The creation of a market for retail electricity supply

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Abstract

In September 1989, as part of its electricity privatization programme, the Government laid down a three-stage timetable (1990, 1994, 1998) for opening up to retail competition the entire electricity market of England and Wales. It might be assumed that the timetable in England and Wales was part of a considered policy to facilitate the introduction and regulation of competition; that the overriding aim was to promote the interests of consumers; that the Government as owner of the nationalised electricity industry would be in a position to dictate the precise arrangements for opening the market; that the phasing over time was designed to take account of the mechanics of implementation, including the costs and uncertainties and learning that would inevitably be involved. It might even be thought that this would be a model of how governments can successfully create a competitive market.

In fact, actual events were almost the opposite of this picture. Initially, competition in supply was regarded as hardly relevant, and the electricity privatisation White Paper in February 1988 embodied no plan to implement it. Then, after discussions lasting over more than a year, the policy agreed by ministers in July 1989 envisaged full retail competition for all customers from Vesting Day. But the generation and distribution companies objected that 'truly open competition' would preclude long-term contracts, rendering the long-term profitability of the generators highly uncertain. To enable them to sign such contracts the companies proposed instead a continuation of the retail monopoly for all but large consumers. The Department of Energy felt that it was not feasible to contemplate imposing a solution on the industry. It also wished to facilitate privatisation of the coal industry, for which purpose it envisaged the need for parallel long-term contracts between the generators and the coal industry. However, by now other ministers and the prospective regulator were expressing concern about abandoning full retail competition.

The eight-year timetable for full retail competition emerged as a last-minute compromise. The final version of the timetable and associated contracts was proposed as a package agreed by the industry itself. The mechanics of implementation were not mentioned. In the event the four to eight year contracts envisaged were not achieved because British Coal was not party to the agreement. British experience of creating a market may not be a model, but the somewhat unpredictable process of balancing conflicting objectives and emerging practical constraints may not be unrepresentative of how governments actually operate, including in creating markets.

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1. Introduction

In September 1989, as part of its programme for privatising the electricity industry, the Government laid down a timetable for opening up to retail competition the entire electricity market of England and Wales. There were three stages: April 1990 (Vesting Day), April 1994 and April 1998. Until 1990 electricity supply was a regional monopoly. Retail competition was essentially illegal, except for limited possibility of direct supply by the Central Electricity Generating Board to a few very large users.

The response was dramatic. Nearly half the largest business users in the country chose a different electricity supplier in April 1990. The proportion had nearly doubled within a few years. By April 2009, within a dozen years of their being allowed to choose, over half the smallest (residential) users had changed supplier too. Other countries have followed suit, especially Sweden, Norway, Australia, New Zealand and several states in the USA. Retail electricity competition is now official policy in the European Union.

It might be assumed that the timetable in England and Wales was part of a considered policy to facilitate the introduction and regulation of competition; that the overriding aim was to promote the interests of consumers; that the Government as owner of the nationalised electricity industry would be in a position to dictate the precise arrangements for opening the market; that the phasing over time was designed to take account of the mechanics of implementation, including the costs and uncertainties and learning that would inevitably be involved. It might even be thought that this would be a model case study of how governments can successfully create a competitive market.

The Department of Energy's own *History of Electricity Privatisation*, only now available, enables us to test these propositions.[1] The *History* was compiled in 1992, shortly after the privatisation was completed. It is a lengthy document (some 450 pages in two volumes), which contains a frank and detailed account of advice given by the Department of Energy [henceforth the Department] to its ministers, and of exchanges of view between senior ministers and with the Prime Minister. There seems no reason to question its veracity insofar as it was originally intended for internal use, to learn from actual experience, rather than for publication.[2] It is consistent with my own limited experience and recollections of these events.[3]

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[1] *History of Electricity Privatisation (England and Wales)*, Department of Energy, February 1992. Unless otherwise indicated, paragraph numbers refer to this *History*. I have had access only to the redacted version, but there are relatively few redactions, and they do not impinge on the narrative and analysis of the present paper.

[2] "This history was authorised by the Department's previous Permanent Secretary and was undertaken during the period April 1991 to February 1992. The objective was to enable successors to those in the Department involved in the privatisation to understand what happened and why, and to assist future policy formulation in the Department." Preface.

[3] The author played a small part in this story, initially as adviser to the Secretary of State for Energy from November 1987, and later as the first electricity regulator (Director General of Electricity Supply or DGES, head of the Office of Electricity Regulation or OFFER), appointment announced in May 1989. As mentioned below, he was also an early proponent (in 1983) of the concept of retail competition in electricity supply, as a means of better protecting customers with less reliance on regulation. A few remarks about this early period have already appeared in S C Littlechild, "Retail

In fact, the account provided by the *History* suggests that actual events were almost the opposite of the picture painted above. Initially, competition in supply was regarded as hardly relevant, and the electricity privatisation White Paper in February 1988 embodied no plan to extend it. Then, after discussions lasting over more than a year, the policy agreed by ministers in July 1989 envisaged full retail competition for all customers from Vesting Day. But the generation and distribution companies objected that 'truly open competition' would preclude long-term contracts, rendering the long-term profitability of the generators highly uncertain. To enable them to sign such contracts the companies proposed instead a continuation of the retail monopoly for all but large consumers. The Department of Energy felt that it was not feasible to contemplate imposing a solution on the industry. Moreover, it was concerned to privatise not only the electricity industry but also the coal industry, for which purpose it envisaged the need for parallel long-term contracts between the generators and the coal industry. But by now other ministers and the prospective regulator were expressing concern about abandoning full retail competition.

The eight-year timetable for full retail competition emerged as a last-minute compromise. The final version of the timetable with an associated set of contracts was proposed by the industry itself. The mechanics of implementing retail competition were not mentioned in these discussions. In the event, initial contracts were limited to three years because British Coal declined to sign longer ones.

2. Background

The Electricity Act 1947 nationalised the electricity industry in Great Britain. It created a British Electricity Authority and 12 Area Electricity Boards in England and Wales (plus 3 in Scotland). The Electricity Act 1957 replaced the British Electricity Authority by the Central Electricity Generating Board (CEGB). [4]

The CEGB was required to develop and maintain an efficient, co-ordinated and economical system of supply of electricity in bulk to all parts of England and Wales. To this end it generated almost all the electricity it needed (supplemented by a small proportion that it imported from Scotland and France) and transmitted it, through the high voltage power lines and cables of its national grid, to Area Boards and direct to the railways and a few large industrial users. [5]

The 12 Area Boards bought bulk supplies of electricity from the CEGB and each Area Board distributed it to consumers in its own geographical area. Each Area Board had

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competition in electricity markets – expectations, outcomes and economics", *Energy Policy*, 37(2), February 2009, 759-763.

[4] The Electricity Act 1957 also created the Electricity Council, the co-ordinating body of the electricity supply industry, which advised the Secretary of State on matters affecting the industry, and promoted and assisted the development and maintenance by the CEGB and Area Boards of an efficient, co-ordinated and economical system of electricity supply. In practice, the influence of the Electricity Council was limited, and it was abolished as part of the privatisation.

[5] Direct supply was not used on a large scale. In the mid-1980s sales to direct consumers (excluding railways) were about 2 TWh per year. They accounted for about 0.9% of the CEGB's total sales by volume (TWh) and about 0.2% by value (£m). *CEGB Annual Report & Accounts* 1984/5, p. 57. It has been said that such direct supply required the authority of the Secretary of State for Energy. (John Vickers and George Yarrow, *Privatization: An Economic Analysis*, MIT Press, Cambridge Mass. and London, England, 1988, p. 284.)

a statutory monopoly over the supply of electricity in its area, apart from the ability of the CEGB to sell direct to a few large users. It was open to a large industrial user to generate its own electricity, but there was no retail market for electricity, no concept of competition in retail supply.

3. Early views: 1979 to 1987

Policy thinking began to change in 1979 and had impacted on the electricity industry by 1983.

> The Conservative administration of 1979 set out to reverse the policy of centralised public sector planning. In 1982, the Secretary of State for Energy [Nigel Lawson] set out the new objective: to create a market for energy. The Oil and Gas (Enterprise) Act 1982 sought, inter alia, to liberalise the gas market and, in particular, to provide for competition through common carriage. The Energy Act 1983 extended the same principles to the electricity supply industry. (1.02) [6]

There was also some initial thinking on privatising and liberalising the electricity. Two major and influential views emerged. As the *History* remarks, these arguments were to recur throughout the debate on the future structure of the industry.

