WHITHER GAS REGULATION?

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PREFACE

The three papers included in this volume are based upon presentations made at a seminar on the theme "Whither Gas Regulation?", held at Hertford College, Oxford on February 7th, 1992. This meeting was one of our regular series of "Hertford Seminars on Regulation", aimed at bringing together interested parties to discuss and examine important issues relating to the conduct and effect of regulatory policies, broadly defined.

The presentations were intended to offer rather different perspectives on gas regulation, so as to help stimulate a wide-ranging discussion at the seminar itself. The latter aim was certainly achieved, and, despite the sensitivity of some of the underlying questions, it is a pleasure to record the openness with which participants debated the questions before them. I hope that the papers will now also prove to be of some interest to a wider audience.

It should be stressed that, as is generally the case in respect of contributions to the Hertford Seminars, the views expressed in these papers are those of the individual authors themselves, and that they therefore do not necessarily reflect the views of the organisations to which each is affiliated.

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FOUR VIEWS OF REGULATION

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1. Introduction

To ask the question "Whither gas regulation?" is to invite theorising of some sort on the process of regulation itself. Such theorising may, of course, be implicit and highly incomplete, but it is no less important for that.

Given that views about the future course of regulation are contingent upon background beliefs about the nature of regulation itself, there is much to be said for making these beliefs explicit. This, for example, facilitates more constructive debate by helping to identify with greater precision the points at which differences in outlook occur. The purpose of this paper, therefore, is to make explicit some of the possible views of regulation that may underpin particular positions on the future course of regulation of gas markets.

Four different approaches to regulation will be described and briefly evaluated. Evaluation necessarily involves looking backwards, to see how successful each of the approaches has been in explaining changes in regulatory behaviour. Generally speaking, we will have less confidence in projections of future regulatory behaviour if they are based upon theories that have worked poorly in the past, and will have more confidence in projections based upon theories that have worked relatively well.

I will argue that none of the four approaches to be described offers a fully satisfactory basis for a theory of regulation. Nevertheless, some are clearly more satisfactory than others, indicating that this initial exercise may have value in helping to assess the future course of gas regulation

2. Regulation as a stop-gap

The first of the four approaches to be considered is one that views regulation as a temporary intervention, designed to guide the market from one equilibrium or one set of institutional arrangements to another. Thus, having identified one or other sort of economic failure, government agencies take temporary action to support the transition to a position where, once again, market forces can be left in control.

Considered as a general theory of regulation, this approach lacks support in the research literature on regulatory processes. Nevertheless, it does appear to have been influential in government circles in Britain in the 1980s. Thus, in the early stages of the process of privatising the major utilities in the UK, regulation was viewed by some government ministers and their advisers as a "stop-gap": price controls and associated measures were seen as

temporary expedients to prevent the use of market power pending the development of competition.

This view was most clearly articulated by Stephen Littlechild, now Director General of Electricity Regulation, in the context of the privatisation of British Telecom. In his report Regulation of British Telecommunications' Profitability (1983), Littlechild concluded first that *"competition is by far the most effective protection against monopoly"* and then, more controversially, that *"profit regulation is merely a 'stop-gap' until sufficient competition develops."* In those heady days of the Thatcher privatisation programme, it was even suggested that the stop-gap might only be needed for the first five years of the post-privatisation period (i.e. until 1989).

The notion of price regulation as a stop-gap, and therefore as something that would wither away relatively quickly, was also closely related to the view that one of the chief aims of privatisation was the "depoliticisation" of enterprise decision making (see the comment of Sir Alan Walters in MacAvoy et al (1989)). Given that regulation is itself a political process, involving the use of the coercive, monopoly power of the state, the stop-gap view looked forward to a future of steady deregulation.

By the time of gas privatisation, this early perspective on price regulation was already changing somewhat. Early development of competition in, and subsequent deregulation of, the tariff market -- defined in 1986 as demands below twenty five thousand therms per annum -- was not contemplated. Instead of stressing the dynamic of deregulation, the rhetoric was instead that of "regulation with a light rein". That is, even if regulation was to be more durable, it would at least be unobtrusive.

In other respects, however, gas privatisation embodied a more radical deregulating approach than that implemented in telecommunications. This is particularly true of the contract market, where behaviour was to be governed by general competition law rather than by the activities of Ofgas. Thus, responsibility for policing of British Gas's conduct in the contract market (i.e. demands in excess of twenty five thousand therms per year) was assigned to the Office of Fair Trading.

By the time of the water and electricity privatisations, the stop-gap approach had been more fundamentally abandoned. Regulation in these industries was, by choice, to be both durable and extensive. Thus, in his report Economic Regulation of Privatised Water Authorities, Stephen Littlechild himself was referring to permanent regulation.

Nevertheless remnants of the early position are still with us. In introducing the consultative process on the current review of the BT pricing formula, the Director General of Telecommunications felt it necessary to argue that control of BT's prices was still justified,

thus implicitly acknowledging the earlier stop-gap view . Similarly, the 1988 White Paper on electricity privatisation stated that regulation could be expected to reduce over time as competition developed.

Needless to say, the withering away of regulatory pressures envisaged in the stop-gap approach has not come to pass. The question of most interest here -- because it is so directly relevant for assessments of the future conduct of regulatory policy -- is why that approach was wrong.

