PREM 19/1583

PART ELEVEN

SECRET.

Confidential Filing

Gas & electricity pricing policy.
Gas & Electricity Industries EFL'S.
Industrial Energy Policy.
Future of the Gas Industry.

NATIONALISED INDUSTRIES

Pt 1: Sept. 1979

Pt 11: June 1985

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~3.6.85~~		~~15.11.85~~					
~~6.6.85~~		~~20.11.85.~~					
~~17/6/85~~		~~21/11/85~~					
~~21/6/85~~		~~22/11/85~~					
~~2.7.85~~		~~26/11/85~~					
~~8.7.85~~		~~27.11.85~~					
~~15.7.85~~		~~4/12/85~~					
~~22.7.85~~		~~6.12.85~~					
~~23/7/85~~		27.11.85					
~~30/7/85~~		ENDS					
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~~7.10.85~~							
~~14.10.85~~							
~~25.10.85~~							
~~28.10.85~~							

PREM 19/1583

PART 11 ends:-

SS.Transport to PM, 27/11/85

PART 12 begins:-

S.S/Energy to PM (undated December)

TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
E(A)(85) 52	26/07/1985

The documents listed above, which were enclosed on this file, have been removed and destroyed. Such documents are the responsibility of the Cabinet Office. When released they are available in the appropriate **CAB** (CABINET OFFICE) CLASSES

Signed J. Gray Date 11/3/2014

PREM Records Team

Published Papers

The following published paper(s) enclosed on this file have been removed and destroyed. Copies may be found elsewhere in The National Archives.

House of Commons HANSARD, 7 May 1985, columns 639 to 640: Gas Industry

Signed J. Gray Date 11/3/2014

PREM Records Team

Prime Minister

The Chief Whip thought your decision was right - but it will be difficult to defend in public.

DRN 27/4

PRIME MINISTER

GAS PRIVATISATION

I am as disappointed as Leon Brittan at Peter Walker's response. None of us who are unhappy about this are seeking for close regulatory control that will lead to the regulator always second-guessing what should be the responsibility of management.

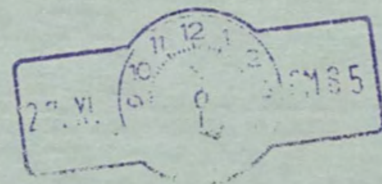
But the dangers of the abuse of the gas supply monopoly are not figments dreamed up by opponents of privatisation in principle - they are events which we must expect to happen unless the appointed watchdog has the power to initiate action to prevent them. That is why I continue to believe that entrenching the separation of the gas supply business in separate PLC's as I am doing for airports is the right course. Naturally, the BGC opposes such provisions - no management likes having its freedom constrained or being told that it cannot just be left free to decide for itself how to serve its customers. If it comes to the crunch I believe that BGC's own desires to be free of the shackles of nationalised industry control will lead them to acquiesce in what is widely seen as the minimum degree of regulatory power to be credible as a deterrent to abuse, just as BAA has acquiesced in what we propose for airports.

If we fail in gas to impose that minimum, both Peter Walker and I will have genuine problems in explaining to Parliament and the public why there should be a stricter regime for airports than for gas.

I am sending copies of this minute to Peter Walker, John Moore and E(A) colleagues and to Sir Robert Armstrong.

NR

NICHOLAS RIDLEY
27 November 1985



OTO

CONFIDENTIAL

CC, BG

Chancellor of the Duchy of Lancaster

CABINET OFFICE,
WHITEHALL, LONDON SW1A 2AS

Tel No: 233 3299
7471

27 November 1985

The Rt Hon Peter Walker MP
Secretary of State for Energy
Department of Energy
Thames House South
Millbank
LONDON
SW1 4QJ

N BATR.

D Peter

PRIVATISATION OF BRITISH GAS

I have seen a copy of your letter of 26 November to Nigel Lawson. - with DN?

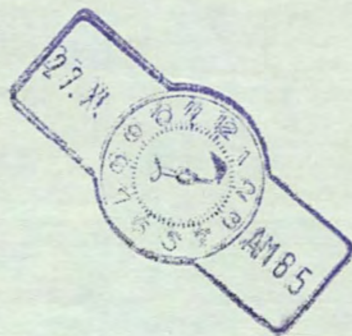
While I appreciate that negotiation with BGC will not be easy, I believe that you should insist upon a level of 15 per cent. I well recall the detailed discussion which preceded the BT launch. I am sure that we were right then to stick to 15 per cent, and I do not see a distinction which would justify moving to a lower figure in respect of British Gas.

Subject to this, and to the views of the Law Officers, I am content with what you propose.

I am sending a copy of this letter to the Prime Minister, Geoffrey Howe, other members of E(A), to Patrick Mayhew, and to Sir Robert Armstrong.

Yours
Norman

NORMAN TEBBIT



CEBG

020

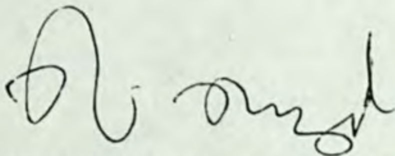
01 211 6402

Prime Minister 2
To note

DRJ 26/11

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

26 November 1985



PRIVATISATION OF BRITISH GAS

I am writing to seek the agreement of my colleagues to my proposals to protect the independence of British Gas after privatisation.

My principal proposal is to include in the company's Articles a provision to prevent any individual or group of individuals acting in concert from holding more than a certain percentage of the company's shares. This is in keeping with the precedent of other privatisations, including British Telecom.

We will need to consider carefully what percentage is most appropriate. Rothschilds are satisfied that a figure of 15 per cent, in keeping with Telecom, would be acceptable to the City. British Gas, for their part, are looking for a figure of 1 per cent, which is unacceptably low.

A difficult negotiation with BGC lies ahead, but I believe in principle that a figure of around 10 or 15 per cent is appropriate and will be accepted by the City. I am advised however that, despite the earlier precedents, there is a risk that even a figure within this range could be challenged as being inconsistent with the requirements of the EEC Admission Directive. I believe the risk is acceptably small, certainly in relation to a 15 per cent limitation. But I should be grateful if Patrick Mayhew could consider this point. My legal advisers have submitted the necessary detailed instructions to his officials.

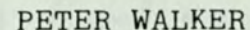
I intend to retain a special share after privatisation with powers to prevent any attempt to remove the shareholding limitation from the Articles of BG plc. As with BT, there will be no fixed time limit on the special share which will be redeemable at the Government's discretion.

I have considered whether a provision requiring the Chairman, or a majority of the BG plc Board, to be British nationals should be included in the Articles. Such a requirement featured in the BT arrangements. The attractions of this are obvious but my legal advisers believe that this would be unlikely to be compatible with the requirements of the Treaty of Rome ie the exemptions which permitted such a provision in the case of BT do not appear to extend to cover a company of the nature of British Gas.

Given that on present plans we do not intend to retain any significant shareholding in the company, other than the special share, I see no reason to take powers to appoint Government Directors.

I hope to be able to lay the draft Memorandum and Articles of the new company before Parliament at an early stage in the passage of the Gas Bill. I should therefore be grateful for my colleagues' early agreement to these proposals, subject to any further views expressed by the Law Officers.

I am copying this letter to the Prime Minister and other members of E (A), Geoffrey Howe and Patrick Mayhew.



PETER WALKER

26. XI.
PM 85

CONFIDENTIAL

DG2AQJ

File bc: Brian Griffiths

10 DOWNING STREET

From the Private Secretary

26 November 1985

GAS PRIVATISATION

The Prime Minister has seen your Secretary of State's minute of 22 November and the comments circulated by the Secretary of State for Trade and Industry and the Financial Secretary on 25 November.

The Prime Minister recognises the reservations which the Secretary of State for Trade and Industry and the Financial Secretary have about the proposal to exclude the Director General of Gas Supplies from the contract market. However, she is prepared to go along with the licence condition proposed by your Secretary of State, to require British Gas to publish the principles by which it will set prices in the industrial contract sector. The Prime Minister believes that if there is criticism in the House of the arrangements proposed for the contract market there may have to be an amendment to the Bill at Committee stage.

I am copying this letter to the Private Secretaries to members of E(A), to Vivian Life (Financial Secretary's Office, HM Treasury) and Michael Stark (Cabinet Office).

David Norgrove

Geoff Dart, Esq.,
Department of Energy.

DSG

CONFIDENTIAL

VT87

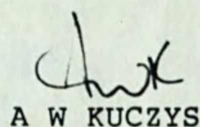
FROM: A W KUCZYS
DATE: 25 November 1985

MR ROBSON

cc PS/Financial Secretary
Mr Moore
Mr Norgrove - No.10

GAS EXPORTS AND IMPORTS

The Chancellor found David Henderson's third Reith Lecture (copy attached) excellent reading - especially the passage, on the third page, headed "Exports, willingness to pay, and international markets". It is, of course, relevant to one of the points on which we are currently in dispute with Mr Walker.



A W KUCZYS

David Henderson: 1985 Reith Lectures—Innocence and Design

3. Needs, centralism and autarchy

In his six Reith Lectures, David Henderson, head of the Economics and Statistics Department in the Organisation for Economic Co-operation and Development (OECD), examines the influence of economic ideas on policy.

Last week I showed my hand as the price mechanist that I am, and I argued, with the help of my fictional colleague Mr MacQuedy that individual willingness to pay should be the main test of how resources are used. You may recall that we made fun of a number of soap-opera notions of do-it-yourself economics (DIYE). In this lecture I want to enlarge on the contrast between DIYE and economic orthodoxy.

Twin aspects of unreflecting centralism

I want to consider first an aspect of DIYE which I call *unreflecting centralism*. It has two mutually supporting elements. One is the disposition to assume that outcomes have to be planned and decided by governments. The second is the tendency to think of governments and states as the principal or even the only actors on the economic scene, and to attribute to them roles and functions which are not necessarily theirs.

A good example of this tendency appeared in a speech which I had the pleasure of hearing in Brussels last year by the Irish Prime Minister, Dr Garret FitzGerald. Interestingly, Dr FitzGerald is one of two Prime Ministers within the European Community who count as professional economists, the other being the Prime Minister of Greece, Dr Andreas Papandreou. In his speech, he described himself engagingly as 'an economist on leave'. Nevertheless, in reviewing the problems of the Community, he advanced a prize specimen of unreflecting centralism.

For Dr FitzGerald there are two economic superpowers, the United States and Japan, and, he argued: 'attempts to compete on an equal basis in the economic sphere with these superpowers by independent, individual action, are quite simply bound to fail.'

The moral drawn by Dr FitzGerald, in common with many other influential people, is that the governments of the European Community must take concerted action to strengthen the competitive position of the Community as a whole vis-à-vis the United States and Japan.

This argument assumes that competition in the markets of the world is between states, and that only large states can successfully engage in it. Both propositions are false. Competition is largely between a multitude of business enterprises of all kinds, over a wide range of products and markets. It is true that governments can influence the outcome of the competitive process in various ways, and that particular business enterprises can be owned or backed by governments. But even when this is allowed for, it is not states that are generally the sole or the principal parties to the vast array of individual transactions around the world in which the competitive process takes shape.

As to large states being necessarily more successful on the contemporary economic scene, this notion is hard to reconcile with the fact that in Europe it is two small countries, Sweden and Switzerland, which by conventional tests are possibly the most economically advanced. The products of Swedish and Swiss enterprises have for decades competed successfully on world markets, without benefit of concerted transnational 'industrial strategies' of the kind that are now so favoured in official and business circles within the European Community. If we look outside Europe, and at the growth of income per head and of exports to world markets, the outstanding success stories of the past two decades are to be found among the developing countries of East and South-East Asia. Three of the most successful, Hong Kong, Singapore and Taiwan, are small, while none of the group is very large. In any case, it is not the governments of these countries, through concerted action among themselves, that have achieved rapidly increasing shares in expanding world markets. This has been the work of individual enterprises—helped, it should be said, by government policies which have provided an environment in which enterprises could grow and flourish, but which have not been based on the mistaken assumption that competition on world markets is largely between states.

Let me quote another official instance of unreflecting centralism, which will take us back into energy policy. A few years ago, in an interesting letter to *The Times* about the United Kingdom nuclear power programme, a former senior British government official, Peter Vinter, observed that 'as a nation we have not yet succeeded in setting up an effective nuclear reactor construction company'. I think his point is a fair one, and perhaps he would say the same today. But why should it be the collective responsibility of 'we as a nation' to establish a nuclear reactor construction company? Why should such a company, if indeed there is a place for it, not emerge from the impersonal competitive selection process of markets, without benefit of high-level official committees?

The history of British nuclear power programmes over the past 30 years provides a depressing example of unreflecting centralism in action—stoutly reinforced, I may add, by other forms of DIYE. One aspect of this centralism is the idea, which has been embraced by successive British governments of both parties, that a choice has to be made at Cabinet level of one particular reactor system for future nuclear power stations in Britain. Here, for instance, is Mr David Howell giving evidence to a House of Commons Select Committee in 1980, when he was Secretary of State for Energy under Mrs Thatcher: '...We must develop a sound thermal reactor strategy,' he said, 'we are virtually the only major industralised country without a chosen reactor system available for series ordering...we cannot continue to run two systems indefinitely....'

Here again it is 'we as a nation', with Her Majesty's Government as agent, that has to decide these things. In Mr Howell's world, in the world of his predecessors and his successors and their official advisers, no other practical possibility exists. It has been taken for granted, whatever the party in office, that the Secretary of State for Energy, or indeed the Cabinet itself, must determine the size of the nuclear power programme, the choice of reactor and the appropriate structure for the nuclear industry.

But, in fact, there are other ways of handling these issues. A few years ago an interesting article made me aware of how nuclear power had developed in Switzerland. The title of the article, significantly, was 'How Switzerland has benefited from the market approach'. At the time when it appeared, there were four nuclear reactors in operation within Switzerland, at three different power stations. The choice of reactors, as of other systems and equipment in the stations, was made not by the federal government but by the individual utilities concerned, which are small by British standards, since the Swiss electricity supply industry is much more decentralised. Two different reactor systems have been chosen and are in operation. According to the article, 'the four operating nuclear units were built in remarkably good time and within their original cost budget'—an achievement, I might add, which is in marked contrast with British results over the past two decades. As to operating performance, a recent comparative table shows the load factors achieved around the world by 232 nuclear reactors. Taking cumulative performance over the whole operating lives of these reactors, the best of the Swiss quartet was ranked third out of the 232, while the worst was placed at 29th.

Essentialism at the national level

One reason for centralism, which applies in energy policy and a number of other fields, is the uncritical acceptance of what I called last week *essentialist* ideas. In the case of energy, each country is perceived as having needs which must be met, and each national government as having an inescapable responsibility to anticipate and provide for these needs. In the more rustic treatments of these questions, reference is made to a possible 'energy gap' which the government has to ensure is bridged. Even in more sophisticated official presentations, governments usually appear as indispensable providers. Here again is David Howell, as Secretary of State for Energy:

> **The Government must ensure that we have enough energy in the future to heat our homes and to power our industries.** Failure to achieve this could mean lower living standards for us all and a very severe constraint on our society.

So essentialism leads naturally to unreflecting centralism. Also here in its place on the DIYE

The history of British nuclear power programmes over the past 30 years provides a depressing example of unreflecting centralism in action

stage is Mr Micawber's dichotomy: either we-as-a-nation have enough energy or we do not. But who is to say how much is enough? You will search in vain in official White Papers and statistical publications for figures showing national energy needs, for the simple reason that the concept can be neither defined nor measured. If you ask someone who uses the term, what are the current or prospective energy needs of the United Kingdom, the only answer you will get is a figure which relates to demand—in other words, to actual or prospective purchases of energy products. Demand is identified with needs, for no better reason than that energy, like food, is cast in the soap-opera script as essential.

This takes no account of the fact that not all purchases of a product or service are of equal value to those who make them. To class all energy purchases indiscriminately as essential is to miss the point that most transactions take place at the margin; and at the margin energy products, like other products, are generally valued by people and by businesses at the prices which they show themselves as willing to pay for them.

And there is a simple proof to hand: purchases of energy respond to changes in relative prices, which they would not if they were literally requirements that had to be met. Between 1973 and 1983 the real national product of the United Kingdom—in other words, the total output of goods and services—rose by something like ten per cent. If there were indeed national requirements for energy in any literal sense, these would no doubt have risen somewhat in response. But over these ten years estimated inland energy consumption actually fell, by more than ten per cent. This, of course, was not because the government failed in its supposed duty as provider, but largely because energy prices rose considerably in relation to other prices. The pattern of expenditure changed accordingly, reflecting individual decisions based on willingness to pay.

Now at this point I fancy I hear the groans from some of my professional colleagues. Henderson, they are saying, is wasting the Reith Lectures labouring points which are familiar to every first-year economics student, and are not important anyway. Well, as to importance, I shall let the evidence that I have presented, and will present, speak for itself. As to familiarity, I would make two responses to the critics: first, they are badly out of touch with first-year economics students; and second, they should note that intuitive economic ideas have cast their spell not only on our eminent professional colleague, Dr FitzGerald, but also on Mr Howell, who himself has a First Class degree in Economics.

The goal of autarchy

Both in the energy field and elsewhere, essentialist ideas lend support to another aspect of DIYE, the belief that autarchy, or national self-sufficiency, is an important goal. Here is a recent illustration from the European Commission in Brussels. The Commissioner for Industry, Karl Heinz Narjes, was quoted as saying that: 'Current Commission policy seeks to encourage food self-sufficiency in developing countries as the only reliable long-term solution to their needs.'

The idea that it is important for developing countries to become self-sufficient in food is widely and uncritically accepted, not just in Brussels; but from the orthodox economic standpoint it is without foundation. There is no magic accession of strength that a country derives from reducing imports of food to zero, whether for individual commodities or across the whole range. Hong Kong has developed over the past three decades as rapidly perhaps as any country in history. It is at present dependent on imports for approximately seven-eighths of its food consumption. There is no reason to suppose that it would have gained in the past, or would gain in the future, from deliberate official attempts to bring down this ratio, while 100 per cent self-sufficiency would be absurdly costly. Neither in Hong Kong nor anywhere else does it make sense to specify as an aim of policy, on the basis of soap-operatic intuition alone, a particular ratio of domestic production to total consumption. This generalisation applies to all products, including food, and to all countries, whether rich or poor.

Security within the national fortress?

For some people, this statement of orthodox economic doctrine may appear too unqualified, since it fails to mention explicitly security of supply. Often, though not always, the case for self-sufficiency is argued with reference to a country's need to ensure security by minimising dependence on foreign sources. The outside world is seen at best as unreliable and subject to instability, at worst as actively hostile. From this 'fortress-mentality' standpoint, autarchy appears to be common prudence. Two sets of measures then suggest themselves: one is to build up domestic production of essentials so as to reduce imports to a minimum; the other is to restrict exports, so as to ensure that domestic supplies are available for domestic use.

Not surprisingly, the tendency to think in these terms has been strengthened in recent years by developments on international energy markets, and in particular by the two oil crises of 1973-4 and 1979-80. Here, for example, is the then President of the United States, Richard Nixon, in an Address to the Nation in November 1973, launching the programme known as 'Project Independence':

> Let us set as our national goal...that by the end of this decade we will have developed the potential to meet our own energy 'needs' without depending on any foreign sources.

Again, the American 'Energy Security Act' of 1980 laid down a specific programme for reducing dependence on imported oil, through the production of 'at least 500,000 barrels of crude oil per day of synthetic fuel by 1987'. Also in 1980, following the second oil crisis, the then (Liberal) government of Canada adopted a comprehensive National Energy Programme. One of the 'three precepts for federal action' underlying it was stated as being to: '...estab-

lish the basis for Canadians to seize control of their own energy future through security of supply and ultimate independence of the world market'.

Well, what is the orthodox economist's response to these arguments, and to the policies based on them? Mr MacQuedy would agree that the question of security of supply has to be faced, by governments as well as by other agents within an economy, and that it may well be worth while to incur some extra cost at the margin to achieve a higher degree of security. But Mr MacQuedy does not share the fortress mentality, nor does he think much of the kinds of autarchic measures that are prompted by it.

One reason for scepticism is the eventual fate of the energy policies that were launched in response to the oil crises of the 1970s. Who now remembers 'Project Independence'? In 1973, the year in which it was launched with such fanfare, the estimated share of United States energy consumption supplied by domestic sources was 85 per cent. In 1980, when the authors of 'Project Independence' had envisaged that it would be approaching 100 per cent, it was in fact 86 per cent. As for the 1980 US synthetic fuel target, of 500,000 barrels of oil equivalent per day by 1987, the likely outcome in that year is something very much lower, possibly 10,000 or 15,000 barrels per day; and this is fortunate, because if the target had been reached, the costs involved would have been inordinately high. The Canadian National Energy Programme of 1980 no longer exists as such; the aim of isolating Canada from world energy markets has been abandoned.

It is true that such failures and reversals of policy are partly due to the fact that governments, like individuals, can easily misjudge the future course of events. But even if economic change were more predictable, there would remain basic objections from the orthodox point of view to the kinds of autarchic policies which are associated with essentialism and the fortress mentality.

In particular, it is wrong to think of security of supply in essentialist terms. Security of supply is not a separate dimension of choice: it is one of the economic aspects. Like other features of the quality of a purchase, such as reliability in service, it has a value; and the best indication of this value is willingness to pay at the margin. This can easily be seen in those markets where buyers are offered a free choice between interruptible and non-interruptible supply contracts; and, more generally, considerations of security do affect decisions about how far ahead to make commitments, and what sort of contracts to sign. Just as there are no precisely defined 'national needs' that have to be met regardless of cost, so there are no overriding requirements for uninterrupted supply which can be identified in central bureaucracies and used as a basis for policies.

Exports, willingness to pay, and international markets

To see where this argument leads, let us consider export prohibitions. According to do-it-yourself economics, these are called for in the case of products that are both essential and scarce. British policies toward North Sea oil and gas provide an illustration. Governments have consistently ruled out exports of gas, on the grounds that estimated reserves are too limited: in this case, scarcity is viewed as chronic. By contrast, exports of crude oil are generally unrestricted, though subject to licence; it is clear, however, that freedom to export is liable to be curtailed in periods of shortage. Just before the general election of 1979 the then Secretary of State for Energy, Tony Benn, was reported as having reacted to news that an oil company operating in the North Sea 'had seriously considered cutting back on supplies in Britain and selling the surplus at higher prices in Europe'. His reaction was: 'to ask the chairmen of all the major oil companies operating here to give him their personal assurances that they were not taking advantage of the general oil shortage in this way'.

Shortly afterwards, it was reported of Mr Benn's Conservative successor, David Howell, that he had 'started a discreet but forceful squeeze on North Sea oil companies to keep more of their production at home'. The squeeze had to be discreet, since formal restrictions might well have been hard to reconcile with obligations which Britain has assumed as a member both of the European Community and of the International Energy Agency. But it could nevertheless be forceful, since an oil company that failed to respond might prejudice its chances of success in the next round of applications for North Sea licences. The situation has not changed since those early days of Mrs Thatcher's prime ministership. If another oil crisis arose, ways would probably be found, whatever government was in power, to safeguard the principle laid down by Mr Howell in a speech of June 1979, that 'the interests of British consumers must come first'.

In cases like oil and gas it is considered irrelevant that exports might command a higher price than domestic sales: prohibitions should still apply. Indeed, Hamish Gray, who at the time was Conservative Minister of State at the Department of Energy, was reported a few years ago as having committed himself, while speaking of a particular North Sea gasfield, to the remarkable statement that 'Britain would not consider selling its share of the Statfjord gas whatever price a foreign buyer might offer'.

This conception of national interest is not shared by Mr MacQuedy. For him, the test of willingness to pay at the margin does not cease to hold good just because national frontiers are involved. How much particular exports are worth to the economy depends on the value of the imports for which they can be exchanged, which in turn depends on how much foreigners are prepared to pay for them. Why should domestic consumers of the product concerned be given unlimited preference, or indeed any preference at all? Successive British governments have rejected any suggestion that in normal circumstances domestic consumers should pay less than the world price for North Sea oil. And the existence of a shortage does not affect the logic that underlies this non-discriminatory policy. Suppose, for example, that oil will fetch $100 a barrel on the international market. Then the value to the economy of a barrel of oil sold on that market is $100, since this is what domestic consumers in general would be willing to pay for the imports that it makes possible. If this amount is more than anyone at home is willing to pay for the oil, then prima facie the balance of advantage lies in exporting it. In general, export prohibitions only serve to ensure that oil, gas, scrap metal, soya beans, or whatever the commodity may be, is put to lower-value rather than higher-value use. Freedom to export should be the rule.

This argument still applies, moreover, to the case where there are limited domestic reserves of some non-renewable resource, as with gas from the UK Continental Shelf. In Britain, the oil companies rightly argue that freedom to export gas from the North Sea would increase the incentive to find new deposits of gas there. This is not, however, the fundamental point, which is that even in a situation where reserves were known and limited, the orthodox argument would still apply: if foreigners are willing to pay more at the margin, then exports represent a higher-value use. The present and long-established restrictions on the export of gas from the UK are therefore not justified.

Arguing in this way is not myopic: longer-term national gains would not be sacrificed to immediate profit. It may well be that oil and gas will be so much more valuable in the future, even allowing for the interest factor that has to be taken into account in such calculations, that governments should limit production now, and possibly also encourage imports, in order to conserve domestic resources for the future. This is quite consistent with the orthodox economists' approach, because if the assumption is correct, the effect of such conservation measures would be to substitute a future higher-value use for a present lower-value one. But the case for giving more weight to the future, and less to the present, does not in any way make a case for discriminating in favour of domestic consumers as against foreigners.

Let me add that, as in other applications of the willingness-to-pay criterion, freedom to export is a general presumptive rule, not a categorical imperative which admits of no exceptions. Restrictions on particular strategic exports may well be justified on grounds of national defence. Taxes on commodity exports, which have the effect of reducing their flow, can in some circumstances be a useful instrument of policy in developing countries. Again, restrictions on food exports are justified in genuine national emergencies, as in some African countries at present, even though in themselves such restrictions will not give those in need the wherewithal to obtain food. All these, however, are exceptional or fringe cases in the modern world. They do not undermine the general orthodox argument that export restrictions based on essentialist ideas are contrary to the interests of a country that imposes them.

Security, international markets, and reserve stocks

What about the second type of autarchic policy, that of minimising dependence on imports? Here the orthodox view is more sympathetic, since it is obvious that serious consequences can result if a major international source of supply for key commodities like oil or gas is suddenly withdrawn or disrupted. But do-it-yourself economics, here as elsewhere, is no help. It leads people and governments both to exaggerate the risk and to use inappropriate ways of dealing with it.

On the first point, there is a chronic DIYE tendency to overstate the dangers of using overseas sources of supply. In part, this is because of the mistaken essentialist belief about national needs. Another reason is that unre-

flecting centralism conjures up a picture in which imports are always bought directly from chronically unreliable foreign governments. More typically, however, it is not governments but business enterprises which ship the imports; and whether publicly or privately owned, these enterprises have an interest both in retaining profitable markets and in keeping their reputation for honouring contracts. Of course, interruptions to imported supplies may none the less take place. But as British energy consumers need hardly be reminded after the recent coal strike, domestic supplies may also be subject to interruption and threats. Whether foreign sources are less reliable than domestic sources will depend on the circumstances. It cannot just be presumed.

On this question of security, orthodox economics has a strong positive message, which comes in two parts. In the first place, it points to the role of broad, well-functioning international markets as a means to reducing uncertainty and providing for emergencies. The existence of such markets, with free access for buyers and sellers, provides the best assurance that purchases can always be made—an assurance which is reduced if countries resort to export prohibitions. The second part of the message is that in the case of storable commodities like oil, security can be improved, often at much lower cost than by substituting home production for imports, by the holding of ample reserve stocks. These stocks can be private, or they can be official, as in the case of the present US Strategic Petroleum Reserve: Mr MacQuedy has no prejudice against government action on these lines.

These two parts of the message are not distinct; for unless markets are allowed to function properly, the level of stocks will be lower than it should be. Holding stocks costs money. Why should any private agency go to the expense of keeping special emergency stocks, except perhaps for its own exclusive use, if it believes that in the event of a shortage the government will at once impose price controls to prevent so-called profiteering, and possibly also make supplies available from its own stocks at controlled prices? If stocks are to play their full potential role in providing insurance against emergencies, markets have to be allowed to set prices freely, and sales from government strategic stocks should be made by auction.

This orthodox message is a general one. But it is especially relevant in the energy field, because it is here in particular that risks are inevitable and the possible consequences of disturbance are still serious. Over the past decade or more, Western governments have taken action, individually and collectively, both to reduce dependence on imported oil and to provide for an emergency should it arise. In particular, they have made considerable progress, some of it quite recent, in freeing internal markets for energy products. Where they have failed to act, largely because of the dominance of mistaken economic notions, is in establishing and making acceptable the principle that even in times of perceived scarcity, energy markets should be allowed to function freely and prices should reflect willingness to pay. Because of this failure, the risk of another energy crisis is greater than it need be, the possible consequences more alarming. The contribution of markets to security is still unrecognised.

Derek Cooper

Going for gold

We were never without olive oil in our house and as children we always knew where to find it—up in the bathroom in the medicine cabinet, alongside the Ex-Lax and the Zam-Buk. Judging by our current minute consumption of the stuff, many people still regard it as being more efficacious in the ear than on the palate.