- A study by consultants Coopers and Lybrand (C&L) assumed a continued monopoly in supply, favoured breakup of the CEGB in order to secure competition in generation, and identified the nuclear programme as an obstacle. It assumed that long-term contracts with Area Boards that continued to have a monopoly of supply would ensure sufficient investment in new generation. (1.04-1.08)[7]
- Sir Walter [later Lord] Marshall, chairman of the CEGB, took a quite different view. He resisted breakup of the CEGB and envisaged the CEGB effectively competing with the amalgamated Area Boards in supply to large users.[8]

By 1983, the Treasury, now under the leadership of Nigel Lawson, was actively taking forward the development of policy on privatisation and competition.[9] To my knowledge, the first suggestion of retail competition for *all* electricity customers was in an unpublished paper by Michael Beesley and myself, entitled "Privatization and Monopoly Power", prepared for the Treasury in November 1983.[10]

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[6] This principle of common carriage was being developed elsewhere too. Chile made provision for a few large customers (over 4 MW maximum demand in 1980, reduced to 2MW in 1982) to be supplied by an individual independent generator via access to the transmission and distribution systems. But neither Chile nor the Energy Act 1982 envisaged retail competition for all customers as an alternative to regulation of electricity supply.

[7] The study was commissioned by Nigel Lawson, who refers approvingly to it in his memoirs. Nigel Lawson, *The View from No. 11: Memoirs of a Tory Radical*, Bantam Press, 1992, p. 179.

[8] "In a letter to the Secretary of State (May 1983) … he saw no advantage in licensing the Area Boards' territorial monopoly. … The amalgamation of the Area Boards into a single distribution company and the expansion of the CEGB's right to sell direct to large users, together with the abolition of the restrictions on undue preference, was the option he suggested for further study." (1.09)

[9] David Parker, *The Official History of Privatisation*, Vol 1 The Formative Years 1970-1987, Routledge, London and New York, 2009, pp 172-177. (See

[10] Parker p. 175 fn 64. I discussed the electricity part of this paper with some industry contacts in December 1983, and then expanded it into a separate paper on electricity privatisation. Amongst other

After the privatisation of British Gas in 1986, the Department returned to the subject of electricity privatisation. Following some internal debate and discussion with the industry, a report to the Secretary of State [Peter Walker] in April 1987 "cast doubt on the competitive benefits of fragmenting the industry" and saw merit in the 'two company' solution". (2.10) Inter alia, "independent generators should continue to have the right to supply customers direct, but the option of restricting this right to large customers should be seriously considered, as should be the possibility of preventing the CEGB from supplying direct". (2.12)

In March 1987, Alex Henney published a monograph arguing for breaking up the CEGB into nine or ten successor generating companies and a separate grid company.[11] The Area Boards "would retain an obligation to supply tariff customers but have no obligation to supply large contract customers." (2.13) Henney proposed that there should be competition in supply for large electricity users and generators.[12] A Department paper identified the many difficulties that Henney's proposal would raise and the time it would take (nearly ten years, covering two Parliaments), and "expressed worry about the disruption caused by such a long drawn out process, especially for the large investment programme in generating capacity that was foreseen". (2.14)

A Department meeting on 28 April 1987 concluded that electricity privatisation was feasible, but reached no conclusions on the appropriate option. The election was called for 11 June 1987. The Conservative manifesto contained a commitment 'to bring forward proposals for privatising the electricity supply industry subject to proper regulation'. It also said that a Conservative Government intended to go on playing a leading role in the task of developing abundant, low-cost supplies of nuclear electricity. (2.18)

Ironically, the C&L report, Sir Walter Marshall, other commentators, the industry and the Department all dismissed the possibility of vertically integrated power boards. That concept is perhaps closest to the eventual outcome today. If the concept of retail competition had been better elaborated and understood by then, power boards might have received more sympathetic consideration.

4. Exploration of options: June 1987 to February 1988

Following the election, Cecil Parkinson was appointed as the new Secretary of State for Energy on 13 June 1987. The day after taking up his post he discussed a Department paper on the options for electricity privatisation. It was agreed that further

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things, the papers proposed to separate the electricity Area Boards into distribution networks and competing private retailers that would buy and sell power over the distribution networks. This would make new use of common carrier obligations on the distribution networks. The aim was to use competition rather than regulation to pass through to retail customers as a whole the increased efficiencies in generation (that we expected would flow from privatisation, competition and new entry into the wholesale market). I am not aware that our paper was shared with the Department of Energy.

[11] Alex Henney, *Privatise Power,* Centre for Policy Studies, London, March 1987.

[12] "Customers taking more than [0.25mkWh per annum] could bargain for contracts in a structure similar to that obtaining in the gas market, and could bypass the distribution companies by using the distribution network direct as a common carrier – as indeed could independent generators themselves. On the other hand, distribution companies would be under no obligation to serve such customers." (Henney p. 40)

work should concentrate on the ‘two company’ option and the break up of the CEGB, and that financial, technical, legal, regulatory and accounting advisers should be appointed. Further discussions among the Department, its advisers and the industry, and a presentation to the Prime Minister and other leading ministers at Chequers on 14 September 1987, explored the many implications of four main options:

- Option A privatise the CEGB as it stood
- Option B as for Option A, except that a block of power stations would be sold off as a competing company
- Option C as for Option B, except that ownership and control of the grid would be transferred to the distribution companies;
- Option D as for Option C, except that the CEGB would be broken up into four or five generating companies.

All these options assumed the separate privatisation of the Area Boards. (3.15)

The Chequers seminar agreed that Option A should be ruled out, and that options C and D should in particular be studied, though option B could not be ruled out. Major issues for study included the feasibility of separating the grid from the other CEGB generating stations, the implications for the nuclear investment programme, for coal, for prices and for Scotland, and the possibility of privatising the industry in one Parliament rather than two.

After further analysis and discussions, the Secretary of State held a weekend seminar at Nuneham Park on 21/22 November 1987. [13] The seminar explored in turn the options earlier presented to the Prime Minister. There was still considerable pressure from the CEGB for option A.[14] Nevertheless, the Secretary of State decided that his tentative preference was option C, given the political imperative to introduce competition into the industry. Option D was envisaged to involve too much disruption and to take two Parliaments to complete. [15]

There was subsequent analysis of how to produce the desired level of new nuclear investment, which was in doubt under any of the options. Possibilities included retaining nuclear in the public sector, subsidising the building of nuclear plant, and imposing some form of obligation on generators or distributors to generate or take X% of electricity from non-fossil sources. This was not a trivial issue, particularly for the Prime Minister.[16]

There were still differences of view among ministers, with the Chancellor and the Secretary of State for Trade and Industry favouring something closer to option D. And

[13] This was my own introduction to the scene. “Professor Littlechild, the Secretary of State’s newly appointed independent adviser, was invited to attend.” (3.26)

[14] “Lord Marshall had told the Permanent Secretary that most, if not all, of the Board of the CEGB would resign if any decision was reached that did not leave the CEGB intact. … The Permanent Secretary informed the Secretary of State of Lord Marshall’s message in the margins of the seminar.” (3.30)

[15] The *History* does not indicate the full nature of the restrictions assumed under option D. For example, the four or five successor generator companies would jointly own the nuclear generating stations (and I was informed that they would be precluded from subsequently divesting or specialising in this nuclear ownership). My main regret about the Nuneham Park seminar, apart from my first exposure to the options and issues being only a few days beforehand, is that the Secretary of State was not presented with a feasible and defensible option for a competitive industry structure.

[16] The Prime Minister “expressed great concern about the future of the nuclear programme and scepticism that a statutory obligation on the Area Boards would work”. (3.41)

again the Prime Minister had concerns.[17] These were not resolved until a Cabinet Meeting on 25 February 1988. And indeed important new issues began to surface.[18]

5. The White Paper February 1988 and competition in supply

The White Paper was published later the same day as the Cabinet Meeting. [19] Effectively, it announced the decision in favour of option C. Two privatised generators would be formed from the CEGB, with the smaller one owning some 30% of existing capacity and with nuclear stations remaining with the larger one. The transmission grid would be separated off, and owned jointly by the distribution companies. The two successor generating companies were known as Big G (later National Power) and Little G (later PowerGen).

