel' offers. Almost half of electricity and gas customers switching did so to take advantage of combined gas and electricity offers. Against this background, Ofgem was concerned that barriers to entry in electricity (such as access to wholesale electricity supplies) could affect the development of competition in the gas supply market. Ofgem said that it was committed to removing remaining barriers in gas and electricity. Major initiatives in 2000 included the New Electricity Trading Arrangements (NETA) and Ofgem's consultation on removing the right of suppliers to object to the transfer of customers in debt.

***b) Respondents' Views***

Most respondents supported Ofgem's approach to assessing competition, although one supplier suggested that Ofgem should consider the whole package that suppliers offer customers and not just focus on price. Another respondent said that Ofgem's approach was limited because it did not consider a comprehensive range of evidence. This respondent said that Ofgem should consider evidence such as the market share of all suppliers by PES area and information on suppliers' service levels.

Respondents expressed a number of concerns, set out below, about BGT's dominance and behaviour that were not specifically addressed in the December document.



*i) BGT's Upstream Market Power*

One supplier said that Centrica had significant financial interests in upstream assets (including the Morecambe Bay fields) and a level of vertical integration far in excess of the PESs in electricity. This respondent said that Centrica had a strong incentive to manipulate wholesale gas prices to increase the value of its upstream assets.

*ii) BGT's Advertising*

Respondents expressed three main concerns:

- the effect on competition of BGT's established brand;
- the level of BGT's advertising expenditure. One respondent argued that BGT had acquired many 'dual fuel' customers because of its large advertising expenditure, even though it was not the cheapest supplier offering comparable offers; and
- the misleading nature of some of BGT's advertising on the development of competition.

*iii) BGT's Complementary Products and Services*

One supplier expressed concern that BGT was not allowing customers who wished to switch supplier to cash in the remaining value of their Gas Stamps.<sup>12</sup> This supplier said this was a barrier to customers switching.

*iv) BGT's 'Dual Fuel' Offer*

One supplier suggested that Ofgem's analysis of BGT's 'dual fuel' offer in July 1999<sup>13</sup> should be revised given the evidence in the Initial Proposals document that Centrica was cross-subsidising its other business units from its gas supply business. This supplier provided analysis that showed that BGT's 'dual fuel' offer did not cover its attributable avoidable costs.

---

<sup>12</sup> Gas stamps can be purchased at retail outlets, usually Post Offices, and can be counted towards a customer's gas bill.

<sup>13</sup> "Review of BGT's Behaviour in the Domestic Gas Market: A Follow-up Document", Ofgem, July 1999.

*c) BGT's Views*

BGT said that Ofgem's approach to assessing competition was a "balanced" consideration of the relevant factors.

*d) Ofgem's Final Proposals*

Ofgem believes that evidence on market shares and switching behaviour by PES area and information on suppliers service levels would be a useful indication of the development of competition. Before Ofgem issues its next competitive market review survey it will consider how best to request this information from suppliers without imposing an excessive regulatory burden.

Ofgem's position is set out below on each of the issues raised by respondents on BGT's dominance and behaviour.

*i) BGT's Upstream Market Power*

Ofgem believes that BGT's dominant position is not in itself a reason for regulatory action. However, Ofgem is concerned to ensure that BGT does not abuse its dominant position and market power. Ofgem has received no firm evidence to suggest that Centrica has abused its dominance by manipulating wholesale gas prices. Ofgem has written to the respondent concerned seeking more information and evidence about the effect it believes that Centrica has, or could have, on wholesale gas prices. Ofgem will take action if information comes to light that Centrica has abused its market power.

Ofgem notes that under the Competition Act 1998, such behaviour would likely constitute an abuse of a dominant position and would expose Centrica to the threat of financial penalties.

*ii) BGT's Advertising*

Ofgem recognises the strong established brand awareness that BGT has using the "British Gas" name. However, Ofgem does not consider this in itself to be evidence of abuse of BGT's dominance. Other suppliers also have a strong established brand awareness, for example the local PESs.

Ofgem has determined a level of expenditure that it believes is appropriate for BGT's advertising and marketing costs for the duration of the next price control (see chapter 6). However, this is not intended as a spending cap on these activities. Within the overall constraints of the price control, BGT is able to spend its allowed revenue in whatever way it considers appropriate, while still meeting its licence obligations and Standards of Service.

As explained in Ofgem's follow-up document to the 1998 domestic competitive market review,<sup>14</sup> Ofgem would consider taking action under the Competition Act 1998 from 1 March 2000, if BGT continued to breach the Advertising Standards Authority (ASA) and Independent Television Commission (ITC) codes of practice. Ofgem notes that BGT has not been found in breach of the ASA code of practice since June 1998. However, BGT was recently found in breach of the ITC code of practice for its "Monster 2002" campaign. Ofgem is concerned by this development and is currently considering BGT's explanation and assurances about its future conduct.

*iii) BGT's Complementary Products and Services*

Ofgem regards the loss of entitlement to the value of accrued Gas Stamps for customers switching supplier as a tie-in that goes against the principles for complementary products that Ofgem established for BGT's 'Goldfish' credit card.<sup>15</sup> Ofgem has requested that BGT address this issue with immediate effect. BGT has agreed.

Ofgem is concerned about the cumulative effect on competition of the discounts and offers available through BGT. These include 'dual fuel' offers, Goldfish, Insurance, Sainsbury's Reward Points and the Joint Payment Arrangement.<sup>16</sup> Ofgem will consider the cumulative effect on competition of BGT's complementary offers in the light of the new tariff structure and prices that will take effect from 1 April 2000. In particular, Ofgem is concerned to ensure that BGT's discounts do not lead to an effective price for

---

<sup>14</sup> "Review of BGT's Behaviour in the Domestic Gas Market: A Follow-up Document", Ofgem, July 1999.

<sup>15</sup> "Goldfish: British Gas Trading's credit card joint venture: A decision document, Ofgas, October 1997.

<sup>16</sup> The JPA allows customers to pay for their gas supply and BG service cover by the same direct debit.

gas that is below avoidable attributable costs and might therefore constitute predatory pricing.

*iv) BGT's 'Dual Fuel' Offer*

Ofgem intends to revise its analysis of BGT's 'dual fuel' offer in the light of BGT's removal of standing charges and the new price control from 1 April 2000. Ofgem will publish its findings later this year.

### **3.3 Scope of BGT's Revised Price Control**

**a) Ofgem's Initial Proposals**

Ofgem's initial view was that competition for Direct Debit customers was sufficiently developed to enable price controls to be removed. Ofgem said that competition was not yet sufficiently developed to remove price controls for BGT's PromptPay, Standard and PrePayment customers.

**b) Respondents' Views**

Three suppliers and two consumer groups welcomed Ofgem's proposals. However, three consumer groups did not support removing Direct Debit customers from the price control.

Two suppliers said that PromptPay should also be removed from the control given that some customers were actively responding to the tariff's price incentive by paying promptly. These suppliers believed that PromptPay's customer behaviour was similar to Direct Debit's customer behaviour. One supplier said that all controls should be removed.

**c) BGT's Views**

BGT said that PromptPay should be removed from the revised controls. BGT argued that PromptPay was sufficiently similar to Direct Debit in terms of customers exercising a positive choice to respond to price incentives and the degree of competition that exists for these customers.

**d) Ofgem's Final Proposals**

In relation to Direct Debit customers no new evidence was put forward that Ofgem did not consider as part of its Initial Proposals. Ofgem therefore proposes to remove Direct Debit customers from the scope of revised controls because competition is sufficiently developed to protect their interests. Additional safeguards will be provided by BGT's Standard Licence Conditions and general competition law, in particular the Competition Act 1998.

It is difficult to derive evidence to conclude that competition is sufficiently developed for BGT's PromptPay customers.<sup>17</sup> Some suppliers do not offer comparable tariffs to BGT's PromptPay tariff. Ofgem recognises some customers within the PromptPay tariff may have similar characteristics to direct debit, such as standing order customers. However, it is not clear that other PromptPay customers are sufficiently distinctive from customers on BGT's Standard tariff. In particular:

- 90% of BGT's PromptPay customers pay by quarterly cash and cheque. For these customers the distinction between PromptPay and Standard is somewhat arbitrary: those paying 10 days after their bills benefit, but those paying 11 days after the bill do not. Some customers frequently drift between the two tariffs; and
- the PromptPay unit charge must be the same as the Standard unit charge. Removing PromptPay from the scope of controls while retaining controls for Standard might lead to distortions in BGT's pricing behaviour.

On the balance of available evidence Ofgem considers that PromptPay customers along with Standard and PrePayment customers, should remain within the scope of BGT's revised tariff caps for 2000/01.

---

<sup>17</sup> No evidence for PromptPay customers was put forward by respondents that Ofgem did not consider as part of its review of the competitive market.

### **3.4 Duration of BGT's Revised Price Control**

#### **a) Ofgem's Initial Proposals**

Ofgem proposed to set revised tariff caps for one year only. Subject to satisfactory progress being made in removing remaining barriers to entry, Ofgem said that it was its firm intention to remove BGT's price control completely from 1 April 2001. Ofgem said that major initiatives in 2000 included the New Electricity Trading Arrangements (NETA) and Ofgem's consultation on removing the right of suppliers to object to the transfer of customers in debt. Ofgem said that, in the context of a one year control, it would not be practical or appropriate include a correction factor.

#### **b) Respondents' Views**

Suppliers generally welcomed Ofgem's 'firm intention' to remove price controls after one year. However, all consumer groups that responded said that one year was too short. They believed that in twelve months' time Ofgem's indicators of competition would not show significant progress, particularly for PrePayment customers. They doubted that Ofgem would make sufficient progress in removing remaining barriers to entry over the next twelve months.

#### **c) BGT's Views**

BGT welcomed Ofgem's 'firm intention' to remove price controls. However, BGT said that Ofgem should give guidance on the process by which it would assess whether the conditions were appropriate to remove all controls.

#### **d) Ofgem's Final Proposals**

Ofgem notes consumer groups' concerns about the proposed one year duration, and, if the Competition Act 1998 were not coming into force on 1 March 2000, would likely have taken a more cautious view of the timing of the removal of price controls.

Ofgem has come to its view because it believes that where competition is sufficiently developed for certain classes of customers, removing specific additional regulation and relying on the provisions of the standard gas suppliers' licence and the Competition Act 1998 is the most appropriate safeguard for these customers' interests. This ensures that the operation of the competitive gas supply market is not distorted by unnecessary

prescriptive regulation. It would also allow BGT to compete and innovate on an equal footing with other suppliers.

In the event that BGT did abuse its dominant position after price controls were removed Ofgem would use its new powers under the Competition Act 1998. For example, the Act allows Ofgem to impose financial penalties of up to 10% of BGT's UK turnover. The potential size of these financial penalties will act as a powerful deterrent to BGT abusing its dominant position.

To enable Ofgem to be in a position to remove controls from 1 April 2001, it is committed to removing the remaining barriers to entry that prevent competition sufficiently developing to protect all customers' interests.

Ofgem discussed in its Initial Proposals two major initiatives over the next twelve months, the New Electricity Trading Arrangements (NETA) and Ofgem's consultation on the right of suppliers to object to the transfer of customers in debt. Since the publication of Ofgem's Initial Proposals, there have been developments in both these areas. The NETA arrangements will be included within the Utilities Bill, which is currently in its committee stage in the House of Commons. Ofgem has reviewed responses to its consultation on the right of suppliers to object to the transfer of customers in debt and aims to publish a progress report in April 2000.

Subject to satisfactory progress being made in removing these and other remaining barriers to entry, it remains Ofgem's firm intention to remove price controls completely from the domestic gas market from 1 April 2001. Ofgem remains of the view that the revised tariff caps should not include a correction factor.

Ofgem's assessment of progress made in removing barriers to entry will be largely informed by its annual review of the competitive market. Given the increasing move towards a 'dual fuel' market, Ofgem intends to combine the gas and electricity reviews from this year onwards. Ofgem will publish its decision document by the end of 2000. Ofgem intends to set out more detail about the process by which it will make its decision when it publishes the agreed new Special Licence Condition for BGT, expected in March 2000.