Cookery writer Richard Olney, who lives in Provence, believes that olive oil 'belongs to the realm of voluptuous experience'. And he's right; although it took me a long time to find that out. Brought up in a bread-and-dripping culture, it wasn't until the early 1950s that I discovered the revelatory Italian equivalent—hot toasted bread rubbed lavishly with garlic and bathed in rich oil as thick as Essolube and as green as summer fern. The best *bruschetta*, or *fentuta*, as they are called in Tuscany, are made with the new season's oil pressed in the autumn.

It was toasted bread that they gave us last week at a tasting in London of ten Tuscan extra virgin olive oils of the 1985 vintage. Star of the show for me was a dark brocade-green sample from the Ugo estates, which lie halfway between Florence and Sienna. 'Last week,' said Franco Amici Grossi, owner of the olive groves which have been in his family for six generations, 'the olives were still on the tree.' He explained that the best oil comes from the first pressing of the first olives to be picked. In Italy, they say that 'the first picking is gold, the second is silver, the third is worthless'. This critical early picking takes place when the olives are only half ripe and rich in delicate liquid glycerides; the yield is small but the quality is high.

To achieve that quality, says Amico, you must press the olives within 24 hours of picking, 'otherwise they begin to start going off. Of course, on the farm they are cold pressed. Hot pressing involves using heated water. The oil comes out quicker, the yield is higher, but the flavour is inferior, what we call *sfibrato*.'

When olives are cold pressed they are crushed whole, in a stone mill. The pulp is pressed to separate the liquid from the solids; then the pure oil is spun in a centrifuge and separated from the watery waste. The pulp is usually sent away to factories for hot pressing with boiling water.

Amico told me it took two years to produce an olive. 'In the first year the trees make the wood that will produce the second year's fruit. A good year for wood is usually a bad year for olives. In Italy, 1984 was a bad year for wine but very good for olive trees. We should have had a huge crop this year, but it didn't turn out that way.'

Last winter's great freeze in Tuscany afflicted the region's 22 million olive trees with varying degrees of severity. Even before snow and frost hit the trees the Stock Exchange in Florence had suspended trading in *extra vergine* because prices were rocketing. T[...] some fairly inferior oils [...] coming winter.

Only the first pressing [...] extra virgin. Some of th[...] be mixed with the indus[...] which are refined, rectif[...] frequently neutral in tas[...] mild, these are the olive [...] widely in Britain.

Leslie Zyw, who with [...] oil on an estate in the h[...] Carducci, has written th[...] on Tuscan cold-pressed [...] appeared in *Petits Propo[...]* March 1981*. She believ[...] of the most nutritious fo[...] only low in saturated fat[...] unsaturated fats, but, be[...] easily digested. It is the [...] produce the green oil, al[...] sometimes mixed with th[...] that colour. In time the [...] green, but it will retain it[...] vegetable residue and its [...] flavour.

In Tuscany the oils are [...] tinged with green, and, t[...] relations activities of the [...] *Vergine*, their virtues do [...]

Franco thinks Tuscan oils [...] personally find them inedi[...] want to be rude but they s[...] of our Italian oils.'

I rated, as I said, the 19[...] Fattoria dell'Ugo highly. F[...] Lower Sloane Street are st[...] vintage at £6.40 for a 75cl [...] have an excellent Catell'in[...] litre. I liked too the Poggi[...] Haynes Hanson and Clark [...] bottle. Most olive trees are [...] year to protect them from [...] they also like a nitrate-rich [...] organically grown sample a[...] from the co-operative of S[...] outside Seggiano. I gave it [...] a litre (proportionately mo[...] it is reasonably priced. Pax[...] sell it in Jermyn Street, Ho[...] Audley Street. For other st[...] importers on 01-602 3548.

*Prospect Books, 45 Lam[...] London SW10 0HU.

Derek Cooper presents 'The [...] Fridays at noon, repeated on [...] Radio 4.

25. XI.
PM 8

CC BG.

PRIME MINISTER

GAS PRIVATISATION

Mr. Walker has discussed the scope for improvements to the regulatory framework for gas with Mr. Brittan and the Financial Secretary. They have not reached agreement, though the Department of Energy thought last week that they had done so. Minutes from Mr. Walker, Mr. Brittan and the Financial Secretary are attached, Flags A-C.

The major disagreement concerns the role of OFGAS in the industrial contract market. Mr. Walker says they should have no role:

- there has been no regulation of this market in the past;
- there is adequate competition;
- the CBI are content with his proposals;
- OFGAS regulation could be extended to the contract market by Ministerial order following an MMC inquiry;
- the support of BGC management for privatisation would be lost if the Government insisted on extending the powers of OFGAS now.

Mr. Walker does not think privatisation would then go ahead successfully. He argues that he has gone as far as he can in agreeing that the licence would require British Gas to publish the principles by which it will set prices in the industrial contract sector. (You may like to glance again at Mr. Walker's minute of last week, Flag D).

Mr. Brittan and the Treasury believe OFGAS must have a role in industrial contracts, to protect industrial gas users, to provide a system of regulation which is defensible in the light of arrangements for British Telecom, and to avoid an

increase in public pressure against the privatisation programme. This could be achieved through the Bill or through the licence. DTI and the Treasury see this as a test case for privatising monopolies and they think Parliament and the public will too.

The Ministers concerned are now looking to you to resolve this. The Policy Unit (Flag E) believe the package proposed by Mr. Walker is acceptable. Clearly it will be extremely hard to persuade Mr. Walker to move further; but DTI and the Treasury also feel very strongly.

The alternatives seem to be either to go along with Mr. Walker or to call a meeting. This would need to be tomorrow, if the timetable is to be retained. 'L' Committee is to take the Gas Bill at noon tomorrow and I am told there is no scope for slippage: the Bill has to be introduced this week to guarantee a Second Reading by Christmas. Your meeting could be at 0930 if Sir John Fieldhouse is postponed or at 1115, which would take time from your preparations for the Debate.

There seems to be no scope for compromise. Mr. Walker may well in the end get his way even if you hold a meeting: the gas privatisation is his respnsibility to deliver as are relations with Dennis Rooke, however strong the arguments of DTI and Treasury (and they are strong). The result will, however, if this is right, be controversial and difficult for the Government.

Do you wish to go along with Mr. Walker, or call a meeting? If a meeting, do you want it at 0930 or 1115?

I'm afraid we shall have to go along with Mr Walker.. If there's criticism in the House - there may have to be an amendment at Committee stage

J. Bowers
pp David Norgrove
25 November 1985

DG2AQH

2153/08

CONFIDENTIAL

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Peter Walker MBE MP
Secretary of State for Energy
Department of Energy
Thames House South
Millbank
LONDON
SW1P 4QJ

NBPM.

25 November 1985

Dear Peter,

L(85)77 : GAS BILL

You have circulated the latest draft of the Gas Bill to L Committee. This draft contains some significant changes from earlier drafts.

In earlier drafts, one of the general duties of the Secretary of State and of the Director of OFGAS was "to promote effective competition". This duty matched a corresponding duty for OFGAS in the BT Act. In the latest draft of the Gas Bill this duty has been dropped.

Promotion of competition is, of course, a central part of the privatisation programme. I think the legislation would be seriously deficient if this duty were not reinstated.

On common carriage, you have proposed a clause setting out in some detail the basis on which the Director shall determine charges for the use of BGC's pipelines. I am not convinced we need a clause of this sort. The draft Bill already provides for the Director to arbitrate on terms in cases of dispute. This is very much in line with the existing legislation in this area in the Oil and Gas (Enterprise) Act. In making such an arbitration the Director would no doubt have regard, inter alia, to his general duties, including the duty to promote competition.

I do not see a need to go beyond this. Setting out the basis for the Director's decisions in the way you propose amounts to restriction on him. It is relevant that, in the case of BT where the inter connection of systems raised similar issues, there is no such guidance in the BT Act and the Licence merely requires the Director to take into account relevant overheads and a reasonable rate of return on attributable assets. This appears to leave him with a good deal more discretion than your proposal.

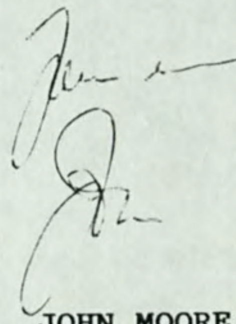
CONFIDENTIAL

I note that the present draft of the Bill does not provide for the important developments in common carriage set out in E(A)(85)65. It is important that Ministers know more about these and the way in which they will be enforced, before approving the draft Bill.

I am also concerned that BGC may be able to escape the common carriage provision of the draft Bill by putting its transmission system into a separate company. We need to safeguard against this.

We are, of course, corresponding separately about the regulatory regime. The issues we are considering also bear on the content of the draft Bill.

I am copying to members of E(A) and L and to Sir Robert Armstrong.



JOHN MOORE

C CC BG

PRIME MINISTER

GAS PRIVATISATION

1. Leon Brittan sent me a copy of his minute of 25 November. I have also seen Peter Walker's minute of 22 November.] with DRN

2. I share Leon's reservations. As he says, we had a discussion with Peter on 21 November at which we appeared to make progress on some of the points I mentioned at E(A). Peter suggested that the licence would incorporate provisions against discrimination and undue preference offshore and in the contract market, and would request BGC to publish its contract prices.

3. Peter is now proposing that the licence would merely require BGC to publish some assurances in this area. As you will appreciate, assurances are not enforceable.

4. In my view we will not be able to retain the present public support for privatisation unless we can demonstrate that the regulation we put in place provides protection against the abuse of market power, and promotes efficiency. For the reasons given by Leon, I do not consider the regime now proposed by Peter is adequate. I fear it will lead to heavy criticism of BGC privatisation, both in the House and outside. These critics are likely to include members of our own Party. Such criticism of this privatisation could well cast a shadow over the privatisation programme as a whole.

5. I am copying this to the recipients of Leon's minute.

JM.

FINANCIAL SECRETARY TO THE TREASURY

25 NOVEMBER 1985

NAT IND: Gas: PE 11

SECRET

ROYAL COURTS OF JUSTICE
LONDON, WC2A 2LL

01-405 7641 Extn

NBPM.

The Rt.Hon. Peter Walker MBE. MP.,
Secretary of State for Energy
Department of Energy
Thames House South
Millbank
London SW1

25 November 1985

Dear Peter,

GAS PRIVATISATION: RESTRICTIVE TRADE PRACTICES ACT

You copied to me your letter of 15 November to the Secretary of State for Trade and Industry concerning the problem that has arisen on BGC's gas purchase agreements.

I agree with counsel's conclusion that there is a substantial prospect that a number of gas purchase contracts entered into by BGC, and other agreements between a number of producers and BGC, should have been registered under the Restrictive Trade Practices Act 1976.

I agree with you that legislation is necessary to deal with the problem. In order to nullify the effects of failing to register the existing agreements, the legislation will have to apply retrospectively as well as for the future. I understand that your officials have concluded that it is unlikely that anyone will be able to reasonably complain that he will be adversely affected by the legislation being retrospective.

I agree that the legislation dealing with existing agreements might have to cover a wider range of agreements than the legislation dealing with future agreements in order to catch all doubtful past cases. I understand that discussions are taking place on the scope of the clause. However, the latest draft that I have seen covers future agreements relating to activities connected with the supply of gas, not merely to gas sales agreements as stated in your letter.

SECRET

You seek views on the question of whether the provisions should be included in the Gas Bill or in a separate Bill. Once the Government and the Director-General of Fair Trading are aware of the failure to register agreements that should have been registered, action should be taken within a reasonable time either in accordance with the 1976 Act or to amend it if the Act is not to lose credibility. Since you intend to introduce the Gas Bill around the end of this month with Second Reading before Christmas, I do not think that the Government or the Director-General can be criticised for not having acted promptly. I therefore agree that the Gas Bill is the most suitable vehicle and I do not think that it is necessary to introduce separate legislation which would bring the Restrictive Trade Practices problem into greater prominence.

I am copying this letter to the Prime Minister, The Chancellor of the Exchequer, the Secretary of State for Trade and Industry and the Leader of the House.

Yours ever,

Patrick

Gas & Elec: NAT. IND. Pt 11

B cc BG

CONFIDENTIAL

PRIME MINISTER

GAS PRIVATISATION

I have seen Peter Walker's minute to you of 22 November. I am afraid that I cannot agree that his proposals provide an acceptable package, either in substance or in presentational terms.

2 I am frankly disappointed at Peter Walker's response to the clear views expressed by collegaues at E(A) on 14 November, which he and I explored further with John Moore on 21 November. The additional proposals he has now made go nowhere near meeting the concerns that John Moore and I put to him on both occasions; indeed they fall short of the limited moves that we had understood him to be contemplating after the 21 November meeting (that an appropriate set of assurances should be enshrined as conditions of the licence).

3 I am very much in agreement with the general line of John Moore's reservations about the regulatory regime for gas, as recorded in the E(A) minutes and reflected in your summing up of the meeting. We have to remember that we are creating a regime that must cope not just with the recently-privatised British Gas under largely the smae management and market background as its public sector antecedent: it must deal with a gas supplier some years on, under a different and differently-motivated management, possibly against a very different market background, where abuse of the gas supply monopoly is a real possibility.

JF5AON

CONFIDENTIAL

4 Peter has not advanced arguments which persuade me that our worries at E(A) were anything but entirely well-placed. In particular - and that is I think the critical point for the Bill, as opposed to the licence - I still strongly favour the Director General of Gas Supplies having a power to propose modifications to the licence with respect to the contract market. I do not think Peter's fears about undue interference are justified; nor can he reasonably defend keeping the Director General out by expressing concern that he may, in effect, be ready to do his job.

5 I still think that with goodwill we can sort this out in time to get the Bill launched reasonably to timetable. I shall certainly do what I can to that end.

6 I am sending copies of this minute to Peter Walker, John Moore and E(A) colleagues, and to Sir Robert Armstrong.

L. B.

L B

25 November 1985

Department of Trade and Industry

JF5AON

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25. XI.
AM 85

PRIME MINISTER

GAS PRIVATISATION

As requested at last Thursday's E(A) meeting I have now discussed with Leon Brittan and John Moore the arrangements to apply to the industrial contract market.

Our common aim is, of course, to produce a package which will command wide support and credibility, and which offers real protection for industrial and commercial companies whatever their size or sector. I have explained to them the support which my approach has received from the CBI and also, over the last few days, from the Chemical Industries Association - effectively the largest single pressure group in this area. But I also undertook to consider further whether there were ways of strengthening the package short of the kind of regulatory interference which both British Gas and the CBI actively wish to avoid.

There are of course severe limits to what I can realistically achieve with the BGC board, given that we are already well beyond the point they consider reasonable. However, I am prepared to put it to Denis Rooke that we need to give more formal status to the voluntary assurances which BGC propose. This would involve a licence condition to require British Gas to publish the principles by which it will set prices in the industrial contract sector. The assurances would then be published pursuant to this licence condition.

By means of this, and the other measures described in my E(A) paper, I believe we shall have achieved an attractive and effective package, which can be defended from the kind of criticism which those pre-occupied with the arguments for close regulatory control are bound to throw at it. BGC's assurances, particularly

those limiting price rises for the next three years and promising fair treatment into the future, will be strong selling points.

In relation to the separate accounting of the gas supply business and BGC's ancillary activities I believe we have also made useful progress. John Moore and I are agreed that the Treasury should participate in the exercise with BGC to set the initial cost allocations to apply between the various parts of the business.

I believe these further measures go as far as practicable in present circumstances. Provided you are content I will now proceed with my paper for next Tuesday's meeting of Legislation Committee and prepare the draft licence for publication in time for Second Reading.

I am copying this minute to other members of E(A).

SECRETARY OF STATE FOR ENERGY

22 November 1985

22.XI
PM 05

PRIME MINISTER 22 November 1985

GAS PRIVATISATION

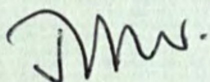
We should not be overawed by Peter Walker's assertion that we are "already well beyond the point (the BGC Board) consider reasonable". The word from those who have known Denis Rooke over the years is that he is still quietly satisfied with the privatisation package which is taking final shape.

Nonetheless, Leon Brittan and John Moore have done a good job in defence of the consumer. If Peter Walker fulfils the further undertakings given since E(A) on 14 November 1985, I believe that we will have a regulatory régime which is sufficiently protective.

The assurances covering BGC's commercial behaviour in the industrial contract market will have the formal status of being given pursuant to BGC's gas supply licence. Perforce, they will have to reflect competition and anti-monopoly law. They will be immutable. Behind that, is the threat that if BGC persistently abuses its position in the industrial market, it will become subject to tighter and more intrusive regulation by OFGAS - a prospect abhorrent to the management. The threat should be sufficient.

That said, there could still be presentational problems in this sensitive area, and the Government will have to be alert to the need for amendments. By then, we should have more, not less, leverage on BGC.

We recommend that the gas privatisation package should be endorsed for submission to next Tuesday's Legislation Committee, subject to the undertakings in Peter Walker's notes of 19 and 22 November 1985.



JOHN WYBREW

NBPM. (PM already knows)

CONFIDENTIAL

MR NORGROVE

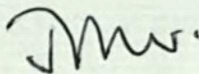
22 November 1985

GAS PRIVATISATION - RESTRICTIVE TRADE PRACTICES ACT

The recent correspondence between Peter Walker and Leon Brittan reveals that BGC's gas purchase agreements with the producers contravene the Restrictive Trade Practices Act (RTPA).

The problem arises from two features of UK North Sea gas development - the oil company practice of forming consortia in order to spread the risks and costs, and the requirement to sell the gas to a monopoly purchaser, BGC. As is normal in the gas industry, the production from a given field is dedicated to BGC under the provisions of a long-term supply agreement. Legally, each member of a licence group must conclude a separate contract with BGC. Yet, operationally and commercially, the terms of each such contract in respect of the same field must be identical; this and the dedication of the entire output of a field to BGC are regarded as restrictive.

Whilst the parties have been remiss in not registering their gas supply agreements under the RTPA, consumers have not suffered. The decision to cater for this in the new Gas Bill is defensible.



JOHN WYBREW

CONFIDENTIAL

2155/47

SECRET

Copy no 27 c/BG

12

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Peter Walker MBE MP
Secretary of State for Energy
Department of Energy
Thames House South
Millbank
LONDON
SW1P 4QJ

NBPM

22 November 1985

Dear Peter.

GAS PRIVATISATION : RESTRICTIVE TRADE PRACTICES ACT

with DRN.

You copied to the Chancellor your letter of 15 November to Leon Brittan, I have also seen Leon Brittan's reply of 21 November. I find it surprising that it is only at this late stage that British Gas have alerted us to this problem. They must have known for some considerable time that they had been sailing very close to the wind with their gas supply contracts. Because of this, I am reluctant to use a legislative route to get them out of their self-imposed difficulties but I see little alternative if we are not to create problems for the flotation. I am therefore content with your proposals.

I am like Leon, concerned to ensure that the legislative provision goes no further than is necessary to rectify the problem. We would not want to give British Gas and its suppliers complete freedom from the requirements of fair practices legislation. I should be grateful if my officials could be kept closely in touch with developments.

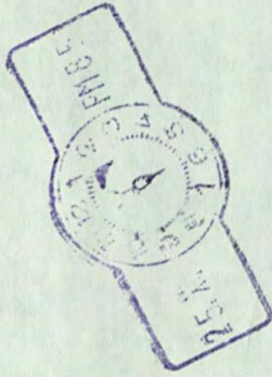
I am copying this letter to the Prime Minister, the Secretary of State for Trade and Industry, the Solicitor General and the Leader of the House.

Yours
John

JOHN MOORE

SECRET

NAT IND: Gas : Pt 11.



PRIME MINISTER

GAS PRIVATISATION

Mr. Walker has discussed with the Treasury and Mr. Brittan the regulatory regime for gas following privatisation. They have agreed that any further restrictions on gas should be put in the licence rather than in the legislation. This gives a little more time to sort out the differences between the Departments. They have made some progress in resolving their differences, but are not quite there yet.

DN

21 November, 1985.

TOTAL COPIES 15

COPY No. 2

(11) ECBG

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
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TELEPHONE DIRECT LINE 01-215 5422
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JU721
Secretary of State for Trade and Industry

21 November 1985

SECRET

The Rt Hon Peter Walker MBE MP
Secretary of State for Energy
Department of Energy
Thames House South
Millbank SW1

NJBPM.

Dear Peter,

GAS PRIVATISATION: RESTRICTIVE TRADE PRACTICES ACT

Thank you for your letter of 15 November about the implications of the Restrictive Trade Practices Act (RTPA) for BGC's gas purchase agreements.

It is regrettable that BGC and the gas producers seem to have behaved so irresponsibly in this matter. Their non-observance of the RTPA has placed the Government and the Director-General of Fair Trading (DGFT) in a very difficult position. Indeed in such cases the DGFT would normally feel compelled to seek an Order of the Restrictive Practices Court effectively making it a contempt of Court for BGC and the gas producers concerned to enter into any similar unregistered agreement in the future. Fortunately, I understand that the DGFT is unlikely to wish to use the resources of the Office of Fair Trading to take proceedings against BGC's agreements provided that the Government makes clear at an early stage its intention to exempt the agreements concerned retrospectively and prospectively. It is, however, important to bear in mind that action to exempt the agreements retrospectively would impinge on the rights of third parties to seek redress through the Courts for the effects of the restrictions in BGC's agreements to which BGC and the other parties have given effect unlawfully. I understand that the Solicitor General is advising on this aspect of the problem.

Your timetable for the Gas Bill does not permit me fully to consider the pros and cons of an exemption but,on the basis of the advice so far received from your officials, I am satisfied that any benefit from the continued application of the RTPA to BGC's gas purchase agreements is unlikely to be such as to outweigh the risks to the flotation. I can therefore agree to an

999-1

SECRET

exemption that is retrospective and prospective in effect and sufficiently wide to cover BGC's existing gas purchase agreements. I am prepared to take a similar view of a retrospective exemption for agreements ancillary to the gas purchase agreements insofar as this is necessary to safeguard the flotation.

I should not wish the exemption to go wider than is necessary. I appreciate that if the exemption is to be included in the Gas Bill it will as a precaution have to be widely drawn at the outset but I would wish to have the opportunity during the passage of the Bill to narrow the provision, particularly as it relates to BGC's future agreements, if this proves to be desirable in the light of further study of the gas producers' marketing and supply arrangements.

In deciding how best to introduce the exemption, one of my major concerns is to minimise the damage to the credibility of the RTPA. I tend to the view that while an emergency Restrictive Trade Practices Bill would expose the problem over a shorter period than the Gas Bill, it would also bring the exceptional treatment to be provided for BGC and the gas producers into sharper focus and is more likely to attract justified criticism from those companies - some of them small - that have had to pay the normal penalty for non-observance of the Act. I therefore agree with your view that provision for exemption should be made in the Gas Bill itself.

I am copying this to the Prime Minister, the Chancellor of the Exchequer, the Solicitor General and the Leader of the House.

Leon

LEON BRITTAN

NAT IND : Gas & elec : Pt 11

10 DOWNING STREET

2

Prime Minister

To note that BGC's agreements with the gas producers probably amount to unregistered restrictive practices. The Gas Bill will have to grant exemption retrospectively and prospectively.

DRW
21/11

010 cc BG

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET
TELEPHONE DIRECT LINE 01-215 5422
SWITCHBOARD 01-215 7877

JU695
Secretary of State for Trade and Industry

20 November 1985

Rt Hon Peter Walker MBE MP
Secretary of State for Energy
Department of Energy
Thames House South
Millbank
London SW1

NBPM.

Dear Peter,

GAS PRIVATISATION: REGULATORY REGIME

ATTACHED

You, John Moore and I are to meet on Thursday to discuss possible changes to your proposals for gas regulation as requested by E(A) on 14 November. I understand that our officials met on 18 November but that this did not take matters much further forward. I thought therefore it might be helpful if I wrote before we met outlining my concerns about your proposals - in particular the exclusion of the Director General of Gas Supply (DGGS) from the industrial market.

Let me say at the outset that I agree with your wish for lighter regulation of this market than the tariff market, both to encourage competition and to preserve flexibility. I am, however, concerned about whether your proposals for voluntary "assurances" coupled with the existing provisions of the Competition and Fair Trading Acts will provide effective safeguards against monopoly abuse. I am also concerned about the public perception - and hence implications for future privatisations - of the exclusion of the DGGS.

On safeguards, I am doubtful whether the existing competition and monopoly legislation - which was not designed for privatised natural monopolies - will be adequate. The Competition Act can only apply where there are practices which 'distort, prevent or restrict' competition: but in many areas of BGC activity there will, by definition, be no competition to be distorted. Monopoly references under the Fair Trading Act would have wider scope; but there is a problem here about speed of remedy. There are no powers to impose a time limit on monopoly references to the MMC

and these tend to be lengthy - two years is about average, not including time for preliminary investigation and for implementation. I think this is too slow to provide an adequate safeguard in the gas contract market. But I would not support taking powers to shorten references just for gas. If, as I believe, the industrial gas market needs special treatment, then it should be brought within the DGGS's ambit. A licence modification reference would be a quick route to remedying an abuse. It would also be more precisely targeted than a monopoly reference which can only be made in respect of the whole of a particular market.

This leads me to the presentational aspects of excluding DGGS. John Moore drew attention at E(A) to the differences between the DGGS's proposed role and that given to the Director General of Telecommunications. I am also not convinced that there is any real risk of over-zealous regulation - the normal concern is of 'agency capture', not the reverse. Much will depend on the regulator - whom you will appoint. And I think the outside world would see it as counter to common sense to set up a special regulator because of worries about monopoly power but to exclude the regulator from part of the market where that power is held.

I am sending a copy of this letter to the Prime Minister and Members of E(A).

Leon

LEON BRITTAN

999-49

20. XI.
PM 85

PERSONAL

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10 DOWNING STREET

From the Private Secretary 20 November 1985

GAS INDUSTRY PRIVATISATION

The Prime Minister was grateful for your Secretary of State's minute of 19 November.

David Norgrove

Geoff Dart, Esq.,
Department of Energy,.

PERSONAL

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0.10

DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

01-212 3434

The Rt Hon Peter Walker MP
Secretary of State for Energy
Department of Energy
Thames House South
Millbank
LONDON SW1P 4QJ

19 November 1985

NBPM.

Dear Peter

GAS PRIVATISATION

ATTACHED.

I was sorry that attendance at a Council of EC Transport Ministers prevented me being present at the meeting of E(A) on this subject on 14 November.

I understand your desire to avoid attracting the determined opposition of the BGC Board. Nevertheless I share the views of colleagues that, without stronger assurances against unfair price discrimination, the privatised company must be expected to continue to use its monopoly powers to protect all its operations against outside competition as BGC has so far done. I am especially worried that, in the absence of specific controls, British gas will remain able to use the profits on the non-regulated industrial gas business to cross-subsidise its retailing and service show-room activities. It will not be enough to rely on non-statutory undertakings to continue to publish separate accounts for such activities. In the case of the London airports, I shall be providing that the privatised BAA must set up separate companies for each airport, so that there will be an arm's length relation between the airports. Without that assurance I would have had even greater difficulty than I did have in persuading the Northern airports that BAA would not use cross-subsidy to expand operations at Stansted unfairly. Without similar statutory provisions for a separate gas retailing company in arm's length relation with the parent company, private competitors to the show-rooms could be severely and unfairly damaged. I thought that colleagues had accepted this point when I raised it on two occasions during the summer.

In view of the interaction with airports issues, I should be grateful if I could be involved in further discussion of this.

I am copying this letter to the Prime Minister and other members of E(A).

Yours ever
Nicholas

NICHOLAS RIDLEY

PRIME MINISTER

Prime Minister
Mr Walker clearly feels exceedingly strongly about this. But I see nothing for you to do at this stage: the Ministers concerned must try to agree.
Agree to await the report back, and hope Mr Walker will be able to reach agreement with Treasury and DTI?
DRN 19/11

GAS INDUSTRY PRIVATISATION

You asked, when we considered gas privatisation at E(A) on 14 November, that I should explore further with the Treasury and DTI the scope for changes in the proposals which would strengthen the role of OFGAS and offer more explicit assurance against unfair price discrimination but avoid attracting the determined opposition of the BGC Board. Peter Gregson has now held urgent discussions with officials concerned. He has, I believe, explained more fully what we intend and has identified ways in which the proposals could be further tightened.

We have re-emphasised to other Departments the differences between this privatisation, Telecom and others due to follow such as water, which bear on where the balance of the regulatory regime is struck. Water is a pipeline monopoly with no ready substitute for the product. Telecom had a statutory monopoly of its network and retailing, both of which we have opened for the first time to competition. It also lacked any established tradition of separate accounting for different parts of the business and work on this had to begin from scratch. Gas, by contrast, competes in the energy market with other fuels, has never been specially protected in its ancillary activities and has a long history of separate accounting, where it has already been subject to regular scrutiny and pressure from the OFT.

Officials have reviewed the points which John Moore made at E(A):-

(a) non-discrimination in purchasing. The fundamental requirement here is that Government should be able to restrain the company from importing gas on a scale or timetable which damages UKCS exploration and development.

Government also needs flexibility to allow UKCS producers to export gas. I shall be bringing forward proposals. On non-discrimination as such, BGC is already subject to the requirements of competition law and I should be prepared to seek from Denis Rooke an explicit assurance that BGC will not engage in practices which would offend under that law.