Very broadly, I believe that the withering away view was based upon (a) an over-optimistic view of the effectiveness of competitive pressures in the industries concerned once private ownership was established and (b) an over-optimistic view of the ability of politicians to set and control the political agenda.

To illustrate the first point, in the early stages of utility privatisation little was made of the distinction between the "transportation" and "supply" businesses of organisations such as British Gas. Whereas competition in supply could readily be contemplated, effective, across-the-board competition in wires and pipelines could not. As a consequence, early deregulation of crucially important "use-of-system" or "transportation" tariffs was never likely. Moreover, given the strong economic interactions between the transportation and supply businesses -- transportation is a major input into supply -- regulation of the former is highly likely to be conducted with one eye on the effects on the latter. Hence, in a certain sense, the supply businesses of the utilities are themselves unlikely to be fully deregulated.

In respect of control of the political agenda, it may be recalled that, although the 1980s were a period when the Central Government did indeed maintain a strong hold over the agenda, that hold was eventually broken.[1] Any attempt at speedy and full deregulation of the utilities would, for reasons that will become clear from the discussion in later sections of this paper, have given rise to counter-pressures which, on past experience, would almost certainly have prevailed.

3. Public interest theories

What is, perhaps, the dominant theory of regulation in the economics literature rests on the view that regulation is designed to promote the public interest by correcting, or attempting to correct, the inefficiencies associated with "market failure".

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[1] For example, by public reaction to the Community Charge.

Much of the mainstream economics commentary on UK privatisation and on subsequent regulatory developments has been in this tradition. In respect of the utility industries, the main difference from the "stop-gap" view of regulation lies in a somewhat more pessimistic view of the effectiveness of private ownership and competition in promoting economic efficiency. Thus, while the importance of competition is heavily stressed in this work, so also are (a) the magnitudes of the market failures that can arise in the network industries and (b) the potential obstacles to introducing competition. Conclusions therefore tend to be of the following form:

> *"... we do not share Professor Littlechild's view that sufficient competition will develop to dispense with the need to regulate BT's profitability. In our view, it is practically certain that regulation will have to continue after 1989 at the very least, even if further extensive liberalization occurs then."*
> (Vickers and Yarrow, 1985)

Insofar as the gas industry is concerned, when viewed as positive, rather than normative, economics[2], the public interest approach would predict that, following privatisation, regulation would develop in response to perceived market failures. Given that the activities of the Office of Fair Trading and of the Monopolies and Mergers Commission since 1986 can reasonably be explained in this light, it can be argued that the public interest approach has in fact predicted developments quite well. For example, the placing of constraints on British Gas's pricing behaviour in the industrial market, the forced release by British Gas of gas on long-term contract, the separation of the transportation and supply businesses, and the easing of restrictions on imports and exports of gas, can all be seen as attempts to correct market failures arising from the monopoly power of the incumbent utility.

Turning to the future, the public interest approach would tend to predict that, once the recent agreement between British Gas and the Office of Fair Trading is implemented, a period of greater regulatory stability should ensue, since, by that stage, most of the substantive factors giving rise to restrictions of competition in the contract market will have been targeted by one or more regulatory measures. A possible exception to this general position, however, concerns the determination of charges for use of British Gas's pipelines. This is a key issue that was ducked at the time of privatisation, and whose significance can only increase in importance as third party suppliers increase their market share.

Although the public interest approach appears to predict regulatory developments in the gas market over the past five years quite well, and although I have used it extensively in my own work, I must confess to having strong doubts about it as an "explanatory" theory of regulation

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2 That is, as statements about what <u>is</u> the case, rather than about what <u>ought to be</u> the case.

(however useful it may be as a basis for developing criteria by which to monitor utility performance). Among the reasons for this doubt are the following conclusions of Joskow and Rose (1989), authors of the most authoritative recent survey of empirical research on the effects of regulation:

> *"The effects of economic regulation often differ considerably from the predictions of "public interest" models, which assume that regulation is intended to ameliorate market imperfections and enhance efficiency.*
>
> ...
>
> *The structure of prices and distribution of revenues across classes of customer often reflect distributional and political objectives ... rather than efficiency objectives."*

This was put even more clearly by Joskow and Noll (1981):

> *"As a positive theory of regulation, the normative theory of welfare economics [i.e. the public interest theory of regulation] is obviously incorrect."*

Other reasons for scepticism about the general explanatory power of the public interest approach include the following.

i. In terms of public policy, perhaps the high point of the philosophy of regulation in the public interest was the 1967 White Paper on Nationalised Industries. Yet the approach set out in that document had little actual effect on the pricing behaviour of public corporations, even when that behaviour was directly contrary to the exhortations of the White Paper.

ii. The measurement of changes in economic efficiency can be an extremely difficult exercise, implying that there may be considerable uncertainty as to how such efficiency is best promoted.[3] Put another way, regulatory objectives may, in practice, not be very well defined.

iii. The theory ignores the agency problems between voters and politicians and between politicians and regulators. That is, it offers no convincing account as to why regulators

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[3] Consider, for example, the difficulties in determining what constitutes an economically efficient level of service quality.

should be expected to promote an ill-defined public interest, rather than their own interests. Put another way, this is the age-old question: Quis custodiet ipsos custodes?

iv. The predictions of the approach concerning the conduct of gas regulation have not yet had to face a significant "regime-shift" test involving a substantial change in the political environment. Such a test will almost certainly be faced after the forthcoming election[4], at which stage we will be in a rather better position to adjudicate on the relative merits of the public interest approach.