Ofgem has reflected this process in the draft Special Licence Condition for BGT's revised price control (see Appendix 1). Paragraph 5 provides that BGT's revised tariff caps will cease to have effect from 1 April 2001 unless Ofgem, based on its assessment of the development of competition, has put forward alternative arrangements before that date.

### ***3.5 Ofgem's Final Proposals***

Ofgem's assessment of the development of competition provides the basis for Ofgem's Final Proposals in three important areas:

- removing Direct Debit customers from the scope of continuing controls;
- revising tariff caps for PromptPay, Standard and PrePayment customers; and
- limiting the duration of these controls to a further one year only (thus removing the need for a correction factor in the revised caps).



## PART II: BGT's Costs

### 4. Gas Purchase and Storage Costs

#### 4.1 Introduction

Gas purchase and storage costs account for about 46% of BGT's costs of serving domestic gas customers in 1999/00. BGT's present price control passes these costs through to customers subject to a requirement to purchase economically. Ofgem's Initial Proposals for revised 2000/01 tariff caps included replacing the pass-through regime with a fixed gas and storage cost allowance.

Ofgem proposed that this allowance should be calculated in accordance with Centrica's single portfolio of gas and storage purchases, including a premium to reflect the attributable costs of meeting its domestic peak requirements and an allowance for renegotiation costs. Ofgem's Initial Proposals set a level for BGT's gas and storage cost allowance of 0.670 pence per kWh.<sup>18</sup>

This chapter considers:

- the form of control for gas and storage costs;
- BGT's weighted average cost of gas (WACOG);
- contract renegotiations; and
- storage costs.

#### 4.2 Form of Control for Gas and Storage Costs

##### a) Ofgem's Initial Proposals

Ofgem proposed a fixed allowance for BGT's gas purchase and storage costs within its revised tariff caps for 2000/01. Ofgem considered that this treatment would overcome

---

<sup>18</sup> Ofgem has been advised by Arthur Andersen in assessing its Final Proposals for the level of BGT's gas and storage cost allowance in 2000/01.

the problems associated with the present pass-through regime, such as uncertainty and delay in establishing the level of the tariff caps, and would strengthen BGT's incentive to reduce its gas and storage costs. In addition, Ofgem considered that uncertainty over BGT's future gas costs was considerably less than at the time of the last review. At that time, BGT was about to enter a process of substantial renegotiations and was subject to volume risk associated with the opening up of competition.

***b) Respondents' Views***

All suppliers that responded supported Ofgem's proposal to set an allowance for BGT's gas purchase and storage costs. Most suppliers argued that this would be consistent with Ofgem's Final Proposals for the PES supply price control reviews. Two consumer groups said that the present pass-through regime meant that customers bore all the risk of cost increases. They said that setting an allowance would provide protection for customers while giving BGT an incentive to further reduce its gas costs. One consumer group said that a fixed allowance would overcome the uncertainty for customers caused by the protracted delays in establishing the level of pass-through costs.

***c) BGT's Views***

BGT said that removing the pass-through for gas and storage costs and replacing it with an allowance introduced new risks for its business. The main risk was unexpected increases in its gas purchase contract costs (some of which had already occurred since the publication of the Initial Proposals). BGT said that not all its contract escalators would be known by the time Ofgem published its Final Proposals. BGT said it should be compensated for the risk that these remaining contract escalator terms might cause gas costs to be higher than expected. The compensation for this risk should take the form of either a higher gas cost allowance or a higher allowed profit margin.

***d) Discussion***

Ofgem accepts that moving from a full cost pass-through regime to a cap could involve some risk for BGT in terms of unexpected increases in costs. However, Ofgem does not consider that these potential risks are significant for a number of reasons including:

- contract escalators. The majority of BGT’s gas demand is met from its long term contract commitments, the prices of which are based on published indices. 75% of the escalator terms affecting gas costs in 2000/01 are now known, since they are subject to historical prices, thus eliminating the risk for that proportion of costs;
- balance of risks. Out-turn values for currently unknown escalator terms could be lower than forecast as well as higher;
- contract renegotiations. BGT is continuing to search for opportunities to renegotiate its long-term contracts. For instance, BGT recently announced that it had renegotiated its long-term contract with Royal Dutch/Shell for gas from the Galleon field.<sup>19</sup> Although further renegotiations are unlikely to be of the same scale as those seen during 1997 and 1998, they will have the effect of reducing BGT’s gas costs relative to its allowance under the revised tariff caps; and
- duration. A pass-through regime would not be practical in the context of a one year price control as a level for gas and storage costs must be set in advance to set the revised tariff caps.

***e) Ofgem’s Conclusion***

Ofgem proposes to set a fixed allowance for BGT’s gas and storage costs for 2000/01 revised tariff caps.

***4.3 BGT’s Weighted Average Cost of Gas (WACOG)***

***a) Definition of Centrica’s Single Portfolio***

***i) Ofgem’s Initial Proposals***

Ofgem proposed to base BGT’s allowance on Centrica’s single portfolio of gas purchases. This included Centrica’s purchase commitments under its long-term contracts, including internally sourced gas from its Morecambe Bay fields.<sup>20</sup>

---

<sup>19</sup> This was announced on 27 January 2000.

<sup>20</sup> These fields, which supply about 20% of BGT’s annual gas demand, are operated by Hydrocarbon Resources Limited, a wholly owned subsidiary of Centrica plc.

Wholesaling purchases that fell outside the present definition of 'regulated' gas were excluded.<sup>21</sup>

Ofgem adopted the single portfolio approach to ensure that domestic customers were not discriminated against by bearing the cost of expensive gas from long-term purchase contracts when Centrica might be purchasing less expensive gas from other sources and passing this gas to customers in parts of the market that were more competitive, such as the industrial and commercial sector.

Ofgem based its view on a contract by contract estimate of Centrica's gas purchases.

*ii) Respondents' Views*

Respondents generally welcomed Ofgem's approach of defining BGT's allowance on Centrica's single gas portfolio. However, one supplier said that BGT should not be allowed to recover the full costs of its long-term contracts on the basis that Ofgem's Final Proposals for the PES supply price controls had disallowed some of the PESs Independent Power Project (IPP) costs. Another supplier said that Ofgem should exclude all those long-term contracts signed after 1986 when BGT could have anticipated the introduction of competition. Moreover, the same supplier argued that wholesaling purchases that currently fell outside the definition of regulated gas should be included. One consumer group said that BGT should not be allowed to continue to recover legacy contract costs on the basis that Centrica's substantial renegotiation process had proved that these costs were not unavoidable.

*iii) BGT's Views*

BGT said that, for the purposes of calculating the costs for a one year control, it was content that the principle of Ofgem's definition of the single gas portfolio should be applied.

---

<sup>21</sup> Broadly speaking 'Regulated Gas' excludes gas purchased under contracts of less than six months duration (or less than one year's duration in the case of purchases from a related person) as well as gas traded outside Great Britain.

*iv) Discussion*

Ofgem considered the arguments put forward by respondents for excluding all or some of BGT's long-term contract purchase costs. Gas purchase costs provide significant scope for competitive cost advantage for new entrants to the gas market. Ofgem continues to believe that including long-term contract costs within the definition of the single gas portfolio provides the most appropriate balance of interests between promoting effective competition; protecting customers' interests where competition is not developed; and considering BGT's ability to finance its licensed activities.

Ofgem considered whether to remove the present exclusion of wholesaling purchases of less than one year duration. However, in practice it is difficult to distinguish paper trades from trades that could be used to meet UK physical demand. As most of BGT's demand in 2000/01 will be met from its long-term purchase contracts, Ofgem has not made an adjustment to incorporate wholesale gas purchases of less than one year.

Ofgem has updated its estimates for BGT's contract escalator terms. Where possible this has been based on published indices of historical data that effect the escalator terms. About 75% of the contract escalator terms affecting gas prices in 2000/01 are now known. Ofgem has also revised its forecasts for the key escalator indices that are not yet known. The effect of both of these factors has been to increase BGT's WACOG by about 0.006 pence per kWh.

***b) Domestic Peak Requirement***

*i) Ofgem's Initial Proposals*

Ofgem proposed to include a premium on its calculation of Centrica's WACOG to reflect the attributable costs of supplying gas to meet its domestic peak requirement. Ofgem based this premium on 230% of domestic swing being met from BGT's long-term contracts and an implied contracted cost of peak of £0.27 per peak day kWh.<sup>22</sup>

*ii) Respondents' Views*

Two suppliers noted that a premium for domestic peak requirement was not given in Ofgem's Final Proposals for the PESs. One supplier said that BGT's cost of peak should be based on market values rather than implied contract costs given the difficulties in

---

<sup>22</sup> The cost of peak is not explicitly identified in BGT's contracts.

assessing the contractual cost of peak. The use of market values would give BGT an incentive to source peak gas from the most inexpensive source. This supplier provided evidence based on recent storage auctions that suggested that the market value of peak was as low as £0.10 per peak day kWh.

*iii) BGT's Views*

BGT agreed with Ofgem's contractual approach to assessing the implied cost of peak gas. In order to derive an implied contractual cost, BGT inflated the £0.341 per peak day kWh value incorporated in the current price control from October 1996 and discounted it by 10-20% to reflect the benefits of renegotiations.

*iv) Discussion*

Despite the difficulties in calculating an implied contractual cost for peak gas, Ofgem continues to believe that a contractual approach should be adopted in preference to a market based approach. This approach is consistent with Ofgem's decision to allow BGT to recover the costs associated with its long-term contracts. Ofgem therefore proposes to maintain its estimate of BGT's implied contractual cost of peak at £0.27 per peak day kWh and for 230% of BGT's domestic peak requirement to be supplied by its long-term contracts.

*c) Ofgem's Conclusions*

Table 11 shows Ofgem's revised view of BGT's WACOG and domestic peak premium for 2000/01.

**Table 11 – Ofgem's View of BGT's WACOG for 2000/01 (nominal prices)<sup>23</sup>**

	<b>Ofgem's Initial Proposals p/kWh</b>	<b>Ofgem's Final Proposals p/kWh</b>
Average WACOG	0.619	0.626
Premium for peak <sup>24</sup>	0.042	0.041
Domestic WACOG	0.661	0.668

Note: Components may not sum to totals due to rounding

<sup>23</sup> Includes renegotiation costs.

<sup>24</sup> The small difference is caused by the fact that Ofgem is now not inflating the value of peak throughout 2000/01.

#### **4.4 Contract Renegotiations**

##### **a) Ofgem's Initial Proposals**

Over the period of the present price control BGT has succeeded in negotiating over 20 deals with third parties to reduce the price terms or volume commitments in its long-term purchase contracts. BGT made up-front payments to third party gas producers totalling approximately £1.2 billion.<sup>25</sup> This compares to an estimated £1.8 billion in price and volume benefits. Ofgem's view was that BGT could pass-through the costs and benefits of its contract renegotiations in a non-discriminatory way in accordance with the guidance notes that Ofgem issued on the economic purchasing objective.<sup>26</sup>

Ofgem's initial view was that the costs and benefits of the external contract renegotiations were profiled in a non-discriminatory way. However, Ofgem disagreed with BGT over the discount factor used to profile renegotiation costs over time. BGT based its discount factor on its view of its weighted average cost of capital (WACC) of 9% in real terms.<sup>27</sup> Ofgem's view of BGT's WACC was 8% in real terms.<sup>28</sup> This reduced the amount of renegotiation costs to be recovered from the gas cost allowance in 2000/01 by 0.003 pence per kWh.

BGT also changed the terms of its internal contract with Hydrocarbon Resources Limited (HRL) over gas sourced from the South Morecambe field. This deal was structured in a different way to third party deals with the compensation payment taking the form of a floating payment linked to movements in the market price of wholesale gas rather than a lump sum up-front payment. Ofgem said that it would assess whether BGT's internal renegotiation with HRL was at arm's length and on a non-discriminatory basis when compared to third party renegotiations.

