

## 8 Conclusions

### The monopoly situation

8.1. We are required to report on whether a monopoly situation exists in relation to the supply in Great Britain of gas through pipes to persons other than tariff customers within the meaning of Part 1 of the Gas Act 1986 (the Gas Act); and, if so, by virtue of which provisions of sections 6 to 8 of the Fair Trading Act 1973 (the Fair Trading Act) that monopoly situation is to be taken to exist, and in favour of what person or persons that monopoly situation exists.

8.2. Section 6 of the Fair Trading Act is concerned with the supply of goods; a monopoly situation can be found under section 6(1)(a) or 6(1)(b) when at least one-quarter of the supply is by or to the same person or members of the same group of interconnected bodies corporate.

8.3. As noted in paragraph 2.10, British Gas plc (BG) is the only authorised 'public gas supplier' in Great Britain and we are aware of only a very limited number of arrangements for the supply of gas by organisations other than BG. We conclude that a monopoly situation exists in favour of British Gas plc in relation to the supply in Great Britain of gas through pipes to persons other than tariff customers (within the meaning of Part 1 of the Gas Act 1986), by virtue of section 6(1)(a) of the Fair Trading Act. BG has accepted this conclusion.

8.4. In accordance with our terms of reference, we have therefore to consider:

- (a) whether any steps are being taken by BG for the purpose of exploiting or maintaining that monopoly situation and, if so, by what uncompetitive practices or in what other way;
- (b) whether any action or omission on the part of BG is attributable to the existence of that monopoly situation and, if so, what action or omission and in what way it is so attributable; and
- (c) whether any facts found in pursuance of our investigations operate or may be expected to operate against the public interest.

### The supply of gas to contract customers

8.5. Our terms of reference require us to consider the supply of gas through pipes to persons other than tariff customers as defined in the Gas Act. Our concern, therefore, is with the supply of gas to customers with whom BG has a special agreement, and whom we, and BG, have termed 'contract customers'. A 'special agreement' is permitted under the Gas Act either if tariffs in force are not appropriate owing to special circumstances, or—more usually—if the agreement provides for a minimum supply of gas to any premises in excess of 25,000 therms in any 12-month period. As discussed above, BG is the only authorised public gas supplier in Great Britain, and accounts for virtually all gas supplied through pipes in Great Britain; the contract sector comprises about 38 per cent of BG's gas sales business by volume (seven billion therms per annum), and about 26 per cent by revenue (£1.7 billion in 1987–88).

8.6. As shown in Table 2.4, BG has about 21,000 contract customers. Some 2,000 of these customers are classified as 'domestic'—but these account for only about 2 per cent of the total volume of gas supplied to contract customers, and less than 2 per cent of all gas supplied to domestic customers is on a contract basis. The bulk of contract gas is therefore supplied for industrial and commercial customers.

8.7. BG supplies gas to contract customers on a firm or an interruptible basis. Firm contract customers receive supplies of gas which BG is contractually bound

not to interrupt; in March 1988 BG had almost 18,500 firm contracts with industrial and commercial customers. BG sells interruptible gas under terms which give it the right to interrupt supplies, usually up to 63 days a year, although in practice, during the past two years, interruptions have taken place on fewer days than this. In March 1988, BG had about 1,300 interruptible contracts, mainly with industrial but also with some commercial customers. Interruptible supplies accounted in 1987-88 for 49 per cent of the therms supplied to contract customers, but only 37 per cent of the value of sales to those customers. The ability to interrupt supplies is one means by which BG is able to continue to meet demand from tariff customers, whom BG is under a statutory duty to supply, and from firm customers during peaks of demand.

8.8. Supply to industrial and commercial premises which consume less than 25,000 therms of gas a year is outside our terms of reference. These premises are supplied according to the published tariff. BG has over 500,000 customers in this category. Tariff sales account for 5 per cent of the volume of sales to industrial customers, and 52 per cent of sales to commercial customers. Criticisms were made to us that to charge the same price per therm to commercial customers using up to 25,000 therms per annum as to domestic users, typically using about 600 therms per annum, amounted to discrimination, and that to apply the 25,000 therm limit to individual premises discriminated against customers who used gas at many locations. BG told us that the distinction between the tariff and contract sector at 25,000 therms was a fundamental feature of the Gas Act; customers being supplied below this limit benefited from the statutory requirement on BG to supply, with protection of the Authorisation formula and the regulatory powers of the Director General of Gas Supply (the Director General). We note, however, that the charges made to these tariff customers are higher than those to contract customers, and suggest that consideration should be given as to whether the 25,000 therm threshold in the Gas Act for supply to any premises on a contract basis is set at the appropriate level. Consideration should also be given as to whether a uniform tariff is appropriate for customers of very different size, and, in particular, whether the structure of tariffs to larger users below the 25,000 therm level should be more consistent with charges to contract customers.

8.9. At a late stage of our inquiry we received a complaint about BG's pricing policy for customers who use more than 25,000 therms of gas annually but who have not yet made a special agreement. Gas supplied in excess of 25,000 therms is initially priced at a Transitional Tariff Rate of 38.5 pence per therm, but customers who have not entered into such a special agreement within 28 days of BG having made a firm offer in writing are charged according to a General Tariff of 57 pence per therm. We view such a practice with concern. It would appear to be one which is difficult to justify and could not be engaged in except by a company in the monopoly position of BG. However, BG told us that at present no customers were being charged according to the General Tariff, and it was proposing to review the usefulness of the General Tariff; we have therefore not pursued the point.

#### **Alternative fuels**

8.10. Although BG is effectively the only supplier of gas through pipes in Great Britain, gas is to an extent in competition with other fuels. Since the development of North Sea gas in the 1960s and the oil price rises in the 1970s, gas has accounted for an increasing share of the United Kingdom's primary energy requirements, now accounting for some 46 per cent of total energy consumed (excluding transport uses), some 35 per cent of energy consumption by industrial users, and 38 per cent by commercial users.

8.11. BG believes that ultimately other fuels could be used to substitute for almost all uses of natural gas. The ease of switching to alternative fuels varies considerably, however, depending on the use of the fuel and the availability of appropriate fuel-burning equipment, and, where necessary, fuel storage facilities. BG has hitherto required users of interruptible gas, other than those who use gas as a feedstock, to have the facilities for using alternative fuels, which they burn during periods of interruption (although during the course of our inquiry BG told us it would no longer insist on such facilities being available). For purposes of price

negotiation, BG has classified its firm customers into three categories according to their ability to use substitute fuels. About 10 per cent of firm gas contracts and 20 per cent of firm gas sales by volume are to Category 'A' customers, who already have dual-firing equipment and can easily switch to alternative fuels; 20 per cent of contracts and 30 per cent of the volume of sales are to Category 'B' customers, who BG considers are able to switch to alternative fuels relatively quickly and at a modest cost; and the remaining 70 per cent of contracts and 50 per cent of volume of sales are to Category 'C' customers, who could switch away from gas only after a longer period and at greater expense. In March 1988, BG had nearly 13,000 contracts with Category 'C' customers.

8.12. We accept that gas forms part of the wider energy market and that over a period of years it is possible for most users of gas to switch to alternatives if they are dissatisfied. Where users have alternative fuel-burning facilities installed, this switch is relatively easily made, and the competitive pressures facing BG in retaining such customers are very direct. This is particularly apparent with BG's interruptible contracts where prices have moved fairly closely in line with prices of heavy fuel oil (HFO), and where contracts are easily lost. However, other users, once they have made their choice of gas as a fuel, have less flexibility in switching and have no alternative gas suppliers to whom they can turn. In a substantial part of the firm gas market we consider that there is at most only limited competition from other fuel suppliers.

### **The regulatory framework**

8.13. The Gas Act established a regulatory regime for the supply of gas through pipes, and made provision for the appointment of the Director General who with the Secretary of State is responsible for operating and enforcing the regulatory regime, and for a system for authorising the supply of gas, subject to regulatory conditions. The relevant provisions of the Gas Act are summarised in paragraphs 2.9 to 2.12.

