The Rise, Fall and the Rise again of British Gas

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Introduction

The story of the exploitation of natural gas reserves from the North Sea, and the development of the British market for gas is best told as the story of British Gas.

The history falls naturally into five periods:

- **1965-86** - During this period, optimal resource use implemented by the nationalised British Gas was the predominant factor.
- **1987-93** – In this period, the monopoly powers of the privatised British Gas company began to be stripped away.
- **1994-96** – In this period, British Gas ran into serious financial difficulties and was forced to begin to split the company into a monopoly pipelines business and a commercial gas supply company. Preparations to open fully for competition the market for gas began.
- **1997-99** – The two daughter companies of British Gas began to forge their new identities and competition for all consumers was introduced.
- **2000 onwards** – Further fragmentation of ‘British Gas’ and start of decline in North Sea gas production.
1965-86

- Important steps prior to discovery of natural gas, including import of gas from Algeria and closure of coal gas plants
- Creation of British Gas in 1973 from regional structure
- British Gas gained immense prestige from smooth conversion of network from manufactured to natural gas and from price reductions that allowed gas-fired central heating to replace coal firing with major welfare gains
- Premium markets policy aimed gas at markets where it had non-price advantages
- Explicit depletion policy not needed because premium markets policy restricted demand
- Increasing conflict with Thatcher’s government from 1980 onwards with British Gas over strategic resource decisions, culminating in privatisation of British Gas in 1986
- Only LNG terminal closed in 1979
<table>
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<tr>
<th>Year</th>
<th>Dry Gas Proven</th>
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# UK Consumption of natural gas (GWh)

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1986-93

- Still, as always, 10 years of gas left in the North Sea, but resource management no longer such an important issue
- Gas privatised in 1986 with no restructuring and no attempt to create competition. Increasing public concern about the creation of a privatised monopoly
- But the new gas regulator (Ofgas) was given a duty to promote competition, a duty he took unexpectedly seriously
- And ‘war’ broke out between British Gas and Ofgas
- Series of investigations by Ofgas, Office of Fair Trading and Monopolies & Mergers Commission led to measures designed to break up British Gas’s monopoly powers over the gas market and its monopsony powers over gas purchase
- Increasing regulatory pressure on British Gas to control profits – ‘X’ factor in RPI-X increased from 2 to 5 in 1992 (the first use of rate-of-return methodology in RPI-X)
1986-93

- New gas market for power plants, created by electricity privatisation in 1990, allowed new gas suppliers into the market and significantly increased UK demand for gas
- By 1993, regulatory dissatisfaction that British Gas still had too much market power and further measures to reduce British Gas’s market imposed
- Proposals to split British Gas up, with network activities separate from its competitive activities
- Diversification into international markets (Canada, Spain and Argentina) appeared successful but were quickly sold
- However, two important decisions taken:
  - to investigate the need for a gas pipeline to Belgium, but for export of gas, not import
  - to build pipelines to Northern Ireland and the Republic of Ireland from Scotland to supply power stations and final consumers there
1994-96

Three processes dominated this period

• The opening of the gas supply market for large consumers and the preparations to give small consumers choice

• The impact on British Gas of the collapse in 1995 of North Sea gas prices leaving it with a legacy of stranded contracts

• The preparations for the break-up of British Gas

Resource management was not an issue
The Opening of the Gas Market

For large consumers, British Gas’s market power broken by:

- Target market share reductions in various sectors of the market;
- A requirement on British Gas to price according to published tariffs; and
- A ‘Gas Release’ programme under which British Gas was obliged to sell on some of its contracted supplies to new competitors.
- These measures were finally effective but nothing to do with competition
- For small consumers, competition was to begin in trial areas in April 1996, to be completed in April 1998
- This was meant, in theory, to bring it gas into line with the electricity timetable, but actually put it 1-2 years ahead
The Stranded Contracts Problem

• By 1995, prospect of significant oversupply of gas lead to collapse of gas price (40% in real terms)
• Cause of ‘gas bubble’, overestimation of UK market by oil and gas companies, overestimation of its market share by British Gas and the result of government measures in 1986 to stimulate North Sea oil exploration and production
• Write-offs in 1995 of £83m and in 1996 of £635m and problem nowhere near solved
The Break-up of British Gas

- By 1994, more than £2bn had already been spent on earlier restructuring, but more had to be spent. £1.1bn charged in 1996
- Company remained profitable overall in 1994 and 1995, but only because profits in pipelines, and exploration & production counterbalanced losses in Trading (sales to final consumers). Losses in 1996. Accounting or structural problem?
- ‘Fat Cat’ problem weakened public support for British Gas
- In 1996, British Gas chose to make split into two new companies complete from 1997
  
  BG plc, comprised Transco, the monopoly pipeline business, some of E&P and all remaining non-UK activities. BG highly profitable, £554m in 1996
  
  Centrica, comprising British Gas Trading, the gas supply business, and the highly profitable Morecambe Bay gas field. Centrica heavily loss-making, £736m in 1996
1997-99

- Three processes dominated period from 1997:
- Establishment of BG plc and Centrica as separate and distinct companies
- Construction of a large pipeline, completed in 1998, linking the British gas system with mainland Europe
- Introduction of competition for residential consumers
- Confusion over names of new companies. BG plc allowed to trade as British Gas in foreign markets. Centrica’s supply division trades as British Gas or BG Trading in Britain
- Resource issues still not on the agenda
BG plc