##### **b) Respondent's Views**

One supplier said that BGT should not be allowed full recovery of renegotiation costs on the basis that no such allowance was given to the PESs in their Final Proposals. One consumer group said that it was unfair for customers to pay for the costs of BGT renegotiating inefficient contracts.

---

<sup>25</sup> In present value terms at 1 April 1997.

<sup>26</sup> Appendix 2 of "BGT Price Control Review: Licence Modification", Ofgas, May 1997.

<sup>27</sup> This equates to a nominal rate of 11.7%.

<sup>28</sup> This equates to a nominal rate of 10.7%.

*c) BGT's Views*

BGT supported Ofgem's approach. However, BGT disagreed with the level of the WACC that Ofgem had used to allocate the costs over time.

*d) Discussion*

Ofgem considered further information submitted by BGT on the profile of the costs and benefits associated with internal and external renegotiations to assess whether they are in accordance with Ofgem's guidance notes, and in particular whether they discriminate against customers over time.

Based on the information provided by BGT, Ofgem is of the view that the profile of BGT's external renegotiation costs and benefits does not discriminate between customers over time. That is, customers in any one year do not appear to bear an undue proportion of costs and benefits compared with customers in any other year. However, as discussed in chapter 8, Ofgem remains of the view that a real cost of capital of 8% should be used to profile renegotiation costs over time.

A number of factors suggest that the internal deal was at arm's length and on a non-discriminatory basis when compared to third party renegotiations. These include:

- the cost:benefit ratio of the internal deal is less than the cost:benefit ratio of third party renegotiations;
- the result of the internal renegotiation was to leave HRL revenue neutral in present value terms. Third parties generally secured a present value revenue gain from renegotiations with BGT; and
- the Assessor for the 1998/99 economic purchasing review found that the effect of the floating rate compensation generated lower costs for domestic customers than if the deal was structured in the same way as third party renegotiations.



On this basis, and in the context of a one year control, Ofgem has allowed the recovery of BGT's internal renegotiation costs and benefits in the manner described above.

*e) Ofgem's Conclusion*

Table 12 shows Ofgem's final view of its allowance for external and internal renegotiation costs over the period of the present price control and the allowance to be included in the revised tariff caps for 2000/01.

**Table 12 – Ofgem's View of BGT's Allowance for Renegotiation Costs 1997-2001, pence per kWh (nominal prices)**

	1997/98	1998/99	1999/00	2000/01
Ofgem's view	0.024	0.064	0.073	0.078

**4.5 Storage Costs**

*a) Ofgem's Initial Proposals*

Ofgem treated storage purchases as part of Centrica's single portfolio of gas purchases. Ofgem proposed to attribute storage costs to the domestic and the industrial and commercial markets in proportion to their share of BGT's peak day demand requirement. On this basis, Ofgem set an allowance for BGT's domestic storage costs of 0.010 pence per kWh.

*b) Respondents' Views*

One supplier said that the level of BGT's storage costs was too high. This respondent said that since publication of Ofgem's Initial Proposals, Transco had agreed a Network Code modification<sup>29</sup> to raise the national domestic load profile, which lowers BGT's domestic peak requirement from 278% to 274%, with a consequent reduction in the level of storage required.

*c) BGT's View*

BGT disagreed with Ofgem's attribution methodology and said that all storage costs should be attributed to the domestic market. BGT said that the requirements for domestic storage were only determined by the requirements of the domestic supply

---

<sup>29</sup> Modification Number 236(A).

security standard in the licence obligations.

**d) Discussion**

Although BGT has a licence obligation to meet its domestic peak requirement, the purchase of storage will depend on its relative price compared with other sources of gas to meet peak demand, e.g. using swing in long-term contracts, using the provisions of interruptible contracts and sourcing gas from the spot market. Storage costs should be seen as an integral part of BGT's single gas portfolio, and their treatment should be consistent with the approach taken to gas costs. Ofgem has therefore maintained its attribution of BGT's storage costs to both the domestic and the industrial and commercial markets in proportion to their share of BGT's demand on the peak day.

Ofgem has updated its calculations of BGT's domestic peak requirement to take into account Transco's Network Code modification that lowers the national domestic peak requirement to 274%. Ofgem has continued to assume that BGT contracts supply 230% of this requirement, therefore lowering the amount to be covered by storage to 44%. Ofgem has also taken into account further information from BGT on its expected level of storage costs in 2000/01.

**e) Ofgem's Conclusions**

Table 13 shows Ofgem's revised view of BGT's storage costs for inclusion in BGT's allowance for gas and storage costs in its revised tariff caps for 2000/01.

**Table 13 – Ofgem's View of BGT's Storage Costs 2000/01 (nominal prices)**

	<b>Ofgem's Initial Proposals p/kWh</b>	<b>Ofgem's Final Proposals p/kWh</b>
Storage cost allowance	0.010	0.010

**4.6 Ofgem's Final Proposals for BGT's Gas and Storage Purchases**

Ofgem proposes to set a fixed allowance for BGT's gas purchase and storage costs based on Centrica's single portfolio of gas purchases, adjusted to reflect the attributable costs of supplying domestic gas customers. Ofgem proposes to include an allowance for renegotiation costs in accordance with Ofgem's previous published guidance. Taking

these factors together, Ofgem intends to set an allowance for BGT's gas and storage costs of 0.678 pence per kWh in BGT's revised tariff caps for 2000/01.

## 5. Transportation and Metering Costs

### 5.1 Introduction

Transportation and metering costs account for about 42% of BGT's costs of serving domestic customers in 1999/00. BGT's present price control passes through these costs to customers, subject to a requirement to purchase economically. Ofgem's Initial Proposals set a fixed allowance for these costs based on estimates of Transco's charges for these services in 2000/01.

### 5.2 Transportation Charges

#### a) Ofgem's Initial Proposals

The level and structure of Transco's charges are regulated by Ofgem. However, in the context of a one year control it is necessary to set a fixed allowance for transportation costs and remove the present pass-through regime. The fact that there is one main transportation provider allows these costs to be estimated with some degree of certainty. Ofgem therefore based its transportation cost allowance on a forecast of Transco's charges in 2000/01.

Ofgem's transportation cost forecast of 0.52 pence per kWh was based on a forecast of the national average domestic transportation charge. Ofgem considered that this approach was reasonable given that BGT supplies 75% of the domestic gas supply market. This figure was then adjusted to reflect the likely outcome of Ofgem's proposals to split Transco's price control into separate price controls for transportation, metering provision and meter reading.<sup>30</sup>

#### b) Respondent's Views

Respondents raised no specific comments on Ofgem's proposed treatment of transportation costs.

---

<sup>30</sup> Ofgem will publish in February 2000 its proposals to split Transco's price control.

**c) BGT's Views**

BGT raised two main concerns with Ofgem's approach. These were:

- Ofgem's review to split Transco's price control. BGT argued that although Ofgem will issue Final Proposals for Transco these are still open to consultation and subject to revision; and
- Transco's flexibility in its pricing decisions. BGT said it faced risks of higher costs from Transco rebalancing between domestic and non-domestic transportation charges and Transco's recovery of its 'k' factor.

BGT said that Ofgem should increase its allowance for transportation costs to reflect these risks.

**d) Discussion**

Ofgem carried out additional analysis and sought advice from Transco to assess the reasonableness of setting an allowance for transportation costs equal to Transco's average national domestic transportation charge. BGT's transportation costs expressed in pence per kWh could differ from the average in two main areas:

- geographic dispersion. The location of BGT's customers affects National Transmission System (NTS) exit charges and Local Distribution Zone (LDZ) charges; and
- NTS entry charges. BGT's NTS entry costs are affected by the beach terminals where it lands its gas.

Ofgem compared BGT's costs in these areas to the Transco domestic average and found that BGT's costs are not significantly different. Ofgem therefore proposes to continue to allow BGT a transportation cost allowance based upon Transco's average national domestic charge. Ofgem has adjusted this allowance to reflect its proposals to split Transco's price control. On this basis, Ofgem intends to set BGT an allowance for transportation costs of 0.507 pence per kWh in 2000/01. This compares to 0.520 pence per kWh in Ofgem's Initial Proposals.

Ofgem notes BGT's concern that the proposals to split Transco's price control are subject to a statutory 28 day consultation and that Transco will have some discretion in its pricing structure after the new controls are agreed. However, these factors could raise or lower BGT's transportation costs relative to its allowance under the revised tariff caps. These risks are included within the allowed profit margin. In the context of a one year control, Ofgem does not propose to include an additional allowance for these risks over and above the allowed profit margin.

**e) Ofgem's Conclusions**

Table 14 sets out Ofgem's Final Proposals for BGT's allowance for transportation costs within its revised tariff caps in 2000/01.

**Table 14 – Ofgem's View of BGT's Transportation Costs 2000/01 (nominal prices)**

	<b>Ofgem's Initial Proposals p/kWh</b>	<b>Ofgem's Final Proposals p/kWh</b>
Transportation cost allowance	0.520	0.507

**5.3 Metering Costs**

**a) Ofgem's Initial Proposals**

Ofgem's Initial Proposals set an allowance equal to the expected Transco charge for domestic credit meters (DCM) and PrePayment meters (PPM). This reflected the likely outcome of Ofgem's proposals to split Transco's price control. For 2000/01 Ofgem set BGT an allowance of £12.64 per domestic credit meter (DCM) customer and £25.28 per PrePayment meter (PPM) customer. This compares to costs in 1999/00 of £10 and £20 for DCMs and PPMs respectively.

**b) Respondents' Views**

One respondent said that Ofgem should discount its forecast of Transco's charges to give BGT an incentive to procure metering services from alternative sources, helping to develop competition for these services.

**c) BGT's Views**

BGT raised no specific comments.

**d) Discussion**

Ofgem revised its allowance for metering costs in light of new information from its proposals to split Transco's price control. Ofgem now proposes to set BGT an allowance of £15.34 per DCM customer and £30.67 per PPM customer. This assumes that Transco recovers all its allowed revenue from new metering and meter reading price controls which are due to take effect from 1 April 2000.

Ofgem has decided not to discount its estimate of Transco's metering charges to give BGT an incentive to procure from alternative less expensive sources. Given that the duration of the revised control is limited to one year, it is unlikely that BGT could replace enough of its meter stock over this period to significantly affect its average metering charge. In any event, setting an allowance equal to that of Transco for the duration of the revised controls still gives BGT an incentive to seek alternative less expensive providers of metering services.

**e) Ofgem's Conclusions**

Table 15 sets out Ofgem's Final Proposals for BGT's allowance for metering costs within its revised tariff caps in 2000/01.

**Table 15 – Ofgem's View of BGT's Metering Costs 2000/01 (nominal prices)**

	<b>Ofgem's Initial Proposals £ per Customer</b>	<b>Ofgem's Final Proposals £ per Customer</b>
DCM allowance	12.64	15.34
PPM allowance	25.28	30.67

**5.4 Ofgem's Final Proposals for Transportation and Metering Costs**

Table 16 sets out Ofgem's allowances for transportation and metering costs to be included in BGT's revised tariff caps for 2000/01.

**Table 16 – Ofgem’s Proposals for BGT’s Transportation and Metering Costs 2000/01  
(nominal prices)**

	<b>Ofgem’s Initial Proposals</b>	<b>Ofgem’s Final Proposals</b>
Transportation allowance (p/kWh)	0.520	0.507
DCM allowance (£ per customer)	12.64	15.34
PPM allowance (£ per customer)	25.28	30.67



## 6. Supply Costs

### 6.1 Introduction

Supply costs account for about 12% of BGT's total costs of serving domestic gas customers in 1999/00.<sup>31</sup> Ofgem's Initial Proposals set a fixed allowance for these costs of £20.93 per year for an average Prompt Pay customer; £42.17 per year for an average Standard customers; and £45.17 per year for an average PrePayment customer.<sup>32</sup>

After considering respondents' views this chapter sets out Ofgem's conclusions in the following areas:

- the opening level of supply costs;
- cost determinants to attribute costs to tariffs; and
- projected efficiencies and the resulting allowance for supply costs in 2000/01.