(b) industrial contract market. The company will be obliged to meet any reasonable demand for gas, wherever it is economic to do so, and this duty will be enforceable by OFGAS. The conract market will be open to the consumer body, which will provide a complaints handling service in the first instance. Discriminatory and predatory pricing are matters for investigation by OFT under the Competition Act and can be referred by them to the MMC (on a 6 month time limit, with the possibility of a 3 month extension). In addition, we are negotiating with BGC the terms of assurances covering:-

(i) publication of prices;

(ii) fairness as between customers (in line with the requirements of the Competition Act); and

(iii) level of prices for an initial period of three years, during which circumstances can reasonably be predicted.

These are new features, being applied for the first time to the gas contract market, and are specifically designed for the reassurance of customers. With proper presentation they will be a strong selling point.

(c) regulatory backstop for contract market. The Bill provides for OFGAS regulation to be extended to the contract market by Ministerial Order following a MMC Inquiry. This is intended as a final safeguard against gross and persistent abuses by

the company, all other channels and remedies having been exhausted. Given the assurances which we are aiming to secure on maximum prices during an initial period, a major concern may be about the possibility of predatory pricing. Should this occur, the anti-competitive practices provisions of the Competition Act would bite and the procedure described at (b) above could lead quickly to an extension of OFGAS regulation to the contract market by Ministerial order.

(d) ring fence. There are a number of detailed issues to be addressed in establishing the initial cost allocations for the gas supply business. We shall need the advice of Touche Ross and will want a number of other expert contributions. I do not agree with John Moore's suggestion that we should delay starting on this until a Director-General of Gas Supply has been identified. The time factor is a major constraint, as details of this kind need to be settled well before the flotation. I shall however be very glad to involve John Moore in the further work on this.

(e) separate accounts. There will be published separate accounts for the ring-fenced gas supply business. Establishing the right initial cost allocations, and control over subsequent changes, should deter hidden cross-subsidy from gas supply into, for instance, retailing which John Moore mentioned. Together with publication of contract prices, the ring fence promises a high degree of transparency for the gas supply business. Within that, details covering the tariff market can be called for by the Director-General who will have substantial discretion as to the information he makes public in his Annual Report to Parliament. As requested I have re-considered the possibility of requiring publication of separate accounts for the tariff and industrial contract markets. I am satisfied that the practical problems would severely impair their objective accuracy. My officials have consulted Touche Ross, who fully endorse this view. I am

however prepared to seek an undertaking from BGC that they will maintain their practice of publishing separate accounts for their upstream, retailing and other ancillary activities. I believe that the arrangements we have in mind are, taken together, fully adequate for our purposes.

I hope these further clarifications and strengthenings will help other Departments to support our proposals. We have provided a very full range of safeguards which, together with BGC's voluntary assurances, constitute an attractive package.

The CBI's positive reaction should not be discounted. Their sentiments were supported by discussions I had only yesterday with the Chemical Industries Association, who were particularly involved on the only previous occasion when problems arose in the industrial contract area.

There is no prospect of persuading the Gas Board to accept an active role for OFGAS in the contract market or a regulatory model designed to suit a very different industry. To say to the Gas Board that the benefit of privatisation is that you will have less freedom to compete in the contract market against oil, electricity and coal and your purchasing policy will be crawled over by officials in a manner which never took place under nationalisation is asking them to change from a system of interference from a government department to a system of far greater interference from a government appointed body. In any case they know that the safeguards that they have been prepared reluctantly to accept in terms of a regulatory backstop means that they could never be tempted to exploit their monopoly position for if they did the regulator would then become a permanent feature of the contract market.

For many months I have toughly and patiently negotiated with the Gas Board without any leaks taking place and I have moved them in almost every sphere to a position that most of my experienced

officials thought was impossible. I must warn you that I can move them no further, nor can anybody else. We can now go ahead with privatisation with their support and therefore with success, or we can enter a public battle with them in which case I think success is impossible.

I am sending this minute privately to you because of the timescales involved. Treasury, DTI and my officials having met, I am now aware of the totality of the arguments and the position. I am endeavouring to fix a meeting with a Treasury minister and DTI minister - I hope on Thursday. But I will have to convey to them very firmly what I now convey to you in this minute.

I will report to you the result of the meeting after it takes place.

SECRETARY OF STATE FOR ENERGY

19 November 1985

Copy No 2 of 6.

9.

01 211 6402

NBPM.

The Rt Hon Leon Brittan QC MP
Secretary of State
Department of Trade & Industry
1 Victoria Street
LONDON
SW1H OET

15 November 1985

Dear Leon

GAS PRIVATISATION: RESTRICTIVE TRADE PRACTICES ACT

As you and the Law Officers know, British Gas has alerted us to a problem about the possible registrability under the Rrestrictive Trade Practices legislation (RTP) of their gas purchase agreements which could have serious consequences for the flotation.

It was agreed with the Law Officers that it would be appropriate to consider the problem in the light of an Opinion which BGC was seeking from leading Counsel in the RTP field. The first part of this was delivered to us at the beginning of November, and my officials have arranged for yours and those of the Law Officers to see the text. The Opinion confirmed there was a real risk that the relevant agreements contained restrictions which were registrable, and that this was a matter which would have to be addressed in the prospectus for sale. The fact that the prospectus would have to mention the problem would in Counsel's view materially increase the risk of challenge to thc agreements. Such a risk is clearly unacceptable and the only solution which Counsel believed practicable was legislation both retrospectively to save past agreements, and prospectively to ensure that in future British Gas' private sector successor could continue to buy gas in an effective commercial manner.

My officials have examined the Opinion carefully with our advisers and agree with the main thrust of its analysis. The problem is essentially caused by the combination of the offshore licensing regime under which (because of the risks inherent in exploration and production) licences are granted to consortia, and the realities of gas transmission and supply, which require the gas produced from a field to be sold by the consortia to a single buyer. Such a combination seems inevitably to lead to RTP problems, and it does not seem to be sensible in the circumstances for that legislation to apply to such sales agreements. In the light of this advice I believe it would be justifiable to remove such agreements from the ambit of the Act both for the future and retrospectively to clear away any doubt about the past contracts. This would of course follow earlier legislation for

exemptions for such matters as syndicated loan agreements, participation agreements and copyright agreements!

My officials have considered the scope of the exemption and believe on the basis of the analysis contained in Counsel's Opinion and their general knowledge of North Sea agreements, that there is no reason for operating agreements between licensees covering possible production of gas to contain restrictions which would cause problems under the Act. In these circumstances I do not think it would be defensible for us to legislate prospectively to cover more than gas sales agreements. But we must be assured that we have caught all the doubtful cases in the past and it may therefore be necessary also to deal retrospectively with agreements ancillary to gas sales agreements. My officials are keeping yours informed about the details of the existing agreements.

I would be grateful for your agreement to amending the RTP legislation in this way. We also need to consider the best way to introduce such a provision. I understand that in the past amendments to the Restrictive Trade Practices Act 1976 have generally been made in short Bills which have been passed in a matter of weeks. If we introduce the Gas Bill with these provisions there will, of course, be a much longer period of exposure - perhaps 6 months before Royal Assent. My advisers do not believe that this would create any significant commercial risks for BGC but I would be grateful for your views on the Government's position - particularly as regards the OFT. If you have doubts about the introduction of the Gas Bill with such provisions I am advised that because of scope problems we could not guarantee to introduce them by Government amendment at a later stage and the only safe alternative would seem to me to be a separate short Bill to deal with the point.

I understand that there is no provision in the programme at present for such a Bill, and the simplest solution would therefore be to include a provision in the Gas Bill at the outset. In view of our timetable for this - we are aiming for introduction around the end of this month and Second Reading before Christmas - I would be grateful for an urgent response.

I am copying this to the Prime Minister, the Chancellor of the Exchequer, the Solicitor General and the Leader of the House.

PETER WALKER

10 DOWNING STREET

Prime Minister

If you can close the meeting by 1755, members of E(A) will not be milling around outside as the people for your 1800 meeting arrive.

DEN
14/11

PRIME MINISTER 13 November 1985

BGC PRIVATISATION

This is no easy task. We need successfully to accomplish the world's largest equity flotation, to net £6-8 billion, to confer sustainable benefits on gas consumers and get nearer to the ideal of an undistorted energy market inducing efficient production and consumption.

Like Denis Rooke, BGC is more solid than glamorous. The utility activity of gas distribution accounts for 90% of revenue. The real cost of purchasing gas from the producers is on a steady upward trend. Gas is becoming more vulnerable to competition from other fuels. The growth potential is limited. Yet, it will be a long time before BGC's other business activities make a substantial contribution to profits.

A necessary but not sufficient condition for the success of the exercise is a well-judged set of balances - between consumer and investor; between a highly-regulated, boring utility and a business which offers an element of worthwhile reward for risk and enterprise; between a management which, on the one hand, has room to manoeuvre and be innovative yet, on the other, is not too powerful and potentially predatory. The essential further condition for the acceptability of the exercise lies in its presentation.

In the main, the package put forward by Peter Walker lives up to earlier promise. It has the makings, both of the well-struck balancing of objectives and a defensible presentation.

1. Does the package expose BGC wherever possible to competitive market forces?

So far, the package scores well on this count. Retaining the practice of individually-negotiated contracts with BGC's larger commercial and industrial customers will allow real scope for interfuel competition. This should permit the full interplay of market forces over an important part of BGC's business. Moreover, the practical measures devised to give private sector gas producers direct access to the industrial market, should at last make the common carrier provisions of the Oil and Gas Enterprise Act work. This will add the further stimulus of gas to gas competition.

BGC's monopsony purchasing power from gas producers will be weakened when producers have the opportunity to place their gas directly into the industrial market. Nonetheless, the freedom to export UKCS gas to the Continent remains a vital missing ingredient left for later consideration.

2. Does the regulatory régime strike the right balance between consumer and investor?

The mass of small consumers purchasing gas under

regulated tariffs will be protected by a tightly-controlled ceiling on gas price increases. The detailed working of the RPI-X+Y formula has been carefully tested. It looks satisfactory.

Those industrial customers who are inflexibly committed to gas, have cause to fear that BGC will exploit its monopoly position, particularly in the early years when gas still enjoys a competitive edge over competing fuels in many parts of the market. There should be comfort in the undertaking that BGC will publish maximum contractual prices, that price increases for 3 years after privatisation will be subject to prescribed maxima, and that BGC is required to be even-handed in dealing with large industrial and commercial customers.

Giving the regulation of the tariff market to OFGAS and the industrial market to OFT is a shortcoming - if not in substance certainly in appearance. An OFGAS, thus limited, will appear more prone to capture by BGC. OFT will seem too cumbersome and remote to be effective. (The rationale is that OFT will have greater freedom to roam the entire energy market, acting as gamekeeper.)

Having regard to this presentational problem, there may yet be a case to reopen the question of establishing a stronger and more independent body (still small) of expertise and experience dedicated to regulating privatised utilities like telecommunications, gas, water and electricity.

The decision not to interpose a regulator in the negotiations between gas producers and BGC is sound. Gas producers will not welcome interference; far better give them alternative disposal opportunities by facilitating direct access to the industrial market and allowing the possibility of gas exports.

The Other Ingredients

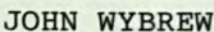
Containing next February's gas price increase to 4% is presentationally shrewd; less scope for criticism of robbing the consumer to pay the Chancellor.

The proposal to gear BGC with £2.5 billion of debt should serve the dual purpose of maximising the Government's proceeds whilst putting a check on Denis Rooke's marauding instincts.

Conclusion

Given our multiple objectives, the package is satisfactory, albeit - perhaps ominously - still missing the liberalistion of gas imports and exports.

The division of regulatory responsibility between OFGAS and OFT should be challenged, particularly on presentational grounds. Why not establish a strong more capture-proof body (still small) dedicated to the related problems of regulating the whole family of privatised utilities?



JOHN WYBREW

1 Icon.

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CONFIDENTIAL

PRIME MINISTER

Gas Industry Privatisation

FLAG A (E(A)(85)65)

BACKGROUND

FLAG B At its meeting on 31 July (E(A)(85)17th Meeting, Item 1), the Sub-Committee broadly endorsed the legislative provisions and price control arrangements proposed by the Secretary of State for Energy in the context of the privatisation of the British Gas Corporation (BGC). Mr Walker was asked to report back to the Sub-Committee on a number of matters:

(a) the treatment of prices charged to larger industrial consumers, which are negotiated between BGC and the customer and have not hitherto been subject to a published tariff;

(b) the treatment of BGC's purchases of gas, where the possible need for any public supervision could be affected by

(c) future arrangements for imports and exports of gas;

(d) the transparency of the separation of BGC's post-privatisation business into three main elements (exploration and production, distribution and supply of gas to industrial and domestic consumers, and appliance retailing and servicing).

2. Mr Walker's further paper (E(A)(85)65) responds to these remits, except for (c) on which he promises a further paper before the Bill reaches the stage of Second Reading (scheduled to take place before the Christmas Recess). Mr Walker also seeks final policy endorsement for the contents of the Bill, and of the licence which will lay down the detailed price and other provisions governing the operations of the new company. (The Bill

He told you that he will leave backbenchers to move an amendment to bring in greater transparency

is summarised in Annex 1, price provisions in Annex 2, and other conditions under which BGC will operate in Annex 3). Finally his paper contains material about the progress of work towards the offer for sale, in the light of the economic prospects for the business. No specific decisions are required on these aspects on this occasion, although Ministers will need to take note of BGC's intention to increase prices to tariff customers by about 4 per cent next April.

MAIN ISSUES

3. The main issues are

(a) arrangements for the supervision of prices charged to consumers, and in particular the treatment of larger industrial consumers;

(b) the transparency of future accounting arrangements for the different parts of BGC's business;

(c) the treatment of gas producers (i.e. including the question of supervision of BGC as a purchaser of gas and the proprietor of the distribution network).

Price Regulatory Regime

(i) Tariff consumers

4. Mr Walker proposes no essential changes from the arrangements previously put forward in E(A)(85)52, which would provide for regulation of prices charged to domestic and other consumers using less than 25,000 therms a year by means of a Telecom-type formula RPI -x (a requirement to achieve efficiency savings on distribution costs which are under BGC's control) +y (changes in the costs of gas which are not under BGC's control. Prices would be set in relation to forecast costs, with provision for subsequent adjustments if exchange rate changes (which impact directly on gas costs specified in some contracts in US dollars) or other factors produce a different outcome. It appears that these arrangements are acceptable to all the Ministers concerned.

(ii) Contract consumers

5. Mr Walker proposes that price regulation should not extend to contract consumers. Instead BGC should give an undertaking limiting rate of price increase for an initial 3 year period; thereafter they would publish schedule (maximum) prices against which rebates would be negotiated, and would be bound by broadly drawn assurances about equitable treatment of customers. Extension of price control into the contract area would only come about if the Director-General of Fair Trading or the Secretary of State initiated a reference to the Monopolies and Mergers Commission and the Commission then recommended a change in the terms of the licence. (In this respect Mr Walker appears to be proposing a looser form of regulation than he put forward in paragraph 13 of E(A)(85)52, when he apparently contemplated allowing the initiative to rest with the Director-General of Gas Supply (DGGS).)

6. Mr Walker's arguments are

(i) there is effective competition in the industrial market from fuel oil, gas oil and coal. BGC have more gas available than they can sell at current prices;

(ii) on the basis of soundings with the CBI, etc there is no demand from consumers for price regulation as in the tariff area - they would rather be free to negotiate with BGC;

(iii) the Director-General of Gas Supply would have a vested interest in extending the coverage of his price regulatory powers, and would be bound therefore to propose this if the initiative were left with him;

(iv) BGC would strongly oppose any interference with their commercial freedom in this area, which has hitherto been left entirely to their discretion by the Government. This would prejudice their support for privatisation, which is essential for the success of the Government's policy;

(v) there would be serious adverse consequences for BGC's prospects for profit growth and business development, which would greatly reduce the potential proceeds from privatisation.

7. DTI and Treasury officials are apparently worried that BGC would thereby be seen to be subject to less stringent regulation than British Telecom, and that this would damage the reputation of privatisation in the eyes of consumers. They point out that there is substantial headroom within the present price of gasoil for increases in the price of 'firm' (i.e. non-interruptible) gas, and claim that the CBI's attitude is more equivocal than Mr Walker suggests. They would like to see at least

(i) a power of initiative resting with the DGGS to press for an extension of the coverage of price control;

(ii) a right in the licence for all industrial consumers to buy gas at the schedule prices;

(iii) safeguards in the licence against unreasonable price discrimination between different consumers;

(iv) the publication of separate accounts for the tariff and contract sectors of the distribution business (see paragraph 9 below).

8. A delicate political balance has to be struck between the need to assume adequate protection for consumers and the need to structure the privatised business in a way which is attractive to investors. BGC does not have prospects for volume growth and lower unit costs comparable with Telecom, and any substantial extension of price regulation into the 50 per cent of the distribution business where there is scope for entrepreneurial decision-making will undoubtedly much reduce its attraction to investors. On the other hand there may be some scope for small adjustments in the arrangements proposed by Mr Walker either by some general safeguards being inserted into the licence or through giving DGGS some role to initiate action.

Cost allocation

Mr Walker told you that he will leave backbenchers to move an amendment designed to produce greater transparency, E(A) should not be told this. DRN 13/11

CONFIDENTIAL

Transparency of accounting arrangements

9. Ministers were concerned at E(A) in July that BGC might unfairly draw profits from their main distribution business to subsidise their appliance retailing and servicing business. Mr Walker now undertakes that the publication of separate accounts for the distribution business will be required under the terms of the licence, and that a convention will be established providing for separate publication of accounts for exploration and production and for retailing and servicing. Given the limited prospects for growth in the main distribution business, it would be unreasonable to prevent BGC from investing its profits upstream and downstream of that business. As to gas distribution, it is not clear that separate accounts for the tariff and contract sectors would achieve much; the allocation of the joint costs of the distribution system can only be done on the basis of assumptions, and in the end it is likely that this will have to be based simply on the volume of gas sold to each type of customer. In setting prices at the outset an allocation will have to be made and explained to the DGGS; thereafter BGC would not be free to change that allocation without his agreement. Under Mr Walker's proposals the baseline would be set before the DGGS was in operation; it might be prudent to agree that he should at any rate be consulted at the initial stage. As to a mandatory requirement for separate accounts for the upstream and downstream business, Mr Walker is likely to argue that this would be an unreasonable discrimination against BGC, who would thereby be placed under constraints more onerous than their competitors in these fields. In practice achieving the objective by convention should be sufficient.

Treatment of Gas Producers

10. There has been concern that a privatised BGC would be seen as in an unfairly strong position as a de facto (though no longer de jure) monopsony purchaser of UKCS gas, and that gas producers might need some regulatory protection to redress the balance. In practice, however, gas is increasingly becoming an internationally traded commodity, and there would be a serious risk that the

effect of controlling UKCS producer prices would be to choke off exploration and production. Another possible approach would be to allow exports of UKCS gas, which have so far been precluded by enforcement of the statutory requirement for UKCS gas to be landed in the UK. Separate consideration is promised of this question; not least because of EC difficulties it does not appear to be practicable or desirable to cover it in the Bill, although Ministers will need to know how to approach it by the time of Second Reading. (It appears that Mr Walker wishes to avoid committing himself either to permitting BGC to import gas or UKCS producers to export it; but both will know that failure to reach a reasonable compromise on the price of UKCS supplies to BGC risks precipitating EC litigation by one side or another which they would both prefer to avoid.)

11. The approach now proposed by Mr Walker is to strengthen the rights of UKCS producers to transport their gas to their own customers using BGC's distribution system as the common carrier. BGC would be obliged to publish specimen prices for the transport of gas (which they have hitherto avoided doing), would undertake to make back-up supplies available on normal commercial terms if the supply from a field directly sold to an industrial purchaser were interrupted, and would undertake to buy residual quantities of gas from fields most of whose output was directly sold to customers using the common carriage facility. The DGGS would be arbitrator of prices for common carriage and back-up supplies in the event of a dispute; further consideration needs to be given to how a dispute would be resolved on the price to be paid for residual portions of directly sold fields, given that this is an area from which the DGGS is in general to be excluded.

12. Although it remains unlikely that any actual use will be made of the common carrier facilities, the new proposals represent a significant advance on present arrangements and a substantial concession by BGC towards a more equitable structure within which to negotiate prices with UKCS gas producers. It does not appear likely that any Minister will argue against Mr Walker's recommendations. A particular side issue of which the Solicitor-General

will be aware is the need for a special legislative provision to make enforceable BGC's existing UKCS gas purchase contracts; there is no need to discuss this.

Other matters

(i) Offer for Sale

13. Mr Walker notes that the flotation could raise between £6-8 billion, with a combination of equity and new debt (£2.5 billion). BGC appear on course for a 1985/86 pre-tax profit nearly 10 per cent up on 1984/85; and the BGC Board should be able to make a prospectus forecast for 1986/87 some 10 per cent up on 1985/86. There are uncertainties here - the oil price and the exchange rate - and Mr Walker is considering with Treasury the scope for using the forward and options markets to reduce their impact. These calculations assume the continuation of the Gas Levy and a 4 per cent gas tariff increase in April 1986.

(ii) Overseas Sales of BGC Shares

14. Mr Walker proposes preparatory work for possible sales in the USA, Japan, Canada, and Europe. Rothschilds, the Department's merchant bank advisers, believe this would be prudent; the Treasury are in agreement.

(iii) Special Share

15. Mr Walker proposes a limitation on the shareholding permitted to any one party or group with the Government retaining a 'golden' share to ensure that the limitation remains. This would be in line with previous privatisations, including Britoil, Enterprise Oil and British Telecom.

(iv) Employee Participation

16. Mr Walker proposes 'to do more' on employee participation than in previous privatisations, eg an incentive for pensioners of the gas industry. He believes this is necessary to counter a major TUC campaign against gas privatisation and union opposition from NALGO. Specific proposals have not yet been agreed with the Treasury. You may wish to draw him out on this.

Reg. regime.
? what has become of
OFGAS

(v) Gas Users' Council

17. Mr Walker proposes that the Secretary of State(for Trade and Industry) be required to appoint a Gas Users' Council to investigate complaints from tariff and industrial consumers. This Council would replace the present network of Regional Gas Consumer Councils under the umbrella of a National Council. In the case of Telecom the comparable consumer body is within OFTEL, but it does not appear that the Secretary of State for Trade and Industry will be arguing for a similar arrangement on gas.

HANDLING

18. You will wish the Secretary of State for Energy to introduce his paper. Thereafter it may be helpful to divide the discussion into three parts:

(i) coverage of consumer price regulation, including treatment of contract consumers, extent of role of DGGS and extent of requirements to produce separate accounts for different parts of BGC's business;

(ii) treatment of BGC's gas purchases, and the proposals on the common carrier arrangements;

(iii) other issues.

Separate accounting for contract & tariff markets
No + subst
Code of Practice

The Financial Secretary, Treasury and the Secretary of State for Trade and Industry will wish to speak on (i) and (ii). The Lord President of the Council, the Lord Privy Seal and the Chancellor of the Duchy of Lancaster will have views on the political and Parliamentary aspects.

CONCLUSIONS

19. You will wish the Sub-Committee to reach conclusions on

(a) the acceptability of the regime of price regulation, including

(i) the treatment of contract customers,

(ii) the role of the DGGS, and

(iii) the accounting arrangements to ensure adequate transparency for BGC's different activities;

(b) the treatment of gas purchase contracts, and the proposed changes in common carrier arrangements;

(c) in the light of (a) and (b), final endorsement for the content of the legislation and the terms of the licence;

(d) the establishment of the Gas Users' Council; and

(e) (on a provisional basis) arrangements for the offer for sale.

J B UNWIN
Cabinet Office
13 November, 1985

CONFIDENTIAL

PRIME MINISTER

GAS INDUSTRY PRIVATISATION

The Treasury will not in the end stand out against Mr. Walker if he claims that to tighten the regulations would jeopardise privatisation. But the absolute maximum needs to be done to reduce the scope for accusations that the Government is privatising a monopoly.

DRN

David Norgrove
13 November 1985

CONFIDENTIAL

7 cc JW cc BU

SECRET

MR NORGROVE

Reference No E 0123

cc Mr Unwin
Dr Walker

GAS PRIVATISATION

The main issues outstanding from the earlier E(A) discussions of the privatisation of the BGC are

(i) whether and how price regulation should extend to the industrial market where hitherto contracts have individually negotiated;

(ii) whether BGC's purchases of offshore gas should be regulated in any way;

(iii) the extent of mandatory transparency in the accounting arrangements for offshore operations, gas supply and distribution, and gas appliance retailing, etc respectively;

(iv) whether offshore gas producers could be given improved 'common carrier' access to BGC's distribution system;

(v) future control over imports and exports of gas.

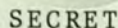
2. I understand that the papers for discussion by E(A) on 14 November will be confined to issues which require to be settled before the legislation is introduced, and that a separate paper will be put forward in a few weeks time on imports and exports of gas. This week's paper will therefore be mainly

about the form and extent of price regulation, the common carrier, and powers concerning the capital structure of the privatised company. The Department of Energy's attitude seems to be that they have brought BGC a long way towards the Government's position on acceptance of an element of debt in capital structure, on improvements in other gas producers' access to BGC's distribution system (which will strengthen their hand in price negotiations with BGC), and on some restraints on BGC's behaviour towards industrial consumers with whom they have individually negotiated contracts. Pressing BGC to go further and accept tighter and more extensive regulation would, in the view of the Department of Energy, risk two serious adverse consequences:

(a) BGC might cease to cooperate, in which case privatisation on the present timetable would become impossible; and

(b) even if BGC continued to cooperate, the proceeds from the sale would be substantially reduced because the business would then be seen as a tightly regulated utility with little scope for business development and profit growth.

3. We understand that Treasury Ministers accept that BGC's gas purchases should not be regulated, but that they are still looking for ways of imposing somewhat stronger control over BGC's behaviour towards industrial customers. They are worried that if the regulatory arrangements are seen to be substantially weaker than those for British Telecom, the reputation of privatisation in terms of its impact on the consumer may be at risk. But they will in the end have to balance this consideration against the importance of BGC's contribution to the £4¾ billion receipts from the special sale of assets projected in each of the Public Expenditure Survey years.

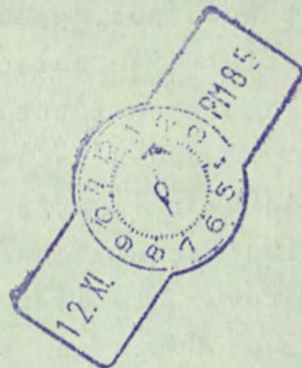


Gas imports and exports

4. It does not appear that there has yet been any very substantial discussion between the Department of Energy and the Treasury on future arrangements for the import and export of gas. We understand that Mr Walker envisages present de facto controls over imports and exports being maintained. The oil companies' acquiescence in this seems to have been secured by the improvements in the common carrier arrangements, and by new arrangements to protect their confidential information about UKCS geology from being exploited by BGC in its future role as an offshore oil and gas producer. BGC meanwhile have more gas available than they can sell, and therefore are not looking for major new imports of gas. It may be that forms of words can be devised for use both during the passage of the legislation through Parliament and subsequently in the Prospectus which effectively shelve this question for a period of years; given the constraints of the Treaty of Rome, it does not appear that overt powers could be taken to control imports and exports, but the existing controls over offshore developments and submarine pipelines give the Government a number of strong cards. Eventually, however, it seems likely that the question will have to be tackled; although the oil industry is not now actively opposing privatisation on the terms proposed by Mr Walker, their attitude would almost certainly change if in the future they were unable to negotiate what they regarded as acceptable prices with BGC and could sell their gas on better terms to continental purchasers. If that situation were to arise, a future Government would find it very difficult to prevent such exports. Similarly if UKCS producers sought to charge BGC a price higher than they would have to pay for imports, the Government would be in difficulty seeking to obstruct future BGC imports. It is clear that Ministers will need to consider carefully how to deal with this question before substantive discussion of the Bill begins; but it does not appear that their future discussions about this point will be substantially prejudiced by the decisions they will be invited to take at this week's E(A) meeting.

JW

A J WIGGINS
Economic Secretariat.
12 November, 1985


12.XI.

10 DOWNING STREET

Prime Minister

Mr Walker wants your support against Mr Tebbit et al. who fear a privatised monopoly. He thinks that if they have their way on safeguards it will not be possible to sell BGC successfully.

Mr Walker is seeing Mr Rooke tomorrow morning.

The accusation that the Govt. is privatising a monopoly probably carries more weight than it did with BT, where people could see strong competition coming, even if not for a few years. It

should be possible to
find a balance on BGC.

DRW
11/11

PRIME MINISTER 11 November 1985

BGC PRIVATISATION - MEETING WITH PETER WALKER

The Government's critics will say that the interests of gas consumers are being subordinated to the objective of making BGC as attractive as possible to investors, thereby maximising the Government's proceeds. Peter Walker can point to the widely perceived success of the BT flotation. He will argue that the inherent disciplines of the private sector, enhanced by the proposed regulatory regime for BGC's gas distribution activities, should benefit the consumer without impairing the appeal to investors.

In the discussion you might like to probe the balance that is being struck between consumer and investor. Could it be said that the Government has been captured by Dennis Rooke?

Possible Questions

1. Deregulating the individually negotiated contracts with the larger commercial and industrial customers should create a real battleground for inter-fuel competition between gas, electricity, oil and, to a lesser extent, coal. More than any other feature of the regulatory regime this should bring external market forces into play.