At no point in this period of policymaking – that is, from the election in June 1987 to the White Paper in February 1988 – does the *History* mention the concept of competition in supply (or retail competition). Nor is there any discussion of the implications of generators being able to sell direct to customers, whether large users or others.

I raised the possibility of competition in supply shortly after I was invited to advise the Secretary of State on electricity privatisation. I was told by the senior civil servant involved that only a customer as large as ICI (the largest electricity consumer in the UK) might be interested in buying directly from a generator, and neither generators nor distribution companies would want to bother with seeking out smaller customers.[20]

I pressed for some recognition of the potential importance of competition in supply in the White Paper of February 1988. The emphasis there was on restructuring to create competition in generation, with a focus on the privatised Area Boards driving the competitive action.[21] There was also reference to "other existing and potential private generators, who will generally contract with the distribution companies, the grid

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[17] "The PM was at first not prepared to accept that privatisation should proceed on a basis opposed by Lord Marshall." (4.01) She had appointed him Chairman of the Atomic Energy Authority in 1981, Chairman of the CEGB in 1982, knighted him later that year, and made him a life peer in 1985 "on successful completion of his crusade to 'keep the lights on' no matter what moves Arthur Scargill's striking miners made against the power stations". ("Obituary: Lord Marshall of Goring", John Baker, *The Independent*, 26 February 1996.)

[18] At this point there is first mention of the potential impact on British Coal of the privatised generators' freedom to import coal. "However, it was thought that the amounts of coal which could be imported over the next few years would be limited; and the generators would have a commercial interest in entering into long term contracts with British Coal." (4.06)

[19] *Privatising Electricity: The Government's proposals for the privatisation of the electricity supply industry in England and Wales*, Secretary of State for Energy, London, HMSO, Cm 322, February 1988.

[20] Nor was there more enthusiasm overseas. During the late 1980s I visited the United States and met one evening with Bill Hogan and Paul Joskow. I told them of my concept of retail competition via common carriage. I thought this concept would appeal to that competition-oriented country. "It won't catch on", they said. "The larger customers already get a good deal from special tariffs and the smaller customers won't be interested."

[21] For example, "there is no reason why there should not be competing power stations, supplying the Area Boards through the Grid". (para 17) The White Paper emphasised the role of the distribution companies in seeking competitive tenders for new construction (para 40) and the new choices open to them (para 41).

company, or large customers". (para 24.) But with respect to competition in supply, there were only a few sentences.

> "The distribution companies themselves will also have to bid for part of their business in a competitive environment. Adjacent distribution companies could find themselves competing to supply large users near their common borders. And larger users will also be able to buy electricity direct from generators, by-passing the distribution companies but using their distribution systems for 'common carriage' of the electricity." (para 42)

The White Paper included a commitment to strengthening the common carriage arrangements.[22] Indeed, it recognised that this was an important area for regulation.[23] There was also an acknowledgement of the need for ring-fencing the various activities of the privatised companies, together with separate accounts. (para 53) So there was an emphasis at this stage on putting in place the conditions necessary to make competition in supply effective. But such competition was still regarded as a matter for large users only, and was not regarded as unduly significant, or as a threat to privatisation. "Even after privatisation, the supply activities of the distribution companies will remain, in large part, natural monopolies." (para 50).

6. Regulation and Competition in Supply

The department put a paper to the industry in March 1988 setting out proposals for the broad structure of regulation. "The monopoly areas of retail supply and transmission would need to be regulated. (7.01)" Thus, at this stage no distinction is drawn between distribution and retail supply, and retail supply is assumed to be a monopoly rather than a competitive activity.

Attention then turned to the regulation of the distribution companies, which would bear the main burden of regulation.[24]

> Questions for consideration on the [distribution] price control included whether there should be the same efficiency factor ('X') for each distribution

[22] "Common carriage was allowed for in the Energy Act 1983, but the provisions of that Act will be updated to ensure that common carriage tariffs properly reflect the costs involved; to ensure that the tariffs are scrutinised by the regulator; and to give the regulator powers to settle disputes." (para 42).
[23] "Another important area for regulation will be the terms of access to the transmission and generation system. While the new structure will provide real incentives for the distribution companies to allow their own suppliers access, they may be less willing to allow private generators to use their systems to supply large customers direct, or to provide back-up and top-up supplies at reasonable cost. So the terms for common carriage of this kind between private generators and large customers will be closely regulated. The Government will review carefully the provisions of the Energy Act 1983 governing common carriage on both the transmission and distribution systems, including back-up and top-up supplies. The Government is determined to remove barriers to full and effective competition." (para 54)
[24] "The weight of regulation would be on the distribution companies. Regulation of generation would be largely based on approval of initial contracts by the Department or the regulator. Explicit regulation of transmission would be unnecessary, given the ownership of the grid by the distribution companies and their commercial interest in costs being kept low." (7.01) The last assumption would of course prove rather optimistic.

> company, whether any costs should be excluded from price control and how industrial sales should be regulated." (7.01)

The Department's preference was for a common X factor, and for a 'yardstick' approach: allowing distribution companies to pass through to customers the average increase in generating costs actually incurred by the generation companies. The third question was more problematic.[25]

It was agreed that the distribution companies would be licensed as 'public electricity suppliers', under an obligation to offer a supply of electricity on reasonable terms to any premises within their areas. "Most other suppliers, including generators supplying direct, would have 'second-tier' licences *to supply defined premises*." (7.08, italics added) The implication is that the regulator, in defining the premises in each licence, would determine which supplier could supply each customer.[26]

As a result of four months thinking about regulation, some of the implications of retail competition evidently began to dawn. For the first time the phrase 'Competition in Supply' merits a subheading in the *History*:

> The new structure of the industry seemed likely to create more competition in electricity supply than was envisaged in the White Paper: there would be no permanent monopolies of supply; and the distribution companies' ownership of their wires would give them a natural monopoly of distribution, but not of supply.
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> Competition in supply faced the distribution companies with the risk of 'stranded investment'. The proposed regime dealt with this problem in two ways:
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> - large customers would be obliged to take supply on contract, rather than by tariff. The contracts could contain suitable exit clauses to deal with stranded investment;
> - in deciding whether to grant a second-tier licence to an alternative supplier, the regulator would need to take account of the impact on the distribution company of stranded investment. (7.11, 7.12)

Another implication surfaces in what is here called an Alternative Approach to Price Formula, namely, distinguishing between price controls on distribution and supply businesses.[27]

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[25] On the question of regulation of sales of electricity to the industrial market, the issues to be addressed included: Were there clearly defined areas of the market which were subject to competition from other fuels or direct sales by generators? How should the contract market be defined, and which consumers should be able to opt for contract or tariff sales? Should there be an obligation to supply contract customers? How to ensure a fair deal for all industrial consumers, including the large ones? Whether prices in the contract market needed regulating?

[26] This is indeed the way in which the initial supply licences were written, with a list of customers the licensee could supply. One of my earliest actions as regulator was to grant a licence enabling the recipient to supply all customers over 1 MW. Licenses have been in this form ever since. Stephen C Littlechild, *Privatisation, Competition and Regulation*, Institute of Economic Affairs Occasional Paper 110 (Wincott Lecture), 2000, pp 24-5.

[27] "Professor Littlechild had suggested that, instead of a single price constraint applying to distribution companies' prices as a whole, there should be separate price formulae applying to the distribution tariff and to the price of electricity supplied. The basis of this was that the companies' business consisted of

7. Regulation: February to December 1988

The *History* refers to the period leading up to the White Paper decisions as the 'political' phase. Next, from February 1988 to around the end of that year, came the 'creative' phase: "the ground-breaking work on regulation, licences and contracts, the initial attempt to square nuclear liabilities with privatisation", culminating in the introduction of the Electricity Bill. (The subsequent 'executive' phase until Vesting in March 1990 dealt with the translation of agreements on principles into a working system, and also covered the decision not to privatise nuclear power stations.)

An early decision (in March 1988) was the timetable for privatisation.[28] On 9 June 1988 the designate members of the CEGB successor companies was announced. On 17 June the CEGB proposed an allocation of power stations between Big G and Little G. Some new appointments were made to the boards of the Area Boards, especially finance directors. Arrangements were made to transform the functions of the Electricity Council. Plans for a new Office of Electricity Regulation (Offer) were developed by September 1988, and my appointment as Director General of Electricity Supply was announced in May 1989 (to take effect as from September).