### 6.2 Opening Level of Supply Costs

Ofgem considered whether costs included in the supply cost base:

- related to activities of other Centrica business units (such as Services and the Automobile Association) or BGT's non-domestic gas supply business units (such as electricity and Business Gas); and
- represented forward-looking avoidable costs.

#### **a) *Attributing Costs Between Centrica and BGT Business Units***

##### *i) Ofgem's Initial Proposals*

To define the scope of BGT's domestic gas supply activities Ofgem reviewed the allocation of costs between Centrica and BGT business units. Ofgem made adjustments

---

<sup>31</sup> Under the present price control the level of these costs that BGT can pass-through to customers is capped using the RPI-X price control formula. The level of X is set at 4.

<sup>32</sup> Ofgem based its Initial Proposals on a detailed review of BGT's supply costs undertaken by Arthur Andersen.

to a number of activities where it had reason to believe that costs relating to other Centrica and BGT businesses were included in the domestic gas supply cost base. Adjustments were made to costs relating to corporate overheads; marketing; business development; depreciation; IT; and call centres. These adjustments totalled a reduction in supply costs of £64.7 million or £4.35 per customer.

*ii) Respondents' Views*

Three respondents supported Ofgem's approach. Two respondents, one supplier and one consumer group, said that BGT was subsidising its 'dual fuel' and electricity business from its domestic gas business to a greater extent than that recognised by Ofgem's cost adjustments. One supplier said that BGT's advertising and marketing under the British Gas brand benefited other Centrica business units. Two respondents, both suppliers, said that Ofgem's attribution between business units appeared tough compared to the approach taken for the PES supply price control review.

*iii) BGT's Views*

BGT disagreed with all of Ofgem's adjustments. In support of its view, BGT provided some additional, more detailed, information on some of the cost activities that Ofgem had adjusted.

*iv) Discussion*

Ofgem reviewed the additional information supplied by BGT. However, Ofgem found that this information did not provide sufficient evidence to alter its Initial Proposals, particularly when the overall level of BGT's supply costs allowance was considered (see section 6.4).

*v) Ofgem's Conclusions*

Ofgem does not intend to adjust its Initial Proposals.

***b) Forward-Looking Level of Domestic Supply Costs***

*i) Ofgem's Initial Proposals*

Ofgem adjusted the level of BGT's supply costs for 1999/00 where they did not represent forward-looking avoidable costs.<sup>33</sup> Adjustments included:

- bad debt. Ofgem set BGT an efficient allowance for bad debt of 1% of turnover. This was consistent with the 1997 price control review and the 1998 tariff rebalancing review. It is also consistent with Ofgem's Final Proposals for the PESs;
- business development. Ofgem excluded a number of large one-off and non-recurring projects such as systems changes for "Y2K"; and
- financing costs. Ofgem excluded these costs because they had already been included within the allowed profit margin.

These deductions totalled £52.7 million or £3.54 per customer.

*ii) Respondents' Views*

Four respondents, three suppliers and one consumer group, suggested that Ofgem should further reduce BGT's marketing allowance because it benefited from significant economies of scale as a national supplier with an established brand and reputation.

*iii) BGT's Views*

BGT was particularly concerned over Ofgem's treatment of bad debt costs. BGT said that different industry structures for gas and electricity warranted different treatments of bad debt provision. In particular, the PESs had generally used PrePayment meters for debt prevention, whereas BGT had used PrePayment meters for debt recovery. BGT also said that Ofgem's proposals to remove the suppliers' right to object to the transfer of customers in debt could increase debt costs significantly.

---

<sup>33</sup> Avoidable costs were considered to be those costs that would be avoided if the supply business as a whole did not continue. The time period considered was one year.

BGT said that Ofgem's adjustments to its marketing costs and business development costs failed to recognise the significant increase in the level of these costs as a result of competition.

*iii) Discussion*

Ofgem has made one adjustment to its view of BGT's forward-looking avoidable costs in light of further information being supplied by BGT. Since the Initial Proposals, BGT has been renegotiating new meter reading contracts. These new contracts will generate significant savings in the future. Ofgem believes customers should benefit from this change in BGT's costs. To reflect this, Ofgem has reduced supply costs, compared to Initial Proposals, by about £9 million or £0.64 on average per customer.

Ofgem has also made a small reduction to BGT's supply costs of about £0.6 million to reflect BGT's proposal to charge PrePayment customers for replacement Electronic Token Meter (ETM) cards where the original is lost, stolen or accidentally or maliciously damaged (see Appendix 4 for details of BGT's proposed policy).

Despite concerns raised by some respondents Ofgem does not propose to make any further adjustments to its allowance for BGT's marketing costs to reflect economies of scale. As discussed in section 6.4 below, Ofgem has already considered BGT's economies of scale in respect of supply costs.

Ofgem does not consider the allowance for bad debt unreasonable, particularly in light of previous reviews and the PES Final Proposals. Indeed, Ofgem believes that BGT's debt exposure should have improved since previous reviews, on the basis that BGT's customers have tended to move away from Standard Credit (where most debt is incurred) to Direct Debit and PrePayment. Ofgem does not propose to give BGT an additional allowance to reflect potential costs arising from Ofgem's proposals to remove the right to object for the transfer of customers in debt. At this stage, it is too early to estimate with any confidence what the effect will be on BGT's costs.<sup>34</sup>

---

<sup>34</sup> Ofgem has allowed BGT full allowance for its debt process related costs such as credit vetting.

v) *Ofgem's Conclusions*

Ofgem does not intend to alter its Initial Proposals for the forward looking level of domestic supply costs, except in the area of meter reading costs where BGT has supplied new information on its forward looking level of avoidable costs. A small adjustment has been made to account for BGT's proposal to charge for replacement ETM cards.

c) *Resulting Opening Level of Supply Costs*

Table 17 shows the total adjustments to the base year 1999/00 outlined above.

**Table 17 – Ofgem's View of BGT's Supply Costs 1999/00 (nominal prices)**

	<b>PromptPay</b> £'s per customer	<b>Standard</b> £'s per customer	<b>PrePayment</b> £'s per customer
Supply costs <sup>1</sup>	21.80	44.35	48.38

Note: 1. Average consumption for 16,588 kWh for PromptPay; 16,705 kWh for Standard; and 14,360 kWh for PrePayment.

### **6.3 Determinants of Supply Costs**

Ofgem reviewed the determinants of BGT's supply costs to assess how costs would change over time in response to changes in BGT's customer base. Ofgem paid particular attention to:

- constant and linear costs;
- attributable and joint costs; and
- customer and commodity related costs.

a) *Constant and Linear Costs*

i) *Ofgem's Initial Proposals*

Ofgem estimated that 75% of costs were related to customer numbers or gas volumes (the 'linear' element), while 25% of costs did not vary as a result of a change in

customer numbers or gas volumes (the 'constant' element).<sup>35</sup> This compared to BGT's estimate of 59% and 41% respectively.

*ii) Respondents' Views*

One supplier expressed support for Ofgem's initial conclusions on the basis that the constant/linear split for BGT was similar to that given to the PESs in their Final Proposals.

*iii) BGT's Views*

BGT said that some costs were constant which Ofgem has classified as linear.

*iv) Ofgem's Conclusions*

Ofgem has not adjusted its Initial Proposals.

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

*i) Ofgem's Initial Proposals*

Ofgem attributed costs to particular tariffs to the extent that those costs would be avoided if the customers were no longer with BGT. Ofgem found that attributable costs accounted for about 75% of BGT total supply costs. 25% of costs that could not be attributed were deemed 'joint'. Ofgem allocated joint costs in proportion to directly attributable supply costs.

*ii) Respondents' Views*

Three respondents, two suppliers and one consumer group, supported Ofgem's approach on the recovery of joint costs.

*iii) BGT's Views*

BGT raised no comments on this issue.

*iv) Ofgem's Conclusions*

Ofgem intends to maintain its approach of recovering joint supply costs in proportion to directly attributable supply costs.

---

<sup>35</sup> Some activities included both a constant and linear element.

**c) Commodity and Customer Related Costs**

*i) Ofgem's Initial Proposals*

Ofgem estimated that 91% of BGT's supply costs were driven by the number of customers served and 9% of supply costs were driven by the volume of gas sold.

*ii) Respondents' Views*

Respondents did not comment on this issue.

*iii) BGT's Views*

BGT did not comment on this issue.

*iv) Ofgem's Conclusions*

Ofgem does not intend to adjust its Initial Proposals.

**6.4 Efficiencies and Resulting Allowance for Supply Costs in 2000/01**

After establishing the opening level of supply costs and the determinants of how costs will change over time in response to market share changes, Ofgem assessed the potential for efficiency savings to set the resulting allowance for BGT's supply costs in 2000/01.

**a) Efficiencies**

*i) Ofgem's Initial Proposals*

Ofgem concluded that efficiencies of 8% on a total cost basis<sup>36</sup> would be a challenging but achievable target given the potential for economies of scope and BGT's historical efficiency performance.

*ii) Respondents' Views*

Two PESs said that Ofgem efficiency target was 'tough' in comparison to the PESs who were not given an explicit efficiency target. One consumer group supported Ofgem's approach to setting an efficiency target.

---

<sup>36</sup> 6.7% on a per customer basis.

*iii) BGT's Views*

BGT said that the addition of an efficiency target of 8% was unjustified given the levels of efficiency already incorporated in the forward looking costs.

*iv) Ofgem's Conclusions*

For the Initial Proposals, Ofgem performed a review of the potential efficiencies in BGT's supply cost base. Limited evidence has been put forward to challenge Ofgem's view that its efficiency target is achievable and reasonable. Ofgem does not intend to change its Initial Proposals.

***b) Resulting Level of Supply Costs in 2000/01***

*i) Ofgem's Initial Proposals*

Ofgem Initial Proposals set an allowance of £20.93 per year for a PromptPay customer £42.17 per year for a Standard customer and £45.17 per year for a PrePayment customer.<sup>37</sup> Ofgem noted that this allowance, based on a detailed review of BGT's costs, looked reasonable when compared to Ofgem's allowance for the PES Initial Proposals and estimates of BGT's future supply costs taken from previous reviews.

*ii) Respondents' Views*

Two respondents, both suppliers, said that Ofgem's allowance for BGT supply costs should be increased. Two suppliers said that Ofgem's supply cost allowance for BGT was reasonable. One supplier suggested that Ofgem's allowance should be lowered.

*iii) BGT's Views*

BGT expressed concern that its allowance for supply costs in 2000/01 was significantly lower than Ofgem's Final Proposals for the PESs' supply cost allowance. BGT said that this was not justified on grounds of economies of scale of potential efficiencies. BGT expressed concern that its supply costs allowance would impair its ability to deliver improvements in areas of customer service or hamper its ability to introduce new items such as those arising under Ofgem's Social Action Plan.

---

<sup>37</sup> Based on average consumption for each tariff.



*iv) Discussion*

Ofgem's Final Proposals result in an average supply cost allowance over all price controlled customers in 2000/01 of £33.46 per customer. Table 18 shows Ofgem's view of how these costs should be recovered from BGT's revised price controlled tariffs.

**Table 18 - Ofgem's Allowance for BGT's Supply Costs for 2000/01 at Average Tariff Consumption (nominal prices)**

	<b>PromptPay</b> £ per customer	<b>Standard</b> £ per customer	<b>PrePayment</b> £ per customer
Ofgem's Initial Proposals	20.93	42.17	45.17
Ofgem's Final Proposals	20.12	41.66	44.77

Ofgem's allowance in the Final Proposals for PES price controlled customers in 2000/01 was £37.49. This is higher than Ofgem's supply cost allowance for BGT's price controlled customers in 2000/01. BGT's supply costs can reasonably be expected to be below the average PES because of its ability to benefit from significant economies of scale and scope.