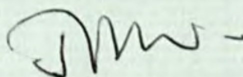
But are we satisfied with the protection for those industrial customers who are inflexibly committed to gas and are therefore vulnerable to BGC exploiting its monopoly position, particularly in the early years when BGC still enjoys a competitive edge over competing fuels in many parts of the market? You could press Peter Walker on the assurances being formulated by BGC. As we understand it, the expert gas regulator (OFGAS) with special knowledge and experience of the gas market is not intended to act as

gamekeeper in this area. Why not? Relying on the DGFT and normal competition law will be slower and less effective.

2. Liberalising the import and export of gas is widely regarded as the touchstone of the Government's commitment to the good Lawsonian view of energy policy - ie a framework which ensures that the market operates with the minimum of distortion and that energy is produced and consumed efficiently. Why fudge this because of presentational difficulties? In the long run the consumer will benefit and UK Ltd will secure the maximum return from our gas resources.

3. Our City advisers want to help the BGC launch on its way with a gas price increase next February of at least 5%. This is sensitive territory - increasing Mrs Jones' gas bill to boost the BGC state proceeds and thence reduce taxes. Peter Walker doesn't want to go as far as a 5% price increase, but can BGC contain costs sufficiently to present a healthy profit increase between 1985/6 and 1986/7?

4. The practical measures being devised to facilitate the entry of private sector gas producers into the industrial market begin to look promising. Can we be sure that BGC will deliver?



JOHN WYBREW

RESTRICTED

10 DOWNING STREET

From the Private Secretary

28 October, 1985.

NORTH SEA GAS PRICES AND JOBS

The Prime Minister was grateful for your Secretary of State's minute of 14 October. She would be glad if Mr. Walker would mention to Sir Denis Rooke her concern about the need to conclude discussions between BGC and the companies as quickly as possible.

(David Norgrove)

Geoff Dart, Esq.,
Department of Energy.

RESTRICTED

10 DOWNING STREET

25 October 1985

Dear Alan,

Gas Bill 1985

Thank you for your letter of 23 October.

I write to confirm that the Prime Minister will be a backer for this Bill.

Yours ever
Nicky Roche

Miss Nicky Roche
Parliamentary Clerk

A D Proud Esq
Parliamentary Clerk
Department of Energy

PARLIAMENTARY BRANCH
DEPARTMENT OF ENERGY
Thames House South, Millbank, LONDON, SW1P 4QJ
Telephone: Direct Line 01-211 7106
Switchboard 01-211 3000

Ms N Roche
Parliamentary Clerk
10 Downing Street
LONDON SW1

23 October 1985

Dear Nicky

GAS BILL 1985: BACKERS

I should be grateful if you would seek the agreement of The Prime Minister to be one of the backers for this Bill, which we hope to introduce in late November.

On 7 May, our Secretary of State announced (OR Col 639 enclosed) the Government's intention to transfer The British Gas Corporation to the private sector, and to provide for appropriate regulation of monopoly aspects of the gas supply business. The Gas Bill will give effect to this.

In addition to our own Departmental Ministers it is suggested that the proposed list of backers comprises:-

The Secretary of State for Trade & Industry
The Chancellor of the Exchequer
The Secretary of State for Scotland
The Secretary of State for Wales
The Secretary of State for the Home Department
The Secretary of State for the Environment
The Paymaster General

Yours sincerely
Alan Proud.

A D PROUD
Parliamentary Clerk

1

CC ~~NO~~

Prime Minister

You will remember that this arose out of your visit to the NE and Scotland. Content for Mr Walker to speak to Sir Denis Rooke, rather than you to write to him?

DRN

16/10.

Yes mt

PRIME MINISTER

Letter attached

I believe your office's suggestion of 3 October that you should write to Denis Rooke about gas purchase negotiations in hand is misconceived.

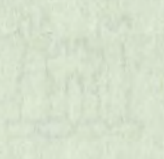
There are a number of discussions underway and it does not surprise me that you should have received this approach. The most advanced of these is with Conoco over 'V' Block. I spoke personally to BGC about this and believe they are doing everything possible to conclude an early agreement.

We are at a rather delicate stage in negotiation on the gas privatisation. Denis Rooke is co-operating but will need careful handling. I would much prefer to mention your concern to him personally and that no new initiatives should be taken at this stage.

SECRETARY OF STAGE FOR ENERGY

14 October 1985

NAT IND
PT 11
GAS + ELECTRIC



Cc NO

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SWIP 4QJ
01 211 6402

NBPM.

David Norgrove Esq
Private Secretary
10 Downing Street
LONDON SW1

14 October 1985

Dear David,

ELECTRICITY AND GAS EFLs

Thank you for your letter of 4 October.

My Secretary of State has asked me to make sure that there is no misunderstanding on the forecast overshoot for the electricity industry. The £710 million which you quote does reflect, indeed is largely attributable to, the effects of the coal strike and the need to rebuild power station stocks before the winter. To this has unfortunately been added increased capital expenditure, largely by the CEGB on the Cross Channel link, which is now more than was reported in E(NI)(85)10. Mr Walker has gone into this personally with Lord Marshall, and stressed the Government's concern that the industry tighten its project control in order to minimise the risk of further cost escalation.

My Secretary of State fully shares the Prime Minister's view on the importance of financial discipline in the industry and the need to set a revised EFL as soon as possible. But the issues, both those arising from the strike and its aftermath (including further coal stocking through the winter) and those arising from the CEGB request for extra capital, have first had to be clarified.

On gas my Secretary of State is keeping a close watch on BGC's position. He believes that they will be able to recover a fair amount of the ground lost by the end of this financial year. In particular the forecast overshoot reflected an increase in gas costs because of a decline in the value of sterling at the turn of the year. Future monitoring reports should show an improvement because of more recent movements in oil prices and exchange rates.

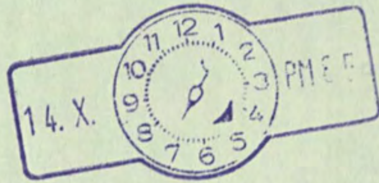
Mr Walker will be coming forward shortly with his proposals for floating a strong viable company. These proposals will pay particular attention to the company's cash flow and the profit profile for the prospectus to which the Prime Minister's points are very germane.

I am copying this to Richard Broadbent in the Chief Secretary's Office.

Yours, Geoff 14/10

G S DART
Private Secretary

NAT IND GAS + ELECTRICITY



PT 11

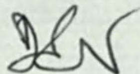
MR. REDWOOD

You asked about the trading performance of NEB and figures for capital gains and losses.

The NEB merged with NRDC in September 1981 to form BTG, but its figures are on a calendar year basis. Taking the period from 1976 to end 1981 it had total trading losses of £138 m. and capital losses of £17 m., making £155 m. (£60 m. of the trading losses and the £17 m. of capital losses were taken in 1981).

NEB figures are, however, still separately identified up to the first quarter of this year. On this basis the losses over the period amount to £132 m.

So you could say something like "£150 m. during its life" or "£130 m. up to this year".



David Norgrove

7 October 1985

54 SRW

10 DOWNING STREET

From the Private Secretary

4 October 1985

ELECTRICITY AND GAS EFLs

The Prime Minister has seen the latest monitoring report on EFL. She is concerned at the prospect of a £710 million overshoot for the electricity supply industry, noting that this figure still does not reflect the effect of the coal strike. The lack of an up-dated EFL for 1985/86 must be undermining the much needed financial discipline in the industry. She believes that discussions on the EFL need now to be resolved very rapidly.

She has also seen that an overshoot is forecast for the EFL of the British Gas Corporation. She notes that this is unprecedented and is concerned about the implications for gas privatisation. She has asked what scope there is to compensate for the overshoot by tighter control of working capital, by trimming capital expenditure, by reducing operating costs, and by selling inessential assets.

I am copying this letter to Richard Broadbent (Chief Secretary's office).

(DAVID NORGROVE)

Geoff Dart, Esq.,
Department of Energy

SRW

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DG2AOV

10 DOWNING STREET

From the Private Secretary

3 October 1985

Dear Geoff,

NORTH SEA GAS PRICES AND JOBS

The Prime Minister has seen your letter to Nigel Wicks of 25 September. She remains concerned that delays in concluding discussions between BGC and the companies could damage the offshore industry. She wishes to write to Sir Denis Rooke along the lines indicated in Nigel Wicks' letter to you of 12 September, and I should be grateful for a suitable draft.

B/F

I am sending copies of this letter to Rachel Lomax (HM Treasury), John Graham (Scottish Office) and John Mogg (Department of Trade and Industry).

Yours sincerely,

David

David Norgrove

Geoff Dart, Esq.,
Department of Energy.

RESTRICTED

MR NORGROVE 2 October 1985

NORTH SEA GAS PRICES AND JOBS

You asked for comments on the recent exchange of correspondence with Peter Walker's office on BGC's gas procurement policy, the implications for UK gas development activity, and the related impact on jobs.

There were certainly grounds for challenging BGC when they contemplated buying a large supply of expensive Norwegian gas (Sleipner), seemingly to strengthen an already dominant position as monopoly purchaser by creating a buyers' market for UK gas supplies.

As things have turned out, there is a buyers' market today, but not because the Norwegians got in ahead of UK producers. It stems from the stimulus to gas exploration of the higher gas prices offered by BGC in recent years and tax changes in the 1983 Budget. A measure of this is the 15% increase of UK gas reserves in the most recent update.

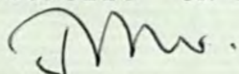
There is now a queue of UK producers anxious to conclude supply contracts with BGC. Not surprisingly, those further back in the queue, with more expensive development plans, are lobbying for BGC to be more expansive in their procurement of new gas supplies. BGC should not commit to purchase more gas than they realistically see the need for; such gas purchasers carry the obligation to take or pay.

In the context of public expenditure control and BGC privatisation, the Government rightly insist that BGC must act commercially, not least in its gas procurement. It would be wholly inconsistent with this line if we now urge BGC to be more expansive, purchasing additional gas so as to stimulate gas development and create more jobs.

On the subject of North Sea development activity, I would point out that the gas-related projects - mainly in the shallow southern North Sea - require much less equipment and generate fewer jobs than northern North Sea oil projects. Thus, at present, the biggest threat to jobs in the UK contracting industry is factors influencing the outlook for oil prices, in sterling, eg OPEC's poker game in the face of a new Saudi Arabian oil export policy, barter deals involving oil, and the rate of sterling against the dollar.

Conclusion

BGC is acting commercially in selectively and toughly negotiating with UK gas producers for new supplies. The Government should not intervene. The issue will soon come back in a broader context when liberalisation of gas imports and exports is debated as part of the BGC privatisation exercise. Allowing exports, and thereby establishing a linkage with the European gas market, will be an important market discipline on a monopsonist BGC, and ultimately will benefit "UK Ltd".



JOHN WYBREW

E.R.

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PRIME MINISTER

NORTH SEA GAS PRICES AND JOBS

This arose out of your trip to Scotland and the North East, when it was represented to you that employment in the offshore construction industry would be encouraged by early development of more North Sea gas fields. This needed higher prices to be paid by BGC and permission for gas to be exported.

Department of Energy comments are at Flag A and Policy Unit comments at Flag B.

There seems to be agreement that the problem is not one of price.

On exports, there is to be a discussion at E(A) in early November, as part of the run up to BGC privatisation. This will give an opportunity for further testing of the arguments.

Agree to note the Department of Energy letter, and that the Secretary of State will be bringing forward proposals on gas exports and imports to E(A) in the privatisation context?

But I promised to write to Denis Rooke about this matter to tell him. The companies do not yet know what price he will pay. "Said to be prepared to pay" is not enough. The shipyard workers in the N.E. needs more orders soon

MT

DRN

David Norgrove
2 October 1985

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SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SWIP 4QJ
01 211 6402

CF
To b/f with any comments. If there are none please b/f anyway on 30/9.
DLW 26/9.

Nigel Wicks Esq
Principal Private Secretary
10 Downing Street
LONDON SW1

25 September 1985

Dear Nigel,

NORTH SEA GAS PRICES AND JOBS

(behind this letter)

Thank you for your letter of 12 September.

There are several Southern Basin gas fields, or groups of fields, which the companies concerned would like to develop over the next couple of years. A number of technical problems need to be solved, including the most appropriate pattern of pipeline development. The main obstacle to early development is, however, as your letter suggests, the fact that BGC has not yet agreed contract terms with the producing companies.

The underlying problem is not one of price. The developments appear to be sufficiently attractive at the prices which BGC is said to be prepared to pay. This point came out clearly from the work of an interdepartmental working group on the North Sea fiscal system. Rather, the problem is that BGC has a surplus of contracted gas in the short term with only a limited need to contract new gas supplies for delivery before 1990.

Nonetheless, BGC is in negotiation with a number of companies at the present time, and is already committed to buy Audrey gas from Phillips in 1988. My Secretary of State has told Sir Denis Rooke that he hopes the negotiations with Conoco on V fields gas can quickly be brought to a successful conclusion, and, more generally, has impressed on the Corporation the undesirability of a loss of momentum offshore. When agreement with Conoco or any of the other companies is reached, field development is likely to go ahead quickly, and this should give important encouragement to the offshore industry.

Beyond the short term BGC's surplus turns rapidly to deficit and prospects for UKCS producers and for the offshore industry generally are excellent. The Government's decision not to endorse the Sleipner contract means that there will be more opportunities in the 1990's

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for UKCS producers to sell to BGC than there is yet gas established and available to sell. But it is obviously important that BGC's short-term surplus should not, by delaying new contracts, damage jobs in the offshore industries or threaten to put firms out of business. My Secretary of State will continue to press these points, and feels that, since we are already in close dialogue with BGC, there is no need for the Prime Minister to write to Sir Denis at this stage.

You also asked about gas exports. There is in fact little scope for speeding UKCS development in the short term by selling gas to the Continental utilities all of whom have contracts covering their immediate needs. The Secretary of State is reviewing the position generally on gas exports and imports, as was agreed earlier at E(A), and will be bringing forward proposals in the privatisation context.

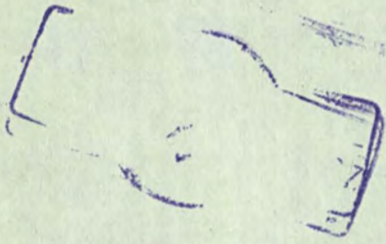
I am copying this letter to Rachel Lomax (Treasury), John Graham (Scottish Office) and John Mogg (Department of Trade and Industry).

Yours ever,

Geoff

G S DART
Private Secretary

Gas & Elec: NAT IND. Pt 11.



Prime Minister
Agree I may write as proposed by the Policy Unit? (Treasury think it may help; Mr Walker will no doubt see it as interference.)
DRN 3/10

MR NORGROVE

20 September 1985

Yes

EFL OVERSHOOTS FOR ELECTRICITY AND GAS

Two forecasts for EFL overshoots in 1985-6 stand out in the Treasury's latest Monitoring Report - that of £710 million for Electricity (England and Wales) and that of £280 million for British Gas.

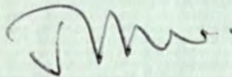
Last December/January there was a rancorous exchange between the Treasury and Department of Energy on the setting of the 1985-6 EFL for the ESI. The differences were not resolved, and the £710 million overshoot still does not reflect the outcome of the coal strike and its impact on the ESI. This means that the normal financial discipline of having to account rigorously for deviations relative to a tight, realistic EFL does not apply; the ESI is able to hide behind very large strike-related items like the £220 million additional interest charges and some £330 million for replenishing coal stocks.

The £280 million overshoot for BGC stems largely from a badly-framed contract for the purchase of Norwegian (Frigg) gas. Although BGC could have foreseen the consequent increase of gas supply costs, provision was not made in the EFL established last year. Unless accompanied by convincing corrective action, this unprecedented overshoot will put BGC in an unfavourable light in the run-up to privatisation.

Subject to the Prime Minister's agreement, you might consider minuting Peter Walker's office:

- Noting the £710 million EFL overshoot for the ESI, expressing concern at the lack of an updated EFL for 1985-6 and hence the lack of a tight financial discipline on the ESI; and urging that this is resolved rapidly with the Treasury, as again proposed in the Chancellor's note of 6 September 1985.

- Expressing concern at the implications for gas privatisation of BGC's unprecedented EFL overshoot, and asking what scope there is to compensate for this by tighter control of working capital, trimming capital expenditure, reducing operating costs, and selling inessential assets.



JOHN WYBREW

Rle EL3AND ECL

CLJW

10 DOWNING STREET

From the Principal Private Secretary

12 September 1985

NORTH SEA GAS PRICES AND JOBS

When the Prime Minister was in Aberdeen and North East England earlier this week, it was strongly represented to her, by representatives of the offshore construction industry, that continuity of employment in their industry required, among other things, early development of more North Sea gas fields. Certainly, some gas developments were going ahead, but many others were, according to the representatives of the offshore industry, inhibited by BGC's reluctance to pay "2 or 3p extra" for gas prices. It was suggested that BGC were, in general, offering prices of 23-24p while projects needed, say, 25-26p to go ahead.

The Prime Minister attaches, for obvious reasons, considerable importance to sustaining and creating new jobs in Scotland and in the North East offshore construction industry and she therefore would like to write to Sir Denis Rooke urging him to give full weight to the new "jobs" which will flow from the satisfactory conclusion of agreements between BGC and the oil companies leading to the development of new gas fields. I should be grateful if you could provide for the Prime Minister a suitable draft.

(1)

More generally, it was suggested to the Prime Minister that development of the North Sea gas fields would be speeded if gas exports were permitted. The Prime Minister would be interested in a note of the current state of play on this issue.

(2)

I am sending a copy of this letter to Rachel Lomax (H.M. Treasury), John Graham (Scottish Office) and John Mogg (Department of Trade and Industry).

Geoff Dart, Esq.,
Department of Energy.

CST

LR3.16

CONFIDENTIAL

cc NO

NBPM

4/9

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

4 September 1985

The Rt Hon Peter Walker MBE MP
Secretary of State for Energy
Department of Energy
Thames House South
Millbank
LONDON SW1

Dear Peter

Thank you for your letter of 31 July.

I agree that the sale must be completed in Autumn 1986. As you know, the Autumn Statement usually takes place each year during November. There are likely to be disclosure problems for a sale in the run up to the Statement, with which your lawyers will be familiar.

This makes a September or October date preferable to November. If the sale is left until November, the timing of the Autumn Statement could mean that the BGC sale would have to be shifted at an awkwardly late stage. In view of this I would much prefer to plan for a sale in September/October rather than in October/November.

I agree that we should avoid other privatisation sales that autumn. I would however like to keep open the option of a sale in July. You will recall that Jaguar was successfully sold in July 1984 prior to the BT sale that autumn.

As regards non-Government sales, my officials have been in touch with the Bank of England. There should be no difficulty in keeping the new issue queue relatively light in the period around the BGC sale, as was done last year for the BT sale. It will be more important to keep the queue light before, rather than immediately after, BGC so that institutional cash flow is at its strongest at the time of the first payment date. I agree officials might discuss this further. I also take your point about the "Big Bang".

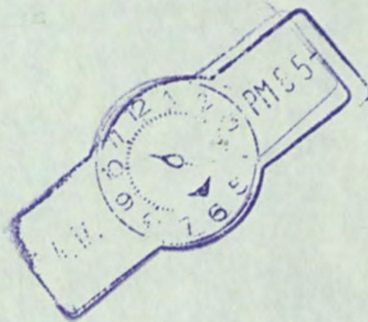
I am copying to the Prime Minister.

Yours

Nigel

NIGEL LAWSON

NAT IND: Gas & elec: Pt 11.

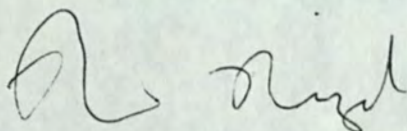


cc NO

01 211 6402

The Rt Hon Nigel lawson MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
London
SW1P 3AG

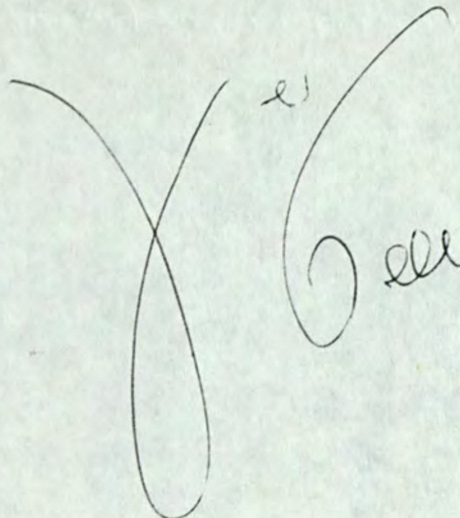
19 August 1985



ELECTRICITY SUPPLY INDUSTRY PAY

Further to my letters of 15 and 22 July, the Electricity Council has now informed me that the unions have accepted the pay offer made covering the professional, administrative and clerical grades. This settlement completes this year's pay round for ESI employees.

I am copying this letter to the Prime Minister, other members of E(PSP), George Younger, Nicholas Edwards, Douglas Hurd and Sir Robert Armstrong.



PETER WALKER

Nat Ind : Gas + Electricity Pt 11

10 DOWNING STREET

From the Private Secretary

13 August 1985

Dear Roger

ELECTRICITY PRICES AND LARGE INDUSTRIAL CONSUMERS

The Prime Minister has seen your Secretary of State's minute of 26 July. She has also seen the Secretary of State for Scotland's minute of 1 August and the Chancellor's of the same date.

The Prime Minister has noted that schemes of this kind have been considered before. She believes it is important that a group of officials from interested departments should first consider and advise on the economic implications of, and the assumptions behind, the proposal put forward in your Secretary of State's minute: the Policy Unit would also need to be represented on the Group. This would pave the way for a discussion by Ministers.

Since the Prime Minister left the office to go on holiday, the Secretary of State for Trade and Industry and the Secretary of State for Wales have also written and your Secretary of State has now responded to the points made in the Chancellor's minute. No doubt the working group will be able to take up and discuss this further correspondence, together with the other minutes already circulated.

I am copying this letter to Tony Kuczys (HM Treasury), John Graham (Scottish Office), Colin Williams (Welsh Office), John Mogg (Department of Trade and Industry), David Normington (Department of Employment), Richard Hatfield (Sir Robert Armstrong's office) and John Wiggins (Cabinet Office).

I am also copying this letter, together with the previous correspondence, to Henry Steel in the Law Officers' Department.

Yours

Mark Addison

MARK ADDISON

Roger Levett, Esq.,
Department of Energy

cc NO

010

NBPM

PRIME MINISTER

ELECTRICITY PRICES AND LARGE INDUSTRIAL CONSUMERS

file with MEA

Nigel Lawson has commented in his minute of 1 August on the proposals in my minute to you of 26 July. As he says, Treasury officials were not involved in the joint paper prepared by my and DTI officials. However, the doubts expressed by Nigel seem to stem from a rather narrow understanding of the benefits of the scheme that I have proposed. I think our approach to this should reflect a rather wider vision than the long run marginal cost of NCB coal.

The scheme is designed in the first place not as an aid to the coal industry but to improve the competitiveness of our energy intensive industries - chemicals, steel, industrial gases, paper and board, and glass. Although it is true that, in general, our electricity prices compare favourably with those overseas, it is precisely in those sectors where the cost of electricity matters most that our firms are at a real dis advantage. Utilities in other countries have realised the importance of cheaper electricity for the preservation and growth of those sectors and have tilted their tariffs in favour of industries with large electricity loads and with high load factors. The extent to which they have done this is evident in their published tariffs, and highlighted in the annual surveys agreed by the CBI with the Electricity Council.

But apart from lower tariffs, utilities in other countries also have special deals for their biggest consumers. These terms are kept secret, but some of the NEDC members who came to see me have first hand knowledge of them from their subsidiaries and associates in Europe. They maintain that electricity prices overall to their competitors in Europe are up to 20% cheaper. That is the size of the gap that these proposals are aiming to bridge; they will not, even so, come anywhere near to equalising the prices given to large consumers in other EEC countries.

I considered with Norman Tebbit 18 months ago a variety of ideas

put forward by the Electricity Council under which our electricity prices to intensive users could be made competitive. Given the costs and structure of the CEGB's bulk supply tariff, I could see no way in which prices could be further reduced without relaxing the esi's financial target and EFL. There was also the risk of legal challenge of "undue preference" under the Electricity Statutes to which Nigel refers in the second paragraph of his minute. It was largely because of that risk that the present proposals involving the NCB have been put forward. By making cheaper coal the basis for the cheaper electricity, there is less risk of legal challenge to the electricity supply industry. I shall of course consult the Law Officers when I have approval in principle for the scheme.

The impact of the scheme on NCB finances - and therefore on the benefit/cost ratio for the scheme as a whole - will be considerably better than Nigel implies. The NCB is closing pits as fast as it can. But it is unrealistic to expect that this will, overnight, reduce NCB production into line with inland demand. Once the current period of CEGB stockbuild is over, NCB will, at least for a short period, have coal production surplus to inland requirements. During this period the value to the NCB of coal not sold to the CEGB is its export netback of £27/t (or less if sterling remains high). In the longer term, and once NCB production is in line with inland requirements, incremental sales will not delay closures but will allow expansion of new relatively low cost capacity. In the time period we are talking about such capacity will comprise expansion of existing low cost pits. Such incremental production could be achieved for significantly less than £32/t but the NCB consider that £32/t represents, in the long term, the average marginal cost of incremental output, including a 5% real rate of return.

Nigel concludes that this scheme is "a form of selective subsidisation of industry". I believe it is much more than that. It is an imaginative and cost effective scheme under which our coal industry can expect to win sales and our energy intensive industries will be given a specific and tailored incentive to maintain production or expand investment. That investment is in key areas such as chlorine.

(If chlorine production declines, our manufacturing industries dependent on chlorine - such as plastics and synthetics - will also decline. Chlorine is not a nice commodity to transport in bulk across Europe). The message from NEDC is clear: if these industries are not given an incentive to maintain or expand their capacity, they will wither; and the jobs will wither too.

As for the overall profits made by ICI and British Oxygen, that seems to me to be not the main point; what matters is the profitability of those operations which would be affected by my proposals. The reality is that both companies are mobile in their future investment plans and will disinvest in the UK if the opportunities are not there. It will be too late to reverse the trend when disinvestment sets in.

Finally, I have not understated in my proposal the possible costs to the NCB. These cannot be quantified with certainty, but they will be small by comparison with the benefits to industry. It is these wider benefits - more production, more investment and more jobs - that justify the public expenditure costs; and it is on that basis that I invite support from my colleagues for the scheme.

I am copying this minute to Nigel Lawson, George Younger, Nicholas Edwards, Norman Tebbit and Tom King and to Sir Robert Armstrong.

PETER WALKER

12 August 1985

NAT IND: Gas & elec: Pt 11

cc NO

Prime Minister

ELECTRICITY PRICES AND LARGE INDUSTRIAL CONSUMERS

I have seen Peter Walker's minute of 26 July. Although there are important points of principle to be considered and some obvious difficulties this is an interesting proposal that I hope will be given careful consideration.

My Department was not included in the discussions which led to this minute. Had they been, other examples of how the benefits might work could have been brought forward: for example, the new Paper Mill at Shotton is expected to exceed 200 million units in 1985/86. It would also have given the opportunity to argue (as I would wish to do) against excluding from the scheme those manufacturers who have been unable to take advantage of Consumer Contracted Load terms. I know from direct experience (I have two major users, Amoco and the Pembroke Cracking Company, in my own constituency) the importance of including such users.

I recognise that any scheme such as this is bound to give rise to complaints from those who fail to qualify, and there are risks that it may hasten the trend towards centralisation and discourage the development of new sites. There are obvious difficulties in attempting to extend the scheme too far but perhaps a further look could be given to the threshold set or at least a promise to do so in the light of experiences on the scheme.

I am sending copies to Peter Walker (who will, I understand, be commenting further on the arguments affecting NCB policy), Nigel Lawson, George Younger, Norman Tebbit and Tom King and to Sir Robert Armstrong.

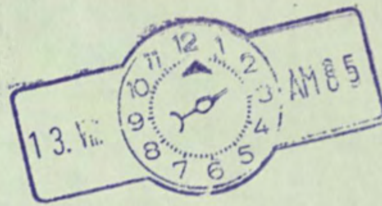
R.C. Williams

12 August 1985

pp RNE

/approved by the Secretary of State and signed in his absence/

NAT IND : Gas & elec : Pk11



DW414

cc NO

CONFIDENTIAL

PRIME MINISTER

ELECTRICITY PRICES AND LARGE INDUSTRIAL CONSUMERS

Peter Walker sent me a copy of his minute of 26 July which enclosed a note produced by his and my officials analysing the "third tranche" scheme. I have also seen a copy of Nigel Lawson's and George Younger's response of 1 August. Let me start by saying that the competitive disadvantage suffered by intensive electricity users has concerned me for a long time and I therefore welcome the attention now being focussed on finding a remedy.

2 Though most of industry faces electricity charges broadly similar to those faced by their European competitors, there is no doubt that the very large users (for whom electricity accounts for a significant proportion of costs) do face higher charges - up to 20 per cent higher in some cases. On present trends, this competitive disadvantage appears likely to continue and the evidence suggests (as George Younger agrees for the Scottish examples) that it will be an important factor in determining future output and investment decisions. Where the companies have a choice of location within Europe - ICI is very much a case in point - higher electricity charges here will be a major factor against further investment in the UK. I thus hope that a defensible way can be found of alleviating these problems.