8.14. The regulatory regime distinguishes between the tariff and contract sectors. In general, for supplies up to and including 25,000 therms a year at any premises, the customer is charged according to a published tariff, and the maximum price is calculated in accordance with a formula set out in BG's Authorisation. For the contract sector, the Authorisation requires BG only to publish a schedule of maximum prices and a statement relating to its willingness to negotiate prices in that sector.

8.15. The Department of Energy told us (see paragraphs 6.2 to 6.12) that in the tariff sector inter-fuel competition was less intense than in the contract sector and the scope for alternative gas supply was limited; hence full regulation of price and other terms of supply was applied at the time of privatisation. In the contract sector, on the other hand, it was thought that inter-fuel competition would be an important check on prices, and that the establishment of a regime for common carriage (use of BG's pipelines by another supplier) would also exert an influence on the setting of prices.

8.16. The expectation of the development of competition from other suppliers of gas was, therefore, an important element of the regime established by the Gas Act. The Gas Act allows BG's pipeline system to be used by third parties and, if negotiation between BG and a third party on the terms of such carriage cannot be brought to a successful conclusion, provides for the Director General to give directions which specify the terms on which BG should convey gas (see paragraphs 2.18 and 2.19). To date BG has only one common carriage arrangement, which was first negotiated prior to the 1986 Act; however, we understand that there are a few projects at present under consideration for supply of gas by third parties using BG's pipelines.

8.17. BG argued that certain of the possible remedies put to it by the Commission (see paragraphs 7.57 to 7.96) would represent major departures from the basis upon which BG was privatised in November 1986; that the principles upon which BG should operate were reviewed by the Government prior to 1986

and approved by Parliament in the Gas Act; and that radical changes could not be justified so shortly after privatisation and before the regime envisaged by the Gas Act had had an opportunity to prove itself. We do not accept that we should approach BG in any way differently to any other organisation whose position we are required to consider in the course of a monopoly investigation, and indeed the BG Offer for Sale document specifically referred to the contract sector being subject to general competition law. We must clearly take into account the provisions of the Gas Act; but if in the course of our inquiry we find any facts which operate or may be expected to operate against the public interest, we are required under our terms of reference to report on those facts and consider what action should be taken to remedy the adverse effects identified.

#### **Submissions from contract customers**

8.18. During the course of our inquiry we received many submissions from contract customers nearly all of which were critical of BG. Some of these customers did not wish to be identified in our report. We received many criticisms of BG's pricing policy particularly concerning the level and structure of prices, and the lack of transparency and the unpredictability in the prices charged. Other main criticisms related to BG's contract terms, and to the difficulty of establishing competition with BG in the supply of gas; but we received no criticisms of BG's technical performance. We also carried out a survey (see Appendix 5.2) based on a sample of 415 of BG's contract customers. This survey sought their views (among other things) on BG's pricing policy; 37 per cent of the respondents described BG's pricing policy as 'fully acceptable', 43 per cent as 'partly acceptable', and 18 per cent as 'not acceptable' (2 per cent expressed no view). We noted that, within the sample, over one-half of larger firm gas users consuming more than one million therms a year said that BG's pricing policy was 'not acceptable'. The principal complaints made by the 61 per cent of respondents who did not regard BG's pricing as 'fully acceptable' were: lack of scope for negotiation, lack of price transparency, companies being placed at a competitive disadvantage in overseas markets by BG's policy, and BG's prices not reflecting the fall in the price of other fuels.

8.19. BG told us that it was already reviewing its pricing policy and other conditions of supply at the time the reference was made. Partly in response to the criticisms put to it, BG submitted for our consideration a number of proposed changes to those policies. We have taken account of these proposals in reaching our conclusions.

#### **BG's pricing policies**

8.20. The gas supplied by BG is of a standard quality, although there is scope for variation in terms of supply. However, the prices for contract gas vary widely between customers by reasons of BG's pricing policy, which BG describes as 'market-related'. BG says that it negotiates contract prices with each customer, with the intention of relating its price as closely as possible to the cost of each customer's alternative fuel, taking account also of the ease or difficulty with which the customer is able to switch to the alternative fuel, and any benefits of using gas rather than an alternative fuel. Where the most appropriate alternative is gas oil, liquefied petroleum gas, or electricity, BG regards the gas as a 'premium' fuel. These relatively expensive alternative fuels are required where the particular processes (eg direct drying in the food industry; heat treatment of metals) require a high quality fuel. Where the most appropriate alternative is relatively inexpensive HFO or coal, BG regards the gas as a 'non-premium' fuel, and usually sets a lower price. BG normally offers 'premium' gas only on a firm basis, and 'non-premium' gas only on an interruptible basis. In pricing gas sold as chemical feedstock, for which there is no realistic alternative to gas, BG takes into account the costs of manufacturers operating in other EC Member States in competition with United Kingdom companies; gas for this purpose is generally sold on an interruptible basis.

8.21. BG operates this market-related pricing policy by charging prices within self-imposed upper and lower limits which it refers to as the 'top stop' and 'bottom stop' prices. BG is required by the terms of its Authorisation to set and

publish its maximum prices, which it regards as the 'top stop' prices for firm and interruptible gas. BG's present policy is that the maximum price for firm gas should not normally exceed the price of tariff gas as regulated under the terms of the Authorisation; BG also stated its intention to limit increases in published maximum firm gas contract prices for a period up to July 1989 to about the rate of inflation. BG identifies its 'bottom stop' prices for firm and interruptible gas on the basis of the incremental cost to BG of supplying gas and a minimum marginal contribution to profits. In estimating the minimum price it is willing to charge for new firm sales, BG also takes account of the load factor of a particular sales contract under consideration. These 'bottom stop' prices are used by BG for its own internal purposes and are not published.

#### **The relative level of prices in the United Kingdom**

8.22. Many manufacturing companies and trade associations complained about the high level of United Kingdom firm gas prices, particularly compared to prices in other EC Member States. We were told that the relatively high level of prices damaged the competitiveness of United Kingdom companies, and also led some manufacturing activity to be located elsewhere in the EC. Among the remedies proposed to us was that gas prices in the United Kingdom should be related to the price of HFO, as is the case in some EC countries.

8.23. It is difficult to make exact comparisons between firm gas prices in the United Kingdom and elsewhere in the EC because of the different pricing methods and the range of prices charged within individual countries. Differences in gas prices can also reflect differences in the structure of revenues between domestic and other consumers, and the relative profitability of gas suppliers. The figures we have seen, however, support the view that firm gas prices for many users are at present higher in the United Kingdom than in other EC countries. On BG's figures, for example, the mid-point of BG's prices for firm gas to large industrial consumers is up to 80 per cent above those elsewhere in the EC (see paragraph 5.29). These differences have emerged since the latter part of 1985; since then the mid-point of United Kingdom prices has fallen by about 12 per cent, compared to a fall of between 30 and 48 per cent in other EC countries. We were given persuasive evidence that these differences can have an adverse effect on the competitiveness of United Kingdom manufacturers of those products, for example in parts of the steel industry where gas accounts for a relatively high proportion of production cost. We accept that gas is not the only manufacturing cost which varies between competitors in different countries, but this does not mean that high United Kingdom gas prices can be viewed with equanimity.

8.24. Despite the difficulties in making precise comparisons, and the various factors which may affect relative prices, we believe that the high United Kingdom gas prices are a cause for real concern. The recommendations made below should in time produce some reduction in the level of gas prices in the United Kingdom compared to those in other EC countries. Because of the importance of gas prices to competitiveness, we also suggested to BG that it should include comparisons of European gas prices at particular volumes of usage in its Report and Accounts, and BG agreed to do this.

