



**THE ADVANTAGES OF FULL OWNERSHIP UNBUNDLING IN GAS  
TRANSPORTATION AND SUPPLY: HOW THE EUROPEAN COMMISSION  
GOT IT WRONG ABOUT THE UK**

**A REPLY TO OFGEM'S CRITICISM OF SERIS' BRIEFING DOCUMENT**

**Sheffield Energy & Resources Information Services (SERIS)  
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**[www.seris.co.uk](http://www.seris.co.uk)**

## **Introduction**

In its Briefing Paper of April 2006 (still available from [www.seris.co.uk](http://www.seris.co.uk)) SERIS addressed the following statement by the European Commission – an assertion which was made without any supporting evidence.

***‘The UK market experience of full ownership unbundling suggests that it significantly changes the behaviour of the transport undertaking: a fully unbundled Transportation System Operator(TSO) will focus on optimizing the use of its network.’***

However SERIS found that:

- 1) Full ownership unbundling of British Gas which involved (a) the demerger of the previously internally unbundled supply function into Centrica plc in 1997, and (b) the demerger of transportation into the Lattice Group in 2000, was not driven by the objective of ‘optimizing the use of the network’ but by purely commercial considerations.
- 2) With respect to the possibility that full ownership unbundling in the UK (driven by purely commercial considerations) *coincidentally* resulted in ‘optimization of the network’, we identify five possible indicators of ‘network optimization’. With respect to three of these indicators (degree of capacity utilization, access arrangements and gas balancing) we find no observable relationship between ownership unbundling and ‘optimization’. The improvements which did occur in these indicators were entirely due to other factors – the mandatory release of gas previously controlled by British Gas, the introduction of the Network Code, and regulatory intervention, none of which had anything to do with ownership unbundling.
- 3) In the case of the remaining two indicators (suppliers’ transportation costs and adequate levels of capital investment), there is some evidence to suggest that these actually deteriorated following the ownership changes.
- 4) The empirical evidence of full ownership unbundling in the UK does not support any assertion that gas network ownership unbundling ‘significantly changes the behaviour of the transport undertaking’ or that ‘a fully unbundled Transportation System Operator will focus on optimizing the use of its network.’

In response to the Briefing Paper, OFGEM have published a paper arguing that the arguments in our paper are ‘fundamentally wrong’. In reply to OFGEM our approach will be to take each of the SERIS original conclusions in turn, counterpose them with OFGEM’s counter-argument, and then demonstrate how OFGEM has either (a) drawn erroneous conclusions from the available empirical evidence, (b) misrepresented our own statements, (c) introduced irrelevant matters into the discussion, or (d) replied with assertions similar in kind to those of the original European Commission statement which we have extensively criticised.

## Original SERIS Conclusion

- 1) **Full ownership unbundling of British Gas which involved (a) the demerger of the previously internally unbundled supply function into Centrica plc in 1997, and (b) the demerger of transportation into the Lattice Group in 2000, was not driven by the objective of ‘optimizing the use of the network’ but by purely commercial considerations.**

### (i) OFGEM response and SERIS reply.

OFGEM states that in 1992, the Regulator ‘Concluded that BG’s conduct in undertaking its business as an integrated business and its failure to provide for neutrality as between its trading and transportation interests, may be expected to reduce the effectiveness of competition and to operate against the public interest by inhibiting choice.’ (OFGEM p.2)

### ***SERIS Reply.***

We entirely agree with the Regulator’s statement. ***Prior to internal unbundling*** BG was indeed abusing its power in this way. We have never suggested otherwise.

### (ii) OFGEM response and SERIS reply.

OFGEM points out that in 1992 the Regulator proposed the ‘divestment of BG’s trading activities (i.e. ownership unbundling)’. (OFGEM p.3)

### ***SERIS Reply***

So it did (and the Monopolies & Mergers Commission 1993 also recommended ownership unbundling) – ***but the Secretary of State rejected this proposal.*** The question therefore arises was the Secretary of State correct to do so? Was the subsequent behaviour of the ***internally unbundled*** British Gas such as to suggest that discriminatory access to the pipeline network continued and competition was inhibited? Were there, therefore, grounds for a further and more drastic regulatory intervention i.e. full mandatory ownership unbundling?

To put the question in a slightly different way, is there conclusive evidence to demonstrate that during the three year period Q1 1994 to Q4 1996 – the years when BG’s transportation and supply businesses were internally unbundled only – there were no significant obstructions to network access and competition in gas supply flourished?