• Heart of business still the pipelines – 75% of turnover
• Regulatory formula seemed very tough, 21% real cut in 1997 followed by 2% cut per year for next 4 years
• But profits doubled – under-investment in the network?
• Exploration & Production and International Downstream highly successful
Centrica

- Centrica only kept solvent by Morecambe Bay
- Renegotiation of gas contracts led to accounting provisions of £608m in 1997 and £63m in 1998. Problem then largely under control
- Also one-off charges of £192m as Windfall Tax in 1997/98 and for restructuring of £155m in 1996-98

But other good news:
- Relaxation of gas tax led to savings of £50m per year;
- Residential consumers, expected to take advantage of lower gas prices offered by electricity companies unexpectedly loyal to British Gas
- Opening of electricity market gave scope to move into electricity supply for residential consumers
- Centrica began to make strategic investments:
  - The Automobile Association; North Sea gas fields; and power stations
The Opening of Domestic Competition

- Electricity companies able to offer discounts of up to 25% because of British Gas’s stranded gas contracts
- All electricity distribution companies (RECs) moved to open gas businesses, sometimes in consortia with oil companies
- But competition got a bad name from dubious sales tactics and cherry-picking
- Consumers appear not to be interested in shopping around and remain surprisingly loyal to the British Gas brand name
- Few RECs still actively pushing their gas businesses, oil companies have generally left the sector, some consolidation into a few aggressive businesses
The Interconnector

- The Interconnector ended Britain’s ‘gas island’ status and firmly couples UK gas prices to European prices.
- 235 km pipeline capable of carrying 25% of UK gas consumption.
- Designed to export gas from UK although imports are possible.
- Import capacity readily increased by addition of more compressors and expected to be needed in 5 years when UK gas production declines below UK consumption.
- Still not clear from trading whether gas trade will be short-term spot sales or long-term contracts.
- Also competition from cheaply-made connections to Norway and Netherlands.
- Now proposals to build new LNG terminals, but no firm commitment yet.
Transco (network)

- November 2000: BG plc spun off Transco as separate (unconnected) company called Lattice
- April 2002, Lattice merged with National Grid Company to form National Grid Transco
- In 2003, NGT tried to sell its gas R&D division, Advantica, but no buyers
- In 2004, bought a mobile phone mast network
Transco (network)

- Regulator also required Transco to separate the network into 8 regional distribution networks and a national high pressure grid
- In 2004, NGT sold 4 out of 8 regional distribution networks
- Scottish & Southern (with Ontario Teachers Pension fund and Borealis) bought two regions (Scotland & Southern England) claiming synergies with electricity networks
- Cheung Kong (aka Hong Kong Electric) bought Northern England in consortium with United Utilities (owns the electricity network there)
- Wales & West bought by Macquarie (Australian bank)
BG plc (oil & gas exploration)

• In 2000, BG sold its UK gas storage to Dynegy - subsequently sold on to Centrica and S&SE
• BG now just an oil and gas exploration and production company
• Possible take-over by a ‘major’ oil company?
Centrica

- Centrica successful in residential electricity market with about 30% of the market but few sales to larger users
- It retains about 60% of the residential gas market
- Centrica tried to develop services outside energy, eg, One-Tel (telecoms), the AA (roadside vehicle recovery) and Goldfish but no synergies
- Goldfish sold in 2003, AA in June 2004 and maybe One-Tel will also be sold
Centrica

- Expanding now outside UK in energy retail in Belgium (Luminus), Canada (Direct Energy) Mid-West USA (Energy America), Texas (Direct Energy) and Spain (Luseo)
- Buying power stations in UK. Now owns about 4000MW of fossil fuel plant and is developing renewables
- Buying gas production assets in North Sea and Canada
- First UK company to import LNG (from Malaysia) at new terminal in S Wales
Wholesale competition

• The electricity market NETA was modelled on the gas market (NGTA)
• Four main components:
  - Long-term contract market
  - The over-the-counter (OTC) spot and short-term market
  - The on-the-day commodity market (OCM), and
  - International Petroleum Exchange futures market (IPE Natural Gas Futures)
• Volumes for these markets are difficult to estimate
Long-term contracts and the Over-The-Counter market (OTC)

• Long-term contracts not as dominant as with electricity
• Bad experience with long-term contracts in the early 90s which almost bankrupted British Gas and seriously weakened National Power and Powergen
• Spot market may be larger than the contract market
• This may lead to price volatility and may make investment in the North Sea more difficult
• The OTC market began to be important from 1995 (time of gas price collapse) onwards
• Now probably the dominant form of trade
On the day Commodity Market (OCM) and the futures market

• The OCM market is the balancing market in which the system operator and other players buy and sell gas to make sure supply and demand balance

• A futures market was established in 1997 and has grown steadily since then
Retail competition: residential consumers

• In 2003, the composition of a typical residential gas bill was 51% gas, 34% transportation & metering and 13% supply cost & margin

• 47% of residential gas consumers had switched at least once from 1998 to end 2003

• 39% no longer buy from British Gas (about 15% of consumers switch each year)

• Choice of 6 main suppliers, mostly selling gas and electricity as a package
## Residential market shares (Dec 2003)

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Outcomes

• Since 1986, the real price residential consumers pay for gas has fallen by about 30%
• However, monopoly charges have fallen by 47% accounting for more than half the price reduction
• Large consumers doing well from retail competition
• Gas consumption has doubled and the Britain will have to rely on imports much sooner than if consumption had been controlled
• How will the gas industry develop when most supplies are imported at prices linked to oil?