#### **Profitability**

8.25. In order to assess profitability by market sector, BG allocates costs to its tariff, firm and interruptible markets. None of BG's capacity costs is at present allocated to interruptible gas, which BG sees as marginal business, using the supply system installed to meet the peak demand from tariff and firm contract customers. The current cost return on assets in the firm contract sector was some 7.2 per cent in 1987-88, compared to 5.2 per cent in the tariff sector. (In historical cost terms the return on assets was 28.3 per cent in the firm contract sector, compared to 18.7 per cent in the tariff sector.) In estimating rates of return in the firm contract and tariff sectors, however, profits on interruptible gas of £106 million in 1987-88 in current cost terms (£109 million in historical cost terms) are not allocated to either sector, and BG does not estimate a rate of return on the contract sector as a whole. If all the profits and assets of the interruptible sector were added to those of the firm sector, the current cost rate of return in the contract

sector would be about 10.4 per cent. We have some doubts about the methods of cost apportionment used by BG—in particular whether sufficient costs and assets are allocated to the interruptible market and the basis of allocation between the tariff and contract sectors. These methods are at present jointly being considered by BG and OFGAS. BG told us that none of the alternative methods of allocation which it had examined to date suggested unreasonable profits on firm gas supply. The current cost rate of return for BG's business as a whole was 6.1 per cent in 1987–88, equivalent to a return on assets of 19.4 per cent on a historical cost basis.

8.26. In assessing the source and nature of BG's profits, we have considered the changing market conditions in which BG has to operate. The fall in oil prices which occurred during 1985 and 1986 threatened BG with the loss of a significant volume of sales from, principally, its Category 'A' and 'B' customers, and a further loss of sales in the interruptible market. BG had to respond to these market conditions by reducing the prices it charged to selected groups of customers. However, it was able to maintain relatively high prices to those customers whose business it was in less danger of losing. This suggests that a part of BG's profits is attributable to BG's monopoly situation.

8.27. In considering BG's level of profit we note that BG is in a more protected position than most companies. It has a statutory monopoly in its tariff business and a *de facto* monopoly in its contract business. We take the view that BG's profits are very substantial for a company in its position. Moreover, they have been achieved at a time of weak oil prices.

8.28. We also consider that as a consequence both of BG's position as a dominant supplier and of its ability to engage in price discrimination, and its policy of systematically doing so, BG's profits in the contract sector are significantly higher than they would be if it were exposed to effective competition. (This subject is discussed in greater detail below.) We therefore take the view that, to the extent that the implementation of any remedies which we find it necessary to recommend leads to reductions in BG's level of profit in the contract sector, there is considerable scope for this without prejudicing BG's ability to continue to operate the business satisfactorily and to provide a reasonable return to shareholders.

#### **Discrimination in pricing of firm gas**

8.29. BG's policy of pricing according to the market circumstances of each customer has led to a wide variation in the prices charged for firm gas. As shown in Table 5.2 (and in further detail in Appendix 5.1), in March 1988 almost 60 per cent of customers, accounting for 24 per cent of firm gas supplied, were charged at 34.4 pence per therm, fractionally below the published maximum price of 34.5 pence; but there was a wide range of prices to other customers. Just under 9 per cent of contract customers were charged at or below 31 pence per therm but these accounted for 32 per cent of firm gas supplied. Prices to some customers were as much as ten pence per therm below the maximum. The variation in prices mainly reflects one or more of the following factors:

- (a) whether or not individual customers have the facilities for using alternative fuels. Average charges per therm are lower for Category 'A' customers who already have the facilities for using alternative fuels than for those customers (Category 'B') who could install the facilities without undue difficulty. Category 'C' customers, who could only switch from gas over a longer period at greater cost, have an even higher average charge. However, within each category there is a considerable variation in prices charged;
- (b) the price at which alternative fuels are available to individual customers. BG's surveys show a wide variation in the prices of gas oil, and this is confirmed by our own survey and others of which we are aware. However, we believe that part of this variation is attributable to differences in conditions of supply; in particular, larger customers tend to be in a position to secure lower gas oil prices. BG said that, if its own prices fail to reflect the variation in gas oil prices, it will lose load and profitability; and
- (c) the higher price which BG is able to charge particular customers because of the special advantages gas has to them in their businesses.

8.30. The range of prices for firm gas contracts has widened since the fall in oil prices in 1986. BG reduced the prices to those customers well placed to switch to potentially cheaper fuels, and who were in a position to benefit from lower prices charged by the oil companies, but maintained its prices to other customers. Average charges to firm gas customers have therefore been only slightly reduced since 1986 (see Figure 5.1). This has been a further source of complaint to the Commission.

8.31. BG argued that its policy of charging different prices to its customers was not against the public interest because this was a response to competition from alternative fuels (principally from gas oil in the firm gas market) which themselves vary significantly in price at any point in time. We accept that there are differences in gas oil prices, but we do not consider that these facts have a material bearing on the issue of whether BG's discrimination in gas prices operates or may be expected to operate against the public interest. First, we do not accept the premise of BG's argument, namely, that there is competition from other fuels across the contract market as a whole. Many of BG's customers have no immediate or realistic alternative to gas, and for these customers the price of alternative fuels can have no more than a limited bearing on the price they pay for gas. Instead, one of the main ways in which BG implements its pricing policy is by systematically classifying customers into groups according to the ease or difficulty with which they are able to switch fuels, and by charging higher prices to those customers who are least able to switch. Second, even to the extent that there is some limited competition from other fuels, BG's ability to respond by charging different prices for gas results from its position as a monopoly gas supplier. If there were greater competition in gas supply, we would expect to see a substantial narrowing of the present range of prices for gas, even in the presence of a range of prices in the market for gas oil.

8.32. In our opinion, therefore, the wide range of prices for firm gas and the way in which BG has responded to different groups of customers is not simply a reflection of the different prices quoted to those customers able to use alternative fuels. It is also a direct result of the extent to which many customers are tied to gas, and of the monopoly position of BG in this part of the energy market. Those customers tied to gas are in a weak negotiating position with BG, and BG's policy of price discrimination operates to the disadvantage of these customers. There is no doubt that the customers for whom there is little or no alternative to gas generally pay more than customers who can switch. If there were competition in the supply of gas, it is unlikely that this degree of price discrimination could be maintained.

8.33. The variation in gas prices between BG's customers means that firms competing in the same markets may face different costs not only because of their own relative efficiencies but also because of BG's discriminatory policy. BG's pricing policy thereby distorts competition in the markets in which its customers operate, including foreign markets.

8.34. By relating prices to those of the alternatives available to each customer, BG is also in a position selectively to lower prices in response to any new competitive threat, and thereby to deter the successful emergence of new gas competitors. A report by the Director General on Competition in Gas Supply referred to the concern of gas producers that BG might offer more favorable terms to selected customers with whom a competitor was negotiating. We have no evidence that BG has hitherto acted in this way, since no competitive threat has yet emerged from other gas suppliers. Nevertheless, we believe that BG's ability to price in this way may be expected to act as a deterrent to the emergence of competition in gas supply.

8.35. We also consider that the present lack of transparency in prices operates to the disadvantage of BG's customers. A number of contract customers and trade organisations told us of difficulties arising from lack of transparency. Two principal problems were identified. First, the fact that all contracts were subject to individual negotiation meant that customers had little idea of the gas prices being

paid by their competitors. This added to the uncertainty that they faced in assessing their position in relation to competitors and in setting their prices. Secondly, they faced uncertainty both in respect of future movements in their own gas prices and how their future contract prices would relate to prices paid by competitors. This made it difficult to make investment decisions and to evaluate the benefits of installing dual-firing facilities; a number of customers told us that BG would not provide a clear indication of the effect on their gas prices of installing such facilities.

8.36. In acknowledging that its pricing policy could be described as discriminatory, BG stressed that it did not accept the pejorative connotation of that term. BG argued that its present 'market-related' pricing policy was the only viable policy open to it in the light of its need to match supply and demand, and to earn sufficient revenue. We acknowledge that BG's policy of price discrimination has enabled it to compete more effectively with other fuels and to offer gas to certain customers at lower prices than would otherwise be the case, and thereby to expand the total market for gas. We accept that BG's prices need to take into account market factors in order to match supply and demand, given fluctuations in oil prices. However, we do not accept that price discrimination is necessary in order to balance supply and demand for gas, since this can be done by varying the levels of non-discriminatory prices and by using the flexibility provided by supply contracts. Nor do we accept that price discrimination is necessary to generate enough profit to make the business viable.