CONFIDENTIAL

3 In his minute Nigel suggests that the third tranche scheme amounts to a selective subsidy for industry. In so far as it amounts to that alone, I would not seek to justify it. But it primarily concerns the price of coal and I therefore agree with Nigel that any scheme must be consistent with our general policy on energy pricing and in particular our policy towards the coal industry. But, in concentrating on the present scheme, I think we should not lose sight of the wider issue, which is the competitive disadvantage faced by the large industrial users of electricity and the need to find a way of removing, or at least lessening it. In this context the possibility of obtaining low-cost electricity from France is relevant though it may be that it would be more difficult to pass the cost benefits of that on to any single class of customers.

4 I am copying this minute to Peter Walker, Nigel Lawson, George Younger, Nicholas Edwards, Tom King and to Sir Robert Armstrong.

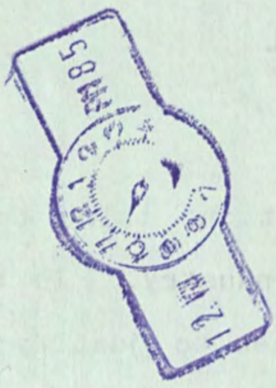
NT

N T

9 August 1985

Department of Trade & Industry

NAT IND: Gas & elec: Pt 11



CONFIDENTIAL

PRIME MINISTER

THIRD TRANCHE COAL

The way Mr Walker has gone about this subject is unsatisfactory. He has deliberately prepared a report and sent it to you without involving the Treasury. As a result there are disputes both about principles and figures. For example, Mr Walker describes NCB's marginal output as that coming from the best pits on grounds that this is the output which is currently being developed. The Chancellor argues that NCB's marginal output is from its highest cost pits - see his minute attached. There is no point in your calling a meeting before the Treasury and other departments have had a chance to argue out the issues more fully.

There is a note already in your box and attached is a note by the Policy Unit. Both argue strongly against this scheme.

Agree that before calling a meeting officials from all the interested departments plus the Policy Unit should have an opportunity to study it further?

Yes mt

AT

Andrew Turnbull
1 August 1985

MJ2AWR

LT.1

CONFIDENTIAL

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

ELECTRICITY PRICES AND LARGE INDUSTRIAL CONSUMERS

Peter Walker sent me a copy of his minute of 26 July.

2. Treasury officials were not involved in the preparation of the paper which Peter circulated. They have a number of doubts about the material in that paper. In addition schemes of this sort can easily fall foul of the relevant nationalised industry legislation and it would have been helpful to have seen a view from the Law Officers.

3. My main concerns about the scheme are, however, more fundamental. In general our electricity prices compare favourably with those overseas, although a few of our largest high load factor users are probably at a disadvantage in relation to competitors in France and, sometimes, to those in Germany and Italy.

4. It is hard to see that any such disadvantage derives from the price of NCB coal. There is an open international market for coal and the current contract between the CEGB and the NCB was based on prices in that market. Any disadvantage derives from either lower non-coal costs of the foreign electricity industry (eg France with its high nuclear generation) or from the sale of electricity below cost ie subsidisation.

5. The paper circulated by Peter asserts that the NCB's long run marginal costs (LRMC) of production are £32 a tonne. Neither I nor my officials know of any evidence to sustain this. The NCB's current marginal costs are probably over £60 a tonne and will probably be some £50 a tonne even when the Board is breaking even.

6. In any case the NCB's costs do not determine the prices it receives for coal (which are set by the international market). The NCB's costs determine how much of its capacity can operate profitably, and how much should be closed down.

7. This is, of course, exactly the principle over which we had to fight a long and expensive coal strike. Our success provides the NCB with a unique opportunity to bring its capacity quickly into line with profitable demand. As Peter's paper makes clear, the proposed scheme only makes sense for the NCB if there is difficulty bringing capacity into line with profitable demand. In my view it is quite contrary to our policy to plan on this basis. Retaining capacity which cannot meet demand profitably is exactly what the NUM sought to force us to do.

8. In the end this scheme is a form of selective subsidisation of industry. The main beneficiaries appear to be ICI and British Oxygen - two large companies with good profits. We should not spend £50 million a year subsidising companies of this sort and we certainly should not do so by means of a device which runs quite contrary to our policy towards the coal industry.

9. I am copying this minute to Peter Walker, George Younger, Nicholas Edwards, Norman Tebbit and Tom King and to Sir Robert Armstrong.

N.L.

1 August 1985

MR TURNBULL — 1 August 1985

THIRD TRANCHE

Peter Walker's beguiling logic argues that if the NCB foregoes sales revenue of £50 million p.a. (declining) so as to fuel cheaper electricity to major industrial customers, thousands of jobs will be saved or created, and our balance of payments would benefit by hundreds of millions - perhaps more. This line of argument is a complete reversal of the economic principles which this Government has stood for.

At great cost, we have fought and won a coal strike over the principle that the capacity of the UK coal industry should be governed by the size of the market which can be served on a sustainable commercial basis. Since the industry must still slim down to come within sight of this objective, the marginal tonne of coal is produced not at £32 per tonne, but at least £60 per tonne. Moreover, we are not in the interim position of having surplus coal production for which the only outlet is dumping at a distress price. For the next year or more, the CEGB need all that the NCB can produce to rebuild power station stocks. Meanwhile there is a pressing need to close down uneconomic capacity, not keep it open to supply the 'third tranche'. The restructuring of the coal industry is already overdue.

Of course, ICI, BSC, Reed, Pilkington and their like lobby vigorously for cheaper electricity - as they do for lower interest and exchange rates, which are no doubt also important influences on the business decisions now being attributed to uncompetitively-priced electricity. The attached note from Peter Warry exposes the implausibility of some of the arguments deployed. Nonetheless, there may be a

case for the ESI to defend its baseload industrial business, or expand it by winning new customers from other fuels. From the point of view of making a commercial return on under-utilised assets handling a highly variable demand pattern, this class of customer is undoubtedly valuable. Maybe the Germans, French and Italians have done no more than recognise this fact, whereas we have got too hung up on the principal of non-discrimination across the industrial sector. These are business judgements which the ESI should be making in its own self interest.

AN ALTERNATIVE APPROACH

1. Why not encourage the CEGB to exploit to the full its opportunities to acquire cheap fuel or electricity on the margin. The electricity link with France is capable of providing twice as much electricity as the estimated third tranche at the same low price. What about spot acquisitions of coal on the international market? Peter Walker's paper tells us that at current exchange rates coal can be purchased for £27 per tonne. What about marginal supplies of electricity from private sector power plants?

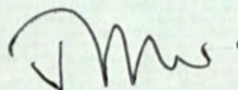
2. Complement this by removing the CEGB's commitment to take 95% of its coal from the NCB.

3. On the strength of lower marginal supply costs the ESI should have more scope on the margin to be flexible and innovative in defending or expanding its industrial market.

4. Now let the NCB fight on a normal commercial basis for its markets, the majority of which are in any case protected by location and fixed investment in coal-fired plants. That will drive the essential closure of uneconomic capacity, vigorous control of costs, and expansion of low cost sources such as opencast.

CONCLUSION

You may recall that some three years ago proposals similar to the third tranche were extensively examined and rejected by MISC 56. With a coal dispute over market-related economics behind us, the economic and political objections are no less compelling.



JOHN WYBREW

ATTACHMENT.

MR WYBREW

31 July 1985

THE THIRD TRANCHE FOLLY

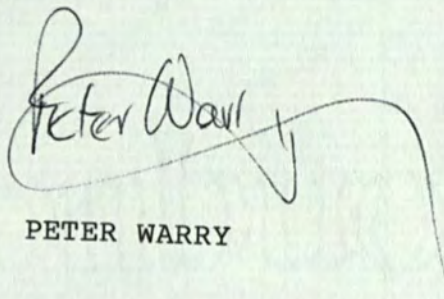
NEDO believe the third tranche will increase demand by 5,500 GWH, save 15,000 jobs and create 1,000 new ones. DTI seem to think it may only be half this number. Over half the demand (and presumably jobs) is attributed to ICI. 925 jobs would apparently be saved at Runcorn by preventing ICI withdrawing from the export market for chlorine, but this is contradicted later (paragraph 22) when DTI say that by implication the reduced output would be on the domestic side. A further 6,000 jobs are apparently to be saved at Billingham as ICI would no longer propose to close its fertiliser division. With other benefits elsewhere, the third tranche is apparently to save something like 7% of ICI's manpower - believe this if you will.

The other substantial beneficiary is seen as steel, with up to 3,000 jobs being saved. This is crazy as the problem in steel is not in producing the stuff but in obtaining sufficient quota from the European Commission to sell it. Lower prices will not help. The main beneficiary is engineering steels where the Government has just agreed to spend £55m on the Phoenix II reconstruction. This sector is entirely divorced from commercial reality, and lower electricity prices will merely alter the amount of money lost, not the number of jobs that remain.

Clearly, some jobs will be created, but whether this will be more than the number of jobs lost through higher taxes on industry, or higher taxes on individuals leading to demands for higher wages from industry, is arguable. The third tranche must move pricing still further away from proper long-run marginal costing and therefore diminish the overall productivity of the nation. Unless one can argue that the propensity to create jobs is higher in these highly capital

intensive areas (chemicals, steel, glass etc), than in other segments of the economy, then clearly the third tranche can only lose jobs overall, not create them.

The only possible basis for supporting the third tranche is if the scheme were financed by savings in even less worthwhile follies already being undertaken by the DTI. At this stage, we don't have sufficient information to know whether more jobs are lost through wasting money on industrial support than they would be lost through wasting money on the third tranche.



PETER WARRY

SCOTTISH OFFICE
WHITEHALL, LONDON SW1A 2AU

PRIME MINISTER

1 August 1985

ELECTRICITY PRICES FOR LARGE INDUSTRIAL CONSUMERS

I have seen Peter Walker's minute of 26 July.

It is unfortunate that my Department was excluded from recent discussions which led to the preparation of this minute and the Note by Officials. I do not therefore have a fully up-to-date assessment of the impact which the proposals would have in Scotland.

Nevertheless, from the most recent information we have, it is clear that the proposed scheme would be of considerable benefit to a number of major industries with plants in Scotland and I therefore support Peter Walker's proposals. I note in particular that paragraph 20 of the Paper by Officials refers to the possibility of a major inward investment involving the establishment of a paper mill at the former Talbot plant at Linwood. Energy prices are an important factor in a decision such as this and an early decision to adopt Peter Walker's proposals would be helpful in our discussions with the company.

We should not underestimate the difficulty we will have in dealing with complaints from those firms who will not qualify but for whom electricity is a substantial element in their production costs. Because of this, I would certainly hope that it would at least be possible to extend the scheme to plants not on the present Consumer Contracted Load terms, since there have been complaints in the past from companies unable to introduce load management arrangements and who therefore cannot benefit from that scheme.

I am copying this letter to Peter Walker, Nigel Lawson, Nicholas Edwards, Norman Tebbit, Tom King and to Sir Robert Armstrong.

G.Y.

G.Y.

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PM 6 5

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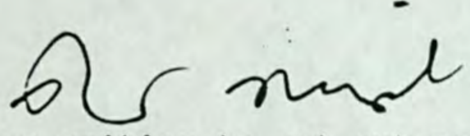
01 211 6402

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

31 July 1985



I am writing to set out my proposals for the timing of the British Gas privatisation and to point out the need to avoid this being prejudiced by any other privatisation exercises.

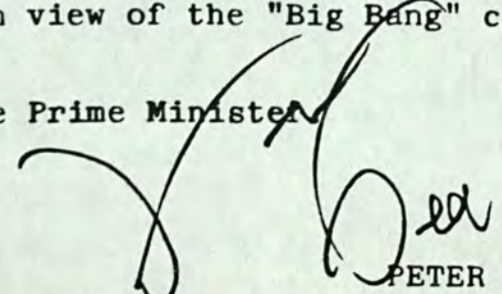
Our objective must to be complete the British Gas offer for sale in October or November 1986. An earlier date would not be practicable given the tight timetable for legislation and the difficulty of carrying out an offer for sale in August or September. A later one would be highly inadvisable for such a large offer given the likelihoo of an Election shadow beginning to develop over the market in 1987 and of the prospectus disclosure difficulties which would be likely to arise in the first quarter of the year while Budget proposals were being prepared.

It will also be important to ensure no other significant Government offers for sale in the three months before October/November and immediately afterwards so that available funds are not pre-empted and there are generally no distractions from the promotional build-up to the British Gas offer.

I would be grateful for your agreement that we should aim for a Britis Gas offer for sale in October or November 1986 with no other significa Government offers for sale being planned for the whole of the period between July and December 1986.

If you agree, I suggest my officials should discuss with yours the constraints which should also be imposed on significant non-Government offers in the period around October and November 1986. They will also need to discuss more precise timing of the British Gas offer with the Stock Exchange who I gather are concerned that an October date might cause them some difficulties in view of the "Big Bang" changes planned for then.

I am copying this letter to the Prime Minister.



PETER WALKER

CONFIDENTIAL

CENTRAL ELECTRICITY GENERATING BOARD

Sudbury House, 15 Newgate Street, London EC1A 7AU. Telephone 01-634 5111

From the Chairman
The Lord Marshall of Goring Kt, CBE, FRS

30 July 1985

The Rt Hon Mrs Margaret Thatcher MP
The Prime Minister
10 Downing Street
London

STRICTLY PERSONAL

Dear Prime Minister,

During the course of our discussion yesterday I made a factual statement which you challenged. I told you that, as I understood it, the Government subsidy to the National Coal Board was not linked to the production of steam coal, and insofar as it was possible to disentangle various parts of the NCB business they were breaking even on their sales to us of steam coal. It follows that £44 per tonne should be the average price related to the cost of producing steam coal.

I have discreetly checked with the NCB again today and they confirm to me that their main loss making activities are in coking coal, smokeless fuel and in exports. They again argue that their steam coal business is "roughly in balance". I am sure you will appreciate that this is not information I am giving you at firsthand but it is the best understanding I can get. Therefore, the scheme I put forward to you yesterday is, in my opinion, a sensible way to manage the steam coal/electricity business of the UK. It has very little to do with the overall subsidy to the National Coal Board. If you looked at the CEGB and the NCB as a single UK business it would be the obvious thing to do to create the market pressures internally that can only be set up externally by difficult institutional changes.

Yours sincerely

Walter Marshall

Marshall of Goring

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SECRET

P 01628

PRIME MINISTER

This makes it unnecessary to read the paper.

Gas Industry Privatisation: Legislation and Price Regulation
E(A)(85)52

BACKGROUND

1. At its 11th Meeting on 11 June, E(A) endorsed the Secretary of State for Energy's proposals for the obligations to be imposed on the privatised company by legislation and the general approach to price regulation (RPI (rate of inflation) - X (target reduction in onshore costs) + Y (increases in gas costs)) he had put forward. E(A) thought that more consideration should be given to the possibility of strengthening the scope for competition in the supply of gas by improving the common carrier provisions of the Oil and Gas Enterprises Act. The Secretary of State for Energy was invited to prepare further papers setting out the shape and content of the legisaltion (including provisions on safety and arrangements for Consumer Councils) and the nature and coverage of the system of price regulation and its impact on the future of BGC's business.
..... The Secretary of State for Energy's memorandum (E(A)(85)52) is the result.

Proposals

2. Mr Walker proposes that the Gas Privatisation Bill should:

(a) establish a new regulatory agency (along the lines of OFT (Office of Fair Trading) or OFTEL) under a Director;

(b) set up a licensing system for gas utilities who will obtain certain rights in return for submitting to the control regime specified in the Bill;

(c) continue the regime established by the Oil and Gas (Enterprise) Act for private suppliers of gas to industry.

(d) specify the Director's functions in relation to licence conditions;

(e) provide for the Secretary of State for Trade and Industry to appoint an Advisory Council to the Director to represent consumers' views;

(f) set out the safety provisions;

(g) provide for the transfer of the existing Corporation to a Companies Act company.

3. Mr Walker also proposes:

(a) for the tariff market, a price formula of RPI (rate of inflation) - X (target reduction in onshore costs) + Y (increase in gas costs);

(b) for contract sales, the following price formula:

(i) a temporary assurance limiting rates of price increase for an initial three year period;

(ii) after that, no price control but publication of scheduled (maximum) prices against which rebates could be given;

(iii) a broadly drawn undertaking on even-handedness between consumers.

MAIN ISSUES

4. The main issues are:

(a) the content of the legislation; and

(b) the price regulatory regime.

Legislation

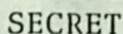
5. The legislative provisions Mr Walker proposes are discussed in Annex 1 of his memorandum. He proposes the legislation should cover:

(a) a new regulatory agency (like OFTEL) under a Director to be appointed by the Secretary of State. The Director will be responsible for day-to-day regulation of the industry and the price control system. At E(A)'s last discussion of gas privatisation, Mr Tebbit was concerned that a proliferation of regulatory bodies such as OFGAS and OFTEL could be untidy. However, a single regulatory body would be unwieldy;

Mr Walker proposes the Director exercise his functions so that public gas suppliers can earn a reasonable return and are not forced into bankruptcy (Annex 1, paragraph 4). There is a similar provision in the case of BT, where the OFTEL Director have regard to BT's need to finance the services BT has to provide. But Treasury fear the gas formula will enable BGC to thwart the Director's wishes, by pointing to a reasonable rate of return criterion.

(b) a licensing system for gas utilities (public gas suppliers).

A licensed public gas supplier will have a general duty to satisfy, subject to an economical and reasonable caveat, all demand for gas in its authorised area and will have a specific duty to supply any customer within 25 yards of a main and requiring less than 25,000 therms (ie including all domestic consumers). Public gas suppliers



will have BGC's existing powers to acquire compulsorily land and rights necessary to supply gas in their authorised areas. Firms which are not public gas suppliers* will have to apply for pipelines under the 1962 Pipelines Act and use the powers under that Act to break up streets etc. The legislation will permit companies other than BGC to become licensed public gas suppliers in areas where BGC has not laid supply pipes.

(c) Continuation of Oil and Gas (Enterprises) Act regime for private supplies of gas to industrialists. Provisions for the common carriage of gas introduced under the Oil and Gas Enterprise Act 1982 will continue. E(A)(85)11th Meeting invited the Secretary of State for Energy to consider the possibility of strengthening the scope for competition in gas supply by improving these common carrier provisions. Mr Walker is likely to be able to submit a paper on this in September.

(d) Specified Functions for the Director as regards licence conditions

In particular, Mr Walker proposes to replace the present Regional Gas Consumers' Councils by a single Council, appointed by the Secretary of State for Trade and Industry. representing consumers with a small staff in the Regions to handle complaints. Consumer lobbies will be critical if provision for consumer representation is inadequate; on the other hand, potential investors may be reluctant to invest, if consumer interests appear to wield excessive influence. The provisions here are similar to those in the case of British Telecom, and the Department of Energy export consumer interests to accept them, although without enthusiasm.

(e) Safety. Essentially, the existing safety provisions of the 1972 Gas Act will be re-enacted. Mr Walker intends to bring existing arrangements more closely into line with the Health and Safety Executives (HSE)'s general safety legislation.

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*i.e. which only supply gas to individual industrial consumers.

Public gas suppliers will be obliged to provide a 24 hour emergency service and to deal with all escapes of gas on consumers' premises. Discussions with HSE and the British Gas Corporation (BGC) are proceeding, particularly over the role and status of the Confederation of Gas Installers (CORGI) and the question of improving standards of installation.

(f) Mr Walker proposes that the Secretary of State will have powers to invest in the successor company to enable him eg to acquire shares to adjust the successor authority's gearing ratio or maintain the Government's proportionate shareholding in the event of a new issue of shares.*

Regulatory Regime

6. Mr Walker proposes that OFGAS regulate the gas supply network - (ie transmission and distribution of gas), where BGC has a "natural" monopoly, with the rest of the business (production exploration, gas purchasing, gas appliance retailing, installation and servicing of appliances) subject to the normal rules of the Monopolies and Mergers Commission (MMC) and the Office of Fair Trading (OFT). He intends the ring-fence to be self-policing, based on clear rules laid down by the Director, with separate accounts for the gas supply business. A preliminary examination of the price regulatory formula RPI - X+Y is set out in Annex 2 of Mr Walker's memorandum. Modelling work so far suggests that a formula on this basis is feasible.

Gas Costs

7. Mr Walker believes the privatised BGC must be able to pass on to consumers the total costs of the gas it purchases (the Y component), for several reasons:

(a) potential investors will wish to know the company can recoup gas price costs which can change significantly

* Department of Energy officials see little need, after flotation, to adjust the gearing ratio; but a proportionate shareholding might facilitate distribution of shares to BGC employees; an incoming Government would be prevented from bringing the company back into the public sector, other than by primary legislation, because the Department propose to set a "target investment limit" setting a limit to the shareholding.

as oil prices and exchange rates fluctuate;

(b) BGC has a well-established track record as a strong purchaser;

(c) US experience prior to deregulation shows that oil companies can be deterred from gas exploration if there is explicit price control at the well-head;

(d) BGC will be interested in buying gas cheaply to preserve its overall competitive position vis-a-vis other fuels such as electricity.

8. Treasury officals disagree. They fear this will make BGC relatively indifferent to the price at which it purchases gas because its monopoly position enables it to pass on high gas prices to consumers. They believe BGC should at least be required to satisfy the Regulator that it had acted prudently in its purchase of gas. (Department of Trade and Industry officials questions the approach Mr Walker is taking, but on balance they are inclined to accept his proposals in the light of Paragraphs (a)-(d) above).

Tariff Market

9. BGC has a statutory obligation to supply all customers within 25 yards of an existing main who consume less than 25,000 therms a year (all domestic and most commercial customers). Although there is some competition here from electricity, Mr Walker believes that in the tariff sector BGC should be required to use the RPI - X+Y formula when pricing their gas. (BGC have made clear to Department of Energy officials their view that there should be no price regulatory formula: in their view the new company should be free to act as it sees fit).

Contract Market

10. Mr Walker proposes a different pricing regime in the contract market. Here he proposes:

(i) a temporary assurance limiting rates of price increase in the contract market for, say, an inital three year period;

(ii) thereafter no price control but publication of schedulted (maximum) prices against which rebates could be given, in effect following the same practice as oil companies; and

(iii) a broadly drawn undertaking on even-handedness between consumers.

11. Mr Walker justifies this on the grounds that:

(a) if the privatised BGC raised its selling prices significantly above the cost of new gas plus the likely toll for common carriage, competitors could use the common carrier provisions of the Oil and Gas (Enterprises) Act to undercut it. He acknowledges potential competitors face difficulties at the moment, but is considering how to eradicate these difficulties to encourage competition;

(b) there is already greater competition between fuels in the contract market.

12. The extent of competition in the contract market is discussed in Annex 3 of Mr Walker's memorandum. For interruptible gas customers, the main alternative fuels are fuel oil or coal. Present price relativities are:

PENCE/THERM

	PRESENT	TYPICAL RANGE
Interruptible gas (regions)	27.8-29.8	
Fuel Oil (low quality)	28	26-32
Fuel Oil (high quality)	35	30-35
Coal	19-22	

In the coming months, contract prices for fuel oil charged by UK companies should fall to reflect the fall in spot prices since the CEGB withdrew from the market after the coal strike. In the immediate future, therefore, there is likely to be keen competition between fuel oil and interruptible gas. What the future holds beyond that is, of course, far less certain.

13. Main alternative fuels for firm gas customers (smaller and medium-sized commercial and industrial companies) are gas oil and electricity. Present price relativities are:

	PENCE/THERM	
	PRESENT	TYPICAL RANGE
Firm gas (regions)	33.3-33.6*	
Gas oil	52	45-52
Electricity (effective price taking account of point of use efficiency)		
"interruptible"	50-61	
"firm"	78	

* the first 25,000 therms a year are supplied at the tariff price of 37p.

These figures do not support the view that the forces of competition are particularly vigorous as regards firm gas. Indeed, they suggest that a privatised BGC would have the headroom to raise firm gas prices to industrial customers substantially, if it so wished, and was able to do so.

14. Under Mr Walker's proposals, predatory pricing by the privatised BGC would fall to the MMC and the OFT. The Treasury

would prefer the RPI - X+Y regime to extend into the contract market, even though this would reduce the likely receipts from privatisation. The Treasury fear that BGC, constrained by a fairly tough price regulatory regime on tariff sales, may seek to edge prices upwards in the contract sector by way of recompense. Department of Trade and Industry officials are also anxious lest this price regime produces real price increases for contract gas prices. Very rough estimates are that a privatised BGC without any price regulatory regime (BGC's preference) would fetch £7 billion; a privatised BGC with RPI - X+Y throughout would fetch £5 billion; and the course recommended by Mr Walker £6 billion. Treasury acknowledge this, but feel that BGC could raise contract gas prices in a way which might give future privatisation a bad name (looking foward, possibly to privatisation of the electricity supply industry). Certainly, real increases in gas prices could provoke an adverse political reaction from the commercial and industrial companies affected. On the other hand, to negotiate with BGC on an RPI - X+Y arrangement for the contract market will not be easy.

OTHER ISSUES

15. Nearer the time of flotation decisions will need to be taken on the following issues (not addressed in Mr Walker's latest memorandum, but covered in earlier papers):

(a) Employee Participation
Mr Walker is keen to get the support of employees for the new company and to provide protection against unwelcome takeover.

(b) the capital structure of the company (proportion of debt and equity) to be settled after a full financial assessment;

(c) should 100 per cent of the company be floated to reduce the risks of renationalisation;

(d) the golden share to prevent unwelcome foreign takeover;

(e) Mr Walker is also considering possible additions to strengthen the BGC Board;

(f) Gas Levy

BGC receive significant windfall profits on old PRT-exempt contracts. The Gas Levy recoups some of these (currently 4p a therm bringing in about £525 million a year) for the Exchequer, and will do so until the fields concerned become exhausted in the early 1990s. At present, the rate can be varied by Order. Appropriate measures will need to be taken to carry over the Gas Levy into the new company. Freezing the rate would accelerate the real reduction in Exchequer take as the fields tail off, and would give the new company significant economic rent. Increasing the rate would reduce the new company's profits (and reduce sale proceeds) or, alternatively, lead to increased gas prices (inviting criticism that privatisation means higher gas prices). Mr Walker believes the level of the Gas Levy can only be determined nearer the time of sale, but feels it would almost certainly have to be at its current level. It would be useful to have in due course some ball-park numbers illustrating what is at stake on this issue.

(g) Import/Export of Gas

Mr Walker is consulting the Treasury and the Foreign and Commonwealth Office about this. He should be ready to submit a paper in November. There has been some study of the possibility of a controlled export regime for UKCS gas, but it seems unlikely that this would prove compatible with the Treaty of Rome. The existing power to control the installation of submarine pipelines will remain, which will give the Government some leverage against future proposals for gas imports; but it seems unlikely that this power could serve for an extended period to prevent a privatised BGC from importing a stream of non-UK gas, and there would be a high risk of challenge in the

European Court if the Government sought in this way to block gas imports.

These considerations suggest that it would not be appropriate for the new legislation to include any specific provisions on gas imports and exports. But the Government's decisions on this point will be of great importance in determining the acceptability of privatisation to the consumer and to UKCS licensees, in ensuring the success (or otherwise) of the privatised company, and in influencing future UKCS activity and tax revenues therefrom. If BGC were allowed to import gas without hindrance, this could greatly strengthen their hand in negotiating with developers of new UKCS gas reserves. This would be advantageous to the consumer but damaging to UKCS activity and tax revenues. If imports were prevented, UKCS licensees would be in a much stronger position in negotiation with BGC, to the disadvantage of the consumer but partially offset by additional receipts to the Exchequer. No early statement is likely to be needed from the Government about this question, but considered views will be needed in time for the second reading of the Bill.

HANDLING

16. You may wish to divide the discussion into two parts - the first part dealing with the legislative provisions Mr Walker proposes, and the second part with the price regulatory framework.

17. On legislative provisions, you will wish to invite the Secretary of State for Energy to introduce his proposals. Thereafter, you may wish to invite the Chancellor of the Exchequer to respond. The Secretary of State for Trade and Industry may wish to comment on the treatment of Consumer Councils. The Secretary of State for Employment might have views on the safety regime. The Attorney General may have points on legal implications.

18. On the price regulatory framework, you will wish to invite the Secretary of State for Energy to introduce his proposals. After that, you may wish to invite the Chancellor of the Exchequer to comment. The Secretary of State for Trade and Industry may wish to comment on any implications for industrial gas prices, as well as on the regulatory framework more generally.

CONCLUSIONS

19. You will wish the Sub-Committee to reach conclusions on:

(a) whether or not to approve the legislative provisions Mr Walker recommends;

(b) whether or not to endorse the approach Mr Walker recommends on price regulation, as regards:

(i) the tariff market;

(ii) the contract market.

J B UNWIN

Cabinet Office
30 July 1985

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PRIME MINISTER

FLAG A

Gas Industry Privatisation
(E(A)(85)52)

Mr Walker's paper responds to the remits from E(A) on 11 June. The full brief attached summarises the Department of Energy proposals and sets out the main issues for discussion. This note concentrates on a few issues where there may be significant disagreement, and which have particular importance for the terms of the flotation. These are:

(i) the desirability of a separate regulatory agency;

(ii) the extent of regulation over 'contract' gas supplies (it is common ground that 'tariff' gas supplies - i.e. supplies to domestic and small industrial/commercial consumers - should be fully regulated on the Telecom model);

(iii) whether there should be any regulation of the price BGC pays to producers of gas;

(iv) the common carrier arrangements.