4. The influence of "opinion"

This third approach to regulation has been briefly and elegantly described by George Stigler in his Presidential Address to the David Hume Institute (1986). Stigler quotes Dicey's view that there exists a

> *"close dependence of legislation ... upon the varying currents of public opinion."*

Among those who, in addition to Dicey, are claimed by Stigler to have subscribed to this view are:

> David Hume (*"It is very usual, in nations ignorant of the nature of commerce, to prohibit the exportation of commodities, and to preserve among themselves whatever they think valuable and useful."*)[5]

> Adam Smith (*"The laws concerning corn may every where be compared to the laws concerning religion. The people feel themselves so much interested in what relates either to their subsistence in this life, or to their happiness in a life to come, that government must yield to their prejudices, and, in order to preserve the publick tranquillity, establish that system which they approve of. It is upon this account, perhaps, that we so seldom find a reasonable system established with regard to either of those two capital objects."*)[6]

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[4] Compared with the pre-1992 administrations, even a Conservative government with a renewed mandate is likely to have a somewhat different agenda and is likely to face rather different political pressures.

[5] Compare with recent UK government policy on the export and import of gas!

[6] We should note, however, that, as on a number of other important issues, Smith's position is by no means clear cut. Thus, elsewhere in the Wealth of Nations he appears to give greater weight to vested interests than to public opinion:

John Maynard Keynes (*"... the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else."*)

Milton Friedman (*"The example of India and Japan ... exemplifies the importance of the climate of opinion, which determines the unthinking preconceptions of most people and their leaders, their conditioned reflexes to one course of action or another. ... The Japanese [post 1867] adopted the policies of Adam Smith. The Indians [post independence] adopted the policies of Harold Laski."*)

To turn these points into a substantive theory of regulation, it of course necessary to be more specific as to precisely whose opinion is assumed to be driving the process -- egs. public opinion (Dicey, Smith), economists and political philosophers (Keynes), Congress and Meiji leaders (Friedman) -- and as to how those opinions are formed and changed.

In respect of gas, it would be hard indeed to explain recent regulatory changes in terms of public opinion. I doubt that the traveller in the Clapham Omnibus has much knowledge of, or interest in, questions such as price discrimination in industrial markets or the separation of transportation and supply businesses. Issues such as profitability and increases in executive salaries may be a different matter, although it can be noted that British Gas has been much less of a target in these areas than BT and the water and electricity companies.

The climate of opinion among public officials concerned with the implementation of competition policy, however, is a potential explanatory factor. Thus, whereas in the public interest theories there is no independent role for such opinion, once the incentive structures of regulators themselves are brought into the equation, such a role becomes feasible. Although there is precious little work on this issue at the moment, the analysis of regulatory discretion would appear to be a necessary first stage in the development of interesting theory. For example, given such discretion, it might be hypothesised that a climate of opinion has emerged which stresses the goals of increasing the number of players in the relevant market and of reducing British Gas's market share below a target level, in both cases without direct reference to the possible consequences.

"To expect, indeed, that freedom of trade should ever be entirely restored in Great Britain, is as absurd as to expect that an Oceana or Utopia should ever be established in it. Not only the prejudices of the publick, but what is much more unconquerable, the private interests of many individuals, irresistibly oppose it."

This hypothesis immediately leads us to a central issue. It can obviously be argued that measures to increase the number of players or to reduce British Gas's market share are simply means of achieving the broader goals of promoting competition and improving economic efficiency. Given this point, how then can the two competing hypotheses -- that regulatory decisions are driven by the public interest and that they are independently driven by the opinions of regulators -- be distinguished?

The answer must lie in careful and detailed appraisal of the conduct of regulatory policy and of the effects of regulatory decisions. If, for example, particular types of regulatory decision are found to have anti-competitive effects, or are found to reduce economic efficiency in systematic ways (so that they cannot satisfactorily be classified as mistakes), this would be powerful evidence against the public interest theory. Whether or not the "opinion" theory would be the preferred alternative would in turn rest upon further analysis of factors such as how decisions were actually made and who benefited from them.

Stigler himself rejects the "opinion" theory of regulation in favour of the approach to be described in the next section. In support, he draws attention to the fact that, contrary to the view of Keynes, the two-century-long efforts of economists to achieve freer international trade have seldom prospered. However, while rejecting the theory as an explanation of long-term trends in regulation, Stigler does accept that the "changeable winds of opinion" can have shorter-term changes on regulatory policies. The question then is: how long does the short-term last? It would appear that the relevant period certainly extends over a period of several years, and is possibly even measured in terms of decades. For many of us, that short-term may seem a long time indeed, implying that it would be unwise to ignore the impact of opinion, whether public or specialist, on regulatory processes.

5. "Economic" theories of regulation

The Chicago tradition of regulatory economics, with George Stigler as its leading exponent, views regulatory rules and/or decisions as "outputs" provided by the state to satisfy "demands" for regulation from interested parties. The demand side of this "market" for regulation is generally analysed in terms of the interest groups that would benefit or lose from particular types of intervention and in terms of the process of coalition formation to promote or oppose a specific policy. Clearly, distributional effects play a large role here, and so the distribution of income and resources is stressed much more (relative to economic efficiency) than in public interest theories. The supply side, which is less well covered in the economics literature, is analysed in terms of factors such as public sector "rule-making" technology, administrative law procedures, political competition, and so on.