Ofgem does not accept BGT's view that Ofgem's supply cost allowance will impair its delivery of improvements in customer service such as the Social Action Plan. Ofgem's supply cost allowance is based on BGT continuing to meet its licence requirements, Standards of Service performance targets and its social obligations.

**6.5 Ofgem's Final Proposals for Supply Costs**

Ofgem proposes to include an allowance for supply costs within the calculation of BGT's revised tariff caps for 2000/01. Ofgem proposes to set an allowance of £20.12 per PromptPay customer; £41.66 per Standard customer; and £44.77 per PrePayment customer.<sup>38</sup>

---

<sup>38</sup> Based on average annual consumption for each of the tariffs.

## 7. Profit Margin

### 7.1 Introduction

BGT's present price control includes an allowed profit margin of 1.5% on turnover. Ofgem's Initial Proposals included maintaining this allowed return for the duration of the revised control. Ofgem attributed some of this profit allowance to particular tariffs on the basis of attributable working capital balances.

Ofgem's Initial Proposals allowed BGT a real cost of capital of 8%.<sup>39</sup> This was used to profile the costs of gas purchase contract renegotiations over future time periods (as discussed in chapter 4).

### 7.2 Allowed Margin

#### a) Ofgem's Initial Proposals

In deciding to maintain BGT's profit margin at 1.5% on turnover, Ofgem took into account several factors including:

- consistency with the PES reviews. Ofgem's proposals for the PESs included an allowed margin of 1.5% on turnover. Ofgem believed it was therefore an appropriate return for BGT given the PES proposals included a cap on generation and other costs and a duration of two years; and
- the balance of risks. Although Ofgem recognised that removal of the pass-through regime involved an element of risk for BGT, uncertainty about BGT's market share and gas volume risk was considerably less than at the time of the last review.

Ofgem said that the allowed profit margin was intended to cover the costs of all interest paid by the business including the cost of working capital. Ofgem attributed working capital costs and benefits to particular tariffs based on a review of monthly working capital balances.

---

<sup>39</sup> This equates to a nominal WACC of 10.7%.

**b) Respondents' Views**

One supplier supported Ofgem's approach.

**c) BGT's Views**

BGT said that the level of the profit should be higher to reflect the increased risks its business faced under Ofgem's Initial Proposals. These risks included:

- gas costs. BGT said that introducing a cap for its gas costs posed significant risks in terms of unexpected increases in gas costs, particularly in light of the doubling of oil prices in the last year; and
- transportation costs. BGT said that it should be compensated for the risk of Transco rebalancing its charges resulting in higher domestic transportation costs.

**d) Ofgem's Conclusions**

Ofgem remains of the view that 1.5% of turnover is an appropriate return for BGT. As discussed in chapters 4 and 5, Ofgem does not intend to compensate BGT for the risks that it identified above.

Ofgem has adjusted its calculation of the attributable profit margin to exclude Direct Debit customers in 2000/01. This is because Direct Debit customers have been removed from the scope of revised controls. Ofgem has attributed the average profit margin of 1.5% over the remaining price controlled customers based on monthly working capital balances. The results of this approach are shown in table 19.

**Table 19 – Breakdown of Attributable and Joint Profit Margin - % of Turnover**

	PromptPay	Standard	PrePayment	Average
Allowed Margin	1.50	1.50	1.50	1.50
Attributable Margin	0.33	1.03	-0.61	0.44
Joint Margin	1.06	1.06	1.06	1.06
Total Margin	<b>1.39</b>	<b>2.09</b>	<b>0.46</b>	<b>1.50</b>

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

#### **a) Ofgem's Initial Proposals**

As discussed in chapter 4, an estimate of BGT's weighted average cost of capital (WACC) is needed to profile renegotiation costs and benefits. Ofgem adopted the capital asset pricing model (CAPM) approach to estimate BGT's WACC at about 8% in real terms. This compared to 9% estimated at the time of the last price control review.

#### **b) Respondents' Views**

Respondents raised no specific comments.

#### **c) BGT's Views**

BGT argued for a higher cost of capital on the basis that its gas supply business faced higher risks from the development of competition than had been captured in Ofgem's approach.

#### **d) Ofgem's Conclusion**

Ofgem proposes to allow BGT a pre-tax cost of capital of 8%. As discussed above Ofgem believes that the uncertainty regarding the impact of competition on BGT's market share and demand volumes is considerably less than that at the time of setting the last review. In addition, since the last review the UK economy has benefited from lower inflation and interest rates, which have reduced the cost of acquiring capital.

### **7.4 Ofgem's Final Proposals for Profit Margin**

Ofgem proposes to set BGT an allowed return of 1.5% on turnover. Profit margins on individual tariffs reflect differences in attributable working capital balances. Ofgem proposes to set BGT's cost of capital at 8% in real terms.

## **PART III – Ofgem’s Final Proposals**

### **8. Revised Tariff Caps under the Present Control**

#### **8.1 Introduction**

Ofgem’s assessment of competition (set out in chapter 3) determined three key features of Ofgem’s Final Proposals. These are:

- removing Direct Debit customers from the scope of continuing controls;
- revising tariff caps for PromptPay, Standard and PrePayment customers; and
- limiting the duration of these controls to a further one year only.

Chapters 4 to 7 set out Ofgem’s Final Proposals for its allowances for BGT’s costs to be included in the revised 2000/01 tariff caps. This chapter draws these proposals together. It sets out Ofgem’s proposed changes to BGT’s tariff caps for the year 2000/01 under the present tariff structure.

#### **8.2 Ofgem’s Final View of BGT’s Costs in 2000/01**

Ofgem’s Final Proposals for BGT’s costs of serving domestic gas customers are summarised in table 20. This sets out Ofgem’s view of the costs associated with PromptPay, Standard and PrePayment for the year 2000/01.

**Table 20 – Ofgem’s Final View of BGT’s Cost Allowances 2000/01 (nominal prices)**

	PromptPay		Standard		PrePayment	
	£/C	p/kWh	£/C	p/kWh	£/C	p/kWh
Gas costs		0.668		0.668		0.668
Transportation		0.507		0.507		0.507
Meter provision	15.34		15.34		30.67	
Storage		0.010		0.010		0.010
Supply costs	18.52	0.010	32.95	0.053	41.06	0.026
EESoP <sup>1</sup>	1.20		1.20		1.20	
Allowed profit margin	0.48	0.017	1.03	0.026	0.33	0.006
PromptPay adjustment <sup>2</sup>	-16.42	0.100				
<b>Total costs</b>	19.12	1.311	50.52	1.265	73.26	1.216
Total at Av. Consumption	235.01		256.89		247.71	
Total at 19050 kWh	268.91		291.46		304.99	

Notes:

1. Energy Efficiency Standards of Performance.
2. This adjustment is required to equalise the PromptPay and Standard/PrePayment unit charges.

### **8.3 Ofgem’s Final View of BGT’s Tariff Caps under the Present Tariff Structure**

Table 21 shows Ofgem’s view of how BGT’s revised tariff caps would look under the present tariff structure. It shows an average price reduction of 4.5%. Ofgem’s Final Proposals imply a cut in BGT’s revenue in 2000/01 of about 4.5%.

**Table 21 - Ofgem's Final Proposals for BGT's Tariff Caps in 2000/01 under the Present Tariff Structure (nominal prices)**

	PromptPay		Standard/PrePayment	
	£/cust	p/kWh	£/cust	p/kWh
Gas costs		0.668		0.668
Transportation		0.507		0.507
Meter provision	15.34		20.41	
Storage		0.010		0.010
Supply	18.52	0.010	35.63	0.045
EESoP	1.20		1.20	
Profit margin	0.48	0.017	0.80	0.020
<b>Total</b>	<b>35.54</b>	<b>1.212</b>	<b>58.04</b>	<b>1.250</b>
Skt Factor <sup>1</sup>			-9.17	0.059
D Factor <sup>2</sup>				0.003
PromptPay adjustment <sup>3</sup>	-16.42	0.100		
<b>Tariff Cap</b>	<b>19.12</b>	<b>1.311</b>	<b>48.87</b>	<b>1.311</b>
Total at average consumption (£)	235.01		254.26	
Present Bill (£)	246.17		266.45	
Reduction (£)	11.16		12.19	
Reduction (%)	4.5%		4.6%	
% reduction in BGT's allowed revenue	4.5%			

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 standing charge that is not recovered from customers burning less than 4572 kWh a year.
3. This adjustment is required to equalise the PromptPay unit charge with the Standard/PrePayment unit charge.

#### **8.4 Cumulative 'k' Factor from Present Control**

##### **a) Ofgem's Initial Proposals**

Ofgem said that as most of BGT's under-recovery was generated on its Direct Debit tariff, it would be inappropriate for BGT to recover this from the remaining regulated tariffs in 2000/01. Ofgem noted that excluding Direct Debit, the level of BGT's under-recovery was relatively small. Ofgem said it would revise its view in light of the 1998/99 economic purchasing review.

Although Ofgem said it would consider the options for the recovery of BGT's k factor, Ofgem said it was minded not to allow k factor pass-through in 2000/01.

##### **b) Respondents' Views**

Two respondents, one supplier and one consumer group, welcomed Ofgem's approach and said that BGT should not be allowed to roll forward any of its under-recovery. The supplier said that this would be consistent with Ofgem's Final Proposals for the PESs.

##### **c) BGT's Views**

BGT said that the cumulative k factor for PromptPay, Standard and PrePayment should be recovered from customers in 2000/01. BGT said that it had always been under the expectation, following previous regulatory reviews, in gas and other industries, that the k factor would be rolled forward. BGT said it would have considered setting a different path of prices over the present control had it known earlier that Ofgem would disallow the k factor.

##### **d) Ofgem's Final Proposals**

Ofgem notes respondents' view that BGT should not be allowed to roll-forward the k factor accumulated over the period of the last control. This approach would be consistent with the treatment of the k factor in Ofgem's Final Proposals for the PESs.

Ofgem is not convinced that BGT, in deciding how to price relative to its tariff caps over the period of the price control, could have been under the expectation that it would be allowed to roll forward its k factor. BGT has argued strongly for the removal of the price control from all customers which, if adopted, would result in the k factor being removed



entirely. Ofgem does not believe BGT would have considered a different path of prices had it known that the k factor would not be rolled forward.

Ofgem's revised view of BGT's k factor shows a larger under-recovery (£92m) than Ofgem's estimate for the Initial Proposals (£76m). However, excluding Direct Debit would result in an over-recovery, which if rolled forward, would tighten Ofgem's revised tariff caps for BGT. Despite this Ofgem remains concerned about the degree of confidence that can be placed in estimates of k factor given that it has not been possible to complete the economic purchasing reviews for costs incurred during 1999/00.

In addition, Ofgem is satisfied that its proposals for BGT's tariff caps above represent the most appropriate balance between lowering BGT's tariff caps to reflect its ongoing avoidable costs and ensuring that there is sufficient headroom for new entrants to compete vigorously against BGT.

Against this background, Ofgem does not propose to include any allowance for BGT's cumulative k in factor in the revised tariff caps.

### ***8.5 Standards of Service Performance***

Ofgem remains of the view that competitive pressures are 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 these circumstances, Ofgem does propose to make further adjustments to the agreed Standards of Performance.

## 9. BGT's Proposal to Remove Standing Charges

### 9.1 Introduction

BGT announced on 13 January 2000 that it intends to remove all standing charges from its gas and electricity tariffs. BGT intends this proposal to come into effect from 1 April 2000 so that it is combined with Ofgem's Final Proposals for BGT's revised tariff caps for domestic gas customers. In announcing this proposal, BGT promised that no customer would see an increase in their annual bill.

This chapter:

- outlines BGT's proposal;
- considers the effect on customers' bills;
- sets out Ofgem's analysis of available 'headroom' under BGT's revised tariff caps;
- sets out Ofgem's assessment of BGT's proposal to remove standing charges; and
- adjusts Ofgem's Final Proposals to take into account BGT's proposal.