The main issues on regulation of retail supply have been identified in the previous section. A related issue to be dealt with was the possible regulation of initial contracts.[29] (7.21-7.24)

These issues were reflected in papers prepared for a seminar on Regulation, attended by the Department's Ministers, on 6 July 1988. Three main regulatory and contract issues that needed to be resolved may be summarised as follows:

1. Whether price regulation should apply to all the distribution business customers, or whether it was appropriate to exclude some subset of these sales.
2. The form of this price control, accepting that "some form of protection needed to be given to the distribution companies against the risk of unforeseen changes in generating costs, whilst still providing incentives to efficient power purchasing." (7.18)

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two parts: running a network (which, as a natural monopoly, could be controlled by a simple RPI-X formula); and a supply business subject to competition, where a different type of constraint was needed to deal with the risk." (7.20)

[28] Vesting [when the restructuring of the industry and the new regulatory arrangements would take effect] was scheduled for 1 January 1990, with flotation of the distribution companies in Spring 1990, the larger generator (Big G) in Autumn 1990 and the smaller one (Little G) in Spring 1991. (6.39)

[29] In principle these were for negotiation between the CEGB and the Area Boards. But the Department was concerned to avoid unjustified price increases arising simply from privatisation. The Area Boards were concerned that the CEGB prices were excessive, and that the two successor generating companies might discriminate by loading the Boards with high cost capacity charges while offering contracts at marginal cost to large customers. The CEGB was arguing for contracts to provide capacity payments for the remaining life of its stations, and for freedom to allocate capacity between distribution companies and large customers. It said that, with shorter contracts, flotation proceeds would be reduced unless capacity charges were appropriately increased, and when the time came to renegotiate the contracts, distribution companies would prefer to bring in new entrants or establish their own capacity. The Department was sympathetic to making the CEGB and its successor companies subject to a non-discrimination rule, but "the problem was that it would run the risk of raising prices for some industrial customers. A less rigorous approach might start from the assumption that initial contracts should not discriminate any more than the electricity industry did at the present." (7.32)

3. What form of regulation or limitation there should be on initial contracts between the CEGB successor generating companies and the distribution companies, with respect to duration of contracts, level of prices, and non-discrimination provisions.

The July 1988 seminar seemed to resolve some of these issues, at least temporarily:

1. The Secretary of State accepted that the whole of the distribution companies' market should be price regulated.
2. He accepted the principle of incomplete pass-through of generating costs; and agreed that further work should concentrate on the options of partial and yardstick pass-through.
3. He concluded that the length of initial contracts should be limited to between 5 and 10 years, so producing a growing wedge open to renegotiation. He agreed that aggregate revenue from these contracts should be constrained so that there was no discontinuity with the Bulk Supply Tariff. (7.33)

But evidently much remained to be resolved, and views differed quite apart from between the CEGB and Area Boards.[30] The Department began to prepare a paper for ministerial colleagues.[31]

These proposals went to ministerial colleagues on 29 September 1988. The Chancellor was broadly content, but (with a view to flotation proceeds) had concerns about profits.[32] The Secretary of State for Trade and Industry was more concerned about competition and prices.[33]

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[30] "In preparing a paper for circulation to colleagues with proposals on Regulation, Electricity Division had to grapple with reservations on the part of Professor Littlechild and the Department's economists. (Sir Alan Walters, adviser to the Prime Minister, shared these reservations.)" (7.35) Accounting advisers Touch Ross and financial advisers Kleinwort Benson were in favour of a yardstick approach. "Professor Littlechild et al favoured either linking the pass through [of generation costs] to an index of international fuel prices or allowing only a certain percentage of generation costs to be passed through. They believed that the yardstick approach was too complex and that it would either have no impact on the distribution companies or would encourage collusion so that each company's generating costs remained close to the average." (7.36) Professor Littlechild is also cited (7.38) as arguing for limiting the scope of price regulation.

[31] In view of the lack of agreement on pass-through of generation costs, the yardstick approach was included as an option. The concept of separate price formulae applying to the distribution tariff and to the price of electricity supplied "won favour", and was proposed. Reversing the July decision, it was proposed that regulation of electricity supply should be limited to prices in the tariff market "since application to all sales would provide less protection for tariff customers, might distort competition and could be a barrier to future deregulation". (7.38) It was proposed that licence conditions should prevent unfair discrimination between contract customers or between tariff and contract customers, in line with the recent MMC report on British Gas. Initial contracts should be limited to 10 years, except for nuclear stations. Distribution companies would not be compelled to pay more in aggregate immediately after reorganisation than what would have been paid to the CEGB under the Bulk Supply Tariff. A distribution company would be limited to owning no more than 15% of its capacity contracted to the CEGB successor companies. (7.36-7.45)

[32] "Sustainable profits, of which investors would wish to be assured, were at risk from surplus capacity in the short term and from competition in generation in the long term. The distribution companies might need some transitional protection from competition e.g. through penalties on contract customers wishing to return to the tariff market. Big and Little G might need longer initial contracts than 10 years. Some direct contracts between the generators and large customers might be struck before flotation, thus reducing the risks to the distribution companies' markets post-flotation." (7.46)

[33] "The Secretary of State for Trade and Industry preferred initial contracts shorter than 10 years, so as to promote competition; and wanted prices in the contract market not to be regulated, though large

The Secretary of State [for Energy] responded on 14 November 1988. He agreed to exclude from regulation contracts with customers taking more than 10 MW maximum demand. He noted that the industry was now proposing two types of contract to deal with the problem of surplus capacity: contracts with capacity and energy charges that would yield prices comparable with current prices, and 'spot price' [also called 'net-back'] contracts in which energy charges reflected running costs and capacity charges were such that distribution companies paid the system marginal price. The first type would provide some reassurance to generators, the second to distribution companies. (The proportion of each and the period of transition to freely negotiated contracts was yet to be determined.) The Secretary of State accepted the possibility of "some initial contracts of up to 15 years to provide stability for some time after flotation". (7. 49) After some further discussion, the Secretary of State embodied these points in the draft licences circulated in December 1988.

8. Contract negotiations in 1988

The evolution of thinking on contracts reflected the parties beginning to come to terms with the implications of competition in supply.

> Progress on contracts during 1988 was hampered by the Area Boards' worries about the opportunity for generators to pick off large industrial customers, particularly given a surplus of generating capacity. To mix the metaphors in vogue, 'cherry picking' by the generators would result in demand 'walking away' from the distributors, leaving them with 'stranded' contracts and investment. A number of ways of dealing with or preventing 'cherry picking' were canvassed, resulting in much argument between the two sides and in justifications to the Department of their positions. (9.03)
>
> The CEGB put forward two contractual solutions. In the contract market, distribution companies' contracts, with those large customers whom they feared might be poached, could be back-to-back with contracts with generators. In the tariff market, contracts with generators would include some provision for 'winding-down' the distribution companies' obligation to buy capacity and energy if generators began poaching customers. The Area Boards were not attracted to these solutions. Wind-down failed to address their concern about the proper level of electricity prices. Back-to-back contracts would hardly be practicable as they would need to be in place for all customers above 1MW (compared with the CEGB's suggestion of nearer 10MW). (9.04)

It is not clear what thinking underlay the figures of 10MW or 1 MW – presumably the different estimates (or fears) of what size of customer would be interested in competition, and would be attractive to the generators. The Area Boards responded to the CEGB by proposing a two-tier approach to contracting, involving the concept of 'net-back' or 'spot-price' contracts.

> A substantial amount of capacity would be contracted for at prices approximating to present Bulk Supply Tariff levels. For the remainder of the

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customers should not be prevented from opting for a tariff supply (despite the unlikelihood of their doing so)." (7.46)

> capacity required, the capacity element of the contract would be determined retrospectively by reference to system marginal price. These 'net-back' contracts would enable distribution companies to offer prices to large customers sufficiently low to remove the threat of poaching by the generators. (9.05)

They also suggested (mentioned for the first time in the *History*) the possibility of limiting competition in supply.