In fact the evidence that this was the case is incontrovertible. Beginning in Q1 1994 there was a massive flood of new ( non-BG) gas supplies onto the competitive sector of the market (the so-called ‘contract market’ – bearing in mind that at this time the domestic gas market was still regulated.) As a result there was what might be described as ‘hyper-competition’ in gas supplies. The price of gas to industrial customers plummeted to unprecedentedly low levels, falling from an average of 0.769 pence/KWh in 1994 to

0.464 pence/KWh in 1996, and in real terms (indexed 1990=100) from 90 to 53.9, a remarkable 40% decline in real terms. Not surprisingly therefore, the IEA, explicitly referring to the behaviour of the UK gas market from 1985 up until 1997 – and with a graph illustrating the major collapse in industrial prices between 1994 and 1996 – concluded that,

‘The introduction of competition in natural gas markets ...has led to changes in the structure of prices, in real pre-tax gas prices in parallel with rising volumes delivered. Consumer choice, including the range of services on offer, has expanded. These trends suggest that gas is being produced, transported and delivered more efficiently and these efficiency improvements are flowing directly to end-users.’ (IEA, 1998)

It would be difficult to imagine a more glowing endorsement of the model of UK gas liberalisation than current and (with the possible exception of a short period in 1997) *a regime based on internal unbundling only*. No wonder there were no further regulatory interventions favouring total ownership unbundling after 1993, since *it was manifestly clear to everyone that the existing system was working extremely well – access to the network was unhindered and competition was flourishing*.

(iii) OFGEM response and SERIS reply.

OFGEM, in asserting that full ownership unbundling was still required reproduces the following statement by Centrica plc: ‘the UK experience suggests that unbundling has been of great benefit to all the key stakeholders – customers, employees and shareholders. While strictly monitored internal separation may be able to capture some of these benefits, we have no doubt that full ownership unbundling is the cleanest and most effective solution that is likely to result in greatest benefits to customers, employees and shareholders’ (OFGEM pp. 2,6)

***SERIS Reply***

We do not accept that this quotation should be accorded the status of evidence. Not only is it inconsistent with the conclusions of the IEA study cited above, but also *no empirical evidence is offered in support*. All we have is Centrica’s assurance that it ‘has no doubt’ as to the advantages of full ownership unbundling – and Centrica is, after all, an interested party which an independent regulator should be wary of using in this way.

(iv) OFGEM response and SERIS reply.

OFGEM also quotes an additional Centrica statement to the effect that British Gas’ decision to move to full ownership unbundling was ‘heavily influenced by the regulatory environment (strict internal separation) and the fact that a bundled organisation structure was failing to meet the expectations of either customers or shareholders.’ (OFGEM p.3)

***SERIS Reply***

The assertion that ‘customers’ expectations were not being met by the internally unbundled regime may be dismissed because there is again no evidence that this was the case and the IEA conclusion quoted above demonstrates that the assertion is fallacious. As to the benefits which ‘shareholders’ might get from full ownership unbundling, this almost certainly *is* correct for what else can this mean except that faced with strict internal unbundling, *the decision – taken in the interests of shareholders – to divest Centrica, was indeed nothing less than a purely commercial decision as we have argued all along.*

**Original SERIS Conclusion**

(For convenience we take the following two arguments together)

- 2) **With respect to the possibility that full ownership unbundling in the UK (driven by purely commercial considerations) coincidentally resulted in ‘optimization of the network’, we identify five possible indicators of ‘network optimization’. With respect to three of these indicators (degree of capacity utilization, access arrangements and gas balancing) we find no observable relationship between ownership unbundling and ‘optimization’. The improvements which did occur in these indicators were entirely due to other factors – the mandatory release of gas previously controlled by British Gas, the introduction of the Network Code, and regulatory intervention, none of which had anything to do with ownership unbundling.**
  
- 3) **In the case of the remaining two indicators (suppliers’ transportation costs and adequate levels of capital investment), there is some evidence to suggest that these actually deteriorated following the ownership changes.**

**(i) OFGEM response and SERIS reply.**

OFGEM complains that not all of the five indicators of ‘network optimization’ selected by SERIS for analysis ‘have a direct bearing on the optimisation of the network by network users,’ and that ‘the key point relates to access arrangements’. (OFGEM, p.5). OFGEM then states (as if to criticise our argument) that, ‘It is incontrovertible that when British Gas was vertically integrated there were ongoing abuses of third party access, and that those problems were resolved by ownership separation’. (OFGEM, p.5)

***SERIS Reply***

Firstly we should remind readers that in its original statement the European Commission failed to cite *any* indicators of the ‘network optimization’ which it insisted would be improved by full ownership unbundling. SERIS therefore had to make good this shortcoming by using the following five indicators:

- ❖ the degree of capacity utilisation-
- ❖ access arrangements including the allocation of capacity
- ❖ daily gas balancing
- ❖ cost reductions
- ❖ investment

OFGEM do not say which of these do not ‘have a direct bearing on ....optimization’. however it does emphasise the importance of ‘access arrangements.’ SERIS entirely agrees, which is why this is explicitly included in our list.