Variants of the "economic" approach include Stigler's "regulatory capture" theory and Posner's view of "regulation as taxation". A good example of this type of work is a short paper by Peltzman (1989), in which attention is drawn to the fact that, historically, a particular set of industries in the energy, communications and transport sectors has tended to attract a similar type of regulation in most countries. This regulation takes the form of either (a) state ownership or (b) regulated private monopoly (involving explicit regulatory suppression of competition).

Peltzman argues that the similarity of the regulatory policies among nations is due not to natural monopoly, but rather to economies and diseconomies of density which imply that, in the absence of regulation, the price structure would show very marked differentials from one geographical location to another. The argument then is that regulation meets a "demand" for geographic cross-subsidisation to flatten the price structure, at least so far as domestic consumers are concerned (the demand being expressed through the political power of representatives of rural interests, for example).

It can be noted in passing that the implications of this argument are directly contrary to those of public interest theories of regulation based on the notion that regulation promotes efficiency by correcting market failures. On the public interest view, geographic cross-subsidisation is economically inefficient since it distorts locational decisions, and hence its elimination, rather than its promotion, should be the policy goal.

Peltzman's argument can be used to offer a neat account of one of the failure's of the 1967 White Paper on the Nationalised Industries. Among other things, that document argued for marginal cost pricing and against cross-subsidisation. Yet if cross-subsidisation objectives lie at the very heart of regulatory policy for the network industries, an exhortation not to cross-subsidise is unlikely to have much effect. And the evidence is that the exhortation against cross-subsidisation did indeed have very little impact on behaviour.

The analysis also offers an account of the Government's propensity, in the 1980s, to set up industry-specific regulatory bodies such as Oftel, Ofgas, Ofwat and Offer. For, if monopoly alone was the basic problem, why were competition matters not simply left to general competition law? BT and British Gas are certainly dominant firms, but market dominance is one of the problems that general competition law is intended to deal with. On the other hand, industry-specific regulatory agencies have been the traditional way of handling franchised monopolies, not least because such monopolies require protection <u>from</u> competition if the desired pattern of cross-subsidisation is to be achieved.

Finally, the geographic cross-subsidisation theory has interesting implications for the future direction of regulation in the UK (explored in more detail in Yarrow, 1990). As indicated in the

last paragraph, introducing competition wherever it is feasible would certainly run counter to cross-subsidisation objectives. Thus, the cream-skimming effects of competition would tend to erode margins in highly profitable activities, thus eliminating monopoly rents that are used to hold down prices in high-cost activities. Similarly, a regulated price structure which closely reflected marginal supply costs would also tend to lead to considerable geographic heterogeneity in prices.

Thus far in the UK, and despite some of the rhetoric accompanying privatisation and regulatory reform, either competition has been limited in nature or, where more competition has in fact been introduced (as in electricity generation and supply), regulatory rules have, as yet, tended to suppress spatial price differences. Examples of the latter include the averaging of energy losses in the electricity pool, and the lack of spatial signals in electricity distribution charges. In gas, transportation charges are distance related and, if this feature is retained, it can be expected that the measures agreed between British Gas and the Office of Fair Trading -- principally separation of the transportation and supply businesses, and release of gas to competitors -- will tend to lead to the emergence of significant geographic differentiation in charges. The Director General of Gas Supply has, however, spoken against such differentiation, and there are therefore indications that the policy trade-offs between competition, efficient pricing, and geographical cross-subsidisation have yet to be properly acknowledged, let alone resolved. The resulting scope for poor regulatory practice is clear and obvious.

6. Conclusions

The discussion has now come full circle in that it is possible to use the geographic cross-subsidisation analysis to throw light on the earlier discussion. In particular, it can be argued that the "stop-gap" approach to regulation, represented in the rhetoric accompanying the earlier part of the UK privatisation programme, was predicated on an implicit assumption to the effect that there had been a major shift of public policy objectives away from the traditional cross-subsidisation goal. For, on that assumption, the major policy issues would have concerned natural monopoly and market dominance, and there would have been at least a prospect that the associated problems could be handled effectively through the institutions of general competition law.[7]

While the objectives of some policy makers may indeed have changed, I can see no evidence that there has yet been a major shift on this matter in the ranks of the Conservative Party in the

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[7] Whether or not the forces of opinion and other (non-geographic) vested interests would, in practice, have permitted this development is another matter.

shires, let alone among Labour and Liberal Democrat politicians. The establishment of industry-specific regulatory bodies also speaks against such a shift, as do a number of recent regulatory decisions and pronouncements which collectively indicate a certain reluctance to move in the direction of sharp spatial differentiation in prices. On the other hand, institutions such as the Office of Fair Trading, which are entrusted with tasks concerning the operation of general competition law, are highly likely to have a negative view of cross-subsidisation and the restrictions of competition that are necessary to sustain it. To some extent, therefore, the tensions between conflicting public policy objectives have an institutional reflection.