### 9.2 BGT's Proposal

From 1 April 2000<sup>40</sup> BGT intends to replace its current tariff structure of a standing charge and a unit charge with a tariff structure that has no standing charge and a two-tier unit charge. The first-tier unit charge would be greater than the second-tier unit charge, similar to the present structure of BGT's PrePayment tariff. BGT proposes that the

---

<sup>40</sup> BGT intends to introduce its proposal from the first meter reading after 1 April 2000 to avoid the confusion of customers receiving bills that are partially calculated on the present tariff structure and partially calculated on the new tariff structure. This delays the point at which some customers will receive the benefit of Ofgem's Final Proposals. However, Ofgem's Final Proposals ensure BGT remains revenue neutral over the twelve months of the revised controls.

threshold between the first tier unit charge and the second tier two charge is set at a consumption level of 4,572 kWh a year.

BGT intends the new tariff structure to be structured in a way that allows the previous standing charge to be recovered over the first 4,572 kWh of gas consumed per year. Commoditising the standing charge in this way means that BGT does not recover all the standing charge revenues from customers that consume less than 4,572 kWh a year. BGT intends its proposal to be revenue neutral for each tariff and overall. Therefore, it has proposed to recover this lost revenue from those customers consuming more than 4,572 kWh a year in the form of a higher second tier unit charge.

BGT proposes to continue to offer a PromptPay discount to those customers who pay within ten days of the bill date. The present tariff offers a fixed £7.85 per quarter (£31.40 per year) discount to PromptPay customers on their standing charge. BGT proposes to commoditise this discount so that customers paying before 10 days receive the discount in the form of 30% off their next bill up to a maximum of £7.85 per quarter.<sup>41</sup> This discount would be deducted from the first tier unit charge in the customer's next bill.

### ***9.3 BGT's Tariff Caps under BGT's Proposal to Remove Standing Charges***

Ofgem has sought to ensure that BGT's proposal to remove standing charges does not result in BGT receiving higher revenues than that implied by BGT's Final Proposals under the present tariff structure.

Although BGT's proposal keeps its allowable revenue the same as that implied by Ofgem's Final Proposals under the present structure, it may result in a higher expected revenue for BGT. This is because bad debt incurred by customers consuming below 4,572 kWh per year is recovered from those customers consuming more than 4,572 kWh per year. This bad debt is already included within Ofgem's allowance for BGT's supply costs. Ofgem has therefore adjusted BGT's bad debt allowance downwards by £3.1 million in order to maintain BGT's expected revenues at the level implied by Ofgem's Final Proposals under the present tariff structure.

---

<sup>41</sup> Ofgem notes that the discount implied under the final proposals is £7.20 per quarter.

BGT's proposal rebalances its allowed revenue so that price reductions for customers on low volumes are greater and price reductions for customers consuming at higher volumes are less than would be the case under BGT's present tariff structure.

Table 22 shows Ofgem's view of the commodity rate price caps for each tariff in 2000/01. PromptPay customers at average consumption can expect to see reductions in their annual bill of 3.1% or about £8. Standard and PrePayment customers, at average consumption, can expect to see reductions in their annual bills of 3.6% or about £10. Customers consuming less than 4,572 kWh per year will benefit from larger reductions in annual bills.<sup>42</sup>

**Table 22 - Ofgem's View of BGT's Tariff Caps in 2000/01 under BGT's Proposal to Remove Standing Charges (nominal prices)**

	PromptPay		Standard/PrePayment	
	Tier 1	Tier 2	Tier 1	Tier 2
<b>Tariff Cap (p/kWh)</b>	<b>1.766</b>	<b>1.327</b>	<b>2.396</b>	<b>1.327</b>
Total at Av consumption (£)	238.58		256.76	
Present Bill (£)	246.17		266.45	
Reduction (£)	7.59		9.69	
Reduction (%)	3.1%		3.6%	
% cut in allowed revenue	4.5%			

Table 23 shows the effect of Ofgem's Final Proposals, adjusted for BGT's proposal to remove standing charges at different annual consumption levels. It shows that all customers will see a reduction in bills from 1 April 2000. Customers consuming at low volumes will see largest reductions in their annual bills.

<sup>42</sup> To put this consumption level into context, BGT has indicated that an average domestic cooker burns about 3000 kWh of gas per year and an average domestic gas fire burns about 4000 kWh of gas per year.

**Table 23 - Effect on Bills of Ofgem's Final Proposals for BGT's Revised Tariff Caps, Adjusted for BGT's Proposal to Remove Standing Charges (nominal prices)**

Consumption 000's kWh per year	PromptPay			Standard/PrePayment		
	Present Tariff	New Tariff	Difference	Present Tariff	New Tariff	Difference
	£	£	%	£	£	%
0	17.47	0.00	-100.0%	48.87	0.00	-100.0%
3	59.14	52.98	-10.4%	90.54	71.88	-20.6%
6	100.81	99.69	-1.1%	132.21	128.49	-2.8%
9	142.49	139.50	-2.1%	173.89	168.30	-3.2%
12	184.16	179.31	-2.6%	215.56	208.11	-3.5%
15	225.83	219.12	-3.0%	257.23	247.92	-3.6%
18	267.50	258.93	-3.2%	298.90	287.73	-3.7%
21	309.18	298.74	-3.4%	340.58	327.54	-3.8%
30	434.19	418.17	-3.7%	465.59	446.97	-4.0%
45	642.56	617.22	-3.9%	673.96	646.02	-4.1%
73	1031.50	988.78	-4.1%	1062.90	1017.58	-4.3%

#### **9.4 Level of BGT's Revised Price Control and Available 'Headroom'**

##### **a) Ofgem's Initial Proposals**

In setting its Initial Proposals for BGT's revised tariff caps from April 2000, Ofgem aimed to strike a balance between setting them at a level to reflect BGT's forward looking efficient costs and maintaining sufficient 'headroom' for competitors to compete against BGT. Ofgem did not want to set tariff caps that reduced competitors' incentives to innovate and compete against BGT by making the conditions for entry less attractive.

To inform this judgement, Ofgem analysed new entrants' costs to assess the extent to which new entrants could price below the level implied by Ofgem's Initial Proposals for BGT's revised tariff caps. Ofgem considered a new entrant supplying gas only and gas as part of a 'dual fuel' offer.

Ofgem's view<sup>43</sup> was that the tariff cap proposals left substantial headroom for new entrants making 'dual fuel' offers of between 10% and 20% for PromptPay, Standard and PrePayment customers. Ofgem found less headroom available for gas only suppliers, but found that it was possible for new entrants to offer discounts for PromptPay, Standard and PrePayment customers of between 2% and 10%.

***b) Respondents' Views***

Of the nine suppliers that responded on this issue, five said that the proposed tariff caps did not allow competitors a sufficient margin to compete (especially for PrePayment). Four suppliers said that the revised tariff caps were reasonable. One supplier said that Ofgem should have reduced BGT's prices further. Another supplier said that while available headroom might be attractive for 'dual fuel' offers, this was not the case for gas only offers. Of the four consumer groups that responded, two said Ofgem's proposals were reasonable and two said Ofgem should have reduced BGT's prices further.

Three suppliers and one academic said that Ofgem's proposal to continue with the merged tariff cap for Standard and PrePayment would leave BGT's PrePayment tariff below the range of prices offered by its competitors, making it less likely that customers would switch supplier.

Some respondents commented on Ofgem's assumptions about new entrants' costs. Four suppliers said that Ofgem's assumptions were reasonable and prudent. One supplier said that Ofgem's assumption of new entrants' gas costs of 0.512-0.546 pence per kWh was too high. This supplier said that competitors to BGT could source adequate supplies of gas to supply domestic customers for about 0.461 pence per kWh.

Two suppliers said Ofgem's assumptions on acquisition costs of £40 for gas only customers and £22 for 'dual fuel' customers were reasonable. Three suppliers said that Ofgem's assumptions for acquisition costs were too low. One of these suppliers said its acquisition costs were as high as £80 per customer, recovered over 2 years rather than the 5 years Ofgem had assumed. Two suppliers said that Ofgem should place less emphasis on the reduced costs of attracting 'dual fuel' customers because 'dual fuel'

---

<sup>43</sup> As published in "Review of the Development of Domestic Gas Supply Competition," Ofgem, December 1999.

customers in their area were originally electricity only customers. Therefore, supplying a second fuel to these customers was equivalent in cost to a gas only acquisition. One supplier said that a reasonable approximation of new entrants' supply costs for gas only Standard and PrePayment customers might be the average allowance given to the PESs in their Final Proposals.

**c) *BGT's Views***

BGT said that although the level of headroom appeared reasonable for 'dual fuel' customers, this was not the case for gas only customers. BGT believed that a significant proportion of the gas market would remain gas only rather than taking up 'dual fuel' offers. Therefore, Ofgem's view of the level of the control and the effect on competition should not be driven solely by 'dual fuel' considerations. BGT expressed particular concern about how the level of the price control would effect the development of competition for PrePayment customers. It said it was unlikely that many suppliers would match BGT's price reductions for these customers.

**d) *Ofgem's Final Proposals***

Ofgem has updated its headroom analysis to reflect respondents' views, new information about entrants' costs and Ofgem's Final Proposals adjusted for BGT's proposal to remove standing charges.

Ofgem has adjusted the supply cost allowance to reflect the average supply cost allowance for the PESs' Final Proposals of £39<sup>44</sup> for Standard and PrePayment customers. Ofgem has expanded the range of new entrant gas costs to between 0.461 pence per kWh to 0.546 pence per kWh. Ofgem has not adjusted its assumption of acquisition costs. Ofgem considered that some of the costs that some respondents associated with acquisition were already captured within the allowance for supply costs. Ofgem's revised view of new entrants' costs is set out in Appendix 3.

Tables 24, 25 and 26 show new entrants' potential headroom under Ofgem's Final Proposals for BGT's tariff caps, for a range of new entrant gas costs. The discounts against BGT's bills assume average annual consumption of 19,050 kWh.

---

<sup>44</sup> Including EESoP levy.

**Table 24 – New Entrants’ Headroom: Gas Costs 0.546 pence per kWh**

	<b>PromptPay</b>	<b>Standard</b>	<b>PrePayment</b>
	<b>%</b>	<b>%</b>	<b>%</b>
Gas only	7	9	4
‘Dual fuel’	9	14	8

**Table 25 – New Entrants’ Headroom: Gas Costs 0.512 pence per kWh**

	<b>PromptPay</b>	<b>Standard</b>	<b>PrePayment</b>
	<b>%</b>	<b>%</b>	<b>%</b>
Gas only	9	11	6
‘Dual fuel’	11	16	11

**Table 26 – New Entrants’ Headroom: Gas Costs 0.461 pence per kWh**

	<b>PromptPay</b>	<b>Standard</b>	<b>PrePayment</b>
	<b>%</b>	<b>%</b>	<b>%</b>
Gas only	13	15	9
‘Dual fuel’	15	20	14

Recent MORI research<sup>45</sup> suggested that customers generally require discounts of at least 10% to consider switching suppliers. Using this benchmark, Ofgem’s Final Proposals for BGT revised tariff caps still leave substantial headroom for competitors offering ‘dual fuel’ supplies. New entrants can offer discounts ranging from 8% to 20% for PromptPay, Standard and PrePayment customers. There is less headroom available for gas only suppliers. However, gas only new entrants can still offer discounts for PromptPay and Standard customers of between 7% to 15%.<sup>46</sup>

<sup>45</sup> “Electricity and Gas Competition Review: Research Study Conducted for Ofgem”, MORI, January 2000.

<sup>46</sup> These broad ranges for available headroom are similar to the range set out in the Initial Proposals despite assuming a lower level for new entrants’ gas costs and a small reduction in the level of the reduction for BGT’s revised tariff caps. This partly reflects increases to BGT’s transportation and metering costs, which are assumed to be the same for new entrants. It also partly reflects the level of Ofgem’s proposed bills for BGT increasing slightly since the Initial Proposals, therefore new entrants need to offer a larger monetary saving to maintain the same percentage discount to BGT’s prices.



