



ACCOUNTING SEPARATION WORKSHOP

A note by Aquavitae (UK) Limited

1. Background

Ofwat was criticised by the Competition Appeal Tribunal (CAT) in the Albion (Shotton) case because of its failure to collect disaggregated cost information from incumbent water companies. For example, in its October 2006 judgment, the CAT said,

‘...it is difficult properly to determine the costs attributable to using the “natural monopoly” element in the supply chain without making some attempt to disaggregate or separate those costs from the costs of other activities now potentially open to competition, such as retail activities. No attempt to do so was made in this case. Moreover, the Authority’s present accounting guidelines have not been developed for that purpose[para. 475]

On several occasions since the CAT judgments, Aquavitae has contacted Ofwat to propose that it should collect disaggregated costs.

We understand that Ofwat is now pressing ahead with separation. In its latest consultation on market competition (December 2007) there is a section on accounting separation which says each company will have ‘to identify clearly and report separately on each key area of its business...it is likely that companies will be required to separate out for accounting purposes their notional retail business, their network business and their production/treatment business.’ In another recent Ofwat consultation paper on setting price limits for 2010-15, it says ‘...there has been a positive response to our proposal to develop accounting separation.’

2. Accounting separation and unbundling: creating a framework to promote effective competition

‘Accounting separation’ can mean many different things so the way it takes place is a key issue. To promote effective competition, appropriate restructuring of the water undertakers’ integrated activities is vital.



Accounting separation should come as near as possible to full business separation or it will not succeed. It needs to `unbundle' existing potentially competitive activities (e.g. production (classes), storage (raw and treated), treatment, metering and meter reading, retailing) from each other and from the `natural monopoly' pipeline network so that each is treated as a separate business unit with its own costs (and profits). Such separation will also facilitate the application of a regulatory regime that is most suitable for each activity. Accounting for pipeline transport as a separate business is particularly important. As entrants all have to use existing pipelines to reach their customers, they need assurance that they are only paying costs that are reasonably attributable to those pipelines plus a reasonable rate of return and that the incumbents' businesses, with which entrants are competing, are charged on exactly the same terms.

3. The workshop

At the workshop, the best way to make progress might be for Ofwat to look at precedents for this kind of separation. The most important precedent is gas in Britain where Ofgas worked out the details of accounting separation for British Gas. Its actions were based closely on a 1993 report by the Monopolies and Mergers Commission (MMC), the predecessor of the Competition Commission, and the regime worked well before British Gas decided that it should voluntarily divest its retail trading business, resulting in the creation of Transco which was responsible for its network business and ancillary services such as metering and storage. Subsequently these ancillary services were also unbundled, leaving the `natural monopoly' pipeline network to be separately regulated.

The main features of the MMC's separation recommendations and Ofgas' implementation of them are explained as follows.

4. The MMC 1993 Inquiry and Ofgas' implementation of separation

At the time of the 1993 MMC Inquiry, there was considerable concern that British Gas was blocking entry to the market by making it difficult for entrants to gain access to its pipelines on reasonable terms. British Gas was at that time a vertically integrated company, owning the pipeline system as well as having production activities and retailing



gas, similar to the present incumbent water companies in England and Wales except that it operated nationally.

The MMC found that British Gas` operation of its gas supply business as an integrated structure could be expected to operate against the public interest by inhibiting competition. Its recommendations involved separating British Gas` trading business from its transportation and storage businesses and implementing a separate system of regulation over transportation and storage. The MMC wanted divestment of BG's trading activities in order to turn its transportation and storage unit into a separate business. But, in the event that the government decided not to pursue divestment (as was the case), the MMC recommended how accounting separation should be carried out rigorously to mimic full business separation. Ofgas implemented the MMC findings on accounting separation (with minor modifications found necessary in their practical application).

4.1 The MMC's specific separation conditions

Ofgas, in implementing the MMC's recommended accounting separation, was seeking to create a structure in which BG's transportation and storage business (Transco), in like conditions, offered exactly the same terms for its services to each of BG's trading units as it did to firms outside BG's control.

Ofgas followed closely the following recommendations of the MMC which related to BG's own organisation and procedures:

- create separate management structures and terms of employment and allocate employees (on a non-transferable basis) to transportation and storage;

- physically separate to the maximum extent possible all common services, e.g. information technology systems, data bases, treasury functions, career management, accounting and financial services, operational services and buildings at national, regional and district (including depot) level;

- publish separate accounts to include as a minimum profit and loss accounts, balance sheets and cash flow statements;



have any contracts or agreements with other parts of the business on fully arms length bases, with any cross-charging to be kept to a minimum; and

report to OFGAS should, in the view of the management of the transportation and storage business, the resources available to it be inadequate to discharge the statutory and other duties in respect of providing transportation and storage services.

(ensure) that any information supplied to the transportation and storage business should not be made available to or used by or to the advantage of the trading business. Appropriate arrangements should be made at Board level to safeguard the confidentiality or transportation and storage information that could be of advantage to the trading business.

(require) the transportation and storage business to publish regularly information on the costs of providing `unbundled' transportation and storage services (subject only to the need to protect the commercial interests of users of these services) and the methods by which such costs are translated into prices.¹

4.2 Ofgas` implementation of the MMC's recommendations

Ofgas had to translate the MMC's recommendations into practice. The following are some of the main areas where it had to make decisions.

Staff transfers

Ofgas proposals allowed staff transfers, subject to a period of `gardening leave' (normally three months).

Adequate resourcing of Transco

This was addressed by a proposal that the Managing Director of Transco should, through the BG Board, make both an annual (published) report to the Director General on his views on the adequacy of the resources made available to Transco during the

¹ The quotations are from Monopolies and Mergers Commission, *British Gas plc*, Cm 2315, HMSO, August 1993, Volume 1, paras 2.133 and 2.134



previous year and a statement of his views on the adequacy of resources allocated for the following year.

`Chinese walls' to prevent anti-competitive information flows

Ofgas proposals banned any information flows, subject to very few exceptions (eg if the supplier/shipper concerned had given permission, or the information was public anyway).

Ofgas proposed the appointment of a very senior and high profile compliance officer who would report directly to the Board member responsible for compliance with the Chinese walls; report to a separately-constituted compliance sub-committee of the Board; make an annual public report to the Director-General on the effectiveness of the Chinese walls; monitor compliance with BG's `code of conduct' for staff in relation to the Chinese walls and suggest changes; investigate and deal with complaints from competitors.

Separation of Common Services

BG agreed to the physical location of Transco staff in separate buildings. It also allocated to each business unit separate responsibility for most previously `common services' such as financial and management accounts, payroll, IT services, legal, personnel, general administration and training and development services.

But Ofgas agreed to the retention of a few common services on the basis that separation would be costly to Transco and was not necessary for effective separation. These services included property management, vehicle fleet operations, group insurance and research and technology. In each case, Transco had to be given the right to go elsewhere for its services if it wished.

5. Separation of Price Controls

The MMC's recommendations for business separation of British Gas` trading activities from its gas transportation and storage activities also encompassed the closely related recommendation to establish separate price controls - first, for British Gas` retail activities separately from its transportation and storage activities, and subsequently for separating transportation from storage since the MMC



said there was potential for competition in storage. In addition, the MMC said there should be an obligation on Transco to enable competition in the provision and reading of meters, which led subsequently to separate regulation by Ofgas of metering, also to facilitate competition.

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