It will be clear from the above that my own view is that the "economic" theories outlined in section 5 offer the best first base for understanding the evolution of regulation. In consequence, I would expect to see increasing political resistance to the implementation of regulatory decisions that seek to promote competition and economic efficiency. The tension is unlikely to fit precisely with simplistic views of the political process (Conservatives and Liberals favouring competition, Labour less keen). Labour heartlands in Scotland and the North of England would, in a number of cases, be overall beneficiaries of the ending of geographic cross-subsidisation, while Conservative rural England would lose in many cases.

Similarly the "market for regulation" approach offers insights into the implications of the establishment of Oftel, Ofgas, Ofwat and Offer. These new bodies represent a change in the supply side of the regulatory market (in the jargon, the "rule-making technology" has been changed). As a consequence the costs and benefits of different types of regulatory intervention have altered. Thus, the relative costs of regulation through public ownership have now increased[8], but the relative costs of accomplishing the same objectives via the alternative method of sector-specific regulation of private enterprise has been reduced. The predicted response is simply that traditional objectives, including the suppression of sharp place-to-place variations in (at least the domestic) prices of gas, electricity, water, telephone services and postal services, will be sought by new methods.

Unlike Stigler, however, I would not discount the importance of opinion as a factor affecting the evolution of regulation. Nor, for analytical purposes, is there any need to. At the moment, for example, the UK regulatory bodies appear to be operating with a high degree of autonomy from their political masters, and are subject to only limited legal constraints on their actions (for example, via judicial review). They are, therefore, endowed with considerable discretion (itself a form of monopoly power), and discretion means that there is scope for the "opinions" of regulators to have an independent effect on decisions.

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[8] Developments in European Community Law have also tended to reduce the political benefits and raise the political costs of regulation through public ownership.

Whether or not regulators choose to exercise their discretionary powers in ways that come into serious conflict with future governments remains to be seen. What is clear is that the potential for conflict is there, particularly since the public policy objectives that regulators are supposed to be pursuing are far from clearly defined -- as already stressed, it is unclear, for example, how the trade-offs between competition, efficiency, and spatially differentiated prices should be resolved -- and political objectives themselves are likely to change over time. The new regulatory regimes, including that in the gas industry, therefore leave unresolved a number of major problems of accountability and control in the network industries, problems that have been debated, on an off, since the 1940s. Further changes in the (regulatory) "rule-making technology" should therefore be expected in the not too distant future.

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FUTURE GAS REGULATION IN BRITAIN: ALTERNATIVE SCENARIOS

Nigel Shaw

1. Introduction

I joined British Gas Regulatory Operations Department, in January 1991, at the start of what was to prove a monumental year in the regulatory history of the Company. There were, in fact, no less than three very significant regulatory episodes during the course of that year, namely:

i. the Tariff Formula Review, involving the assessment and adjustment of the original RPI-X+Y pricing condition which had been operative since privatisation in 1986,

ii. the LTI (Long Term Interruptible) price schedule debacle, concerning the pricing of gas destined for new gas-fired electricity generation facilities, and

iii. the Office of Fair Trading Competition Review.

I have been closely involved in each of these three episodes and the experience has, I believe, been revealing as to the nature of certain aspects of regulatory processes, at least in relation to the gas industry.

When George Yarrow asked me to speak at this seminar and told me the title, I remarked to him that the choice of the word "whither" was a nice pun. The answer to the question as it stands -- Whither gas regulation? -- is "Your guess is as good as mine." Dropping the "h", however, and turning a blind eye to the grammar, the question might be read as asking whether gas regulation is likely to wither away. I think the chances of such a development are virtually zero in the medium term.

Given that this seminar is concerned chiefly with a forward look at regulatory prospects based upon a general debate about fundamental principles, I will not comment on immediate, short-term issues. Rather, what I propose to do is to look at how regulation may develop, taking two scenarios as benchmarks, one of which I will label "optimistic" and the other "pessimistic". I shall cover the ground under three broad headings:

a) the rules of the game,

b) political interference, and

c) the regulatory process.

2. The rules of the game

Recent history has taught us that the rules of the game can change frequently and substantially. My pessimistic scenario would be characterised by a continuation of this history, implying further frequent and substantial variations in the regulatory rules. For example, changes in the rules could potentially widen the scope of regulation to include a whole raft of additional areas, including upstream activities, gas purchasing, retailing of appliances, capital expenditure on investment, the fine detail of the structure of prices, diversification, and dividend policy.

Another negative possibility would be an acceleration of the already visible drift toward rate of return regulation. Such a development would inevitably make regulation more intrusive, involving, for example, more detailed investigations of costs and efficiency, including efficiency in investment planning. The danger, of course, is that the five-year incentives which were originally envisaged under the price-cap approach will be lost as a result.

Frequent changes in the rules also create regulatory shocks in the capital markets. Shareholders must inevitably ask questions as to what kind of business they own and as to the degree of security of their property rights. The potential conflict between the safe utility, with a correspondingly low cost of capital, and an organisation whose business environment appears to be highly uncertain will need to be resolved at some stage.

Turning to my optimistic scenario, this would be characterised by medium-term -- up to five years, say -- stability in the recently established rules of the game. Unless this happens, for British Gas regulation will continue to be an activity that absorbs huge amounts of top management time. I do not believe that such an outcome would be consistent with the aims of privatisation, which, among other things, included incentives to focus managerial effort on the task of improving the Company's performance in meeting the requirements of its customers. In my view, those aims are best met by allowing management to concentrate on the Company's main businesses, whilst operating within constraints defined by a relatively fixed regulatory framework.