> In addition to this approach, the Area Boards suggested other safeguards [including] … a temporary limitation on grant of second-tier licences to supply customers below a certain size. (9.06)

The CEGB initially argued strongly against the net-back contracts. But by December 1988 the CEGB and the Boards had agreed on the broad principles of the contracts. They would be on a set-by-set basis. There was still some disagreement over the size of the net-back tranche and the duration of such contracts, but the way ahead seemed clear.[34]

9. Contract negotiations and first contract package: July 1989

Despite the apparent agreement, a number of important issues needed to be resolved.[35] Concerned about the need for progress, the Department in February put in place arrangements to resolve some of these issues. By May 1989 it had become apparent that decisions on contracts were urgently needed if the timetable was to be met. Following a seminar with the Department and advisers, on 14 June the Secretary of State sent the Prime Minister a paper on Electricity Contracts, Prices and Proceeds.[36] The *History* makes no reference to discussions with the industry, let alone agreement. This would turn out to be critical.

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[34] "The generators were offering 10% of capacity and a contract length of three years. The Area Boards were seeking 20% and five to eight years. (9.07) It was agreed that the generators would offer 'indicative' contract prices by the end of January 1989 on the assumption of a 15% tranche of net-back contracts. Thereafter, the timetable envisaged provisional contracts by April, final contracts by July, and Government approval by the end of September, so that shadow vesting [to allow for a period of 'shadow running' before actual Vesting on 1 January 1990] could take place on 1 October." (9.08) National Power expressed concern about the divergence of approach between the parties. (9.09) However, "The generators sent drafts of contracts to the Area Boards at the end of January 1989 and the first set of indicative prices early in February." (9.10)

[35] These included the level of coal prices in energy charges (and the rate at which they would trend down to world prices), indicative nuclear prices, whether the successor generators should be allowed to enter new contracts for direct supply to consumers before privatisation, the implications of competition legislation, and the structure of pricing for energy (whether contracts – which would be on a set-by-set basis - should reflect separate energy prices for baseload, mid-merit and peaking plant, or should include more detailed separate prices for start-up, part-load and full load operation).

[36] The key features were initial five year supply contracts for fossil-fired generation; immediate competition between Area Boards and generators to supply large customers, starting from the establishment of the new industrial structure; a market-related price for fossil-fired generation amounting to a 10% reduction on the Bulk Supply Tariff; coal supply contracts with British Coal moving to world market prices in five years, with a phased reduction in the annual volume purchased, e.g. by 15 mt [million tons] over a three year period; life-of-station contracts for nuclear, with sufficient revenue to cover forecast costs and an appropriate rate of return; tariffs for use of the transmission and distribution systems set to produce revenue covering costs and a 5.5% return on a CCA basis (compared with 8% for which the Area Boards and the Grid company had argued); and pursuit of a number of options for limiting price increases to large industrial customers. (21.18)

The Area Boards would have options to terminate 19% of the contracts for supply from existing fossil-fired plant every six months. Each fossil-fired generating set would receive a market-related price equivalent to the price expected to be offered by a new entrant generator. The price estimates assumed coal at the world coal price, with a tapering charge for recovery of the additional cost of supply from British Coal. Competition in supply was now a key element.

> An important feature of the package was that competition between generators and Area Boards to supply large customers would be allowed to commence as soon as the new structure was established and use of system charges were published. (The Department's view was that if the Area Boards were going to lose customers, it was better that this should happen before, rather than after, flotation.) The Area Boards argued that their obligation to supply, which was more onerous in the regulated market, would put them at a competitive disadvantage. They preferred that competition should be restricted to the unregulated market until after flotation. (At the time it was envisaged that the unregulated market would be that for customers taking more than 10MW.) (21.20)

The paper explained how the package would address four main problem areas. [37] After measures to help large users and the introduction of the nuclear levy, average prices to domestic and commercial customers would rise by only about the rate of inflation.

Ministers including the Prime Minister broadly supported the package, albeit with some reservations.[38] It was agreed on 18 July 1989. The industry seems to have accepted it with some reservations, though British Coal was still aggrieved.[39]

This seems to have been a high point for the prospects for retail competition. Competition in supply would start immediately the new industry structure took place i.e. at Vesting, then scheduled for 1 January 1990, only five months hence. In addition, there was no obvious restriction on the extent and nature of such competition. The package referred explicitly only to large customers, but this clearly went beyond unregulated customers (maximum demand 10 MW) and seemed to include customers with a maximum demand over 1 MW. Moreover, there was no

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[37] Additional measures were suggested for limiting the increase in prices to industrial customers. A transition to world prices and lower volumes would help to secure the future of British Coal. Short-term contracts with market-related pricing would provide comfort for investors. "The Department's financial advisers believed that a contractual package based on broadly competitive prices provided the only sound basis for flotation if competition was to be introduced". (21.21) The contract package would benefit independent generators by preventing the two main generators from tying up the market on long-term contracts.

[38] The Chancellor "was not so concerned about avoiding a real increase in prices to consumers before privatisation": there were justifiable grounds for a modest real price increase and he was concerned that "a very substantial cost might fall upon the Exchequer". (21.23) The Secretary of State for Trade and Industry was concerned about the proposed increase in prices for large users (although it was accepted that prices would have to increase because they had previously been uneconomically low). The Prime Minister was concerned about the possible effect on pits worked by the Union of Democratic Mineworkers (UDM).

[39] British Coal was concerned at having been kept in the dark about the package, and about the proposed tapering payment. The company continued to hold out for a ten year contract for the greater part of its supplies.

statutory or licence barrier to competition to supply smaller customers as and when the companies or competitors thought it worthwhile to do so.

The policy agreed by ministers in July 1989 thus effectively envisaged full retail competition for all customers from Vesting Day. But events were soon to undermine this expectation.

10. Other developments to July 1989

During the first half of 1989, the CEGB and Area Boards had been working on the basis of a two-Pool system, involving a Generators' G Pool and Distributors' D Pool.[40] As discussions developed, the Area Boards became concerned that this approach would lead to the loss of their largest customers.[41] The generators, for their part, were concerned that the D Pool with its attempt to mirror the actual despatch of plant (based on the detailed contracts) amounted effectively to the leasing of plant to the distributors i.e. vertical integration. This would also be complex, inefficient and unduly restrictive on the generators and on large users wanting load management terms.

In May 1989 the Area Boards tabled proposals involving 'nine rules' governing pooled and unpooled contracts. In July the Secretary of State rejected these proposals as too restrictive on the nature of contracts. He asked the industry "to develop the two-Pool approach in accordance with three principles which any pooling, contractual and regulatory arrangements should satisfy"[42], although he also indicated that "he was willing to consider some restrictions on the generators' freedom to supply customers direct". (21.17)

There had also been further work on nuclear. The costs and risks of the older Magnox stations became increasingly apparent. On 24 July 1989, his last day as Secretary of State for Energy before moving to Transport, Cecil Parkinson explained that he was withdrawing the Magnox stations from the privatisation. (20.39)

11. Rethinking: August to September 1989

On taking up his appointment, the new Secretary of State (John Wakeham) was advised that vesting by 1 January 1990 had become unrealistic, as had flotation in Spring 1990. A revised timetable was announced in September: Vesting on 31 March 1990 and flotation of the distribution companies in Autumn 1990 followed by the two generating companies in the first half of 1991.

This in itself would have meant only a three month delay in the opening of full retail competition. However, two other aspects of the July 1989 arrangements - the two-

[40] The generators' G Pool would allow generators to trade so as to meet their contractual obligations at lowest cost. The distributors' D Pool would allow the distribution companies to trade their contract entitlements so as to meet demand at the lowest contract price.
[41] The generators would sell direct to customers, bypassing the D Pool; they would be able to engage in cross-subsidy and predatory pricing; and they would be able to sell reserve capacity (which the distributors had already paid for) to large consumers on an interruptible basis. (21.12)
[42] These were: freedom of contractual form, effective capacity trading arrangements and effective policing of anti-competitive behaviour by the generators.

Pool system and the first contract package - soon began to unravel. And by November the remaining nuclear stations were pulled from the privatisation.[43]

The Area Boards concluded that the two-Pool approach could not be satisfactorily adapted to comply with the Secretary of State's objectives. At the beginning of August 1989 they came up with a completely revised single Pool approach: a Unified Settlements System. This in itself was not a problem, but there was more. Unrestricted competition in supply presented a problem for the industry.