A separate regulatory agency

2. At the last discussion Mr Tebbit suggested that it might be better to have one body to regulate public utilities, rather than a separate body for each industry as it was privatised. This may prove to be the sensible and efficient approach in due course; but the regulatory powers proposed for the gas regulatory agency (OFG) - which on any basis would not extend beyond the terms for the purchase and sale of gas - are appreciably narrower than those enjoyed by OFTEL, and it would be undesirable for bad relations between

SECRET

Telecom and OFTEL to sour the atmosphere in which OFG will be operating. It would be as well to establish that the successor company to BGC will be required to bear the costs of running OFG.

Contract gas supplies

3. The decision here is a matter of judgment rather than of a clear correct answer. The tighter the coverage of regulation, the less scope the privatised company will have for developing its business in the way which suits it best. If the RPI + X - Y formula covers all BGC's sales, the company will be a tightly regulated utility with little scope to develop a new independent marketing strategy designed to promote its growth. On the other hand, if there were no regulation over the contract market, BGC would have substantial scope to increase prices and profits in this area, and so could be expected to concentrate on it to the exclusion of development of the tariff business. As the brief below notes, the difference in the privatisation receipts, depending on the form and coverage of regulation, could be as much as £2 billion (i.e. between £5 and £7 billion).

4. Treasury officials have been inclined to argue for a wider coverage of regulation, despite the adverse impact on the receipts, in order to strengthen the protection of the (industrial) consumer. The Department of Energy emphasise the strength of the competition interruptible contract gas supplies will be facing from coal and fuel oil, and firm gas from gasoil and electricity. With oil product prices to consumers declining in Sterling terms because of both lower free market prices and Sterling appreciation against the dollar, there is likely to be somewhat less headroom for BGC to increase prices in these markets following privatisation. The Department of Energy further argue that measures to give gas producers readier access to BGC's main gas distribution network on a common carrier basis(on which they are still working) should also help to limit BGC's ability to exploit their position in relation to this class of customers.

5. The economic impact of price regulation will be different in the case of gas from that which arises in the case of Telecom. Unlike Telecom, gas will be facing rising marginal costs, at least of new supplies of gas, and possibly also in the distribution network given BGC's view that the market is almost saturated. Once prices to tariff consumers have been set, additional sales to such consumers could be at a loss. If contract supplies were unregulated, and tariff supplies tightly regulated, BGC would have an incentive to develop their contract market to the exclusion of their tariff market. But if the whole business were subject to the same degree of price regulation, then BGC's ability to develop its business in an entrepreneurial way would be reduced, arguably putting in question one of the main advantages of privatisation. Mr Walker's formula - a limit on price increases for three years, followed by a broadly-drawn requirement for even-handedness as between industrial consumers - represents an attempt to find a middle course which gives BGC some entreprepreneurial scope, while giving industrial customers some element of reassurance.

Treatment of BGC's purchase contracts

6. Mr Walker's proposal is to exclude BGC's gas purchase contracts from the scope of regulation. BGC have hitherto had effective commercial freedom in this area (except where imports are concerned), and it would be a new departure for the Government or a regulatory agency to seek to supervise the details of such contracts. The Treasury argue that allowing BGC to pass on all their gas purchase costs without question could lead the privatised company to become indifferent to the price it pays for gas, to the disadvantage of the consumer. This argument would be stronger to the extent that the prices of BGC's contract sales were subject to the same formula as the tariff sales. Underneath this question lies the issue of the treatment of gas imports and exports, and the interests of the oil companies. Hitherto the complaint of the companies has been that BGC has been too successful in exploiting its

power as monopsony purchaser; it is them, not the consumer, who needs protection. As long as BGC have some commercial freedom to develop their business, this will remain true after privatisation. Given that it is likely to be impossible for the Government to prevent gas imports after privatisation, sooner or later exports are likely to have to be allowed of UKCS gas. Once free trade in gas has been established, there would be no further scope for OFG to regulate the prices BGC pays for supplies. Mr Walker has undertaken to put a further paper on gas imports and exports to his colleagues in the autumn; meanwhile it would seem premature to decide to subject BGC's gas purchases to regulation in the same way as its sales.

Common carrier

7. So far no use has been made of the Oil and Gas (Enterprise) Act provisions enabling gas producers to sell gas directly to UK industrial consumers, transporting it through BGC's trunk lines. No doubt BGC will do their best to ensure that no such sales are actually made. But the position of gas producers in negotiating sales to BGC would be considerably strengthened if appropriate transparent terms could be specified on the basis of which they would have access to BGC's distribution network; this would then limit the extent to which BGC could seek to force down the price it pays to its suppliers, since if the privatised company were too greedy, direct sales to industry would become an attractive option to them. Strengthening competition by facilitating access to BGC's distribution network on 'fair' terms should thus help to reduce the need to regulate both the prices BGC charges to its large industrial consumers and those it pays to its offshore suppliers. It would clearly be helpful if Mr Walker could put a further paper on this issue to his colleagues as soon as possible after the Summer holiday.

J B UNWIN
Cabinet Office.
30 July, 1985

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CONFIDENTIAL

ELECTRICITY PRICES AND LARGE INDUSTRIAL CUSTOMERS
Note by H.M. Treasury

A. The Scheme

It is proposed that the NCB sell cheap coal to the CEGB. The CEGB would turn this coal into electricity and sell it at a low price reflecting the cheapness of the coal.

2. The objective of the scheme is to reduce electricity prices to large industrial users.

3. The scheme would initially cost some £50 million a year. It proponents claim the cost would fall in the "longer term" to £30-41 million a year.

B. Assessment

4. This scheme is a selective industrial subsidy. It is not designed to serve energy policy objectives.

5. The Treasury has not yet seen the evidence on relative electricity prices referred to in the note. In general UK electricity prices compare favourably with those overseas. That said, our largest industrial users do complain of a disadvantage with France and, sometimes, with Italy and Germany.

6. Any such disadvantage does not derive from the price charged for NCB coal. There is an open international market for coal and the NCB's prices are based on that market. This was the basis of the coal agreement signed by the NCB and CEGB in 1983.

7. Any disadvantage derives

either (i) the lower non-coal costs of the electricity industry in the country in question (eg France with its high nuclear

capacity)

or (ii) the sale of electricity below cost (possibly happening with large consumers in Germany and Italy).

8. The paper says the NCB long run marginal costs (LRMC) of production are £32 a tonne and below its present selling prices. The Treasury knows of no evidence that the NCB's LCRM is £32. The costs of one of the most profitable mines of the future, Asfordby, are £39 and this is not the marginal capacity. The marginal capacity currently has costs around £60 a tonne and, even the NCB is breaking even, the marginal costs are likely to be over £50 a tonne.

9. In any case the NCB's costs (including its LRMC) do not determine its prices (which are set by the international market). The NCB costs determine which pits can make a profit at the market prices and which pits can not - and so should be shut.

10. This is a key point. The recent coal strike was fought and won to establish that the coal industry should be run as a commercial, market orientated business with the size of the industry (e.g. in terms of numbers of pits) determined by its costs.

11. The thrust of the present proposal run quite counter to this philosophy. It returns to the Labour/NUM philosophy

that the size of the NCB should be determined by physical production capacity. This comes out quite clearly in paragraph 28(ii) of the paper which makes clear the scheme only makes sense for the NCB "if there is difficulty in bringing capacity into line with profitable demand" i.e. if the Government abandons the philosophy of a market driven NCB and runs the NCB at excess capacity in the medium and long term. This is exactly what Mr Scargill wants the Government to do.

12. The cost of the scheme does indeed look like £50 million a year. It is unconvincing to suggest additional electricity demand would reduce this much over the years and so cut this figure.

13. 80% of the benefit of this scheme look like going to ICI, BOC and BSC - i.e. two highly profitable companies and one state pensioner. BSC would not in fact benefit as the paper says its EFL would be reduced to offset the gain from chaper electricity.

14. Sir Walter Marshall's interest in the scheme is no doubt driven by pressures on him from industrialists (Giordano of BOC is on the CEGB Board). His best strategy would be to seek to translate this pressure into public pressure for CEGB investment in lower cost capacity (i.e. Sizewell and further PWRs). Reducing electricity prices by means of the proposed scheme would mean industrialists would see less need to support the case for Sizewell and PWRs.

C. Points to make

(a) the scheme looks a poor energy policy - the NCB sells coal at prices based on the international market. The NCB's own costs determine how much of its capacity is

economic. Its costs do not determine the price of coal;

(b) coal strike implications - the coal strike was fought and won to establish that the NCB's capacity should be determined by its costs. As the paper says, a scheme of this sort would only make sense for the NCB if its capacity is not brought into line with profitable demand. In short the scheme assumes we run the NCB at excess capacity - this is pure Scargillism;

(c) cost figures - the Treasury do not think it likely the scheme's long term costs would be significantly below the initial £50 million a year;

(d) industrial subsidy - the scheme is a selective subsidy to industry. Most of the benefit goes to ICI and BOC i.e. to two companies with good profits. BSC would not benefit as its EFL would be cut.

(e) international electricity prices - our electricity prices are indeed higher than those in France. This has nothing to do with the price of coal. It reflects the lower non-coal costs of the French electricity industry. Surely this comparison should be used by the CEGB to build support for Sizewell and PWRs. If the present scheme were approved industrialists would be less inclined to press the Sizewell case.

PRIME MINISTER 29 July 1985

GAS PRIVATISATION

In 1982 when he was Secretary of State for Energy, Nigel Lawson saw the Government's task as 'setting a framework which will ensure that the market operates in the energy sector with a minimum of distortion and that energy is produced and consumed efficiently'.

That is still a good touchstone with which to test Peter Walker's proposals for regulating a privatised BGC. Having decided to leave BGC as an integrated whole, it is important that wherever possible we should establish points of contact between BGC's monopoly gas supply activity and external market forces.

Judged by this standard, we are still satisfactorily on course, although it is a pity that the question of liberalising gas imports and exports has been left until later.

1. Ring Fence: Yes; it is essential that the monopoly gas supply component of BGC's business (currently 90% of total revenue) is ring fenced, so that its financial and operational performance is wholly transparent.

2. Competition from other gas suppliers: It is a nice idea to permit other companies to become public gas suppliers in areas where BGC has not laid supply pipes. This could be a welcome stimulus to exploration for small onshore gas deposits aimed at developing new gas markets in those rural areas not currently served by BGC. This would provide peripheral competition for BGC.

3. Competition from other gas producers: Peter Walker wants to keeps a competitive curb on BGC in the industrial sector by

making it easier for other private-sector gas producers to supply industrial customers through BGC's transmission network, under the common carriage provisions of the Oil and Gas (Enterprise) Act.

The measures Peter Walker plans could help those onshore producers who have already developed a separate local market as public gas suppliers and want to make inroads into BGC's industrial business. However, even if BGC are required to provide back-up supply cover, direct competition from offshore gas producers is unlikely to become a significant feature of the market. The snag is that offshore gas producers will not want to develop a new field until they have a firm supply contract. On the other hand, most industrial customers are unlikely to be interested in committing, say, five years ahead to a dedicated gas supply contract. They prefer greater flexibility.

4. The tariff market - (RPI - X+Y): This is the British Telecom model for inducing efficiency by setting a challenging price target. A special feature in the case of gas is the 'Y' component, ie the facility to pass directly through to consumers the increasing real terms cost of gas supplies.

Previously we have baulked at letting BGC simply pass what will become an increasingly large proportion of their costs directly to customers. The problem is that not to do so would seriously expose BGC's cash flow to the vagaries of exchange rate and oil price fluctuations. (For consumers there should be some comfort in the fact that BGC will be under pressure to contain gas supply costs in order to compete in the deregulated industrial market - see below). Otherwise, the Department of Energy appear to be alert to the practical problems of defining and setting X and Y.

5. The industrial contract market: Large commercial and industrial customers supplied not under a fixed tariff but

individually-negotiated contracts account for 30% of BGC's total revenue.

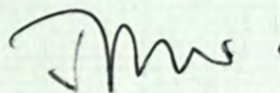
Peter Walker proposes effectively to deregulate this market, subject to a degree of protection for those customers who are inflexibly committed to gas, and are therefore vulnerable to BGC exploiting its monopoly position. He will argue that deregulation in this area will make British Gas shares more attractive to investors. The Treasury are fearful that BGC will thereby escape a rigorous commercial discipline.

In our view, this sector of the market could become a real battleground for inter-fuel competition between gas, electricity and oil. More than any other feature of the regulatory regime it should bring external market forces into play. To enhance that competition we would propose removing the provision whereby the Electricity Supply Industry is not allowed to discriminate between customers and conclude individual supply contracts with major industrial consumers. We would also complement inter-fuel competition in the industrial market by making BGC compete with European gas consumers - albeit more in theory than practice over the next decade - for UKCS gas supplies.

6. The Bill: Looks satisfactory.

Conclusion

So far so good, but liberalised gas imports and exports will be the real acid test of our resolve to bring external market forces into play.



JOHN WYBREW

PRIME MINISTER

You will be aware that for some months there have been discussions on the possibility of a scheme to reduce the price of electricity to large industrial consumers.

The initiative for this came when the leading industrial interests concerned approached Sir Walter Marshall and had talks with the Coal Board. As a result of this a joint scheme has emerged which both Sir Walter and Ian MacGregor strongly support.

Their proposal is that the National Coal Board should supply to the CEGB a tranche of coal at a favourable price which the NCB consider represents their long run marginal cost of production, including a 5 per cent real rate of return. To the degree that this "third tranche" contained coal which is currently being purchased by the CEGB at a higher price, the Coal Board would lose money. But the Board believe that the scheme will result in consumption of electricity, and hence of coal, that would not otherwise take place.

I have discussed these proposals with the Department of Trade and Industry and I enclose a joint paper which has been prepared by officials of the two Departments. This identifies the areas in which the low price of electricity could save jobs that are otherwise going to be lost. It is of course more difficult to specify new jobs that can be created and new investment that would be obtained.

You will know that our major competitors in Europe have operated tariffs which give a distinct advantage to their big users. The Germans, French and Italians have all been very active in pursuing such policies.

For most of British industry energy costs now compare reasonably, and in some instances even favourably, with Europe. But for the bigger energy users there is no doubt that our competitors have been enjoying a substantial advantage. You will see from the DTI analysis of the industrial position that the chemical, steel, glass, cement and paper industries would benefit most from the proposal. DTI also bring to our attention the regional advantages, as many of the industries in question are situated in the North, Scotland, and Wales.

In my judgement, at a time when we have excess generating capacity, substantial stocks of coal, and when we hope to see coal production costs beginning to fall in real terms, this would be a good positive measure in respect of a number of industries that could otherwise be eliminated. It would at least give them the possibility of not having to meet the considerable advantages that their German, French and Italian counterparts enjoy.

The scheme will clearly have some adverse affect on the Coal Board's accounts. But Ian MacGregor's judgement is that some of his sales may disappear altogether unless these industrial users can obtain their electricity at a lower prices. If they do survive they will benefit further from the low cost coal production that he is hoping to achieve in the coming years.

The scheme has very considerable support. The pressure for it has recently come from the NEDC, under whose auspices Lord Gregson recently led a delegation to me which included senior representatives of ICI, the Tioxide Group, BSC, Reed Paper and Board, and Pilkingtons. It is they who subsequently

produced evidence suggesting that unless the scheme is put into operation there would, in their judgement, be 15,000 job losses in the next five years. The CBI have expressed their strong support for such a scheme, as have the trade unions involved in the electricity industry.

I am anxious to inform the industries that in principle we are prepared to go ahead with such a scheme, and do the necessary work to bring it into place. I would therefore be grateful to have the approval of colleagues for these proposals. If you feel there is a need for further discussion, I would be grateful for this to be arranged as soon as possible.

I am sending copies of this letter and paper to Nigel Lawson, George Younger, Nicholas Edwards, Norman Tebbit and Tom King and to Sir Robert Armstrong.

pp SECRETARY OF STATE FOR ENERGY
(Approved by the Secretary of State and signed in his absence)

26 July 1985

ELECTRICITY PRICES AND LARGE INDUSTRIAL CONSUMERS

Note by Department of Trade and Industry and Department of Energy Officials

Introduction

There is good evidence that large consumers in energy-intensive industries such as chemicals, steel and industrial gases are paying more for electricity in the UK than in other European countries. This cost disadvantage reduces competitiveness and threatens profits, output and employment in the industries concerned.

2. This note discusses a scheme devised by the National Coal Board (NCB) and the electricity supply industry (ESI) which would reduce electricity prices to the largest industrial consumers. It is based on the NCB's supplying a tranche of coal to the Central Electricity Generating Board (CEGB) at a low price. It would allow electricity prices for the largest consumers to be reduced to about 2p a KWh compared with 2.6p under the present lowest published industrial tariff. Although there have been no detailed discussions with the South of Scotland Electricity Board (SSEB), we understand that the SSEB's current purchasing arrangements with the NCB could readily be adapted to allow them to offer similar terms.

3. Although the broad outlines of the scheme are clear, many details would require further discussion between the NCB, the CEGB and the Electricity Council: the industries do not consider that it would be appropriate to go too far into details without an indication that the Government is prepared in principle to endorse their approach.

Comparative Electricity Prices

4. Although for the greater part of UK industry electricity prices are now broadly comparable with those in the rest of Western Europe this is not so for large and high load factor consumers. Comparison of published prices shows a continuing disadvantage for such consumers, particularly against our main competitors in France, West Germany and Italy. The situation is aggravated by the existence of special unpublished contracts on the Continent which reflect pricing policies aimed at promoting industry, lower costs of generation, and the attractive loads which the users present to the utilities. They also include more favourable allowances, such as night tariffs lasting for up to 4 hours longer than in the UK. The result is differences nominally

of around 20%. Fuller details are given in Annex A.

5. These pricing disparities have been experienced over several years and have damaged the competitiveness of electricity intensive industries in the UK, such as chlorine, oxygen and nitrogen production, steel production, and paper making. Many of the products made from these materials, in which electricity represents between 10% and 60% of manufacturing costs, are internationally traded in intensely competitive markets where margins are very small.

The Proposed Scheme

6. The NCB supplies coal to the CEGB under a Joint Understanding. In broad terms, this provides for the NCB to supply 87% ("the first tranche") of the CEGB's total coal requirements at a price related to the costs of delivering imported coal to inland power stations and a further 8% ("the second tranche") at a price related to that of imported coal to coastal power stations. The price of the first tranche is currently about £44 a tonne and of the second about £36 a tonne.

7. The proposed scheme would provide for a supply by the NCB to the CEGB of a "third tranche" of coal under a separate Coal Supply Agreement (CSA), outside the Joint Understanding, at a price of about £32 a tonne. The NCB consider that this is a representative estimate of the long-run marginal costs of production, including a 5% real rate of return, on the better end of their existing deep mines and green field development of new mines. The CSA would make it clear that the "third tranche" was being made available for processing into electricity for sale to a defined class of large consumers. (This would enable the CEGB to pass on the benefits to the consumers without infringing the statutory prohibitions against "undue preference" between classes of electricity consumers).

8. The supply terms would allow electricity boards to offer a new tariff to consumers with sites taking more than 100 million units of electricity a year. Such consumers would pay for the first 100 million units (1 unit = 1 KWh) at each site on the basis of the NCB's normal coal prices, plus capacity costs and a contribution to overheads; units in excess of 100 million a year would be charged at a price based on the marginal costs of processing the "third tranche" of coal. The new tariff would be so constructed as to avoid step changes at the qualifying level of 100 million units a

year or from the existing Consumer Contracted Load (CCL) terms* available to large industrial consumers. The largest consumers would pay overall just over 2p a unit, compared with 2.6p under the cheapest current published industrial tariff.

9. Annex B gives a list of consumers on CCL terms with sites consuming more than 100 million units a year. On the basis of this list the CEGB estimate that about 60 separate sites, operated by 25 companies, would qualify in Great Britain. The main benefits would accrue to the chemicals, steel, cement and paper industries. Recent consumption at the sites concerned in excess of 100 million units represents a primary coal input of about 4.5 million tonnes in England and Wales.

10. It would be for consideration whether sites taking more than 100 million units a year but not on CCL terms would be eligible for the new tariff. (There are about 20 such sites in England and Wales. Their consumption in excess of 100 million units represents a primary coal input of the order of 0.5 million tonnes a year). On the one hand, it would extend the benefits of the scheme and avoid the complaints that would result if the sites were excluded. On the other, most of the sites (which include Heathrow Airport) would be unlikely to increase their consumption of electricity, so that including them would increase the "deadweight" cost of the scheme. For that reason, the NCB wish to include in the scheme only consumers engaged in manufacturing industries.

11. The scheme would not include load management requirements such as feature in CCL terms: some potential beneficiaries of the scheme have made it clear that this is an important point for them, since mandatory load management would require them to maintain or install expensive standby generating facilities. However, the scheme would include optional load management terms; these would be less favourable to consumers than under existing CCL terms.

12. There would need to be a firm commitment to the scheme: industrialists would not be willing to commit themselves to new investment (or avoiding disinvestment) without an assurance that the new terms would last. The CEGB suggest that the contracts between the electricity boards and the consumers concerned should normally be for a period of 5 years, subject to the NCB continuing to make enough coal available to support the scheme.

*In order to help the CEGB match load and generating capacity CCL terms offer large electricity consumers incentives both to contract for a steady base load and to reduce this load at times of peak demand on the system. Consumers who, for safety or other reasons, cannot undertake to reduce their demand when necessary cannot enter into CCL arrangements.

13. By the same token, there would be attractions in providing that the first 100 million units were on a "take or pay" basis. This would provide increased assurance that the scheme would encourage additional output (or avert reductions in output).

Industrial Implications (note by DTI officials)

14. The attached paper by NEDO (Annex C) lists the likely effects on the benefitting companies* as seen by the companies themselves. Though NEDO stress the considerable uncertainties, their best overall estimate (Para 3.5) is that 5500 million KWh (5500 GWh) of additional electricity will be used each year compared to current consumption by these companies of about 15000 GWh). NEDO do not have any estimate of the overall effect on output but conclude that over 5 years 15000 jobs that would otherwise be lost will be saved and 1000 new jobs created.

15. NEDO recognise that it is difficult to make a precise estimate of the additional electricity demand that might result from the third tranche scheme. However important to costs, electricity prices will not be the sole factor determining investment decisions and therefore forecasts of what will happen with or without lower energy costs are inevitably uncertain. The DTI have therefore assessed NEDO's material where possible in conjunction with the affected companies, in an attempt to estimate the likely range of effect. Accepting that there is great uncertainty, their view is that NEDO's figure of 5500 GWh lies rather above the top of a likely range of some 2800 - 4500 GWh which is equivalent to 1.3 - 2.1m tonnes of coal. Of this addtional demand we judge that 1600 GWH (0.8m tonnes) - 2100 GWh (1.0m tonnes) is over and above electricity currently used; the remainder of 1200 GWh (0.6m tonnes) - 2400 GWh (1.1m tonnes) would maintain present consumption which in the absence of the scheme might be expected to be lost. (This distinction is important to the finances of the scheme - see paras 25 to 29 below).

*The exact coverage of the scheme is not yet determined. The NEDO paper is based on the CEGB"s first list of plants using over 100 million KWh on the current CCL load management scheme, with the addition of Pilkingtons (glass) and 3 paper mills which are potentially eligible. It is likely that coverage will be extended to at least some customers not currently on CCL who consume over 100m KWh (compulsory load management not being a feature of the third tranche scheme), though the NCB may further restrict eligibility eg to manufacturing plants only. These decisions, though important in themselves, are not thought likely to change the range of estimates substantially.

16. DTI point out that company behaviour in response to lower electricity prices will depend on their expectations about how long such price changes will last, and how they will relate to prices in competitive countries over the longer term. The third tranche scheme could risk misdirecting industrial investment if price differentials were only to be narrowed temporarily or if the plants concerned could still not compete in the longer term with the yet lower Continental prices. It is assumed that companies have (a) based their calculations on the continued availability of the "third tranche" reduction in UK electricity prices and (b) have taken into account the fact that certain Continental prices, for example in France and Sweden, will remain significantly lower.

17. The largest beneficiary of the proposal is the chemical industry, primarily ICI which accounts for over half of the estimated additional demand. ICI's chlorine and fertiliser divisions would be the main beneficiaries, with plastics and petrochemicals also assisted. Electricity accounts for 60% of chlorine production costs and 13% of fertiliser costs. Without the scheme, ICI say they would close 40% of chlorine capacity, virtually withdrawing from the export market with the loss of 925 jobs at Runcorn, and gradually withdraw from fertilisers, with a potential loss of 6000 jobs at Billingham. With the scheme there would be reinvestment and modernisation in both areas. Though smaller, other chemical and industrial gases companies (BOC, Air Products, BP, Tioxide, Staveley and Monsanto) forecast similar effects of the scheme on disinvestment/reinvestment decisions.

18. Steel is the next largest beneficiary. Product quality is an important factor in enabling BSC and private sector companies to compete effectively with overseas competitors. Improved electricity costs would encourage the introduction of new technology into the production process. No precise estimate of the ultimate effect on output and profit levels is possible, but BSC estimate that in their own case the product quality improvement projects which they can identify at present could result in 500 GWhs of additional electricity consumption. The most immediate direct effect on steel output would be felt in the electric steelmaking sector, where competitive pressures are leading to rationalisation. This sector accounts for 1/3 of crude steel production and includes all private sector steel producers and significant parts of BSC (concentrated in the Sheffield/Rotherham area and South Wales). Without the scheme it is estimated that a major works could be closed with the loss of 2000 - 3000 out of the 15,000 jobs in this sector. With the scheme some contraction is still possible, but lower electricity prices would improve the chances of arresting the long term decline of electricity consumption in the UK steel industry and provide the basis for investment in modernisation of plant.

19. The other major benefitting sectors are paper and board,

glass and cement. Paper and board has high import penetration (60%). It is marked by low profitability (despite the industry's efforts to reduce energy and other costs) and doubts about future investment. The scheme (which would bring savings equal to 1.5% - 2.0% of selling prices, compared to an overall rate of return on sales of only about 5%) would markedly improve prospects for future investment necessary for the industry's health. It could also help tip the balance on a possible inward investment project from Finland. Similar beneficial effects of the scheme are likely for glass (investment in new technology process by Pilkingtons) and for cement (reinvestment by RTZ, investment in new milling facility by Blue Circle). The latter is facing increased imports and there is evidence of dumping from Eastern Europe and Spain.

DTI Assessment

20. For all the above industries electricity represents a significant proportion of total costs: 90% for industrial gases, 60% for chlorine, 13% for fertilisers, 9% for electric steelmaking, 18% for paper and board, 13% for cement. All are products whose competitiveness is largely determined by price. There is no reason to doubt that lower electricity prices (the scheme will reduce prices by about 7 - 15%) would bring significant benefits to the companies concerned and in many cases would have a significant impact on their future plans. The examples described above show that electricity costs will be a significant determinant of investment (which in some cases is crucial to survival) in a broad spectrum of heavy industry. The regional implications are also noteworthy; most of the sites potentially at risk are in sensitive areas eg Runcorn, Billingham, Sheffield, St Helens and S Wales. The potential inward investment site for a new paper mill is the old Talbot plant at Linwood in the Strathclyde development area.

21. Over and above the additional net output of the companies concerned, there will be some indirect effects on their customers and supplies. These indirect effects will mainly depend on the ease with which customers can obtain (probably by importing) equivalent products at similar prices. The evidence suggests that, with some exceptions, most of the eligible companies produce semi-manufactured or intermediate products and are operating in highly competitive environments for which equivalent imported products are available to customers without major additional cost.

22. The direct impact of the scheme on ICI's plants is discussed at paragraph 17 above. Chlorine is difficult and costly to transport. Reduced output would probably therefore imply the loss of some downstream activities to a point at which the intermediate product was readily tradeable; but the precise downstream effects are difficult to estimate. Downstream

activities are less electricity intensive and therefore less sensitive to changed prices. But failure to invest in new chlorine technology in the UK would undermine ICI's ability to win export contracts for such technology overseas.

23. Rationalisation of the steel industry continues, but without the scheme there would be a loss of competitive facilities and the impact would be exacerbated by the regional distribution of steel plants. Some of the products made by the electrical route (eg engineering steels) are of relatively high added value and the DTI's view is that, with appropriate investment, this sector has a viable and competitive future. The paper and board and glass industries' products are generally available at competitive prices from overseas producers although there are significant exceptions and imported cement is increasingly available. (It is relevant that electricity prices are not the most critical input to cement production nor do they appear to be the least competitive part of the industry's cost structure). The prospect of investment in new technological process at Pilkington's glass operation is potentially interesting.

DTI Conclusion on industrial implications

24. It follows from this limited analysis that the main industrial implications of the third tranche scheme seem to be concentrated on the plants directly affected, as discussed above and in the NEDO assessment. While there would undoubtedly be some indirect benefits - as there would be with all increases in industrial activity provided that the cost of these did not crowd out other options - there seems no reason to believe they would be disproportionately great. Incremental output figures for the affected plants are not available. NEDO's estimate of 16000 jobs preserved (largely) or created was associated with their estimated incremental demand of 5500 GWh, which seems to DTI officials rather above a likely range of outcomes starting at around half that.

Wider Economic Benefits

25. The scheme will have favourable effects not only on employment and investment as described above, but also on the balance of payments and public expenditure. NEDO evidence is that in the chemical sector alone, the benefit to the balance of payments could amount to almost £1000 million pa. (This figure is derived from estimates given to NEDO by ICI chemical and agricultural divisions). In addition in the paper, steel and cement sectors, import penetration would be reduced and exports could be increased. These effects have not been quantified by the companies concerned but the evidence given to NEDO by each sector is compelling.