Unfortunately, my personal view, based on the experience to date, is that we are more likely to find ourselves closer to the pessimistic scenario in the course of the next few years.

3. Political interference

The extent to which the privatised utilities remain subject to political interference must be counted as one of the major failings of privatisation. One of the great claims of privatisation was that utilities would be free to manage their businesses and that the regulators would effectively be independent of government. The reality has been very different. In retrospect, perhaps it was rather naive to expect that the privatisation of such basic goods and services,

supplied to such a large number of customers (who are also voters), could have removed these activities from the political agenda completely. Nevertheless, the level of interference could feasibly have been less than it has been.

The promotion of competition is a key feature of the present Government's political ideology, and this objective has been pursued aggressively by regulators without any deep analysis of the long-term consequences of the resulting actions. British Gas is not opposed to the development of competition, although the Company does not accept that competition is an end in itself. Rather, competition is a means to achieving a desirable outcome, namely an efficient industry that serves its customers well at favourable prices, not only today but also into a relatively distant and uncertain future. The tilting of the playing field to encourage entry into gas supply will not necessarily deliver that outcome. Rather than ideology, the strategic importance of the gas industry and the industry's structure of production should be relevant factors in determining policy.

The development of competition in the generation of electricity has been another major political objective of the present Government. This has had a major impact on British Gas in respect of the supply of gas to power stations, particularly to the independent sector. It is my view that the LTI (Long Term Interruptible) pricing issue escalated in the way that it did because of political pressures, rather than as a result of genuine problems of economic efficiency.

Looking into the future, my pessimistic scenario would feature increasing levels of political interference in the businesses of the Company, with the regulators acting to a large extent as agents of the government of the day. At some time or other, a future government would realise that an energy policy based exclusively on market forces could well fail, and that a somewhat different type of intervention was be required to secure the (then) desired allocation of resources. Moreover, as environmental pressures mount, it would be likely that competition would be replaced by least-cost planning (or by similarly motivated schemes) as the major public policy objective. This would almost certainly lead to a more intrusive form of regulation.

My optimistic scenario would be for a lessening of political interference, and for the benefits of privatisation claimed at the time of flotation to be more nearly realised. I regard this as very unlikely.

4. The regulatory process

An alternative heading for this section would be "Who regulates the regulators?", a question that is now being asked much more frequently and much more widely than it used to be. Given that the regulators deal with issues of great economic importance and make decisions with far reaching consequences, it is perhaps surprising to find that:

i. the regulators are effectively monopolists, and

ii. despite this, and unlike monopolistic businesses, the regulators are themselves subject to very little public scrutiny.

In my personal view, the processes by which both the Tariff Formula Review and the Office of Fair Trading Competition Review were carried out were wholly inadequate. Both British Gas and the wider public were provided with a bare minimum of information about the thinking and analysis that was taking place within the relevant institutions.

Looking at UK regulation more generally, it is clear that different regulators have adopted different styles and approaches. Some have adopted open and consultative approaches, others have been more closed and secretive. While the more open and consultative approaches are to be welcomed, the very fact that such major differences can emerge is itself an indication of a wider lack of control of the regulatory system (that is, of the "regulatory discretion" described by George Yarrow in his contribution to the seminar).

The lack of satisfactory procedural safeguards within the current system may ultimately mean that the system will fail (unless, of course, such safeguards are established in the future). I recognise that at least some of the regulators take the view that the process of judicial review and the backstop role played by the Monopolies and Mergers Commission do, in fact, provide the necessary safeguards. However, when we look at the reality, I do not believe that this view can be sustained.

Judicial review is concerned with assessment of the actions of regulators in relation to their legal duties and powers, it is not a process established to resolve economic issues. Regulators can, and do, make mistakes of interpretation and analysis, for example, but where is the evidence to suggest that judicial review serves as an effective mechanism for protecting interested parties against the consequences? Nor, as it is currently constituted, is the Monopolies and Mergers Commission a satisfactory body for controlling regulators. Indeed I would suggest that, to date, the MMC has served more as an instrument with which regulators can threaten regulatees than as an instrument for "regulating the regulators".

I would not wish to advocate the complex administrative systems and the associated litigation to be found in the United States as "solutions" to the problem of regulatory accountability and control. I do think, however, that some arrangement whereby both the nature of the evidence heard from interested parties (including regulated firms such as British Gas) and the full analysis/reasoning of the regulator are made publicly available on a regular basis would be a desirable first step toward a more effective regulatory system.

In this area, I think my pessimistic scenario would simply comprise a continuation of the status quo, as I really do not think that things could be any worse than at present. My optimistic scenario would involve far greater openness, with regulators recognising the need for wider accountability for their activities.

Unlike under the two previous headings, in respect of "regulating the regulators" I would hope, and perhaps even expect, that the outcome will be closer to the optimistic scenario.

5. Concluding remarks

The consequences of creeping, changing, and more comprehensive regulation will inevitably bear first, and most heavily, on the shareholders of the Company (although the longer-term consequences for customers should not be neglected). One limiting case would be a situation in which utilities such as British Gas are wholly rate of return regulated and in which the only uncertainties would arise from factors such as the weather. Of course, low risks will mean low returns, and in this situation utility shares will be closer to bonds than to (conventional) equity. Where higher risks are borne by the utility, there have to be higher prospective returns, with some symmetry between the prospects of gains and losses. In the current regulatory environment, there is a definite risk that gains can never be realised to any significant extent, and this is a far from satisfactory state of affairs.