> At about the same time [early August 1989], Mr Duncan Ross, Chairman of Southern Electric, wrote to Mr Guiness [Department of Energy] about the basic issues between generators and distributors. He believed that the generators were concerned that in a world of truly open competition there would be a severe risk of generating capacity failing to be adequately remunerated on a long term basis. The Area Boards' new proposal for a unified pool did not itself address this concern. Mr Ross suggested that there were only two ways of addressing it:
>
> Either
>
> 1) long term contracts between distributors and generators, with both capacity remuneration and fixed prices for energy, allied to a distributors' monopoly over supply to regulated customers within their licensed areas;
>
> or
>
> 2) open competition in supply, with a flotation value for the generators reflecting the resultant volatility of profits.
>
> The Area Boards believed that it could well be possible to reach agreement with the generators on pooling, settlement, contracts etc, on the basis of option 1), but option 2) would require the Department to intervene strongly. (22.01)

The Department saw advantages in the Unified Pool proposal.[44] However, as Mr Ross suggested, the generators "were worried that it would encourage distributors and other customers to buy from them on a spot basis only. Given the surplus of capacity, the spot price would be low."[45]

> They [the generators] envisaged alternative ways in which their concerns could be allayed:

[43] The efforts in the next four months to keep AGR and PWR stations in the flotation foundered on the rocks of the difficulty of establishing a Magnox company; National Power's high indicative prices for AGR and PWR electricity, even on the assumption of relief from major risks, and the implications for the size of the fossil fuel levy; and the unwillingness of banks to finance PWR construction unless they were relieved of all risk. (20.40) Sometime in October, the intractability of the various nuclear issues began forcing on the Department the seemingly heretical idea of excluding nuclear from privatisation altogether. (20.82) On 9 November 1989 the Secretary of State announced that all the nuclear stations would remain in the public sector. A week later Lord Marshall resigned the Chairmanship of the CEGB and his position as Chairman-designate of National Power (formerly Big G). (20.92)

[44] "It was capable of reproducing the same effects as the two pool approach, it met the objective of freedom of form of contract, it established a single market in electricity with a single market price and it ought to be easier to explain to investors." (22.03)

[45] "In addition, low spot prices for sale of electricity would be inconsistent with high prices on a long-term basis for British Coal, which the Government might want to insist on. Also, low spot prices would not fund FGD investment." (22.03) Flue Gas Desulpherisation (FGD) was required in order to clean up the emissions of coal-fired power stations.

Either

a) persuading the Area Boards to sign a proportion of longer term contracts at the outset, so that the range of duration of contracts was up to fifteen, rather than five years;

or

b) accepting substantially lower prices in the initial contracts, so that they faced less risk of declining profits when those contracts expired. (22.03)

The Area Boards and the generators were thus thinking along the same lines. But both options presented problems for the Department.

> The difficulty with a) was that the Area Boards would refuse to sign long-term contracts without a monopoly of some part of the market. (It was thought this would be very unattractive to Professor Littlechild, the No. 10 Policy Unit and possibly to DTI and the European Commission.) The difficulty with b) was that it could make the generators unflotable, would greatly reduce proceeds, could require cash injections into the generators' balance sheets and would not enable them to sign long-term high-priced contracts with British Coal. (22.03)

At the beginning of September, the Department recommended that the industry should proceed on the basis of the single pool, and that there should be further analysis of the viability of the generators depending on the extent of long-term contracts and an assessment of the Area Boards' argument that they could only accept long-term contracts if they had a monopoly of part of their market. The Secretary of State agreed. But the Department was overtaken by events.

12. The industry proposal: September 1989

The generators and distributors scented a solution to their problems, and were working faster than the Department's processes envisaged. They accepted competition in supply above 1 MW but not below. On which basis they proposed a set of contracts agreeable to both sets of parties.

> In the meantime, the industry had been working up proposals on markets and contracts; and on 6 September Dr Jim Smith, Chairman of the Area Board Chairmen's Steering Committee wrote to the Secretary of State with proposals agreed with National Power, PowerGen and the Area Boards. The proposals were intended to deal with the problems of a surplus of capacity and of uncertainty created for investors if trading was on a largely spot price basis. The industry was agreed that the Unified Pool, on the lines proposed by the Area Boards, was a sensible way to proceed, provided it was set in an appropriate regulatory framework. However, additional measures were needed to avoid instability in the generation, supply and distribution business. These were:
>
> a) <u>Franchise</u>. Distributors should have a monopoly franchise to supply individual premises with demands up to and including 1 MW within their licensed area. These franchises would cover about 70% of the total electricity market in terms of sales of kilowatt hours.
> b) <u>Contracts for franchise market</u>. For supply to the franchise market, distributors should be obliged by condition of licence to place long-term

contracts for fossil-fired generation. Contracts would be for an average of 10 years, subject to a maximum of 15 years. The additional payment of £12.50/kW for British Coal, tapering over a five year period would apply to this tranche of contracts only.

c) Other contracts/purchases. For initial contracts for supply to individual premises with demand above 1 MW, distributors would seek to contract for at least 50% of the demand by means of short (six month to five year) contracts. The rest would be met by spot purchases. In return, National Power and PowerGen were willing to agree that not more than 15% of their joint total capacity should be capable of being contracted to customers outside the distributors' franchise market; and that in aggregate they should not acquire more than 15% of the total supply market in any one distributor's licensed area.

Generators and distributors were united in the belief that this package would remove sources of uncertainty, facilitate rapid progress on contracts and allied matters, preserve substantial competition and permit successful flotations. (22.05)

13. The Department's dilemma

The Department was faced with concerns about this proposal from a wide range of sources.

> No. 10 fired a warning shot across the Secretary of State's bows on 31 August. The Prime Minister had seen press reports of discussions within the industry about the post-privatisation market framework. She hoped that in considering proposals from the industry, the Secretary of State would keep at the forefront of his mind the crucial importance of achieving genuine competition in contractual and operating arrangements, so that the consumer secured proper benefits from privatisation. (22.06)

In reply, the Secretary of State said that "achievement of the prime objective of privatisation might mean some modification of other objectives in the short term".(22.07) While the industry's recent proposals "represented a major initial limitation of the competitive structure which Mr Parkinson had agreed with officials in July, the industry maintained that they were indispensable to privatisation proceeding on the current timetable." And they had other advantages.[46]

There was also a letter from the Secretary of State for Trade and Industry.

> He was concerned about reports that the industry wanted to have long-term supply contracts and a distributors' monopoly of small customers. This would run counter to the pro-competitive approach agreed in the summer. A move to long-term initial contracts would jeopardise the chances of proper competition

[46] "The proposals retained competition in generation; were likely to be welcomed by independent generators; and could well make it easier to accommodate the costs of reducing sulphur emissions. Longer-term contracts with distributors would enable the generators to enter into longer-term commitments to British Coal." (22.07)

developing and would be especially hard on emerging private generators. (22.07)

The Secretary of State had a meeting with the Prime Minister on 13 September. She reaffirmed that achieving privatisation had to be the first priority. "At the same time it was important to avoid the extent of competition being over-diluted, resulting in a rerun of the British Gas privatisation. But she recognised that some degree of compromise on competition was likely to be necessary in striking the overall balance." (22.08)

14. The Department's response

How did the Department deal with this situation? It concluded that it could not impose a solution on the companies because they all had to be satisfied before signing contracts. It therefore sought to find a less severe restriction on competition that could nonetheless still be acceptable to the industry.[47] In this it perhaps reflected the inclinations of the new Secretary of State, who had a reputation as a 'fixer' of difficult political problems.

Meanwhile other departments reaffirmed their concerns about competition.[48] The Department had "extensive discussions with all sides of the industry and two discussions with Professor Littlechild". It then identified two options in a minute of 22 September to the Secretary of State. Both assumed competition in supply above 1 MW but envisaged different provisions for customers below 1 MW, with associated different sets of contracts.