8.37. To summarise, we believe that the substantial differences in prices of firm gas would not be sustainable if there were competition from other gas suppliers. BG's ability to discriminate in such a way, and to maintain the price of firm gas to many customers despite the fall in oil prices, also shows that competition from other fuels is relatively weak across a substantial proportion of the contract market. In our view, therefore, the extensive discrimination in prices of firm gas is attributable to the existence of the monopoly situation since it would not be sustainable if there were competition from other gas suppliers. It is also a step taken to exploit the monopoly situation, since it enables BG to maintain its present level of profits from the contract sector by charging higher prices to those customers whose business it is in least danger of losing.

8.38. We further conclude that BG's policy of extensive discrimination in the pricing of firm gas operates, and may be expected to operate, against the public interest, by reason of the following particular adverse effects:

- (a) It imposes higher charges on those customers less well placed to use alternative fuels or to obtain alternative fuels on favourable terms. This practice also places an arbitrary cost disadvantage on some customers, thereby distorting competition in the markets in which they operate.
- (b) By relating prices to those of the alternatives available to each customer, it places BG in a position selectively to undercut potential competing gas suppliers; this may be expected to act as a deterrent to new entrants, and to inhibit the development of competition in this market.
- (c) By the lack of transparency in prices it creates uncertainty in the minds of customers about their future gas prices and those of their competitors, thereby rendering more risky the business environment in which they operate.

**Pricing and supply of interruptible gas**

8.39. A main source of complaint to the Commission was the significant widening in the differential between the price of firm and interruptible gas since the fall in oil prices in 1985. BG told us that this reflected the larger fall in the price of HFO compared to gas oil and that a higher price of interruptible gas would have led to a significant loss of load. We note that users of interruptible gas generally have the facility for using alternative fuels, and that interruptible gas is in more direct competition with these fuels, principally HFO. Because of this competition from alternative fuels, we are less concerned about the prices charged for interruptible gas; our principal concern is with BG's policies with regard to the supply of interruptible gas.

8.40. There is a limit to the amount of gas which BG needs to supply on an interruptible basis to enable it to meet peak demand without an additional requirement for expensive storage facilities. BG's sales of interruptible gas exceed this amount, however, since it is also able to sell gas on an interruptible basis which would not be saleable at firm gas prices, and for which it does not incur additional costs of installing capacity. We recognise that BG needs the ability to determine the total volume of gas offered for sale in the interruptible market. However, BG's policy is generally to supply interruptible gas only for 'non-premium uses' (see paragraph 8.20), where users have the alternative of HFO. It requires 'premium' users of gas to use firm gas, although BG believes that many such users with the facilities to use alternative fuels would be prepared to accept gas on an interruptible basis if this were available at an appropriate lower price. We believe that BG's practice of refusing to supply interruptible gas to most current users of firm gas is attributable to the existence of the monopoly situation, and is a step taken by BG to exploit the monopoly situation, since it enables BG to maintain higher profits on firm gas supply. We also believe that this practice operates against the public interest by imposing additional costs on users by requiring them to take a more expensive type of supply than they would prefer.

**Industrial site combined heat and power schemes**

8.41. We received several complaints about BG's policy of pricing gas for industrial site combined heat and power (CHP) schemes, especially gas turbine CHP schemes. Gas for such schemes is suitable for interruptible supply; to date BG has offered gas for such schemes at a discount from firm gas prices, but above the price of most other interruptible supplies. We were told, and BG accepted (see paragraph 7.56), that at these prices gas turbine CHP schemes were not viable. We conclude that BG's present pricing policy for gas used in industrial site gas turbine CHP schemes in this respect operates against the public interest by inhibiting the implementation of such schemes which could otherwise provide an economic use of energy.

**BG's proposals**

8.42. Following its own review of pricing policy, BG made a number of proposals that it argued would have reduced discrimination in pricing of firm gas, namely:

- (a) to publish a maximum price schedule, related to volume bands (as illustrated in Table 7.1), which would also be index-linked, but with negotiation of prices below the maximum;
- (b) to treat all customers as if they either have facilities for alternative fuels or could easily install them (ie to abolish the present 'C' category of customers); and
- (c) to offer customers a choice of indexation of contract terms or quarterly negotiation.

BG estimated the cost of the first two of these proposals at some £30 million a year.

8.43. We acknowledge that BG's proposals would produce some benefits to contract customers; they would, for example, provide customers with more assurance as to the future changes in gas prices. However, higher prices would still be charged to customers not having existing facilities for using alternative fuels, and there would still be substantial scope for price negotiation with divergences in price according to the negotiating position of each customer.

8.44. To meet the concern that it could engage in predatory pricing against competing suppliers, BG suggested to us an undertaking by which, in competing with another gas supplier, it would not price below the cost of gas plus the common carriage charge it had quoted to the competing gas supplier. BG suggested that the appropriate cost of gas could be its average cost of gas, or its incremental cost of

gas in any year, whichever was the lower. However, the minimum price would not be published or known to the competitor, nor would it apply if BG were competing against a supplier of an alternative fuel.

8.45. We consider that while the proposed undertaking would put some lower limit on the price which BG could charge, it would still allow BG selectively to reduce its prices to certain customers, and hence make it more difficult for independent shippers to compete. We also believe that there would be practical problems, both in deriving an adequate measure of a minimum price and in monitoring the undertaking. We do not therefore think that this proposal would be sufficient to overcome the adverse effects we have identified.

8.46. As regards interruptible gas, BG proposed that gas should be made available to larger 'premium' users on the basis of interruptibility of up to 35 days per annum, and at a discount on firm prices of some four pence per therm. BG estimated the initial cost of this proposal at some £30 million per annum; but there could be offsetting savings to BG after a period of some four years.

8.47. We believe that BG's proposal goes some way to remedying the adverse effect of its policy toward availability of interruptible gas identified in paragraph 8.40, but it still envisages differentiation in the terms of supply according to the use made of the gas. Indeed BG would still be in a position to discriminate in the prices charged for interruptible gas, for example in such a way as to deter present firm contract customers from using gas on an interruptible basis. More generally, we consider that the distinction which BG maintains between 'premium' and 'non-premium' uses for gas is one which should not be used in determining the availability or price of gas. All gas supplied by BG, for whatever purpose, is of standard quality and should be made available to all contract customers on terms which do not differentiate according to final use (subject to the one specific exception discussed in paragraph 8.72 below).

8.48. As regards pricing of gas for gas turbine CHP schemes on industrial sites, BG told us that it was committed to the use of gas for such schemes, and proposed to change the basis of charging for CHP schemes to reflect the mix of usage of the energy generated (see paragraph 7.56). We accept that these proposals would improve the viability of CHP schemes. However, such schemes would still be treated as a special case by BG and we do not consider that such special treatment is appropriate. CHP represents one amongst many alternative uses of gas and we believe that the economic use of gas resources would be best promoted if gas for this purpose were priced in the same way as for any other customer with similar supply requirements.

#### **Recommendations on pricing and supply**

8.49. We have found that BG's policy in the contract market involves systematic and extensive discrimination in the pricing of firm gas, and discrimination in willingness to supply interruptible gas. We have concluded that this policy is attributable to the existence of the monopoly situation, constitutes a step taken for the purpose of exploiting the monopoly situation, and operates or may be expected to operate against the public interest by reason of the adverse effects identified in paragraphs 8.38, 8.40 and 8.41. We are therefore required, under section 54(3) of the Fair Trading Act, to consider what action (if any) should be taken for the purpose of remedying or preventing these adverse effects; we may, if we think fit, make recommendations as to such action.

8.50. We do not believe that BG's proposals are adequate to remedy the adverse effects which we have identified. We therefore have to consider what alternative remedies are available.

8.51. We have considered the possibility of regulation of prices—for example, similar to that adopted for the tariff sector. However, we do not consider that this would be appropriate in the contract sector, where BG needs some ability to react to changing conditions of demand and supply. Moreover, price control would do nothing to remedy the underlying monopoly situation; indeed it might make new entry more difficult.