THE CURRENT REGULATORY SYSTEM FOR GAS: AN ASSESSMENT

Peter Adams

In making this presentation I will first offer a personal view of the evidence that has come to my attention over the last year, and then I will try to draw some conclusions on the direction that gas regulation should take arising out of that.

1. History

I start with a short review of the history so far as it is relevant to the growth of competition in the gas industry. It is well known that, following a lengthy period of statutory monopoly, the first tentative steps towards opening the gas industry in Great Britain to competition arose out of the Oil and Gas (Enterprise) Act 1982, and in particular the provisions in that Act which allow for third party access to the on-shore gas transportation system. It is equally well known that from 1982 to 1990 nothing that anyone would notice happened within the industry that might be taken as evidence that the competitive structure of the industry was changing.[9]

In 1987 the Director General of Fair Trading made a reference to the Monopoly and Mergers Commission, which reported in 1988. Given the structure of the industry, the conclusion that a monopoly situation existed within the definition of the Fair Trading Act was inevitable, but I would argue that the conclusions on the public interest in the Report contain several pointers that ought to have alerted British Gas to the dangerous path it was following in relation to its general responsibilities to avoid practices which might fall within S2 Competition Act 1980.

For example, on price discrimination:

> *"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 .... In our view, therefore, the extensive discrimination in prices of firm gas is attributable to the existence of a 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." (Paragraph 8.37)*

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9 See, for example, the MMC Report, paragraph 8.10 for the situation in 1987.

And on refusal to supply:

> *"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." (Paragraph 8.40)*

Or on contract terms:

> *"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." (Paragraph 8.76)*

And finally on common carriage:

> *"Although the final terms upon which the 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 provided sufficient guidance to prospective users as to the terms to be sought by BG .... BG is under no competitive pressure to provide such information and may believe that it would be disadvantaged by so doing." (Paragraph 8.83)*

Undertakings were negotiated with the Company, and I am not aware of any evidence that the letter of these undertakings has been breached. In entering into the undertakings, however,

BG appears (to an outsider) to have decided that it was doing sufficient to meet its competition law obligations, and indeed the Chairman of the Company said as much in an article published in the Financial Times in August 1991.

For a company having such a dominant position in the market, this is a dangerous assumption, and coming so soon after the publication of the Financial Times article, the 1991 Report from the Office of Fair Trading Review must have been something of a shock for the British Gas.

2. Common carriage

Let me turn from matters of public record to individual relations with BG. My experience of negotiations with British Gas in the last year has been almost exclusively confined to matters of common carriage. With the experience of those discussions, the conclusions of the OFT Report in relation to common carriage came as no surprise, and indeed reflect many points which I had previously made to BG in correspondence in the course of negotiation. In general terms my company's principal criticisms were:-

1. The difficulty and man hours to conclude negotiations.

2. The difficulty of getting any departure from what BG wanted.

3. The absence of contracts for anything other than standard point to point transportation of gas.

4. The absence of clear evidence of a level playing field between third party shippers and British Gas as a shipper.

The complexity, and the related difficulty of negotiation of these contracts, combined with the disparity between restrictions imposed contractually on shippers and those which the operation of the system imposed on BG itself undoubtedly produced a distortion in the marketplace. The agreements contain an assurance that BG will treat all shippers in an even handed manner, but that assurance is somewhat modified by the response to the request for confirmation that BG is caught up within this same provision: the main user of the system is not a shipper for the purposes of these agreements!

I have described the agreements as complex and I have said that they take considerable time to negotiate: in the particular case I have in mind, between mid May and November. The text exceeds 90 pages. I must add that it is well crafted and carefully thought through, which I think is in keeping with BG's general reputation for engineering quality. However, it must also be added that the very complexity of the issues that the agreement seeks to address contains the seeds of its own destruction: with a rapidly expanding market and increasing

experience on the part of companies like mine, a tension has not surprisingly come to exist between some of the more complex provisions and the requirements of the operation.

In conducting the negotiations (the latest stages of which were carried out under the umbrella of a Notice under Section 19 of the Gas Act) we raised a significant number of matters which had in our view arisen from previous negotiations and which had implications for the transporter's position under Section 2 of the Competition Act --that is, I asserted that they were contractual preventions, restrictions or distortions of competition. The course of the correspondence did produce some illuminating insights into the attitude of the Company's management towards its responsibilities to UK and EC Law, and it is an interesting reflection on its own that the conclusion of the negotiations in a form acceptable to my company required the preparation of a request for the assistance of the Director General of Gas Supply.

In the late summer of last year my company concluded an agreement for the handling of commissioning gas. The negotiations were concluded speedily, and ultimately on terms with which we did not find ourselves wholly comfortable. As I understand United Brands v The Commission of the EEC (1978 CMLR 429) one conclusion that can be fairly safely drawn is that a trader having a dominant position in the marketplace needs to be aware of the relationship between the cost of a product and the price he seeks to charge.[10] I am not convinced that I was ever able to persuade British Gas of this, though the Company may take the view that they were unable to persuade me of the very reasonableness of their position. I do know that the response of BG on this gained little sympathy from either the OFT or Ofgas.