Available headroom is tightest for PrePayment customers. The headroom for gas only PrePayment customers is less than 10% even at Ofgem's lowest assumption for new entrant gas costs.

Appendix 3 considers Ofgem's headroom analysis for different annual consumption levels. The conclusions above are broadly repeated at high consumption levels. However, available headroom is lower at lower consumption levels.

Ofgem's main concern is the effect that BGT's revised tariff caps will have on the development of competition for gas only PrePayment customers.<sup>47</sup> Acquisition costs for gas PrePayment customers are likely to be higher than the average level Ofgem has assumed for new entrants. This is because about 70% of PrePayment customers have an outstanding debt with BGT and therefore, BGT can object to their transfer to a new supplier. Ofgem's believes that its proposals to remove the right of suppliers to object to the transfer of customers in debt<sup>48</sup> and work on removing other barriers to entry will help to reduce new entrants' acquisition costs for PrePayment customers. In due course, this should increase the available headroom for these customers and make them a more attractive target for new entrants.

### ***9.5 Ofgem's Initial Assessment of BGT's Proposal***

Ofgem generally welcomes innovations in tariff structures as offering a greater choice and range of offers to customers. In assessing BGT's proposal, Ofgem has been primarily concerned to ensure that BGT does not abuse its dominant position to the detriment of the development of competition and innovation by rival suppliers.

To consider the effect on competition, Ofgem has principally assessed BGT's proposals against the terms of Standard Condition 13 of its gas suppliers' licence, which prohibits undue discrimination and preference and setting terms that are predatory. Ofgem has also considered BGT's proposal against the provisions of general competition law.

---

<sup>47</sup> Most suppliers do not offer an additional discount for customers taking gas and electricity through PrePayment meters.

<sup>48</sup> "Customers in Debt and their Access to the Competitive Market", Ofgem, December 1999.

Ofgem has been particularly concerned to ensure that BGT's proposal is not unduly preferential or predatory. In assessing undue discrimination and predation Ofgem considered whether:

- the intent or effect of BGT's proposal would be to deter competitors or potential competitors from competing vigorously in the gas market; and
- whether the prices charged are set at a level below attributable avoidable costs.<sup>49</sup>

Ofgem's preliminary view is that BGT's proposal to remove standing charges will not by effect or intent adversely effect the development of competition. In coming to this view, Ofgem considered several factors including:

- removing standing charges is an option available to all suppliers. Indeed, a number of other suppliers already offer tariffs on these terms;
- BGT will need to finance its price savings to low volume customers from gas customers consuming higher volumes. This will make those at higher volumes a more attractive target to BGT's competitors. Ofgem's recent review of the development of competition found that BGT already faced relatively stronger competition at higher volumes;<sup>50</sup> and
- Ofgem's firm intention to remove BGT's price controls completely by 1 April 2001, subject to satisfactory progress in removing the remaining barriers to entry.

---

<sup>49</sup> Ofgem has previously said that it may be possible for prices to be considered predatory in intent, even if they do cover their attributable avoidable costs. "1997 Price Control Review: Supply at or below 2,500 therms a year – British Gas Trading: The Director General's Final Proposals", Ofgas, November 1996.

<sup>50</sup> "A Review of the Development of Competition in the Domestic Gas Market", Ofgem, December 1999.

There is no doubt that BGT's prices are below attributable avoidable costs at very low volumes.<sup>51</sup> However, in assessing undue preference and predation, prices and attributable avoidable costs should be considered over the expected lifetime that an identifiable class of customers will be supplied by BGT. While, there is limited evidence about customers' consumption patterns over time, anecdotal evidence suggests that some customers spend only a short period of time at very low consumption levels.<sup>52</sup> There is also no evidence of any intent on the part of BGT to price in a predatory manner to secure the business of low volume customers. On this basis of it is difficult to conclude with any degree of certainty that BGT's prices amount to predation of an identifiable class of customers.

Based on current information, Ofgem is minded at this stage not to consider BGT's proposal to remove standing charges to be in breach of Standard Condition 13 of its gas suppliers' licence, or general competition law. However, Ofgem will review this conclusion in light of respondents' views. In any event, Ofgem will monitor the effect of BGT's proposal on competition once it is introduced.

***Ofgem invites views on its Final Proposals for BGT's price regulation from 1 April 2000. In particular, Ofgem welcomes view on its initial assessment of BGT's proposal to remove standing charges.***

---

<sup>51</sup> It should be noted that low volume customers should not be confused with the fuel poor. There is very little evidence to suggest that the fuel poor consume at very low volumes, and much to the contrary.

<sup>52</sup> For example, houses that are empty for some proportion of the year.

# **Appendix 1: Draft Special Licence Condition for BGT's Revised Price Regulation**

## **NOTICE**

### **Notice of proposal to modify the conditions of the licence treated as granted under Section 7A(1) (a) and (b) of the Gas Act 1986 to British Gas Trading Limited**

The Director General of Gas Supply (hereafter called "the Director") pursuant to section 23(3) of the Gas Act 1986 (c.44) (hereafter referred to as "the Act"), hereby gives notice as follows:

1. The Director proposes to make modifications of the conditions of the licence treated as granted under section 7A(1) (a) and (b) of the Act to British Gas Trading Limited to the effect set out in the Schedule hereto.
2. The reasons why the Director proposes to make the modifications are stated in the preceding pages of this publication.
3. Any representations or objections with respect to the proposed modifications may be made to the Director at the Office of Gas and Electricity Markets, Stockley House, 130 Wilton Road, London SW1V 1LQ by 10th March 2000.

**10th February 2000**

**Director General of Gas Supply.**

**SCHEDULE**  
**MODIFICATION**

For Condition 3 and 4 of the Special Conditions of the Licence treated as granted under section 7A(1) (a) and (b) of the Act to British Gas Trading Limited there shall be substituted the following Condition-

**“Condition 3: Restriction of certain prices for domestic customers**

1.-(1) In this Condition, unless the context otherwise requires-

“Accepted Variation”, in relation to any terms or terms and conditions, means such variation of those terms or, as the case may be, terms and conditions which-

- (a) had been made to give effect to any change in the law affecting relations between the Licensee and its domestic customers; or
- (b) had been made for the sole purpose of disapplying an Accepted Variation to which sub-paragraph 2 below applies; or
- (c) had been specified in a notice given by the Licensee to the Director accompanied by a statement of the reasons for making it and, where the variation relates to the imposition of an Additional Charge, a forecast of costs that would not be incurred by the Licensee if the variation were made after deducting any additional costs that would be so incurred and which –
  - (i) had been consented to by the Director in a notice given to the Licensee; or
  - (ii) had not been objected to by the Director in a notice given to the Licensee within two months of the giving of the notice to the Director;

“Additional Charge” means a charge for the provision of goods or services to a particular domestic customer, or a class of domestic customers, making payment for gas supplied under any of the Regulated Terms in addition to the charge for gas supplied;

“Gas Payment Provisions”, in relation to the terms or terms and conditions referred to in paragraph 2 (1) (a) below, means the provisions relating to payment of charges for gas supplied (other than the amounts to be charged) therein described;

“Regulated Term” means any of the following categories of Gas Payment Provisions-

- (a) the provisions described as Prompt Payment by cash or cheque, Quarterly direct debit payment and Standing order payment ("Category A");
  - (b) the provisions described as Late payment by cash or cheque (later than 10 days), Payment with magnetic card, Payment by Benefit Agency, Monthly repayment and Using a prepayment meter ("Category B"), being the provisions in force immediately before 1st April 2000.
- (2) Where an Accepted Variation entitles the Licensee to impose an Additional Charge, the Director may, after consulting the Licensee and taking into account any representations made by it, not later than three months after the giving of the notice by the Director to the Licensee in respect of that variation under paragraph (b) (i) of the definition of "Accepted Variation" in paragraph 1(1) above, direct that, so long as the variation remains in force, the entry in each part of the Table in paragraph 4(1) relating to any charge for gas supplied shall be treated as varied in such manner as the Director may determine for the purpose of taking into account any costs that would not be incurred by the Licensee in consequence of the making of the Accepted Variation after deducting any additional costs that would be so incurred.

2,- (1) The Licensee shall-

- (a) ensure that-
  - (i) the terms on which it is prepared to enter into a contract for the supply of gas to domestic customers determined under condition 3 (1) (a) of the Standard Conditions;
  - (ii) the terms and conditions on which it supplies gas to domestic customers, other than last resort customers, determined in accordance with the scheme made under paragraph 8 (8) of Schedule 2B to the Act; and
  - (iii) the terms and conditions on which it supplies gas to domestic customers, determined by, or in accordance with, the scheme made under paragraph 19 (4) of Schedule 5 to the Act,

provide for payment of charges for gas supplied, subject to any Accepted Variation, in accordance with any of the Gas Payment Provisions comprised in the Regulated Terms; and

- (b) ensure that such of the terms or terms and conditions referred to in subparagraph (a) above, other than the amounts to be charged, which applied where payment of charges for gas supplied was to be made in accordance with any of those provisions immediately before 1st April 2000 apply, with any Accepted Variation, where any such payment is to be made after that day;

(2) In this paragraph “last resort customers” means customers supplied with gas pursuant to a direction given to the Licensee by the Director in accordance with Condition 5 of the Standard Conditions.

3.- (1) Notwithstanding the provisions of Conditions 4(6) and 11 (1) (d) of the Standard Conditions, the Licensee shall take all reasonable steps to furnish the required particulars-

- (a) to each domestic customer supplied with gas by the Licensee at least once in the year commencing on 1st April 2000;
- (b) to any such domestic customer, or any potential domestic customer of the Licensee, requesting them; and
- (c) where a reduction is made in the amount charged under any of the Gas Payment Provisions comprised in the Regulated Terms, to any such domestic customer making payment under any of those provisions of any amount charged thereunder which is greater than the amount so reduced.

(2) In sub-paragraph 3 (1) above, “required particulars” means particulars of-

- (a) all the Regulated Terms; and
- (b) the amounts to be charged in respect thereof for the time being in force.

4.- (1) The Licensee shall ensure that in the year commencing on 1 April 2000 (“the commencement date”) the amounts charged for the supply of gas to any domestic customer under each of the Regulated Terms do not exceed –

- (a) as regards amounts payable up to the first meter read date the amounts specified with respect to those terms in Part I of the Table below; and
- (b) as regards amounts payable after that date, the amounts so specified in Part II of that Table.

TABLE  
MAXIMUM PRICES  
PART I  
PRICES BEFORE FIRST METER READ DATE

	Category A	Category B
Standing charge (£/customer)	17.47	48.87
Unit charge (p/kWh)	1.389	1.389

Note: In this Part of the Table "standing charge" and "commodity charge" have the same meanings as in Special Condition 3 of the Licence in force immediately before the commencement date.



TABLE  
 MAXIMUM PRICES  
 PART II  
 PRICES AFTER FIRST METER READ DATE

	Category A	Category B
Tier 1 charge (p/kWh)	1.766	2.396
Tier 2 charge (p/kWh)	1.327	1.327

- (2) The Licensee shall ensure that –
- (a) the provisions of paragraph 2(c) of Special Condition 3 of the Licence in force immediately before the commencement date are complied with in respect of any particular domestic customer until the first meter read date applying to that customer; and
  - (b) any amount for a tier 2 charge for gas supplied or for an Additional Charge for the provision of particular goods or services is the same in respect of all the Gas Payment Provisions comprised in the Regulated Terms.
- (3) In this paragraph “first meter read date” means the first day on which the customer’s meter is read or its reading falls to be estimated after the commencement date.

5.-(1) This Condition shall cease to have effect on 1st April 2001 unless, not later than 1st March 2001, the Director shall have notified the Licensee that, in the opinion of the Director, competition has not sufficiently developed in respect of domestic customers supplied under the Regulated Terms to justify the disapplication of this Condition.

(2) If the Director has so notified the Licensee, this Condition shall cease to have effect on 1st July 2001 unless the Director has made a reference to the Competition Commission under section 24(1) of the Act relating to the modification of this Condition before that day.”