8.52. We believe that ultimately the only effective means of remedying the adverse effects of the present monopoly situation is direct competition in gas supply. We therefore make three major proposals for action—concerning BG's pricing policy for gas, its charges for common carriage, and its policy with respect to gas purchasing—which all seek to encourage effective competition. These measures are intended to ensure that potential competitors are not deterred by selective price cutting on the part of BG, by uncertainty as to the level of common carriage charges, or by lack of availability of gas. Until direct competition in gas supply is effective, we also see a need to restrain BG's discriminatory policy on pricing and supply of gas.

8.53. The Director General, in his report on competition in gas supply, had suggested that for BG to price gas according to a published price schedule would help relieve the fears of competitors that BG might engage in selective retaliatory or predatory pricing. We agree. We also believe that such a schedule would have the additional merit of protecting those customers currently paying high prices for gas. It would thereby provide some remedy in the shorter term until effective competition has developed, as well as assisting in the development of that competition. We further believe that, in order to facilitate the design, operation and enforcement of a price schedule, it would be helpful to establish the principle behind it by means of a supplementary requirement on BG not to discriminate in pricing or supply to contract customers.

8.54. We therefore suggested to BG the possible remedy that it should publish a price schedule for both firm and interruptible gas, which might take into account factors such as volume and load factor of supply, without scope for negotiation within that published schedule; that it should cease to refuse to supply interruptible gas to certain customers; and that it should be required not to discriminate in pricing or supply to contract customers.

8.55. BG's comments on these possible remedies are given in more detail in paragraphs 7.58 to 7.78. For firm gas, BG estimated that a schedule with the least adverse effect on its profitability would consist of prices (for customers with load factors of between 40 and 50 per cent) of between 34 pence per therm at lowest levels of consumption and 27 pence per therm at highest levels of consumption; it said that the prices paid by a significant number of firm contract customers would therefore be likely to increase. BG suggested that with such a schedule it would lose sales to firm contract customers, and would reduce its offtake of gas from the cheaper Southern Basin fields with more flexible 'take or pay' arrangements. This would raise BG's average cost of gas and, through the operation of the tariff price formula, would lead to higher prices to tariff customers. BG also estimated that our possible remedies would result in the virtual elimination of its contract sector profits of £291 million in 1987-88. BG argued that having to publish a price schedule would also make it more vulnerable to selective price-cutting by the suppliers of alternative fuels.

8.56. We acknowledge that the requirement to price according to a published schedule would mean that prices paid by some customers would be likely to increase, at least in the short-term until effective competition emerges. However, since BG's present policy is to charge each customer according to the price of that customer's alternative fuel it follows that customers faced with higher prices would experience relatively little detriment from having to switch to an alternative fuel. We believe that losses to those customers would be considerably more than offset by the gains to other customers whose prices decreased. We also believe that the effect, if any, of our proposals on the price of gas to tariff customers would prove to be temporary since any immediate reduction in offtake of gas from the cheaper Southern Basin fields would increase the availability of lower cost gas from such fields in the future.

8.57. We carefully considered the effect of our proposed remedies on BG's profitability. As discussed above, BG's present level of profitability in the contract sector results from its policy of discrimination in pricing and supply; in particular from charging higher prices to those customers less able to use alternative fuels, or

obtain such fuels on favourable terms, and from refusing to supply interruptible gas to 'premium' users. It is a policy which, we believe, exploits the monopoly situation and could not be maintained if there were competition from other gas suppliers. It follows, therefore, that a reduction in profitability would be the unavoidable consequence, at least in the short-term, of discontinuing the policy of price discrimination. Even BG's own proposals, we note, were estimated to cause an initial reduction in profitability of £60 million per annum.

8.58. We considered whether the expected reduction in profitability should be considered in terms of its effect on the rate of return on assets in the contract sector alone, or on the rate of return of the business as a whole. BG repeatedly stressed to us that the results of its cost apportionment and profitability exercise played no part in its pricing decisions. This argument implies that the effects of any constraint on BG's pricing policy should similarly not be judged on an imputed rate of return in the contract sector alone, since this return results from an arbitrary allocation of joint costs and assets between the tariff and contract sectors.

8.59. We note BG's arguments that our proposed price schedule would lead to BG's losing virtually all its profits in the contract sector. But even if this were to happen, BG's rate of return on an historical cost basis on the gas supply business as a whole would (on the basis of 1987-88 figures) fall only to some 15 per cent; such a rate of return, although below the average in the United Kingdom, would not be out of line with that achieved by a substantial number of companies. We also note that, when we put our proposals to BG, although it emphasised the adverse effects on the profits of its contract business, it did not suggest that the continuation of its contract sector business would be jeopardised.

8.60. We believe that BG needs to adjust to the more competitive market structure which will develop as other gas suppliers enter the market; such competition will itself lead to greater pressure on BG's profits. Our proposed schedule is in part a surrogate for such competition. The price schedule we have proposed would enable BG's more vulnerable customers to 'piggy-back' on the superior bargaining power of its less vulnerable customers (ie those with access to alternative fuels). To some extent, therefore, our proposals would simply bring forward the financial effects of a more competitive market with which BG would eventually have to come to terms anyway. BG would still have the incentive and ability to increase its level of profits from the contract sector by means which do not involve the exploitation of its monopoly position.

8.61. We believe therefore that the adverse effects on BG's profitability of the adoption of a price schedule in the short term would not be such as to jeopardise the continuation of the business on a sound financial footing and are no more than is necessary to remedy the adverse effects of BG's present policies, and to enable competition to take place.

8.62. Finally, we note BG's arguments that a price schedule would render it more vulnerable to competing fuel suppliers, although we emphasise that BG would be able to take into account such considerations when setting its own prices and would be able to respond by changing its own price schedule, provided it reduces prices to all customers in any given class. One of the purposes of our proposal is to give potential gas suppliers a clearer target to aim at, and to protect them from retaliatory action by BG; we believe that the disadvantage of any reduction of BG's ability to compete with suppliers of alternative fuels would be more than outweighed by the benefits of increasing competition within gas supply itself.

8.63. Against the alleged disadvantages of our proposal, there are a significant number of advantages. We believe our proposed remedies:

- (a) will lead to a reduction in price discrimination. This will ensure that BG's prices for gas to all its contract customers will need to take into account competition from alternative fuels, in particular the level of oil prices; BG would no longer be able partly to insulate itself from changes in fuel prices by maintaining high prices to those customers less able to use alternative

fuels or to acquire alternative fuels on favourable terms. We expect our proposal therefore to result in lower prices to many customers. A reduction in price discrimination will also remove the present arbitrary cost disadvantage on some customers, and the market distortions that result;

- (b) will encourage the development of competition from other suppliers of gas. BG will no longer be in a position selectively to reduce its prices to meet competition from potential competing gas suppliers. Transparency in the prices charged by BG will give potential competitors a clearer target to aim at. The encouragement to competition in this way may be expected to lead to lower prices in the future;
- (c) will produce greater transparency in the prices charged to each customer and to their competitors, thereby removing some of the uncertainty that results from BG's present pricing policy;
- (d) will make available gas on an interruptible basis to present users of firm gas. It will be for BG to determine the appropriate price for interruptible supplies, but if BG charged a high price or partly withdrew from the interruptible market, this in itself would provide a stimulus to competition. We believe therefore that this recommendation could produce significant benefits to those users of firm gas who would be prepared to accept an interruptible supply; and
- (e) will remove the present discrimination in the pricing of gas for CHP schemes; by pricing gas for this purpose in the same way as any other interruptible supply, the economic use of gas resources would be encouraged.

We believe that these advantages will more than outweigh any disadvantages of our proposal.

8.64. BG also argued that the price schedule that we proposed would be inconsistent with BG's right, under section 14(4) of the Gas Act, to enter into 'special agreements' with individual contract customers. BG further argued that such a schedule would constitute a tariff within the meaning of the Gas Act. We have been advised by Counsel, and we ourselves consider, that these arguments are not correct, and that the requirement to introduce a price schedule for contract customers would be consistent with the provisions and intention of the Gas Act.