In closing these comments on the evidence, let me draw attention to the deficiency in the range of agreements made available by British Gas: I am aware that discussions on "the umbrella" have been pursued by various companies, including my own, for more than 18 months. It is well documented that this agreement, which will remedy some of the operational inefficiencies that derive from the point to point nature of the transportation agreements, has never been made available to shippers --that is, using the BG definition of the shipper to exclude its own trading arm.[11]

3. Conclusions

Before turning to the conclusions, I would like to say that I do not question the motivation of British Gas in the dealings that I have had with them. I believe that their actions have been undertaken in good faith and that they reflect a lack of understanding of the company's

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[10] Paragraphs 250 et seq.

[11] In its recent Undertaking, BG states very clearly that it will in future act in a non-discriminatory manner.

responsibilities under competition law, rather than an orchestrated policy to distort the market. This is a key management issue for the company over the next few years.

What conclusions, therefore, do I draw from the above evidence on the direction that gas regulation should take? It is three fold.

1. First, the evidence points to matters which are subject to the existing law, both national and EC. The matters of which I have complained are not matters which are special to gas, but are restrictions or distortions in the market-place by which any citizen who could obtain market dominance might be tested. There is therefore nothing that arises from these experiences that argues for unique legislation or quasi-legislation for this industry, except so far as undertakings or regulation is required to rectify specific infringements of the public interest flowing from the continued dominance of one company.

2. Secondly, it will come as no surprise to anyone involved in Competition Law that the process under Section 2 of the Competition Act is very much more useful for addressing these problems, despite its shortcomings, than the Restrictive Trade Practices Act. I shall not dwell on that point.

3. Thirdly, since I believe that the underlying malaise is a lack of understanding of the Company's responsibility in relation to Competition Law, having regard to its dominant position, then the question that follows from that is how to address that problem. The annual reports of the Office of Fair Trading provide the evidence that British Gas is not alone in failing in this area. While I am not privy to the internal workings of the Company the continuity of evidence does, however, suggest to me that this is a question that does not receive enough attention at a senior management level, and that the proper direction is either not given to the staff of the Company, or, if given, is not given sufficient significance. I think that the Competition Act needs "teeth". If fines of the type that attach to infringements of Article 85 or 86, or indeed the threat of custodial sentence for directors or managers guilty of repeated or reckless failure, were added to the existing remedies these might be expected to focus the "mind" of the company to its competition responsibilities.[12]

My main purpose in speaking here today was to lay before the seminar the evidence of my personal experiences and draw the conclusions that I considered appropriate from that. The

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[12] The Director General of Fair Trading has also argued for additional powers of this nature, most recently at a presentation to the Centre for Business Strategy in March 1992.

invitation nevertheless asks us to consider certain questions, and I will now attempt these briefly.

Is regulation with a light rein a feasible long-term option in the UK?

For the specialist regulators I believe the answer is "Yes", though I am not qualified to comment on the activities of the regulators of other industries. The existence of a natural monopoly in the pipeline system will always demand some form of regulation, and the extent to which that can be carried out with a light rein will depend upon the activities and attitudes of the transporter. However, I would argue that a light rein is desirable. The specialist regulator is constrained by judicial review to act properly, and thus (theoretically) actions against the wishes of a specialist regulator by a dominant company would be likely to be abusive. I have argued for the greater penalties to be applied to the principal legislation in this area, and thus I draw a distinction between the light rein of the specialist regulator and the mailed fist (hopefully employed within the chamois glove) of those responsible for operating the principal legislation.

What are the main pressures giving rise to changing regulatory practice?

When the record of the gas industry in extending competition since 1982 is reviewed, there can be little doubt that the main pressure is frustration. The industry has always required a specialist regulator to provide surrogate competition since the privatisation of British Gas, but I believe that the frustrations would have become apparent with or without the Office of Gas Supply.

What is the outlook for de-regulation in gas supply (as opposed to gas transport)?

De-regulation can only occur and will only occur as its role is replaced by the inability of any one company or a small group of companies to have a disproportionate influence on the marketplace. Since these are qualitative decisions, the arguments that will surround the removal of the schedules and other restrictions on British Gas's ability to compete with a free hand in the marketplace will be great and lengthy. I would, however, urge those who argue for the early removal of these restrictions and those in whose power it lies to determine when and how they will be removed, to review carefully the record of the company and the reasons why they were imposed. The removal of the restrictions should not be linked mechanistically to a particular portion of the market. Rather, it should depend on:

i) Real and sustained evidence that the company's attitude towards its competition responsibilities has changed from top to bottom, and

ii) A share of the market at which it is unable to impose decisions independent of the market.

What is the likely impact of the changing political climate?

I have not seen any evidence that leads me to conclude that there will be a change in the fundamental competition practice in the near future.

Given developments in European Law and in environmental regulation, are regulatory institutions such as Ofgas likely to endure long in their present forms?

I believe that the role of Ofgas is assured for the foreseeable future, by the need to regulate the natural monopoly in the transmission and distribution systems and the statutory monopoly in the tariff market. The question is more interesting in relation to the rest of the market and I can only say that I have no crystal ball telling me how that will develop. I believe, however, that it is common ground amongst all participants (including the Director General of Gas Supply) that the growth of self-sustaining competition and a healthy market is the common objective.