## **Appendix 2: Summary of Assessor's Report for Gas Costs 1997/98 and 1998/99**

### ***A2.1 Introduction***

Under Special Condition 3 of its gas suppliers' licence, BGT is required, no later than seven months after the end of the formula year, to submit to Ofgem an audited statement of its gas costs for the formula year, referred to as the Total Gas Cost Notice ("TGCN"). BGT is also required to appoint an Assessor to assess its purchase of gas in the formula year against the Economic Purchasing Objective. This process has been completed for the first two of the three formula years of the present price control period.

### ***A2.2 Formula Year 1997/98***

BGT submitted a TGCN of £3,847.5 million, relating to 526,150 million kWh or 0.731 pence per kWh.

In its report, the Assessor recommended a number of alterations to BGT's TGCN. These included:

- stored gas injected into the system was double counted, both in terms of costs and volumes;
- Take or Pay gas adjustment was carried out incorrectly;
- accruals in relation to the expected costs of settling disputes with suppliers was overstated;
- some of the renegotiation costs allocated to 1997/98 related to the prior year and were removed;
- the net margin that Accord made on trades with BGT was removed; and
- the cost of capital used to profile renegotiation costs was lowered from 9% to 8%.

The effect of the Assessor's alterations was to reduce BGT's TGCN to 0.731 pence per kWh<sup>53</sup>.

In determining BGT's allowable gas cost, which is used to calculate its domestic gas supply tariff caps, BGT's single portfolio is adjusted for increased peak requirements of its domestic customers. This adjustment gives an allowable gas cost for the formula year of 0.776 pence per kWh.

**Table A2.1: The total gas costs for 1997/98 as adjusted by the Assessor's findings:**

	Costs	kWh	TGCN	Allowable gas costs
	£ million	Million	p/kWh	p/kWh
<b>Total gas cost per TGCN</b>	3,847.5	526,150	0.731 <sup>1</sup>	0.779 <sup>2</sup>
Stored gas injected into the system	(107.8)	(15,269)		
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	(2.7) <sup>1</sup>			
<b>Total gas cost to be allowed by Ofgem<sup>3</sup></b>	<b>3,732.8</b>	<b>510,881</b>	<b>0.731<sup>1</sup></b>	<b>0.776<sup>1</sup></b>

Notes:

1. As calculated by Ofgem
2. As submitted by BGT
3. Components may not sum to total due to rounding

### ***A2.3 Formula Year 1998/99***

BGT's TGCN for 1998/99 was £3,146.0 million, relating to 485,677 million kWh or 0.648 pence per kWh.

BGT stated that an additional cost of £12 million was incurred as a result of 307,636 million kWh of gas being lost from the gas transportation system. This represented an

<sup>53</sup> BGT's TGCN to 4 decimal places is 0.7312 pence per kWh. The Assessor's adjustments reduce this to 0.7305 pence per kWh.

additional 0.0004 pence per kWh which BGT said should be added to the allowable gas cost for this formula year.

The Assessor made several adjustments to BGT's TGCN, including:

- elimination of accrual reversals for gas prior to 1 April 1997;
- the treatment of the complex Southern Basin field renegotiation costs, which involved negotiations with 8 external parties;
- removal of the margin that Accord makes on regulated gas trades with BGT;
- the cost of capital used to profile renegotiation costs was lowered from 9% to 8%; and.
- a reconciliation of gas volume differences caused by loss of gas from Transco's system.

These reduce BGT's TGCN to 0.644 pence per kWh. After adjusting for the increased peak requirements of its domestic customers, BGT's allowable gas cost for the formula year was 0.701 pence per kWh.

**Table A2.2: The total gas costs for 1998/99 as Adjusted by the Assessor's Findings:**

	Costs	KWh	TGCN	Allowable domestic rate
	£ million	Million	p/kWh	p/kWh
<b>Total gas cost per TGCN</b>	3,146.0	485,677	0.648 <sup>1</sup>	0.712 <sup>1,2</sup>
Seasonal supply field – elimination of accrual reversals for gas prior to 1 April 1997	2.2			
Contract re-negotiations – Southern Basin field	(15.5)			
Accord margin	(1.8)			
Using real discount rate of 8% for renegotiations	(9.6)			
Gas volume reconciliation difference		(1,319)		
<b>Total gas cost to be allowed by Ofgem<sup>3</sup></b>	3,121.3	484,358	0.644 <sup>1</sup>	0.701 <sup>1</sup>

Notes:

1. As calculated by Ofgem
2. Includes BGT's additional 0.0004 pence per kWh for loss of gas from the transportation system
3. Components may not sum to total due to rounding

## Appendix 3: Headroom Analysis

### *A3.1 Assumptions about New Entrant Costs*

Based on responses to the Initial Proposals document Ofgem has assumed that new suppliers would have average gas costs of between 0.461 and 0.546 pence per kWh. Ofgem has maintained its acquisition costs assumption of £40 per gas only customer and £22 per 'dual fuel' customer. It is assumed that these acquisition costs are recovered over 5 years.

Ofgem has assumed that new suppliers face supply costs of £20 per customer for PromptPay customers and £39<sup>54</sup> per customer for Standard and PrePayment customers. Suppliers offering 'dual fuel' deal are assumed to face additional supply cost of 20%. Ofgem has assumed for the purpose of this analysis that the 'dual fuel' saving is split equally between gas and electricity. Therefore, 'dual fuel' supply costs are assumed to be £12 for PromptPay customers and £23 for Standard and PrePayment customers. New entrants are assumed to incur the same level of costs as BGT for transportation, metering and storage services.

Table A3.1 shows a new entrant's costs using the assumptions outlined above.

---

<sup>54</sup> Including EESoPs.

**Table A3.1 – Ofgem’s Assumptions about New Entrants’ Costs, 2000/01 (nominal prices)**

	PromptPay	Standard	PrePayment
Gas Costs (p/kWh)	0.461-0.546	0.461-0.546	0.461-0.546
Transportation costs (p/kWh)	0.507	0.507	0.507
Metering costs (£ per customer)	15.34	15.34	30.82
Storage costs (p/kWh)	0.010	0.010	0.010
Supply costs (Gas only) (£ per customer)	20.00	39.21	39.21
Supply costs (Dual fuel) (£ per customer)	12.00	23.53	23.53
Acquisition costs (Gas only) (£ per customer) <sup>55</sup>	9.43	9.43	9.43
Acquisition costs (dual fuel) (£ per customer) <sup>56</sup>	5.19	5.19	5.19
Margin (%)	3	3	3

### ***A3.2 Available Headroom at Different Annual Consumption Levels***

Using the assumptions for new entrants’ costs outlined above, this section sets out the degree to which new entrants can price below BGT’s revised tariff caps (set out in chapter 9) at a range of annual consumption levels. It also considers the range of scenarios for new entrants’ gas costs.

#### ***a) Low Consumption Levels***

Tables A3.2, A3.3 and A3.4 show new entrants’ headroom under Ofgem’s Final Proposals for BGT’s tariff caps at an annual consumption of 10,257 kWh.

**Table A3.2 New Entrants’ Gas Costs of 0.546 p/kWh**

	PromptPay %	Standard %	PrePayment %
Gas only	-1	4	-5
Dual Fuel	2	11	3

<sup>55</sup> Based on the first year cost of recovering £40 over 5 years.

<sup>56</sup> Based on the first year cost of recovering £22 over 5 years.

**Table A3.3 New Entrants' Gas Costs of 0.512 p/kWh**

	PromptPay %	Standard %	PrePayment %
Gas only	1	6	-3
Dual Fuel	5	13	5

**Table A3.4 New Entrants' Gas Costs of 0.461 p/kWh**

	PromptPay %	Standard %	PrePayment %
Gas only	4	9	0
Dual Fuel	8	16	8

The above tables show that at low consumption headroom is relatively tight for gas only suppliers. However, there is more headroom available to competitors who offer a dual fuel.

**b) *Tariff Average Annual Consumption***

Tables A3.5, A3.6 and A3.7 show new entrants' potential headroom assuming tariff average annual consumption of 16,441 kWh for PromptPay, 16,324 kWh for Standard and 14,331 kWh for PrePayment.

**Table A3.5 New Entrants' Gas Costs of 0.546 p/kWh**

	PromptPay %	Standard %	PrePayment %
Gas only	5	8	0
Dual Fuel	8	13	6

**Table A3.6 New Entrants' Gas Cost of 0.512 p/kWh**

	PromptPay	Standard	PrePayment
Gas only	8	10	2
Dual Fuel	10	16	8



**Table A3.7 New Entrants' Gas Cost of 0.461 p/kWh**

	PromptPay	Standard	PrePayment
Gas only	11	13	5
Dual Fuel	14	19	11

The tables above broadly support Ofgem's conclusions in chapter 9.

**c) High Consumption Levels**

Tables A3.8, A3.9 and A3.10 show new entrants' potential headroom assuming an annual consumption of 27,842 kWh.

**Table A3.8 New Entrants' Gas Costs of 0.546 p/kWh**

	PromptPay %	Standard %	PrePayment %
Gas only	10	11	8
Dual Fuel	12	15	11

**Table A3.9 New Entrants' Gas Costs of 0.512 p/kWh**

	PromptPay %	Standard %	PrePayment %
Gas only	12	14	10
Dual Fuel	14	17	13

**Table A3.10 New Entrants' Gas Costs of 0.461 p/kWh**

	PromptPay %	Standard %	PrePayment %
Gas only	16	17	13
Dual Fuel	18	21	17

These tables show that at high consumption levels there is substantial headroom available to competitors, in both the gas only and dual fuel markets for PromptPay and Standard, but only in the dual fuel market for PrePayment.

## Appendix 4: BGT's Proposal to Charge for Replacement Electronic Token Meter (ETM) Cards.

### *A4.1 Background*

On 1 March 1999, BGT submitted an Accepted Variation proposal, under the process set out in Special Condition 3 of its gas suppliers' licence, to introduce charges for customers who requested replacement ETM gas cards where the original was lost, stolen or accidentally or maliciously damaged.<sup>57</sup> BGT estimated that it replaced about 130,000 gas cards a year in 1998. BGT said that the proposal was aimed at altering customers' perceptions about the value of ETM cards in order to reduce the number of replacement cards required. BGT proposed to charge customers £10 for cards sent by post and £15 for replacements that were hand-delivered.

### *A4.2 Ofgem Consultation*

Ofgem consulted on BGT's proposal in April 1999.<sup>58</sup> Ofgem had several concerns:

- discrimination. ETM customers could not respond to price signals like most other customers, as 70% have outstanding debt. BGT would therefore have the ability to object to their transfer to another supplier.
- rebalancing. The proposal would raise the effective PrePayment tariff relative to the Standard credit tariff, which went against the conclusions of Ofgas' tariff rebalancing review,<sup>59</sup> and
- review. BGT's proposal did not include an interim review where Ofgem and BGT could assess the performance of the proposal.

---

<sup>57</sup> BGT did not propose to levy a charge for cards that were faulty due to reasonable wear and tear; issued with new meters or change of tenancy; or lost but subsequently found within 14 days.

<sup>58</sup> "BGT's Proposal To Charge For Replacement Gas Cards For Electronic PrePayment Meters", Ofgas, April 1999.

<sup>59</sup> "Review of British Gas Trading's Domestic Supply Tariffs: A Decision Document", Ofgas, June 1998

In light of responses to the consultation and discussions with Ofgem, BGT withdrew its submission in order to consider the proposal further.

#### ***A4.3 BGT's Revised Proposal***

On 7 October 1999, BGT submitted a revised proposal. The revised proposal included:

- no charge for the first replacement card, whatever the circumstance;
- a reduced charge for replacement cards of £5.00 for cards sent by post and £10.00 for those requiring a home visit;
- GasCare registered customers excluded from charges; and
- BGT agreed to review the scheme after six months of its implementation to enable Ofgem to judge the success of the project.

In light of these revisions to BGT's policy on charging for replacement ETM cards, Ofgem is minded to accept BGT's proposal.