8.65. We therefore recommend that BG be required to publish a schedule of prices for firm and interruptible gas at which it is prepared to enter into special agreements with contract customers. This schedule would relate prices to characteristics affecting the supply of gas, such as volume or rate of consumption, load factor and extent of interruptibility and could also incorporate different charges according to the contract terms agreed—for example, for contracts of different duration, or with arrangements for indexation—provided that similar terms were available to all other contract customers. However, the schedule would not relate prices to factors characterising individual customers' willingness to pay, such as purpose of use or ability to use alternative fuels (with the exception discussed in paragraph 8.72). The level and structure of prices incorporated within the schedule would be a matter for BG to decide in the light of market conditions. BG could change the schedule as and when it deemed this appropriate, subject to notifying the Director General in advance. The Director General however should ensure that frequent changes were not used to circumvent the purpose of the schedule in order, for example, to secure a particular company's business. We recommend that such a schedule should be introduced by the beginning of BG's next financial year.

8.66. As part of this proposal, we recommend that BG should be required not to refuse to supply interruptible gas on the basis of the use made of the gas, or the alternative fuel available. It would be for BG to determine the prices of interruptible gas to be incorporated in the schedule, possibly on several different bases of interruptibility, that would allow it to sell the volume of interruptible gas appropriate to balance supply and demand. We also recommend that gas for industrial site gas turbine CHP schemes should be supplied on the same basis as any other interruptible supply of gas.

8.67. We acknowledge that it may be difficult to incorporate in the published schedule all the factors which could reasonably be reflected in BG's prices and that BG may need scope to vary the price and other terms from those in the published schedule in order to meet a particular user's requirements. However, it is important that any such variations are consistent with the principle of non-discrimination underlying the proposed schedule, namely that BG should not supply gas to any one contract customer on terms which are more or less favourable than the terms on which it supplies other contract customers with similar volumes, load factors, provision for interruptibility and other relevant conditions of supply. It is also important that the Director General be given the power to monitor and enforce the price schedule and in particular to ensure that the purpose of the schedule is not circumvented by special discounts or premia for variations from the schedule.

8.68. We therefore recommend that BG's Authorisation be modified by the requirement not to discriminate in pricing or supply as set out in paragraph 8.67. It would not, however, be adequate merely to impose a requirement not to show undue preference, or to exercise any undue discrimination, such as applies to the fixing of the tariffs under section 14(3) of the Gas Act, since such a requirement would be liable to interpretation as requiring all prices to be identical, regardless of volume, load factor and other conditions of supply, which would be contrary to our intention.

8.69. We further recommend that BG should be required to publish as amendments to the schedule, any variations from that schedule and to make such variations available on the same terms to all other customers. In the event of a complaint that two or more customers were being supplied with gas at different prices, the Director General would have power to obtain the relevant information about contract terms, and the onus would be on BG to prove that its policy was not discriminatory.

8.70. We considered whether it would be sufficient to impose a non-discrimination clause alone, without publication of a price schedule. Such an approach would reduce the extent of discrimination, but would be less effective in protecting customers and potential competitors, although for this reason the financial effects on customers and BG would be less severe. We took the view that, in the present monopoly situation, the transparency of a price schedule was an intrinsic part of our remedy, which could not be achieved by a non-discrimination clause alone.

8.71. We further recommend that this requirement on BG to publish and operate such a price schedule should apply, in the first instance, for a period of five years. Towards the end of this period, the continued appropriateness of the price schedule, or of some variant thereof, and of the non-discrimination clause, should be reviewed by the Director General, taking into account the extent to which effective competition has by then emerged, or is likely to emerge, in the supply of gas in the United Kingdom.

8.72. There is one exception to the general principle we are proposing. We are conscious of the particular importance of gas as a feedstock. Unlike other uses of gas, no realistic alternative raw material is available, and the level of gas prices has an immediate impact on the viability of the United Kingdom feedstock industry. In this one case, if BG believes it is unable to incorporate feedstock users within the price schedule, we recommend that BG should be allowed not to apply the price schedule to interruptible gas for this use.

8.73. We considered whether it would be preferable to stipulate a price range within which BG would be free to negotiate; and whether this could remedy the adverse effects at less financial cost to BG. Such a proposal would put a limit on price discrimination, but some discrimination would still remain. BG itself argued that it would be difficult to negotiate within a range, and that prices could drift towards the published minimum. We also considered whether our proposal for a

schedule should exclude larger customers, eg those taking over one million therms a year. Since this is the sector with the greatest scope for competition from new gas suppliers, we concluded that this would allow BG too much scope selectively to cut prices and deter new competition, while doing little to mitigate any financial effect on BG.

**Contract terms**

8.74. We received complaints about several other aspects of the contract terms set by BG, in particular:

- (a) refusal to aggregate quantities of gas supplied to the multiple premises of individual customers;
- (b) the specification in the contract of the purpose for which gas is to be used, and BG's requirement that it should have access to premises to validate this; and
- (c) in the case of interruptible supplies, the requirement that customers should have facilities for using alternative fuels.

8.75. BG told us that under its own proposed changes to its contract terms—which it had put forward only in the context of its proposals for a maximum price schedule (see paragraph 8.42)—it would be prepared to aggregate quantities of firm gas supplied to the multiple premises of an individual customer, for the purposes of deciding the appropriate volume band. The maximum scheduled price would then apply to the total load. BG also proposed to discontinue the specification in the contract of the purpose for which gas is used, and the provision which allowed it access to a customer's premises to ensure that gas was being used for the purposes specified. So far as the conditions for interruptible supply are concerned, BG said that its contracts now provided that the customer is contractually responsible for standby, but not contractually obliged to provide it. In practice, BG's position is that a customer should be capable of complying with the terms of the interruptible contract.

8.76. We find the complaints made about these contract terms to be justified. We believe that BG's imposition of these terms is attributable to the monopoly situation and operates against the public interest by reason of the following adverse effects:

- (a) BG's refusal to aggregate quantities of gas supplied to the multiple premises of individual customers results in higher prices for these customers than would be the case in a more competitive situation;
- (b) the specification in the contract of the purpose for which gas is to be used and BG's requirement that it should have access to premises to validate this is a means of discriminating between users, and is objectionable for the reasons discussed in paragraph 8.40;
- (c) in the case of interruptible supplies, the requirement that users should have facilities for using alternative fuels imposes unnecessary costs on those users who would prefer temporarily to discontinue production.

8.77. We have considered what action (if any) should be taken for the purpose of preventing or remedying these adverse effects, and recommend the following remedies, which essentially coincide with BG's own proposals for changing its terms of contract:

- (a) that BG should offer a single contract for the multiple premises of an individual customer (each premises having an offtake exceeding 25,000 therms per annum), the annual firm load of all these premises being added together to determine into which volume band a customer falls;
- (b) that BG should discontinue the contractual terms specifying the purpose for which gas is used, and providing for access to premises to check this; and
- (c) that BG should not require users of interruptible gas to have facilities for using alternative fuels; (BG told us that this policy had already formally been discontinued, but that this had not been fully disseminated to BG's customers).

8.78. Criticism was also made to us about the stipulation of minimum and maximum usage in contracts, with provision for penalty payments or an excess charge if consumption was not within these limits. BG told us, however, that this provision was rarely if ever used, because it was ready to renegotiate the usage terms of a contract if a customer so requested. It was also suggested to us that BG imposed unreasonably high interest charges, of four per cent above base rates, in the event of late payment of bills. We accept BG's argument that such a charge is not unreasonable.

8.79. BG proposed to offer customers the choice of indexation of contract terms or quarterly negotiation. It is possible that, with the adoption of the price schedule and other remedies we have proposed, BG would not wish to offer indexation. Our proposals do not, however, preclude the possibility of BG's making available alternative prices based on different arrangements for subsequent price changes if customers so wish provided that the same arrangements are available to all customers. BG also proposed to quote customers of firm gas the alternative prices that would be charged with, and without, dual-fuel facilities installed. Under BG's present pricing policy, this would provide the customer with the information necessary to determine whether it would be economic to install dual-fuel facilities and as such would be welcome. However, under our own recommendations, price differences on the grounds of availability of dual-fuel facilities would be discontinued, hence BG's proposed remedy would no longer be required.