26. Lower electricity costs to British Steel would reduce their

external finance requirement, and would help to offset the cost of the scheme. Additional coal movements would also benefit British Rail and produce a further offset. There would also be benefits to the Exchequer in increased revenue resulting from higher employment. These include both receipts from income tax, national insurance contributions and VAT, and reductions in unemployment and social security benefits. Some benefit could also be expected from increased Corporation Tax. No account has been taken either of the beneficial knock-on effects of increased investment by the sectors concerned or the construction and capital goods industries.

Effects on ESI

27. The financial effects on the ESI would be broadly neutral. In effect, the scheme would be a "toll processing" agreement under which the NCB would supply coal for the benefit of certain categories of industrial user, which the CEGB would convert into electricity. For several years to come the CEGB has substantial excess generating capacity; and this would not be significantly affected by the new scheme. In the longer term, the capacity implications might need further consideration. Since, as noted in paragraph 10 above, the optional load management terms in the scheme would be less beneficial to consumers than CCL terms, they would also do less to limit the growth of peak demand on the generating system. The ESI would not wish to see this lead to the premature construction of additional generating capacity. If the scheme is introduced it may be necessary to modify it in later years so as to offer greater incentives to load management.

Effects on the NCB

28. The effects of the proposed scheme on the NCB's finances are the sum of two things:

(i) Coal which would have been required by the CEGB in order to meet that part of the demand from beneficiaries of the scheme which would have occurred even if the scheme had not been adopted will earn revenue for the Board at the "third tranche" instead of the "first tranche" price. With current prices that means a loss to the NCB of £12 a tonne on all such coal. (This is the "dead weight" cost of the scheme).

(ii) In the longer run, coal supplied in addition to that mentioned in (i) above will earn revenue from the NCB equal to the difference between the "third tranche" price and the marginal cost of production. The NCB estimate that the "third tranche" price of £32 a tonne will allow them to make an adequate profit on marginal production. In the medium term, if there is difficulty in bringing capacity into line with profitable demand quickly enough, this coal will earn a higher return equal to the difference between the third

tranche price and the revenue that can be earned from export sales (the only alternative means of disposal). At current world coal prices and exchange rates export sales earn about £27 a tonne.

Immediate Effects

29. In the short term, before consumers have been able to adjust production and demand for electricity to meet the new situation created by the scheme, there would be only the "dead weight" cost of the scheme. On 4 - 4.5 million tonnes of coal sales, the NCB would receive about £32 a tonne instead of £44 a tonne, and would thus lose initially around £50 million a year. After the first year, this would begin to reduce as factors outlined in paragraph 28(ii) above became effective. The cost could be accommodated without amending the deficit grant limit of £2 billion laid down by the Coal Industry Act 1985.

Longer Term Effects

30. In the longer term, the effects of the scheme on the NCB's finances will depend on how successful it is in preventing reductions in demand for electricity that would otherwise have taken place and in securing additional sales of electricity. For existing intensive electricity users electricity costs tend to constitute a much larger proportion of total costs than for industry as a whole. In addition, most of the companies involved are selling internationally traded goods which compete mainly on price (rather than on technical specification etc). The electricity prices paid by these consumers is thus a factor in their ability to maintain the size of their operations, and in new investment.

31. On the basis of the assessment in paragraphs 14 to 15 above, Department of Energy officials estimate that the longer term cost of the scheme to the NCB would probably be in the range of £30 - £41 million a year.

18 July 1985

EXTRACT FROM NEDC PAPER OF 21 JUNE

P.M.

ANNEX A

2.1 Price Disparities

2.1.1 Although for the greater part of UK industry electricity prices are now broadly comparable with those in Continental Western Europe this is not so for large and high load factor consumers. Comparison of published prices shows a continuing disadvantage for these consumers, particularly against our main competitors in France, W Germany and Italy. This situation is aggravated by the existence of special unpublished contracts on the Continent which reflect pricing policies aimed at promoting industry, lower generating costs and the users' favourable electricity load from the standpoint of the utility, also more favourable allowances eg night tariffs lasting for up to 4 hours longer than in the UK. This results in differences nominally of around 20%. The latest international surveys on representative electricity prices for the steel (which reflect special deals) and chemicals industries are included in Annex 1. Direct evidence of some such contracts and the actual prices paid will be supplied orally and in confidence at the meeting.

ANNEX I

Current Electricity Price Differentials

Rather than duplicate the extensive work regularly undertaken on this subject, general comparisons for the steel and chemical industry are included. Plant-for-plant comparisons, for which details can be made available on a confidential basis, are also included.

1. Steel

The latest figures for special contracts/'as found' from the 'Energy Advice' survey for 1 April 1985 for 80MW maximum demand consumers are as follows:

Pence/KWh

Belgium	France	Italy	Netherlands	W Germany	UK
2.94-3.14	2.19-2.31	2.34-3.02	2.68-2.96	2.49-2.78	2.74-2.79

UK prices include load management; prices for other countries reflect prices obtainable as a result of interruptibility, modulation, higher voltage etc.

2. Chemicals

This note provides a comparison of electricity tariff prices in the industrial EEC countries agreed by the Chemical Industries Association and the Electricity Council. The prices shown are 'annualised' figures based on tariffs applicable at 1 April 1985 and with the Continental EEC prices converted to sterling at exchange rates at that date.

In those countries which have not adopted a unified or national system of charging, a range of prices will usually exist. However, where a single price is shown for any load this is thought to be reasonably representative of prices generally paid by chemical industry consumers.

Table 1

Load & Load Factor	England & Wales	Scotland	Belgium	France	Germany	Italy	Netherlands
40MW 40%	2.80	2.87	3.75	2.74[1]	3.86	3.91	5.06[2]
60%	2.77	2.84	3.29	2.53	3.23	2.99	3.29[2]
80%	2.77	2.77	3.04	2.36	2.81	2.50	2.87[2]
	load management						

Notes: 1. Loads just over 40MW would qualify for tariff C at the following rates:

40%	60%	80%
2.59	2.40	2.25

2. Not agreed by the CIA.

3. Glass - single company, comparison for actual costs

6.5 MW load, single float glass line

P/KWh

UK 3.77 Sweden 2.38

8.1 MW load, two unit float glass works

UK 3.45 Germany 2.96

4. Chemicals, plant for plant comparisons within multinational companies (all plants above 100 million units)

Company A — 1984 average

P/KWh

France	Italy	UK
1.18	1.23	2.50

Company B — 1984 average

France	Belgium	UK
2.01	2.47	2.54

Company C — May 1985

P/KWh

N Holland	UK
2.60	3.25

Company D — May 1985

France*	UK
1.5	2.9

* guaranteed up to the year 2,000.

ANNEX B

List of CLC Consumers with Unit Consumption in Excess of 100m kWh in 1983/84

		mkWh
LEB	-	-
SEEB	Sheerness Steel	289
	Blue Circle Industries, Northfleet.	183
	Bowater Paper, Kemsley Mills.	160
SEB	National Gas Turbine Establishment	112
	Esso, Fawley.	216
SWEB	ICI Severnside	334
	English Clays Lovering Pochin & Co.	305
	Commonwealth Smelting	125
EEB	Mobil Coryton Refinery	117
EMEB	British Steel, Corby	123
	Stanton & Staveley, Stanton	101
	Staveley Chemicals, Chesterfield	141
	Ketton Cement, Stamford	116
MEB	Michelin	109
	Goodyear	122
SWaEB	British Steel, Ebbw Vale	225
	British Steel, Llanwern B	585
	British Steel, Margam	504
	British Steel, Trostre	154
	ASW Arc Furnace	297
	Aberthaw Cement	123
	Alpha Steel	109
	British Oxygen, Margam	252
MANWEB	ICI Castner Kellner	1982
	ICI Lostock	122
	Bidston Steel, Birkenhead	101
	British Petroleum Chemicals, Sandbach	175
	Associated Octel, Ellesmere Port	512
	British Oxygen, Widnes	333
	Brymbo Steel, Brymbo	245
	British Steel, Shotton	168

		mkWh
YEB	Union Carbide, Sheffield	112
	Sheffield Forgemasters, Tinsley Park	623
	British Steel, Stocksbridge	361
	" " Aldwarke	554
	" " Templeborough	198
	" " Appleby-Frodingham	585
	Blue Circle, Hope	181
	ICI, Immingham	117
	BTP Tioxide, Grimsby	104
	British Oxygen, Scunthorpe	203
NEEB	British Steel, Grangetown	253
	Monsanto, Seal Sands	324
	ICI, North Tees	210
	ICI, Wilton	395
	ICI, Billingham	399
	British Oxygen, Middlesborough	401
NORWEB	Air Products	174
	Ribblesdale Cement	129
	ICI Hillhouse	304
	Bowater Scott, Barrow	111
	Shell Chemicals	201
	Thames Board, Workington	164

National Economic Development Office

ANNEX C

Millbank Tower Millbank London SW1P 4QX
Direct line 01-211 ... or Switchboard 01-211 3000

The Rt Hon Peter Walker, MBE, MP
Secretary of State for Energy
Department of Energy
Thames House South
Millbank
London
SW1

5 July 1985

Dear Mr. Walker,

ELECTRICITY PRICES FOR LARGE INDUSTRIAL USERS

At our meeting on 25 June when we put proposals to you for reduced prices to large industrial users, based on a cheap tranche of coal, you asked for more information on the economic benefits that would result from introduction of the proposals.

I enclose a paper which describes those benefits which has been prepared from inputs from the companies in the main sectors affected. I very much hope that you and your colleagues in Government will find this persuasive.

I should point out that much of the data included is highly commercially confidential. We are therefore numbering all copies of the document.

Yours sincerely,

Dick Hamm
on behalf of
THE LORD GREGSON DL

cc PS/PUSS (MR HUNT) (2)
PS/PUSS (MR GOODLAD) (3)
PS/PUS (4)
Mr Manley (5)
Mr Buckley (6)
Mrs Brown (7)
Mr Fullerton (8)
Mr Agrell (9).

STRICTLY PRIVATE AND CONFIDENTIAL

Copy 6 of 6
This copy is for
The Secretary of
State For Energy

ELECTRICITY PRICES FOR LARGE INTENSIVE INDUSTRIAL USERS

1 INTRODUCTION

1.1 A team, led by Lord Gregson, Chairman of the Chemicals EDC, of representives of large electricity intensive industrial users of electricity presented to the Secretary of State for Energy on 25 June proposals for the supply of electricity to large industrial consumers at reduced prices based on a tranche of low cost coal, together with evidence on disparities and potential benefits. The Secretary of State asked to receive within 10 days more information on the industrial, and economic benefits that would result from introduction of the proposals. This paper therefore focusses on the expected impact of the scheme on the main electricity intensive companies and sectors - chemicals, steel, glass, cement and paper - in terms of electricity demand, output, investment and employment if the scheme is introduced, as compared with the outlook on present policies.

1.2 The Secretary of State for Energy is invited to obtain Government support and approval to authorise urgently the NCB and the electricity supply industry to introduce the scheme.

2 COMPETITIVE ENVIRONMENT

2.1 The Department of Energy has been given detailed evidence, based on actual prices, that the main Continental competitors of UK large electricity users pay typically around 20 per cent less for their electricity supplies. The difference has remained, at least, at this level for a number of years. The resulting damage to the companies' competitiveness was described in the earlier NEDO paper (of 21 June).

2.2 Even with the very large disparities that exist, the damage this causes to the economy takes place on a relatively slow time-scale and will continue to be a gradual process; electricity prices are only one, though a major, factor in the competitive package. For the most electricity intensive products like industrial gases they are dominant but many of these products are difficult to transport economically. For the potential beneficiaries to the scheme, higher electricity costs, ranging up to 12 per cent of their total production costs, constitute a severe competitive handicap.

2.3 One feature worth stressing is that many UK companies eg Pilkington, Blue Circle, believe that their competitors are able to move ahead in the introduction of new technology which is electricity intensive. UK companies are constrained because of higher UK prices from developing such technology in Britain and fear that this could result in their becoming fundamentally and irretrievably uncompetitive in the future.

3 BENEFITS OF THE PROPOSALS

3.1 The benefits to industry of implementation of the proposed scheme cannot be easily described or quantified. It would be unrealistic to expect a change in one input, however important to business costs, to have a simple, immediately definable effect in isolation in the real world. It is of course true that the outlook is uncertain on the continuation of current pricing policies. But companies expect output, employment and electricity consumption in these energy intensive sectors to decline in this event. They cannot predict by how much in total - Government is presumably equally uncertain of the effect continuation of current policies will have on electricity (and thus coal) consumption.

3.2 It is also quite unrealistic to expect to forecast a 'theoretical' total effect on UK industry from implementation of the proposals. NEDO has however again obtained from them inputs for over 90 per cent of the potential qualifying companies. Companies whose input was included in the first paper have been asked to develop their contribution and additional companies have been pressed to define the impact of the scheme on their UK business.

3.3 The results from each industry are reported below. On a rather conservative basis it can be concluded from simple addition of the 'probable' estimates that introduction of this proposed scheme would lead within five years to at least 15,000 jobs being saved that would otherwise be lost, over 1,000 jobs being created and 5,500 million units of electricity being consumed each year more than would be the case if current pricing policies were maintained. Though they cannot be aggregated, the company inputs show that there would be significant beneficial effects on the trade balance for individual products, and an investment in a number of substantial new projects if the scheme were implemented.

4 CHEMICALS INDUSTRY

4.1 Overall sites qualifying for the proposed scheme at present consume over 50% of the total chemical industry consumption of electricity (about 14,000 million KWh pa). The future health and growth of the products they manufacture is therefore critically important not only to the industry as a whole but as a direct consumer of ESI electricity and thus coal. A number of the dozen or so companies which are potential beneficiaries have calculated the impact of the scheme on their future business. These are listed below:

4.2 ICI

4.2.1 Summary

In total ICI's incremental purchases of electricity under the new terms would amount to about 4,000 million KWh pa, equivalent to 2 milllion tonnes of coal. Without considering the beneficial effect on downstream plants and companies 6,000 jobs in ICI would be safeguarded and job creation prospects would be enhanced on a much wider scale. The effects on three main electricity consuming Divisions are described in detail below. Annex 1 tabulates the effects in more detail.

4.2.2 Mond Division

The future of ICI's UK chlorine industry is critically dependent on electricity prices which form 80% of the marginal cost and 60% of the total cost of manufacture. Several of ICI's plants are now entering a phase during which they will either have to be shut down or replaced

with modern advanced technology. The new investment, which will cost up to £100 million will not be embarked upon unless there is a competitive long term electricity tariff in the UK.

In the absence of the new tariff, the first major chlorine plant closure is scheduled to take place in 1986, followed by further closures in 1988 and 1989 leaving ICI with 60% of its present chlorine capacity. The company will have withdrawn from a large slice of its export market.

On the other hand, with the benefit of a secure and competitively priced electricity supply, ICI would embark on progressive modernisation and replacement of its chlorine manufacturing assets. ICI is among the world leaders in chlorine technology and successful exploitation of this strength in the UK would enable the company to expand its world-wide business in chlorine technology licensing.

The differential advantage which would be expected to accrue from the new industrial electricity tariff over the next 5 years is quite striking. ICI's chlorine business is forecast to be consuming an additional 2,000 million KWh pa of electricity and to be supporting 1500 more direct jobs (+ 3,000 jobs outside ICI) compared to the situation if there is no new tariff. The cumulative advantage of the new tariff to the balance of payments would amount to £150m pa.

In addition the new investment during the period would provide around 250 jobs in the engineering, fabrication and construction industries. Many of these jobs might be maintained indefinitely on the strength of a successful chlorine technology export business.

4.2.3 Agricultural Division

Agricultural Division's main activity is the production of ammonia and fertilisers of which ICI is the only UK-owned producer in Britain. International competitive pressure is increasing largely as the result of lower energy costs available elsewhere, compared with the natural gas and BST electricity in NE England.

Major reinvestment is necessary over the next decade, which will be judged on ICI's cost-base as compared with its international competitors and which if not achieved will mean a gradual run down of operations over the same period and a loss of 6,000 direct jobs. Recent economic studies show that total job loss including the support jobs element would be of the order of 20,000.

Reinvestment would mean a retention of probably 85% of these jobs (5,000 direct) and would secure for the future an electricity consumption of 1800 million KWh pa, equivalent to 1 million tonnes of coal. The new technology uses a higher ratio of electricity in its overall energy consumption than the existing process; reinvestment is therefore contributing a nett increase of 1000 million KWh/year in the 1800 million KWh total.

4.2.4 Plastics and Petrochemicals Division

For P&P Division, centred in NE England, the new tariff would substantially underpin the viability and future of its activities. A measurable impact short term would be a substitution of fuels for generation by purchased electricity equivalent to 175 million KWh pa (c.100 kte coal).

4.3 Monsanto

4.3.1 Monsanto has one site in the North East that would qualify. The major electricity consuming product is a synthetic fibre intermediate. The company believes that introduction of the scheme would probably lead to increased exports of 10,000 tonnes pa and possibly up to 30,000 tonnes pa. Electricity represents about 10% of the total cost of production (the selling price is £1,500/tonne). As there is existing over-capacity no new investment or jobs will be created.

4.3.2 If the scheme is not introduced production is expected to decline by 15-20,000 tonnes over 2-3 years. As volumes fall, unit costs will rise and the company will be progressively priced out of markets. It is expected that this will lead to the loss of 50 direct and indirect jobs within five years.

4.3.3 Electricity consumption is forecast to be the following:

	million KWh	
	With the proposed scheme	Unchanged policies
1986	340	300
1987	345	300
1988	348	290
1989	355	275

4.4 UKF Fertilisers

4.4.1 UKF is considering investing £30 million in new process plant in the UK but this has to be weighed against alternative investment possibilities open to the Group in Continental Western Europe - where electricity prices are much lower. The prospects of the investment coming to the UK will be significantly enhanced if the proposed scheme were implemented - the pay-back period could be reduced by 10%. This would create 50-60 new direct jobs and a further 150 indirect jobs. (500 construction jobs would be created during building of the new plant and about £30 million spent with UK engineering companies.)

4.4.2 Around 50% of UKF's UK output is sold at break-even prices. Imports have increased from 30,000 tonnes in 1982 to over 1,000,000 tonnes last year. The company is constantly having to reconsider the continuity of production in the UK. 1,000 jobs are at risk. The company believes that the proposed scheme would do much to secure the jobs of some 300 people on the electricity intensive product range. Operating costs would be reduced by 1.4% if the scheme were introduced.

4.4.3 Future electricity demand is estimated as follows:

	million KWh	
	with the scheme	Current pricing policies
1985	130	130
1986	130	130
1987	130	130
1988	130	+
1989	140	+
1990	150	+

+ Production curtailment is being considered. Demand would fall below 100 million KWh pa.

4.5 BP Chemicals

4.5.1 BP Chemials does not have a site large enough to qualify at present. An investment in BPCL's 'A5-Acetyls' project at Hull is currently being considered. If the scheme were introduced it would reinforce the case for peripheral investment which would lift usage from 73 million KWh to 125 million KWh pa - or possibly as high as 370 million KWh. This would create 200 jobs for the whole investment.

4.6 Others

4.6.1 Tioxide, Associated Octel, Beecham, Hays Chemicals and Union Carbide believe the scheme would do much to protect current output and jobs by enhancing cost competitiveness of their electricity entensive products. Tioxide envisage an increase in electricity consumption of between 3% and 8% over five years at their qualifying plant if the scheme were introduced.

5 FLAT GLASS MANUFACTURE

5.1 If Pilkington Brothers were able to benefit fully from the scheme (some form of aggregation of demand of their existing 5 sites in St Helens would be necessary) the major impact would be to enable the company to aggressively pursue the new technology of large scale electric melting in the UK. (Pilot work is being done in Sweden at present.) On this assumption the company has forecast 'probable' and 'possible' power demand as follows:

5.2 'Probable' scenario

(Partial substitution of gas/oil firing by electricity for glass melting)

The programme will depend entirely on successful technical development; maintenance of high produce quality will be paramount. But it could lead to a 150% increase in electricity demand at St Helens.

million KWh

Year	Electric Melting Demand	Total (St Helens)
1986	22	214
1987	22	214
1988	31	223
1989	131	323
1990	210	402
1991	242	433
1992	289	481

and continuing at approximately the same level thereafter.

5.3 'Possible' Scenario

(Major/total substitution of gas/oil firing by electricity for glass melting).

Glass production by this further application of electric melting technology is highly speculative but offers additional potential advantages in terms of reduced atmospheric polution, and the energy input is significantly lower because of reduced thermal losses. Mainenance of high standards of product quality will be the major problem and may prove insuperable.

Year	Electric Melting Demand (million KWh)	Total (St Helens)
1986	22	214
1987	22	214
1988	31	223
1989	153	345
1990	337	529
1991	337	529
1992	490	682
1993	490	692
1994	564	756
1995	564	756
1996	564	756
1997	766	958
1998	945	1137

and continuing at approximately the same level thereafter.

5.4 If current pricing policies were continued production of electric melting would be impossibly uneconomic in the UK. The company speculates that (with uncertainty compounded by future exchange and inflation rates) glass making by the 'traditional industrial route' in the UK would become increasingly uncompetitive. This would lead to investment elsewhere in Europe by competitors and possibly defensive investment overseas by Pilkington. The company's best guess is that in this case numbers employed at St Helens, forecast to be about 7,000 by end-1986, could be eventually reduced by 50 per cent ie 3500 jobs could be seriously at risk.

6 INDUSTRIAL GASES

6.1 BOC, whose total electricity consumption this year will be about 1,700 million KWh, reduced the price of liquid nitrogen by 15 per cent in 1982 and have since frozen it. The have achieved 15 per cent pa market growth as a result over this period. This has led to investment of £9 million in a new production plant at Scunthorpe which supports 35 jobs within BOC.

6.2 Based on this experience, BOC believe that implimentation of the proposed scheme (which would lead to roughly a 10 per cent reduction

in their electricity costs) would stimulate/maintain the growth in demand for their products. This would lead to increased electricity consumption of 5 per cent pa (equivalent to 85 KWh pa) and additional investment of £8 million in 1986 and £12 million in 1987. This would support 50 jobs within BOC.

7 CEMENT

7.1 There is a vast excess of production capacity of cement in Europe, estimated at 20 to 30 million tonnes, particularly in Greece and Spain. This has arisen from continued capacity expansion at a time when third world countries, especially in the Middle East, have been developing their own cement industries while construction activity has lessened. There is surplus capacity in the UK, but not to the same extent, largely because of gradual rationalisation to match market requirements. Imports in 1984 amounted to nearly 400,000 tonnes, only 3% of the market but nevertheless equivalent to a medium-sized plant employing 200 people, using 50,000 tonnes pa coal and 50 million KWh. Imports were on average £4/tonne cheaper than domestic supplies. There would have been a much higher level of imports but for very active promotion of the high quality of British cements, price restraint for 3-4 years in Great Britain and price cutting in Northern Ireland, coupled with other defensive measures. International cement traders who rely on marginal cost sales and cheap freight, or purchase from COMECON countries, are active and are currently known to be seeking alternative outlets to replace declining markets in the Middle East. A single bulk ship supplying cement through a floating terminal, or shore installation at any UK major port could supply 800,000 tonnes per annum, equivalent to 250 jobs, 100,000 t.p.a. coal and 100 million KWh. Apart from the direct effect, the reduced volume of production would add to unit costs at other plants. Continued efforts to improve efficiency are being made, but lower energy prices to match those available to low cost European producers are essential.

7.2 Of the three UK cement manufacturers, two have sites that would qualify for the proposed scheme. Blue Circle Industries produced 7.8 million tonnes of cement in the UK in 1984. Electricity at £27 million represented 13% of production costs (their major cost is coal for kiln fuel at about £60 million pa). The benefit of the proposed scheme is estimated to be £1-2 million pa, the scheme applying to 4 out of their 11 works (assuming eventual implementation in Scotland).

7.3 Two of RTZ Cement's sites would benefit (out of a total of four). They estimate the benefit of the proposed scheme at £500,000pa, representing a saving of 6.4% in power costs. RTZ estimate the consequent benefit to the company as:

i) an incremental 125,000 tonnes of cement sales;
ii) improved security of employment for 57 people;
iii) an incremental 15 million units pa of electricity sales;
iv) an incremental use of 25,000 tonnes of home produced coal (as the prime energy source in cement manufacturing).

7.4 RTZ decided in 1982 to rebuild their Ketton works (which would qualify) at a cost of over £60 million. As prices have only just been increased by 4.5% for the first time in three years, the prospective rate of return on this investment has been lowered to the extent that cuts in the remaining part of the expenditure are under constant and critical consideration. Over £2 million has been identified which

will be delayed. This would be reinstated if the proposal were introduced. Investment proposals which are now being deferred would be developed and submitted for capital expenditure authorisation. A specific scheme which would benefit is a new mill estimated to cost £3 milllion.

7.5 Blue Circle have considered the benefits to their qualifying works:

i) Aberthaw (South Wales). Installation of new cement milling, with the additional facility to dry and grind blast furnace slag, otherwise wasted, as a partial cement replacement. Improved bagging and loading facilities with modern storage of materials to improve the environment. Total estimated cost £18 million phased over the years 1986/1989. Welsh Office grant support of £1.75 million has been offered. Other than during construction additional jobs will not be created. Closure of an associated grinding plant nearby at Rhoose will accompany the project but would become inevitable because of high operating costs and environmental problems. Apart from the protection afforded to the jobs of 428 employees at Aberthaw by the improved efficiency, and continued consumption of 125,000 tonnes coal and 155 million KWh electricity, it is planned to ship clinker made available by the use of blast-furnace slag to Northern Ireland to replace imports from Eire. Imports from Eire totalled 100,000 tonnes in 1984, equivalent to 15,000 tonnes coal and 13 million KWh.

ii) Northfleet Works (Kent). This is the largest UK cement works, has been a major exporting plant in previous years and is currently the major supplier to London and South East England. It is particularly vulnerable therefore to imports attracted by the large market. It has 680 employees and in 1984 used 370,000 tonnes coal and 239 million KWh electricity. It also supplies raw materials to neighbouring Swanscombe Works, manufacturing special cements including Oilwell Cement and White Cement, being the only UK producer of these materials. (While Swanscombe would not qualify under the 'third tranche' proposal, it relies on Northfleet quarries for its raw material and hence continued operation.) The consented reserves of the primary raw material, chalk, will be totally exhausted in approximately 7 years, but it is essential for new reserves to be developed in advance. Planning permission is necessary and discussions with Kent County Council have been in progress for a long time. However, it will also be necessary to purchase land and install new extraction, handling and processing machinery at a cost in the range of £15 to £25 million. Before proceeding, the continued viability of Northfleet (and Swanscombe) Works must be confirmed. Commissioned in 1970, and converted to a more efficient process in 1983, Northfleet is relatively modern but the high moisture content and difficult handling characteristics of the new materials in South East England require the use of more energy-intensive processing to dry the raw materials. The Works is therefore more costly to operate than European plants with ideal materials. This is why exports ceased to be profitable when fuel prices escalated. The significant cost reduction arising from the proposed 'third tranche' would be a major factor in deciding to continue production in S E England, rather than import cement clinker or finished product.

iii) Potential Project, Cauldon Works (Staffordshire). A major modernisation programme nearing completion will leave Cauldon with surplus clinker capacity, which could be converted by installation of an additional finishing mill and rail despatch facilities at a cost of around £7 million. This extension would bring Cauldon into the large users category. Previous evaluations of the project have shown it not to be economic but the availability of lower cost electricity for the additional tonnage could be decisive. In addition to economic benefits, transfer of deliveries from road to rail would be beneficial to British Rail and to the environment.

7.6 As indicated above, coal is the largest single cost item in cement manufacture and its price is therefore a critical factor. While NCB are fully aware of the threat imposed by imports and have provided valued support to the locations at greatest risk, they are nevertheless exporting low cost coal to Europe. Again, they are cognisant of potential consequences for UK cement producers and avoid supplying known potential exporters with cheap coal. However these export activities must tend to have a depressing effect upon European fuel prices. If the proposed scheme achieves its objective of improving industral competitiveness and raising coal usage, the companies hope that this will reduce, or perhaps remove, NCB's need to export cheap coal and hence alleviate this additional threat to UK competitiveness.

8 PAPER AND BOARD

8.1 With 60% import penetration in the UK paper industry, partly due to high UK energy costs to large electricity intensive mills over the last 6-7 years causing uncompetitiveness, there is considerable potential for the UK industry to claw back some market share. Introduction of the proposed scheme by the six existing mills that would qualify (which produce about one third of UK output) would reduce electricity costs by between 7% and 20% - roughly equivalent to 1.5-2.0% of selling prices, currently £4-500 per tonne. All of these sites operate on a world scale, with modern plant and such is the ferocity of international competition that the savings incurred would, in the majority of sites, have a substantial positive impact on profitability and hence future investment in the UK.

8.2 Without the benefits of the scheme, and in order to continue to take advantage of CLC, there could be a need for further investment in standby and self generating plant to enable the contractual criteria to be met - a ridiculous situation in a country with excess generating capacity standing idle. This would divert cash flow away from the mainstream of paper and board making, which could further impact on the competitiveness of the companies concerned. This is additional to the costs incurred by the companies in having to shut down production in order to meet the contract load criteria. The impact of the scheme in specific mills is described below.