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[47] "The Department's initial advice to the Secretary of State was that some deal with the industry was essential if flotation was to be achieved during the present Parliament; but that an attempt ought to be made to limit the restriction on competition that the proposals represented. They were unique in that it was the first time that the Area Boards and the generators had agreed on the principles on which the new contractual, operating and settlement regime should be based. Before the new regime could be activated, all the parties had to sign contracts for supply. This meant that they all had to be satisfied that the contracts would not damage their businesses. It was not therefore feasible to contemplate imposing a solution; and the industry clearly believed that some restriction on competition was essential. Moreover, they had said that the proposed package should be taken as a whole: if part of it was unacceptable, they reserved the right to withdraw the whole package. On the other hand, the proposals would significantly reduce the scope for competition compared with the package agreed by Ministers in July. Thus, the proposed monopoly of distributors to supply individual premises up to 1 MW within their areas contrasted with the previous intention of opening up all supplies to competition from the outset. Also, the proposal for initial contracts with a duration of five to fifteen years for suppliers to franchise markets contrasted with the previous intention of contracts with a duration of six months to five years. It was questionable whether in practice there would be much competition for supplies of less than 1 MW in the early years, particularly given the need for metering on a half hourly, rather than a total consumption, basis if supplied by a second-tier licensee. On length of contracts, the generators' fears seemed exaggerated, since it was likely that the distributors would want a spread of contracts of varying duration to minimise risk. An attempt to persuade the industry to accept less restriction on competition could take the form of: a reduction in the size of the franchise market below 1 MW; the right to this market for only a limited period of, say, five years; and a reduction in the maximum length of the initial contracts to ten years. The Secretary of State agreed that the Department should sound out the industry about these ideas." (22.09)

[48] "The Treasury were concerned that Ministers should be presented with an alternative option that would do much less violence to the Government's objective of achieving competition. They favoured the exclusion of any monopoly power over part of the market, and much shorter average contract lives. … Discussion with the DTI confirmed the Department's initial view that they would be very unhappy with the restrictions on competition proposed by the industry and foresaw serious difficulties in getting acceptance of it by the European Commission." (22.10)

The <u>first</u> would consist of:

a) a five year restriction on competition in supply to premises consuming less than 1 MW. This would be reviewed at the end of five years. If the Government decided to remove the restriction, the transition to a fully competitive market would be phased over three years;
b) life-of-station contracts for nuclear (which had already been agreed) and ten to fifteen year contracts for 12 GW of fossil-fuel capacity. (The combination of these would amount to coverage of about 50% of the market by longer-term contracts.) The remainder of the market would be met by shorter-term contracts;
c) a limit of 15% of the generators' aggregate direct sales in any one distributor's licensed area. (22.11)

The Department envisaged that the industry would accept such a package. On the other hand, Professor Littlechild would not be prepared to accept it.[49] What then was the alternative proposal?

The <u>second</u> option consisted of:

a) a three year restriction on competition in supply to premises consuming less than 1 MW;
b) after the three years were up, a phased reduction of the 1 MW limitation to 0.1 MW (100 kilowatts) over the next two years;
c) the 0.1 MW limitation being phased out altogether over a further three years;
d) life-of-station contracts for nuclear and ten to fifteen year contracts for 12 GW of fossil-fuel capacity (as in the first option);
e) the remainder of the initial franchise market (initially about 20%) being met by three to five year contracts;
f) the initial non-franchise market (about 30%) being met by a mixture of spot and six month to five year contracts, as proposed by the industry; and
g) generators' aggregate direct sales in any one distributor's area being limited to 15%, as proposed by the industry. (22.12)

PowerGen was relaxed about this option. The Area Board chairmen and National Power reacted adversely. Professor Littlechild responded favourably. The Department recommended that the Secretary of State should seek to persuade the industry to accept the second option, on the same basis as they put forward their own proposals, "i.e. that they would cooperate constructively and effectively to deliver privatisation during the present Parliament", otherwise the only proposal remaining on the table would be that agreed by Ministers in July.

Professor Littlechild confirmed his strong reservations about the industry's proposals in a letter faxed to the Secretary of State on 25 September, the day that the latter was due to meet the industry chairmen.[50]

[49] "He thought that a five year monopoly in the market below 1 MW would provoke much criticism, particularly on the part of larger retailers and other commercial operators who would be excluded for some time from the benefits of competition in supply. The Department's advisers considered that opposition from Professor Littlechild, or even reluctant acquiescence, would unsettle investors and lead to lower proceeds." (22.11)

> At his crucial meeting with the industry Chairmen on 25 September, the Secretary of State explained why the industry's proposal of 6 September presented him with difficulties: he did not believe he could persuade colleagues to accept it, there would be considerable difficulties with the European Commission, and difficulties, too, with the DGES. He was prepared to put to colleagues the alternative proposal tabled by the Department [the second option] if he could tell them the industry was united behind it. (22.14)

The industry Chairmen raised various objections, which were generally countered.[51] Nevertheless, as the industry appeared to be dissatisfied with the Department's proposal, the Secretary of State asked the Chairmen to come forward with a modified proposal by the end of the day.

15. The industry's modified proposal

The Chairmen worked on this issue during the afternoon and presented a package which the Secretary of State believed there was a reasonable chance of colleagues accepting. (22.14)

> The modified proposal had the following features:
> a) a <u>four</u> year limitation on the issue of second-tier supply licences for supply to premises taking 1 MW or less
> b) a further <u>four</u> year limitation on issue of second-tier licences for supply to premises taking 0.1 MW or less
> c) thereafter no limit on the issue of second-tier licences
> d) life of station contracts for supply from nuclear stations
> e) <u>four to eight</u> year contracts for 12 GW of supply from fossil-fuelled stations, equivalent to the extent of the distributors' monopoly franchise
> f) the distributors to secure the balance of their requirements under contracts with the generators of <u>up to five years</u>
> g) during the first four years, National Power and PowerGen would, in aggregate, be limited to supplying no more than 15% of the demand in any one distributor's territory. This limit would be <u>raised to 25% for the next four years and then be completely lifted</u>. (22.15)

Professor Littlechild's main concern continued to be the timing of the reduction in the distributors' monopoly. He would much prefer modifications to alleviate this.[52]

Nonetheless, on 26 September the Secretary of State recommended the industry's modified proposals to his colleagues. They gave a qualified acceptance, inviting him

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[50] "The second option represented a move in the right direction, but he preferred a faster transition to competition, and a reconsideration of the 15% restrictions on the generators." (22.13)

[51] E.g. "The Area Boards said that … under the Department's proposal, they would not be able to offer independent generators sufficiently long-term contracts to make investment worthwhile, though this might be different if the distributors were given a permanent monopoly below 0.1 MW. The Secretary of State said that he would not be able to secure colleagues' agreement to a permanent franchise." (22.14)

[52] One or more of the following: "removal of the 1 MW to 0.1 MW franchise within two rather than four years; the DGES to have discretion to allow aggregation of premises; and the timetable for removal of monopoly to be reviewed by the DGES after two years". (22.16)

to seek a shorter transitional period.[53] The Department advised that this would make the coal contract negotiations very difficult.

The Secretary of State wrote to the industry chairmen on 29 September 1989, accepting the package they had put forward.

> The Secretary of State described the discussions as the most productive since the Electricity Act was passed. (22.26)
>
> The agreed package meant that from vesting nearly one third of the electricity market in England and Wales would be opened up to competition from suppliers other than the distribution companies. After four years, about half of the market would be opened up. After a further four years, it would be completely opened up. (22.27)

16. Subsequent events

As the *History* remarks, "there remained the enormous task of translating the principles and framework now agreed into contracts, codes and agreements" (22.28) This had to be complete by Vesting on 31 March 1990, just six months hence. This necessitated resolving a wide variety of questions.[54] In addition, the pooling and settlement arrangements needed to be finalised, the transmission and use of system charges set, and the form of the distribution company price controls resolved.[55]

The coal and electricity contracts that had driven the supply competition timetable also had to be negotiated. The Secretary of State indicated that "he had accepted the eight year limitation on competition within the electricity industry because that would make it easier for long-term coal contracts to be signed". (26.03) But British Coal and the generators were unable to reach agreement on the envisaged four to eight year contracts, and the final contract package brokered by the Secretary of State was limited to three years. British Coal declined to sign longer contracts on the terms on offer. This in turn led to three year contracts between generators and distributors,

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[53] "The Prime Minister said that the Secretary of State had achieved a great deal in his discussions with the industry. The revised proposals would go a long way towards improving the arrangements for competition. He should now seek to persuade the industry to accept a reduction in the total length of the transitional period from eight to six years. However, it would be for the Secretary of State to judge whether such an improvement could be achieved consistent with keeping to the tight timetable now required." (22.24)

[54] For example, whether the Area Boards would have an obligation to offer tariff terms to 1 MW (non-franchise) customers, how a 1 MW customer should be defined (the phrase '1 MW maximum demand at a single premises' led to several dozen regulatory determinations over the meaning of 'single premises'), whether a 1MW customer in one year should fall back into the franchise area if its maximum demand fell back below 1 MW in a subsequent year, whether the 15% joint limitation on generators' market shares should be abandoned on the grounds of impracticality of implementation, whether the parties should be able to drop the higher priced contracts in the event of a breach of the franchise by the government and/or regulator, whether additional time should be allowed to negotiate the first contracts with large users, and so on.