**The development of competition**

8.80. As discussed above, we regard the development of direct competition in gas supply as ultimately the only effective means of remedying the adverse consequences of the present monopoly situation. Competition has to date been slow to emerge. Our recommendations above are intended, amongst other things, to encourage the development of competition in gas supply, but there are two additional key elements to its further encouragement: arrangements for the common carriage by BG of competing supplies of gas; and arrangements for the purchase of gas from producers:

**Common carriage**

8.81. As summarised in paragraph 8.16, the Gas Act reiterated and developed earlier provisions of the Oil and Gas Enterprise Act 1982 and provided for the carriage by BG of gas on behalf of third parties; it also established a regime for regulating the terms on which such common carriage facilities would be provided. To date, although BG has one arrangement for common carriage negotiated prior to the 1986 Act, no new agreements under the current provisions have been made. A report by the Director General in December 1987, to which we referred above, listed a number of difficulties in the development of competition.

8.82. Under the terms of its Authorisation, BG is required to provide a statement of guidance about common carriage, including examples of the prices which it would expect to be paid in typical circumstances, and the principal matters to be subject to negotiation. A statement of this sort was published in November 1986 which gave two examples of charges, of 3.5 pence and four pence per therm, for transportation of firm gas, depending on distance and load factor.

8.83. Although the final terms upon which gas is to be carried will be subject to negotiation with BG and, if necessary, determination by the Director General, we do not think that the information made available by BG provides sufficient guidance to prospective users as to the terms to be sought by BG. It is not possible from the two examples to determine the underlying relationship between price and distance; nor is there any specification of the additional charge for using the local distribution system. BG is under no competitive pressure to provide such information, and may believe that it would be disadvantaged by so doing. We believe that BG's failure to provide adequate information is attributable to the monopoly situation, and that this failure will make it difficult for third-party suppliers to estimate transmission costs and negotiate contracts with customers.

We conclude that BG's failure to provide adequate information on the charges to be made for common carriage may be expected to operate against the public interest by deterring the development of competition with BG from other suppliers of gas.

8.84. We therefore recommend that BG should publish more information about the principles and assumptions used in calculating common carriage charges, with further examples of these charges, in sufficient detail to put a potential customer in a position to make a reasonable estimate of the charges that would be sought by BG for using different parts of the BG pipeline system if capacity for common carriage were available. We recommend that the Authorisation be modified to require the publication of such further information.

8.85. We have examined the method used by BG in calculating its two published examples of common carriage charges. BG has employed a different method of cost apportionment to that used for its own internal purposes. It has also employed different principles of calculating costs, for example the assumption of a 20-year asset life compared to up to 40 years in its accounts, the effect of which is to increase the calculated charge for providing the common carriage system. BG has told us that this is not anti-competitive, since, apart from calculation of 'bottom stop' prices, its own prices are not based on cost, and not therefore affected by the cost apportionment system adopted internally.

8.86. We are not persuaded by BG's arguments on these points, and are seriously concerned that BG's proposed methods of charging will place potential customers at a disadvantage to itself. A number of organisations did indeed complain to us about the high level of the illustrative charges published by BG, particularly since an additional element would have to be added for the cost of using the local distribution system. We note, however, that it is for the Director General to determine the charges for common carriage in the event of disagreement between BG and a third party. He has indicated that he will examine critically the basis of the charges sought by BG. We regard it as of the highest importance that third parties have access to the pipeline system on terms which enable effective competition to take place.

8.87. We are, however, concerned in case the view is taken that the construction of sections 19(5) and 19(6) of the Gas Act requires the Director General to determine common carriage charges on the basis of an average cost. This may be significantly above the incremental cost incurred by BG itself. We were, for example told that one organisation had been quoted charges for use of BG's distribution and transmission system of between 13 pence and 20 pence per therm; this would be considerably above BG's own estimates of an incremental cost of distribution and transmission of about three pence per therm, upon which its present 'bottom stop' calculations are based. We express no view on the correct construction of this provision, but if it should transpire that the Director General finds himself constrained by it from determining common carriage charges in a manner which enables effective competition to take place, he may wish to consider whether to recommend an appropriate amendment of this section of the Gas Act.

8.88. A further concern expressed to us was that BG would be able to use the information available in the course of common carriage negotiations to identify the potential customer, and the potential source of gas. BG argued that it would get to know this information anyway, since the customer in question would ask BG for an alternative quotation. We are not convinced that this would always be the case. We believe that BG's ability, as the only company in the United Kingdom with a pipeline system available for common carriage, to use information in this way may be expected to operate against the public interest by deterring new entry into the market. Such a consequence is less likely if it is required to set gas prices according to a schedule. Nonetheless, we recommend that BG should undertake to preserve the confidentiality of negotiations with third parties for use of its pipeline system and not to allow such information to become available to those within BG concerned with the purchasing or marketing of gas. We consider that a modification of the Authorisation would be appropriate on this point.

## Purchase of gas

8.89. BG is at present the sole purchaser of gas from the UKCS (although gas is retained by producers for their own use). Various complaints were made to us that BG used its position as the sole purchaser of gas to obtain excessively favourable terms from producers. The contrary criticism was also expressed that it paid too much for gas. We examined the pricing clauses of the proposed Sleipner contract outside the UKCS and a UKCS contract agreed at a similar time, but the difference in circumstances made comparisons difficult. We did not discover any evidence sufficient to prove either assertion.

8.90. Another substantial concern was that BG was in a position to use the information acquired during negotiation for the purchase of gas for its own upstream activities (ie in exploration and development); it was suggested to us that the safeguards incorporated in section 63 of the Gas Act and the directions set out in Schedule 4 of the Authorisation were weaker than the confidentiality provisions adopted by BG prior to privatisation. BG told us that before privatisation, confidential information was protected by various clauses in contracts with producers, and this continued to be the case after privatisation, with the addition of Schedule 4 and the procedures required in the schedule. We have not been told of any specific instance in which producers believed BG had abused information in the way that was feared.

8.91. Our main concern has been whether, with BG as the present sole purchaser of gas from the UKCS, competitors would encounter difficulties in acquiring sufficient gas supplies to compete with BG. BG at present generally contracts for all gas from a field, with the result that there are very limited supplies available for new competitors until the early 1990s. The Director General's report referred to two concerns, first, that BG might discriminate in subsequent contracts against any producers which engaged in direct sale; secondly, that BG might be unwilling to allow a producer to retain a part of the output of a larger field for direct sales, while selling the rest to BG.

8.92. It was suggested to us in evidence that gas producers were unwilling to take any steps that would jeopardise their relations with BG. Although we ourselves approached over 50 gas producers, only eight replied, of which five gave substantive evidence to the Commission and three of these asked not to be identified in our report.

8.93. BG told us that it had given an undertaking to the Government that it would not discriminate against offers of gas from part of a field of which another part had been sold direct to customers. BG also said that it would not discriminate against a producer who had previously sold the whole of a field to a purchaser other than BG. Nonetheless, we believe that BG's position as the dominant purchaser of gas makes it unattractive for producers to sell gas to new competitors and has led to real fears of a possible retaliation should they do so. We conclude that BG's position as the dominant purchaser of gas may be expected to operate against the public interest by deterring entry by new suppliers of gas.

8.94. As action for the purpose of remedying this adverse effect, we considered and suggested to BG that there should be a restriction on BG's purchasing 100 per cent of a field; that BG would be limited to the purchase of, for example, 85 per cent or 90 per cent of a field; but if no suppliers took up the balance within a year, BG would be required to buy the remainder at the same price as that paid for the bulk of the gas. BG claimed, amongst other things, that this proposal could give rise to very difficult problems in planning gas supply (see paragraph 7.89) because of the uncertainty about whether it would eventually have to buy this gas. BG told us, however, that it was prepared to offer all potential sellers two alternative contracts, one covering 100 per cent of recoverable reserves, and the other covering 90 per cent, with conditions of purchase broadly comparable. BG told us that it would be prepared to extend its existing undertaking to cover unfair discrimination on price, terms or otherwise as between sellers of 100 per cent and sellers of 90 per cent.