OFGEM then draws attention to British Gas’ ‘abuses of third party access’ and that these were ‘resolved by ownership separation’. SERIS entirely agrees that prior to 1993 there were ‘abuses of third party access’. However it should be absolutely clear from the observations we have made above in relation to our first major argument, that these were most certainly *not* resolved by ownership separation – *they were resolved by internal unbundling. Between 1994 and 1997 there were no significant problems of access to the network as the evidence of hyper-competition and tumbling gas prices makes absolutely clear.*

(ii) OFGEM response and SERIS reply.

In relation to the issue of gas balancing, OFGEM claims that since the balancing rules under the Network Code were introduced in 1996, only a year before full ownership unbundling ‘an empirical analysis of the effects of unbundling are not possible by us or SERIS.’(OFGEM, p.5)

***SERIS Reply***

SERIS has not attempted ‘an empirical analysis of the effects of unbundling’ nor is there any need to do so. We are simply making *the purely factual point that successful gas balancing was a function of the introduction of the Network Code in 1996 and had nothing to with ownership unbundling.* As a matter of fact, the implementation of the balancing rules under the Network Code during its first year of operation were generally regarded as being satisfactory, albeit with room for improvement. Subsequently modifications in the rules were introduced (as knowledge and experience increased) but here again, this was in no manner contingent upon full ownership unbundling and could have equally well been achieved under a regime of internal unbundling.

(iii) OFGEM response and SERIS reply.

Commenting in general on our treatment of the five indicators of ‘network optimization’, OFGEM remarks, ‘The regulatory intervention was key in relation to most of the indicators suggested by SERIS and as explained above was intimately related to ownership unbundling.’ (OFGEM, p.5)

***SERIS Reply***

SERIS has made it absolutely clear that regulatory intervention (not ownership unbundling) was indeed the ‘key’ in relation to some of the indicators. As far as the second part of the statement is concerned, we have also made it clear that ***there was no regulatory intervention requiring full ownership unbundling***. The fact that at one point, the Regulator (and the 1993 MMC Commission) expressed a preference for it does not change the fact that ***Regulatory intervention requiring full ownership unbundling simply did not happen***. And once it became clear that internal unbundling was proving perfectly consistent with non-discriminatory access and competition in gas supplies, by 1995 the subject had dropped out of the regulatory agenda.

(iv) OFGEM response and SERIS reply.

In relation to our argument that there are signs that the average suppliers’ transportation cost fell strongly before ownership unbundling but rose slightly after ownership unbundling, OFGEM states, ‘with regard to suppliers; transportation costs: the regulated energy network companies have commercial incentives to become more efficient and they have made significant improvements in productivity since the industry was unbundled.’(OFGEM, p.5)

***SERIS Reply***

This OFGEM response contains no relevant information about the relationship between ownership unbundling and the behaviour of transportation costs. In this instance SERIS therefore has nothing to reply to.

(v) OFGEM response and SERIS reply.

In relation to our observation that there were serious problems of either actual under-investment or attempts to ‘game’ the system by overestimating investment requirements prior to the setting of the price control (or both), in both the period before and after full ownership unbundling – but possibly worse after ownership unbundling, OFGEM replies that ‘it is confident that ....’appropriate levels of investment’ have taken place.’ (OFGEM, p.6)

***SERIS Reply***

Aside from the fact that the investment failings we noted were recorded and discussed in OFGEM’s own reports and that of the UK Health & Safety Executive, SERIS wishes to point out that our intention here was merely to refute the Commission’s statement that, after ownership unbundling, ***network optimisation improved***. We are satisfied that, with respect to this particular indicator, this refutation has been made.

(vi) OFGEM response and SERIS reply.

Finally OFGEM observes that ‘Since the privatisation of British Gas, investment in the network has been much higher than before privatisation.’ (OFGEM, p.6)

*SERIS Reply*

We are genuinely puzzled as to the relevance of this statement. To which of our arguments is it addressed? The topic of privatisation and its supposed deficiencies or benefits was never mentioned in our Briefing Document.

Original SERIS Conclusion

- 4) The empirical evidence of full ownership unbundling in the UK does not support any assertion that gas network ownership unbundling ‘significantly changes the behaviour of the transport undertaking’ or that ‘a fully unbundled Transportation System Operator will focus on optimizing the use of its network.’**

(i) OFGEM response and SERIS reply.

Once again, at the end of its document, OFGEM’s uses quotations from Centrica on the basis of which OFGEM then states that it is ‘confident that ownership unbundling has been one of the key elements in the creation of competitive energy markets in the UK, and has undoubtedly produced major benefits to UK customers.’ (OFGEM, p.6)

*SERIS Reply*

SERIS is also confident that OFGEM has not engaged the arguments in our original Briefing Document in a way that has invalidated them, and has not therefore made a case that ownership separation resulted in an optimisation of the use of the UK’s transportation network. Moreover, and as we have previously stated, it does not seem appropriate for OFGEM, as an independent regulator, to rely to such an extent for its evidence on statements made by a regulated company.