[55] By January 1990 the controversial yardstick concept was dropped. "It was thought that the yardstick might provide the distribution companies with an incentive to buy more of their electricity on a spot basis, which would be detrimental to proceeds from flotation of the generators. It was complex to define and administer; and it was, in any case, very close to full pass through of generating costs." (27.01) There was an additional extensive debate about the nature and coverage of the price cap.

despite the franchise having been agreed at eight years.[56] In December 1989 the contract package was modified accordingly.[57]

The Government considered it important to assess the implications for prices. Calculations just before the December contract package suggested a 6% to 8% nominal price increase for domestic [residential] consumers, reductions in real terms for the majority of commercial and industrial customers [inflation outturn for 1989/90 was 9.4%], price increases of 15% nominal for large users and up to 30% nominal for the dozen or so very large users. "Such increases were clearly unacceptable." (26.21) Steps were taken to reduce the projected price increases to a politically acceptable level.[58] The price increases announced by the Area Boards gave average price increases of 9.2% nominal for domestic customers (presented as below the rate of inflation) and average price reductions of 8.47% nominal for non-franchise customers. (26.38) In fact non-franchise customers fared even better with competition. The *History* adds a Note:

> A survey of industrial users on behalf of the Major Energy Users Council reported that for the year ending March 1991 76% of consumers with sites consuming 1 MW or more had experienced price reductions of at least 10%, and 31% had had reductions of over 20%. (*Power in Europe* 18 July 1991)

The possible impact of supply competition was unknown before Vesting. In the event, generators proved keen to offer attractive terms and large users proved keen to respond. Within the first month or so, 28% of non-franchise (over 1 MW) customers, accounting for 43% of non-franchise load, had signed up for an alternative (second tier) supplier. Within eight years these proportions had increased to 63% and 75%,

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[56] "Part of the thinking underlying the contract package agreed in September was that there should be a tranche of longer-term contracts between the generators and the distribution companies related to the period and extent of the latter's franchise. It was subsequently realised that the length of the contracts would have to be determined not by the period of the franchise but by the length of the generators' contracts with British Coal. The latter had ended up at three years; and, at the tonnage of coal contracted for, the whole of the electricity contracts to serve the franchise market would be needed to underpin the coal contracts. The franchise contracts therefore also became three year contracts. The length of the distribution companies' contracts with the generators for electricity for supply to the non-franchise market were, in turn, determined by the length of the companies' contracts with their customers in that market." (26.24)

[57] It now comprised three year contracts with National Power and PowerGen, covering 70% of output, to underpin the coal contracts, plus one and two year contracts with options for either side to terminate after three months covering 10% of output. The early options to terminate would allow immediate competition to supply larger customers to commence. The remaining 20% of output was covered by "eight year contracts with Nuclear Electric reflecting the true cost of nuclear power", but these were priced at pool price plus a fixed Non-Fossil Fuel Levy, and Nuclear Electric would offer short-term hedging contracts priced on exactly the same basis as those offered by National Power and PowerGen. There was reference to subsequent five year contracts starting at the end of the third year, probably covering some 50% of output. (26.12, 26.13, 26.25)

[58] A price cap of RPI-0 for large (non-franchise) customers was agreed, which "could be presented as a price freeze while large users gained experience of the market and negotiated deals during the first year". (26.30) But this indicated average increases to domestic customers of 11% nominal. "The Secretary of State called an urgent meeting with the industry on 15 February. … He asked the industry to consider urgently some rebalancing between franchise and non-franchise customers, together with some other measures set out in a note handed to the industry. They were to report by 19 February on how average increases for domestic customers would be kept to less than 9% nominal." (26.34)

respectively.[59] In 1994, medium-sized industrial users (maximum demand over 100kW) showed that they too were willing to switch supplier.[60]

Would residential customers be interested in competition in supply? Many in the industry doubted it. [61] But in 1998 residential customers moved to new competing suppliers at the rate of more than 1% per month. Within ten years, more than half of residential customers were supplied by non-incumbent suppliers. The measures needed to enable extensions of the competitive market in 1994 and 1998, and the contract negotiations that this time involved the coal industry explicitly, are intriguing and controversial stories that lie beyond the scope of this paper. There was also, of course, the task of actually selling the companies, which takes up over a quarter of the *History*.

17. Conclusions

The market for retail electricity supply was 'created' by the Government in England and Wales in the sense that it removed the statutory monopoly of the Area Boards and allowed competition to happen. Initially, the Government thought this market was irrelevant, other than for a few large users. About eighteen months later the Government was prepared to remove the monopoly entirely. It considered that five year contracts priced at the expected new entrant price would suffice to offset the risks to investors. However, this package was not acceptable to the industry, which proposed its own agreed package with contracts up to 15 years and competition limited to large users above 1MW. The Government felt unable to dictate terms to the industry because it needed industry acceptance of the contracts that would underpin privatisation. Nevertheless, it was able to persuade the industry to accept that retail competition should eventually be extended to all customers. The industry then agreed a modified package, to phase in the introduction of retail competition, and hence the removal of the monopoly, over eight years, with contract durations modified accordingly. The Government accepted.

In the end, some phasing of competition was not necessarily a bad idea. It allowed time for learning from experience, and for regulatory provisions to make competition effective for residential users. The main cost was born by medium-to-large users in the 100kW to 1MW maximum demand range, who were prevented from switching supplier for four years, and by smaller and residential customers who had to bear a very considerable burden of subsidising the coal industry for eight years.

The phasing later provided the opportunity for certain distribution companies to argue against full opening of competition, particularly with the advent of a new government. But the agreed phasing also provided a defence against such opportunism. This was particularly important when the Government came to broker the signing of new contracts with a view to privatising the coal industry. In the absence of the agreed

[59] Office of Electricity Regulation, *Annual Report 1997*, p 28.
[60] In 1994/5 some 25% of 100kW customers, accounting for 30% of 100kW load, switched supplier. By 1997/8 those proportions had increased to 41% and 53% respectively.
[61] One of the most senior Regional Electricity Company (REC) chairmen was given responsibility for coordinating company arrangements for retail competition. I told him that I could envisage residential (called domestic in the UK) customers choosing their own electricity supplier, perhaps selecting from entries in the Yellow Pages telephone book. "It will never happen" he said firmly, "It will never happen."

introduction of competition, there is no doubt that more customers would have been saddled with the costs of high-priced contracts for a longer period of time.

How does this experience of creating a market relate to the issues raised by this conference? It has elements of economics (the implications of competition for prices, profits and flotation values), politics (the trade-offs between competition and electricity flotation proceeds and the subsequent flotation of the coal industry) and law (the specification of the franchise and the removal of monopoly).

The actions under discussion perhaps lie in the middle level of the suggested three levels of analysis: the negotiation of 'market rights'. The Department of Industry was leading the privatisation policy, but was not in a position entirely to dictate terms. It needed to gain the agreement of the relevant economic and political actors, including the incumbents and potential entrants (with the generators and distribution companies being incumbents in their own markets but potential entrants into the markets of the other parties). Consumers per se were not actors but other parties acted on their behalf, notably the Department of Trade and Industry and the Director General of Electricity Supply. The Prime Minister and the Treasury played critical roles.

It became apparent that a solution proposed by the Department and agreed by ministers was not viable. The subsequent outcome was in effect a negotiated settlement, a package comprising a competition timetable and associated contracts, that was negotiated between the industry parties and modified to meet the concerns of ministers and the DGES. Significantly, perhaps, the failure to deliver the contracts specified in the package was the result of a critical party, the coal industry, not being a party to the package.

It is interesting to speculate on whether the outcome was independent of the personalities involved. It seems likely that competition would have been extended to large users over 1 MW. But would it have gone much further without key ministers and advisers as committed to the principle of competition as Nigel Lawson, Lord Young, Nicholas Ridley and Sir Alan Walters? Or without a prospective DGES that had earlier proposed the policy of universal retail competition?

British experience of creating a market may not be a model. However, the somewhat unpredictable process of balancing conflicting objectives and emerging practical constraints, the resort to negotiated agreement within the industry, and the eventual failure to deliver fully on this agreement, may not be unrepresentative of how governments actually operate, including in creating markets.