8.95. In our view, neither BG's existing undertaking nor its proposal to offer two alternative contracts would be sufficient to secure adequate availability of gas for independent suppliers. Producers might opt for sale of 100 per cent of a field to BG, either through fear of retaliation or simply as a matter of convenience. We are not convinced that our initial suggestion would give rise to the problems BG claimed, since the uncertainty would relate to a relatively small part of BG's total contracted supply, and for a relatively short period of time. However, we believe that a modification of our initial suggestion will avoid this difficulty.

8.96. We therefore recommend that BG should be required initially not to contract for more than 90 per cent of deliveries from any new field within the United Kingdom Continental Shelf, nor to contract for the balance of such a field within two years of the date of the initial contract. We believe that this proposal would make available a significant but not unmanageable tranche of gas for potential competitors. Producers would have every opportunity to sell the balance of a field to independent suppliers or direct to customers. They would also be able to offer the balance to BG, which has undertaken to treat such balances on a par with other fields offered for sale. We are not, however, proposing any obligation on BG to contract for the balance after the two-year period has elapsed, in order not to impose greater uncertainty on BG in planning supplies. More importantly, we believe that if BG had such an obligation, there would be less incentive on the producers to sell direct to customers or to find alternative buyers. We do not believe that under our recommendation the producers would have any difficulty in selling the balance of a field: at most, any risk associated with selling the balance of the field would be reflected in the initial purchase price of the 90 per cent of gas sold to BG. However, we do not believe this risk would be significant—BG told us that the various enquiries already made to it concerning independent supplies of gas amounted to some five billion therms per annum, about one-quarter of the total gas market. We do not therefore believe that our proposal will jeopardise the interests of the gas producers, or the future supply of gas.

#### **Alternative remedies**

8.97. A number of companies and individuals suggested to us that effective competition in gas supply could not develop as long as the structure of BG remained as it was at present. In particular, it was suggested to us that a prerequisite for the development of competition would be the establishment of a separate transmission company, providing carriage facilities to BG and independent suppliers on equal terms.

8.98. We do not recommend this course at present; we believe that the remedies we have suggested, together with the regulatory regime already in place by which for example the Director General can determine the terms for common carriage, have a reasonable chance of enabling the development of competition to take place. At the least it is too early to say that this approach must necessarily fail. If, however, competition in the supply of gas fails to develop over the next five years, further consideration will then be appropriate as to whether changes in the structure of the gas industry are indeed necessary to ensure competition in the supply of gas.

### **Summary of conclusions and recommendations**

8.99. We have concluded that a monopoly situation exists in favour of British Gas plc by virtue of section 6(1)(a) of the Fair Trading Act 1973, in relation to the supply in Great Britain of gas through pipes to persons other than tariff customers within the meaning of Part 1 of the Gas Act 1986. We have also concluded:

- (a) that BG's extensive discrimination in the prices of firm gas (paragraph 8.37), and its refusal to supply interruptible gas to most current users of firm gas (paragraph 8.40) are steps being taken for the purpose of exploiting that monopoly situation;

- (b) that the following actions or omissions on the part of BG are attributable to the existence of the monopoly situation: its extensive discrimination in its prices of firm gas (paragraph 8.37); its refusal to supply interruptible gas to premium users (paragraph 8.40); its imposition of particular contract terms (paragraph 8.76); and its failure to provide adequate information on the charges to be made for common carriage (paragraph 8.83).

8.100. We have also concluded that the following facts operate or may be expected to operate against the public interest, with the particular effects adverse to the public interest which we have identified above and summarise below.

- (a) BG's policy of extensive discrimination in the pricing of firm gas (paragraph 8.38), which has the following adverse effects:
- (i) it imposes higher charges on those customers less well placed to use alternative fuels, or obtain such fuels on favourable terms. This practice also places an arbitrary cost disadvantage on some customers thereby distorting competition in the markets in which they operate;
  - (ii) by relating prices to those of the alternatives available to each customer it places BG in a position selectively to undercut potential competing gas suppliers; this may be expected to act as a deterrent to new entrants and to inhibit the development of competition in this market; and
  - (iii) by the lack of transparency in prices it creates uncertainty in the minds of customers about their future gas prices and those of their competitors, thereby rendering more risky the business environment in which they operate;
- (b) BG's practice of refusing to supply interruptible gas to most current users of firm gas, which imposes additional costs on users by requiring them to take a more expensive type of supply than they would prefer (paragraph 8.40);
- (c) BG's present pricing policy for gas used in industrial site gas turbine CHP schemes, which has inhibited the implementation of such schemes (paragraph 8.41);
- (d) BG's insistence on certain contract terms (paragraph 8.76) namely:
- (i) its refusal to aggregate quantities of gas supplied to the multiple premises of individual customers, which results in higher prices for these customers than would be the case in a more competitive situation;
  - (ii) the specification in the contract of the purpose for which gas is to be used, and BG's requirement that it should have access to premises to validate this, which is a means of discriminating between users, with the same adverse effects as identified in (b) above; and
  - (iii) its requirement that users of interruptible supplies should have facilities for using alternative fuels, which imposes unnecessary costs on those users who would prefer temporarily to discontinue production.
- (e) BG's failure to provide adequate information on the costs of common carriage, which may be expected to deter the development of competition with BG from other suppliers of gas (paragraph 8.83);
- (f) BG's ability to use information obtained when negotiating common carriage terms to identify potential customers of competing suppliers and the potential source of gas, which may be expected to deter new entry into the market (paragraph 8.88); and
- (g) BG's position as a dominant purchaser of gas which may be expected to deter entry by new suppliers of gas (paragraph 8.93).

8.101. For the purpose of remedying the adverse effects identified, we have recommended that BG should be required:

- (a) to publish a schedule of prices for firm and interruptible gas at which it is prepared to enter into special agreements with contract customers (as described in more detail in paragraph 8.65). Such a schedule should be

introduced by the beginning of BG's next financial year and should in the first instance apply for a period of five years, and the Director General should review its appropriateness thereafter (paragraph 8.71). The schedule should be supplemented by a requirement on BG not to discriminate in pricing or supply (paragraph 8.68), and any variation from the schedule should be published and made available on the same terms to all other customers (paragraph 8.69);

- (b) not to refuse to supply interruptible gas to any user on the basis of the use made of the gas or the alternative fuel available (paragraph 8.66);
- (c) to supply gas for industrial site gas turbine CHP schemes on the same basis as any other interruptible supply of gas (paragraph 8.66);
- (d) to offer a single contract for the multiple premises of an individual customer; to discontinue the contractual terms specifying the purpose for which gas is used and providing for access to premises to check this; and not to require users of interruptible gas to have facilities for use of alternative fuels (paragraph 8.77);
- (e) to publish more information about the principles and assumptions used in calculating common carriage terms, with further examples of these charges, in sufficient detail to put a potential customer in a position to make a reasonable estimate of the charges that would be sought by BG (paragraph 8.84);
- (f) to undertake to preserve the confidentiality of negotiations with third parties for use of its pipeline system, and not to allow information acquired during negotiation on common carriage to become available to those concerned with the purchasing or marketing of gas (paragraph 8.88); and
- (g) not initially to contract for more than 90 per cent of deliveries from any new field within the United Kingdom Continental Shelf nor to contract for the balance of such a field within two years of the date of the initial contract (paragraph 8.96).

8.102. We recommend that to implement all of these remedies, the Secretary of State should make an Order under section 56 and Schedule 8 of the Fair Trading Act 1973, and that, with respect to all but the last of these remedies, the Order should provide also for a modification of BG's Authorisation under section 27 of the Gas Act 1986. In the case of the last remedy, it is our understanding that an Order could not provide for a change in Authorisation. We understand that by incorporating these changes in the Authorisation, the Director General will be able to monitor and enforce these remedies.

**H H HUNT** (*Chairman*)

**AUDREY M HEAD**

**J D KEIR**

**S C LITTLECHILD**

**L A MILLS**

**D P THOMSON**

**S N BURBRIDGE** (*Secretary*)

24 August 1988