Mill A

8.3 This mill has invested nearly £15 M over the last four years in order to maintain its competitive position in the world markets that it is serving. Introduction of the scheme would result in projected savings of £1.7 M pa. The significance of these savings is apparent when related to pre-tax/pre-interest profits which, over the past four years, have amounted to a mean of £1.97 M; £1.2 M at worst and £3.0 M at best. The company is considering investing a further £14m over the

next four years. The investment, which covers two interdependent areas of the company's business, would preserve some 1000 jobs. Energy prices are a major component in the cost of the produot and hence the company's competitiveness. Price reductions from the introduction of the proposed scheme have a major influence on the investment decision.

Mill B

8.4 This mill has a proven track record of taking advantage of every single scheme aimed at lowering energy costs. They would most definitely join the scheme under the terms proposed. With the savings from the scheme expected to be in the order of 10-15% pa, there would be a dramatic impact on profitability and, hence, on the mill's investment profile:

- the mill would proceed with a £4.5 M investment which would increase output of a particular paper grade by 35%. If this investment were not to take place some 500 jobs would be placed in jeopardy.

- the mill has recently invested some £12.5 M on a particular paper machine with the result that that machine is now the only one in the UK which is competitive with European and Scandinavian producers. If sufficient profits were to be generated, an additional £2.5 M would be spent in order to raise output by 20%. This additional investment would also ensure that the product remained competitive.

- a further section of the mill manufactures two grades of paper and the viability of one is dependent on the existence of the other. The competition is investing heavily and unless the mill follows suit, there would be considerable doubt about the future of the whole site, thereby jeopardising the current workforce of 660. In order to remain competitive the mill would have to invest £5 M which would increase output for one grade of paper by 30% and upgrade the quality of the other grade. A part of this investment would be the installation of a second processing unit which would create 16 new jobs.

Other qualifying mills

8.5 All six qualifying mills have had a higher than average investment profile in recent years - some £300 million in total. The remaining four mills all have a number of planned investments for which the decision to proceed could be influenced by the introduction of the scheme.

New Pulp Mill

8.6 Increasing supplies of uncommitted timber in northern Scotland would support either a 100,000 tonne (£35m) tissue-linked mechanical pulp mill or a 150,000 tonne (£125m) integrated mechanical printing paper mill. The former would create employment of 110, and the latter 330. Energy accounts for approximately 18% of the cost of the product. The proposed scheme will therefore have a significant impact on the decision to proceed with a new pulp mill and, in fact, the price of electricity was a major reason why an earlier Scottish newsprint project was never realised.

Investment in New Technology

8.7 In addition, reduced electricity prices would generate extra cash for investing in new technology (eg radio frequency drying) thereby further improving competiveness. At the moment, high electricity prices are inhibiting investment in new technology which consumes high levels of electricity.

Electricity Consumption - Paper Industry

8.8 Purchased electricity by the qualifying mills would probably increase by some 300 million KWh as a result of a switch away from self-generated electricity. If this switch were not to take place, four of the qualifying mills would have to spend approximately £60 million over the next five years to maintain existing levels of self-generating capacity thus diverting funds away from the mainstream business activity. A further 60 million KWh pa of purchased electricity would be realised if the investments identified for Mill A and Mill B were to be implemented. A new 100,000 tonne pulp mill would have a purchased electricity consumption in excess of 100 million KWh pa.

9 STEEL

9.1 Overall Picture

The proposed scheme would directly help the steel industry in increasing its market penetration in Europe and elsewhere. This will be particularly important when existing European Commission production and trade quota constraints are eased. It would have a significant impact on special and engineering steels currently produced in the main by the electric steelmaking route.

9.2 Impact of the Proposed Scheme

9.2.1 The scheme will enable companies to improve competitiveness and expand market share. BSC believe that production at their Thrybergh bar mill will increase by 135,000 tonnes because of enhanced competitiveness and sales in export markets. This will lead to incremental consumption of 145 million KWh of electricity and create 100 extra jobs. Allied Steel and Wire and Sheerness Steel would each anticipate a 10% increase in electricity consumption and Brymbo a 5% increase.

9.2.2 Introduction of the scheme will enable companies to introduce new, competitiveness enhancing technology. Particular examples are the projects on edge heating of strip, arc heated secondary steelmaking units for integrated Works, electrical control of hot metal temperature and also electrical control of steel temperature in the tundishes of continuous casting machines. All these projects are aimed at improving product quality which is essential in maintaining market competitiveness and would probably result in up to 500 million KWh of additional electricity consumption across BSC. Introduction of secondary steelmaking would become feasible if the scheme were introduced. For example, at BSC's Aldwerke plant electricity consumption could be increased by 15% and some new jobs created.

9.2.3 Some reduction in own-generated electricity in cases where currently the difference in costs between purchased and self-generated electricity is marginal would take place. This would lead to an increase in demand from the ESI.

9.3 Results of Maintenance of Current Policies

9.3.1 Companies will continue to be forced to reduce electricity consumption by new processes and technology. For example, oxy-fuel replacement of electricity in electric arc furnaces will be introduced by BSC and lead to a sector wide decline in electricity demand of up to 180 million KWh pa.

9.3.2 The current level of manpower in the Private Sector and BSC involved in electrical steelmaking is 15,000. The industry expects that if electricity prices are not reduced, between 2-3,000 further jobs in the electric steel making sector will be lost including possible closure of a major works over the next four years, and that electricity consumption will be reduced by around 500 million KWh pa.

9.4 Private Sector Case Histories

9.4.1 Three private sector steel companies operating four electric arc steelworks see the prospects as follows (making reasonable assumptions about other economic circumstances).

9.4.2 Allied Steel & Wire

The savings on electricity prices could be channelled into attacking a significant UK market sector (light sections) where import penetration is now nearly 40%, or into exploiting substantial third world export opportunities where price is the main constraint, or a combination of the two. The net result should be an increase in steel melting production of 10% and a consequent increase in electricity consumption.

The company are considering an investment to upgrade two of their electric arc furnaces at a cost of £6 million. This would become certain rather than possible and in any case brought forward if electricity costs were reduced. They also contemplate the closure of the arc furnace at one of their works and this could possibly be saved if electricity costs were reduced.

It is unlikely that employment would be substantially increased because of continuing productivity improvements. Without production increases, manpower will definitely reduce especially as one works may well be closed (at a loss of 250 jobs).

Without a reduction in UK electricity costs there will be even more severe competitiion in two or three years time from electric arc developments in France where it is accepted that electricity prices are very much lower than in the UK.

9.4.3 Sheerness Steel

This company is in a similar market to the above and would expect about the same increase in market opportunities, production and electricity consumption ie 10%. In addition they would expect their customers in the wiredrawing sector to increase their exports and reduce imports of wire because of the price competitiveness which could be available.

The company have in mind to operate one furnace and close their other in 2 or 3 years time. A reduced electricity price could encourage it to maintain the second furnace; if so electricity consumption could be 50% higher than otherwise.

No significant increase in labour employed is envisaged. The downside is similar to that for ASW.

9.4.4 Brymbo

This company operates in a high quality steel market where international competition is intense. Savings from the scheme would be 0.7% of selling prices. Following the doubling of productivity over the last 5 years substantial further labour productivity improvements are now unlikely, but will continue at perhaps 3% a year. Savings in energy and also electrode and industrial gases costs (both of which are electricity intensive) now offer the best scope for cost improvements.

The company would expect to increase its exports by about 10% because of the electricity price reductions from the proposed scheme, and as a result its electricity consumption by about 5%. This expansion would protect jobs which could otherwise be lost by gradually increasing productivity. The general improvement in costs would ultimately assist its UK engineering customers in protecting and expanding their market in motor components.

All the companies would expect beneficial effects of reduced electricity prices to accrue almost immediately.

National Economic Development Office
Millbank Tower
Millbank
London SW1P 4QX

5 July 1985

ANNEX I

COMPANY SECRET

SUMMARY OF THE ECONOMIC EFFECT OF THE LARGE USER INDUSTRIAL TARIFF ON ICI

MOND DIVISION OF ICI

Scenario	Existing Tariff								New Industrial Tariff							
	Probable				Possible Additional				Probable				Possible Additional			
	Site	Year	mu	Jobs Direct ICI (Indirect) UK	Site	Year	mu	Jobs Direct ICI (Indirect) UK	Site	Year	mu	Jobs Direct ICI (Indirect) UK	Site	Year	mu	Jobs Direct ICI (Indirect) UK
Plant Closures*																
Chlorine	Wilton	1986	600	(-) 175(350)												
"	Runcorn	1988	600	350(700)												
Chlorine/PVC	Fleet-wood	1989	350	400(800)												
New Investment																
Chlorine (replace)									Wilton	1986	n/c	**250(500)				
"									Runcorn	1990	n/c	**250(500)				
"													Fleet-wood	1988	n/c	**250(500)
Fuel Substitution																
Gas/Condensing									Runcorn	1986	(+) 400					
									Fleet-wood	1987	100					
Total Impact																
Electricity			(-) 1550								(+) 500ø					
Jobs Lost				(-) 925(1850)								(+) 500(1000)			-	(+) 250

*UK Balance of payments will be adversely affected by the above closures by approximately £150m/yr in total.

**The new investments would hold steady the numbers of people directly employed. Further there would for each of the initial 2 years be additional employment for c.250 people on each project for design, fabrication and erection work. With ICI's cell licensing activities worldwide it would be hoped to sustain that level thereafter.

øChlorine electricity consumption swing of 2000 mu equates 1 million tonnes coal.

Annex I

COMPANY SECRET

SUMMARY OF THE ECONOMIC EFFECT OF THE LARGE USER INDUSTRIAL TARIFF ON ICI

PETROCHEMICALS & PLASTICS DIVISION OF ICI

Scenario	Existing Tariff								New Industrial Tariff							
	Probable				Possible Additional				Probable				Possible Additional			
	Site	Year	mu	Jobs Direct ICI (Indirect) UK	Site	Year	mu	Jobs Direct ICI (Indirect) UK	Site	Year	mu	Jobs Direct ICI (Indirect) UK	Site	Year	mu	Jobs Direct ICI (Indirect) UK
Plant Closures*																
New Investment																
Fuel Substitution		1986	-							1986	(+)175					
Total Impact																
Electricity											(+)175				-	(+)250
Jobs Lost																

KJGD3DOC25P2:HB

ANNEX I

COMPANY SECRET

SUMMARY OF THE ECONOMIC EFFECT OF THE LARGE USER INDUSTRIAL TARIFF ON ICI

AGRICULTURAL DIVISION OF ICI

Scenario	Existing Tariff								New Industrial Tariff							
	Probable				Possible Additional				Probable				Possible Additional			
	Site	Year	mu	Jobs Direct ICI (Indirect) UK	Site	Year	mu	Jobs Direct ICI (Indirect) UK	Site	Year	mu	Jobs Direct ICI (Indirect) UK	Site	Year	mu	Jobs Direct ICI (Indirect) UK
Plant Closures					Billingham Ammonia/ Fertiliser/ Methanol	1985/ 1995	- (-)800	(-)6000 (-)(12000)								
New Investment										1985- 1995	(+) 1000					
Fuel Substitution																
Total Impact																
Electricity							(-)800				(+) 1000					
Jobs Lost								(-)6000 (-)(12000)				(-)1500				

KJGD3DOC25P3:HB

ELECTRICITY PRICES

FIRST TRANCHE AT £46/ton

2nd " " £38/ton

Now 3rd Tranche at £32/ton = Long Term Price from Selby, Nottingham etc

Cost = (4 M tons) × (£44 − £32) − (x M tons) × £32

↑ Initial Third Tranche

↑ Extra Business Stimulated

= £(48 − 32x) M

Break Even at $x = 1\frac{1}{2}$ — Should be easy

Direct Jobs stimulated with it ≃ 1000

Jobs lost without it ≃ 15000 ?

Real value is long term.

Anti-Scargill

Pro Nottingham Mines

Pro advanced technology : Pilkington's to Electric Melting

Steel to Electric Arc Furnaces.

Resists drift of industry to France.

CONFIDENTIAL

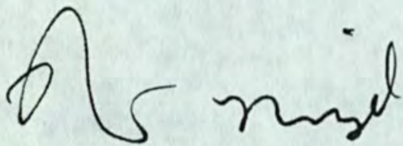
NBPM
AT 25/7

CC NO

01 211 6402

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
London
SW1P 3AG

23 July 1985



ELECTRICITY SUPPLY INDUSTRY PAY

I have now heard from the Electricity Council that a settlement was reached on managers' pay at the meeting on Friday 19 July. This was along the lines set out in my letter to you of 15 July and consists of the following elements:-

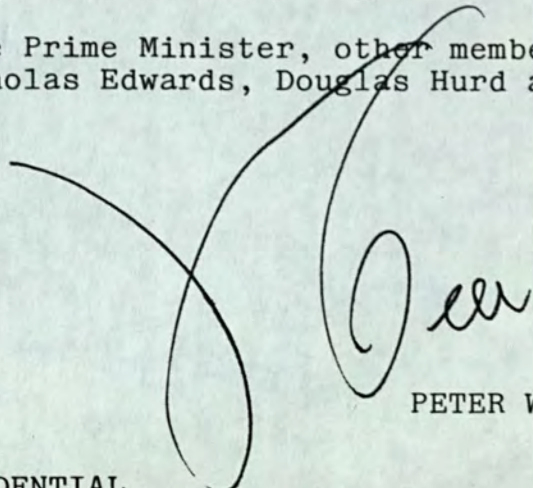
i) A general increase of 6.7%;

ii) The addition of an increment to the top of the Band VI, VII and VIII scales and the removal of the bottom point with effect from 1 April 1985; and

iii) The addition of an increment to the top and the removal of the bottom point of all scales with effect from 31 March 1986.

The increase in average earnings will be about 6.5%.

I am copying this letter to the Prime Minister, other members of E(PSP), George Younger, Nicholas Edwards, Douglas Hurd and Sir Robert Armstrong.



PETER WALKER

CONFIDENTIAL

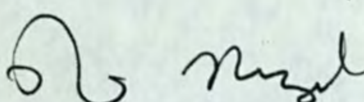
NBPM

AT 23/7

01 211 6402

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

22 July 1985



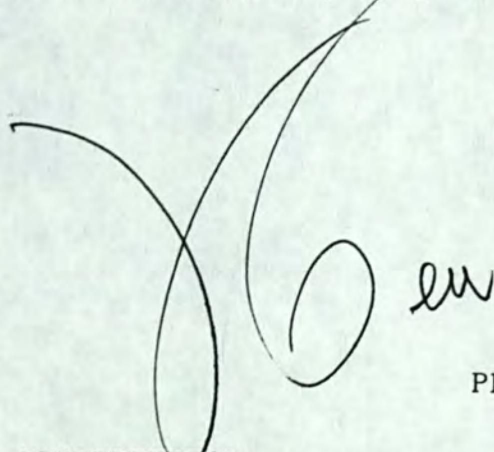
ELECTRICITY SUPPLY INDUSTRY PAY

My letter of 15 July described the final offers by the Electricity Council to the clerical unions for clerical grades and for professional and administrative grades. I promised to keep you in touch with progress.

There was a further meeting of the NJC on 17 July. The unions indicated that they would recommend acceptance of the offers to their executives. The decision will not be known until the second week of August; but the Electricity Council believe that it will be favourable.

There are two points besides those in my letter of 15 July which I should mention. First, the Electricity Council have secured as part of the prospective deal a helpful joint statement giving Electricity Boards much greater freedom to introduce new technology: it will, for example, accept that differences of view between management and unions over grading will not prevent the introduction of new equipment. Secondly, the overtime calculator for the grades concerned will not be increased until 1 August; and even then it will be increased only to 1984 salary levels.

I am sending copies of this letter to the Prime Minister, other members of E(PSP), George Younger, Nicholas Edwards, Douglas Hurd and Sir Robert Armstrong.



PETER WALKER

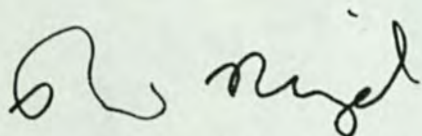
NAT IND: Gas + Elec Pt 11

NDPM
16/7

01 211 6402

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

15 July 1985



ELECTRICITY SUPPLY INDUSTRY PAY

Thank you for your letter of 8 July. In the event, the Electricity Council made what they described as their final offer to the clerical unions at the 9 July meeting. The increases in salary ranged from 4.0% to 5.9%, giving an increase in average earnings of some 5.2%. The Electricity Council also sought concessions on the introduction of new technology and proposed the addition of a new lower point at the bottom of all clerical pay scales in order to depress the rates paid to new entrants in future. The professional and administrative grades were made a parallel offer to the NJB settlement which would increase average earnings by just fractionally below 6%.

The unions will now consult their Electricity Committee and will give their formal response to the offers at the meeting on Wednesday 17 July. This may, or may not, be the final stage and I will keep you informed of progress.

In your letter you seemed to imply that you wished to argue that the engineers and manuals should be regarded as special cases. In the first place it would be invidious, and indeed erroneous, to employ such an argument. It would imply that people such as quite senior administrators, finance and contract officers and computer staff did not make a significant contribution to the industry's overall achievement during the dispute. This was clearly not the case. In the second place, as I made clear in my letter of 21 June the two settlements reached so far can scarcely be described as generous in the circumstances particularly given the general level of private sector settlements.

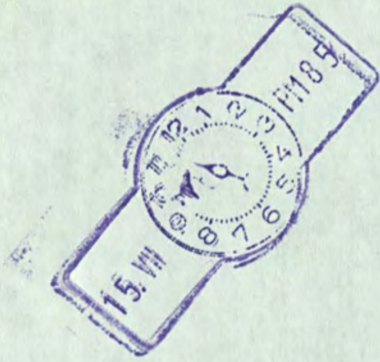
You also asked about the Electricity Council's intended approach to the meeting on managers' pay on Friday 19 July. There is a formal link between the top of the Principal Engineers' scale and the top of the managers' Band III scale arising from a 1979 arbitration award. I understand that the Electricity Council therefore expect to make an offer matching the increase at the top of the engineers' scale ie a general increase of 6.7%. They also propose the addition of an

increment to the top of the Band VI, VII, and VIII scales. The managerial pay scales have been significantly compressed over time and the Electricity Council believe it is essential to motivate their managers adequately, particularly given their response during the strike and their key position in terms of power station endurance. They believe that such an offer is the lowest possible in the circumstances, particularly given the upward movement in private sector salaries at this level.

I am copying this letter to the Prime Minister, other members of E(PSP), George Younger, Nicholas Edwards, Douglas Hurd and Sir Robert Armstrong.

PETER WALKER

GAS & Elec. NAT. IND. Pt 11.



M10.1 **CONFIDENTIAL**

cc NO

ND/PM
AT
9/7

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

8 July 1985

The Rt Hon Peter Walker MBE MP
Secretary of State for Energy
Department of Energy
Thames House South
Millbank
LONDON SW1

Dear Peter

ELECTRICITY SUPPLY INDUSTRY PAY

You wrote to me on 2 July about the ESI negotiations with managers, with professional and administrative staff and with clerical staff.

I am disappointed to learn that, despite our earlier correspondence, the Electricity Council have made an offer to their professional and technical staff so close to the settlement agreed with the engineers and above that for the manuals. That makes it harder to argue that the engineers and manuals have been treated as special cases and I therefore hope you will find it possible to dissuade the Electricity Council from increasing their offer to eliminate completely any gap with the engineers' settlement.

These developments may well make it more difficult for the Electricity Council to reach a settlement with their clerical staff substantially below the settlement with their manuals. But I think it important that they should do so. A settlement at this level would also, of course, make it harder for the ESI to meet its cost reduction target with its implications for economy and efficiency.

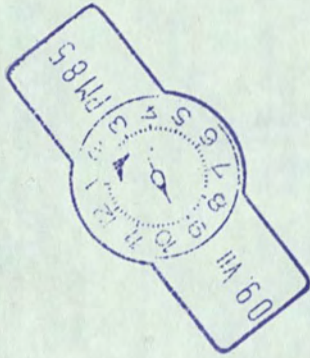
I am grateful to you for keeping me in close touch with these negotiations. You mention that there will be a meeting on ESI managers' pay on 19 July and I should be glad of the opportunity to comment on the ESI's plans before it makes any offer.

I am copying this letter to the Prime Minister, to other members of E(PSP), to George Younger, Nick Edwards and Douglas Hurd and to Sir Robert Armstrong.

Yours ever
Nigel

NIGEL LAWSON

NAT IND: Gas & Elec: Pt 11.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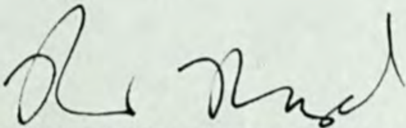
cc P. Unit

NB PM
AT 2/7

01 211 6402

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

2 July 1985



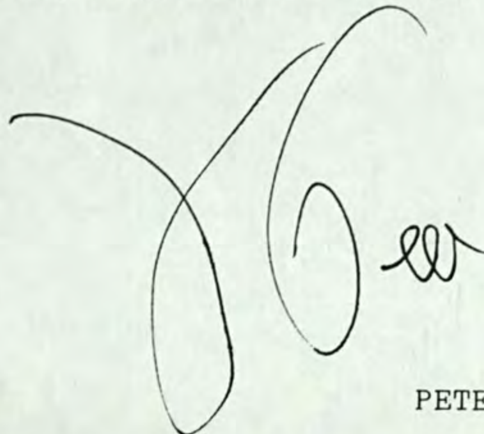
ELECTRICITY SUPPLY INDUSTRY PAY

As expected, negotiations with the unions representing the professional, administrative and clerical staff did not reach any conclusion last week. Slightly improved pay offers were made to both the clerical staff (worth some 4.8% on average earnings) and to the professional and administrative staff (worth some 6% on average earnings). While some progress was made in drawing up a new agreement with the unions about the introduction of new technology, no overall settlement was reached.

A further all-day meeting has been arranged for Tuesday 9 July and a full meeting of the National Joint Council on Wednesday 17 July. The Electricity Council expect to make their final offer at the second meeting and the unions are then expected to consult their membership. The Electricity Council expect their final offer to the clericals to be below the level of the manuals' settlement and that the professional and administrative staff will accept essentially the same settlement as the engineers. It is likely that no final settlement will be reached until August. I will keep you informed of progress.

A meeting of the National Joint Managerial Committee has now been fixed for Friday 19 July to discuss the pay settlement for the managers.

I am copying this letter to the Prime Minister, others members of E(PSP), George Younger, Nicholas Edwards, Douglas Hurd and Sir Robert Armstrong.



PETER WALKER

CONFIDENTIAL

CONFIDENTIAL

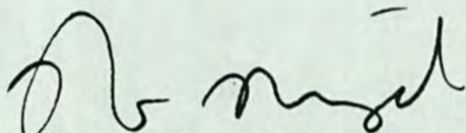
CCND

NDPM
AT 21/6

01 211 6402

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
London
SW1P 3AG

21 June 1985

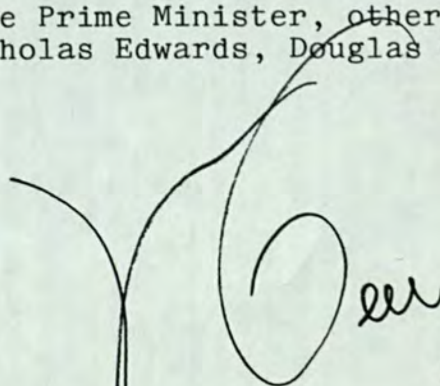


ELECTRICITY SUPPLY INDUSTRY PAY

Thank you for your letter of 17 June. I can now confirm that the engineers' pay settlement has been ratified by the unions at their meeting this week. As you say, I believe that the Electricity Council has achieved two very good settlements so far, although I would scarcely call them generous given the circumstances and particularly the general level of private sector settlements.

As far as the remaining negotiations are concerned, I have made it clear all along that the Electricity Council negotiators will try to obtain the lowest possible settlement. In line with this, at the meeting on Wednesday 19 June the clericals were offered substantially less than the manuals had accepted. The Electricity Council's offer, worth some 4.4% on average earnings, was rejected out of hand. For the professional and administrative grades, where the position is significantly constrained by relativities with the engineers, an opening offer a bit below the level of the engineers' settlement was also rejected by the unions. The discussions were adjourned and a further meeting will be held on Thursday 27 June. The Electricity Council's view is that it is unlikely that they will reach a settlement at that meeting. I will keep you informed of progress.

I am copying this letter to the Prime Minister, other members of E(PSP), George Younger, Nicholas Edwards, Douglas Hurd and Sir Robert Armstrong.



PETER WALKER

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NAT IND: Gas & elec: Pt 11.

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NBPM 17/6 CCNO

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

17 June 1985

The Rt Hon Peter Walker MBE MP
Secretary of State for Energy
Department of Energy
Thames House South
Millbank
LONDON SW1

Dear Peter

ENERGY INDUSTRY PAY

Thank you for your letter of 13 June. In all the circumstances, it looks as though the Electricity Council have handled their negotiations satisfactorily with their manuals and the engineers.

I am, however, concerned at the suggestion in your letter that the settlement with other ESI grades might not be significantly lower than for the manuals and engineers. We exchanged letters about this in April and had, I hope, agreed that on both merits and affordability, there was no case for allowing the same generous treatment for all the groups in the industry, in particular the clerical grades. We must ensure that the settlements are clearly differentiated both within and outside the ESI.

May I also raise a separate point on the UKAEA negotiations? As I said in my letter of 5 June, I was grateful that the UKAEA management kept their offer to their manuals to 5 per cent. I believe this contributed to the civil service industrials' decision not to reject the Treasury's offer of 4.9 per cent on 10 June.

The subsequent consultation process with the civil service industrials' members should be completed by 15 July but we cannot be certain of its outcome. I understand that the UKAEA have a further negotiating meeting with their manuals on 2 July, and there must be a real risk that, if they increase their offer then,that could lessen the chances of the 100,000 civil service industrials settling for 4.9 per cent - the two groups have common unions. I should be grateful, therefore, if you could press the UKAEA to stand firm on 5 per cent.

I am copying this letter to the Prime Minister and to Sir Robert Armstrong.

Yours
Nigel

NIGEL LAWSON

NATIND Pt 11 GAS TELECTRIC

File

CONFIDENTIAL

MR TURNBULL 14 June 1985

GAS PRIVATISATION - COMMON CARRIER PROVISIONS OF THE OIL AND GAS ENTERPRISE ACT, 1982

At Tuesday's E(A) discussion on gas privatisation, Patrick Jenkin pressed the case for greater use of the common carrier provisions of the Oil and Gas Enterprise Act to promote competition in the supply of gas to end consumers. The discussion indicated that there is still some confusion as regards the scope of this aspect of the Act.

Until the Oil and Gas Enterprise Act came into force, BGC had the monopoly to supply all classes of consumer in the UK. The Act effectively removed this monopoly for medium and large business consumers. To facilitate competitive gas supplies to such businesses, the Act not only removed BGC's monopoly, but also gave private sector producers access to BGC's distribution network for a tariff - ie the concept of common carrier pipelines. So far, no private sector producer has used this facility, although Shell/Esso has had exploratory discussions in one case. Various factors account for this:

- Operationally, it is difficult to match demand and supply, especially in the case of supplies from offshore gas fields. The smaller the gas field, the easier it is to market the gas to a limited number of large customers. On the other hand, the smaller the field, the more prone it is to operational shutdowns and disruptions, either planned or often unforeseen. BGC is able to maintain

supply continuity efficiently and flexibly by having a large portfolio of supply contracts, a highly flexible distribution network, some storage capability, and further flexibility in the form of interruptible industrial customers.

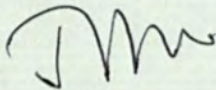
- Even for onshore gas fields, use of the common carrier provisions is not necessarily straightforward. Disparities of gas pressure and quality may pose difficult operational and contractual problems.

- BGC are not required to publish and adhere to set tariff scales for carrying third party gas. To be fair, the setting of equitable tariff scales would be extremely complex because of the different variables relating to duration of supply, flexibility, pressure and quality. Thus, in any negotiation with prospective third party carriers, BGC have the dual advantage of being able to discourage competitive supply deals by quoting high tariffs, whilst offering prices for straightforward gas purchase which remove the incentive to compete.

- In any case, most gas producers realistically regard BGC as their prime customer. Even in the unusual circumstances where a direct supply deal via BGC's distribution network would be commercially and operationally achievable, producers are reluctant to antagonise BGC by challenging their monopoly.

One of the more significant features of the proposed gas legislation is the intention to offer public gas supply licences in areas not so far served by BGC. This could present very interesting business opportunities for small onshore gas fields. It may well succeed where the Oil and Gas Enterprise Act had failed in providing the stimulus of competition around the fringes of BGC's business.

In any event, it must be assumed that BGC will retain its monopoly over the great majority of the UK gas market; hence the critical importance of the regulatory régime for the privatised British Gas.



JOHN WYBREW

NDPM
AT
13/6

01 211 6402

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
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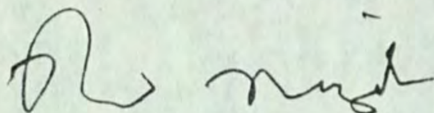
13 June 1985

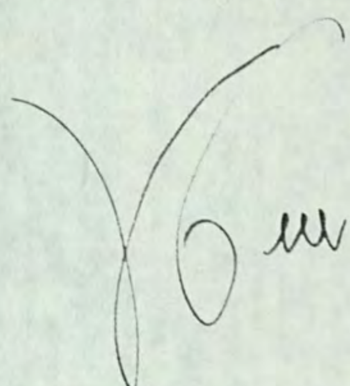


ELECTRICITY SUPPLY INDUSTRY PAY

I can now confirm that the manuals' pay settlement has been ratified by the unions at their meeting this week. This should now lead to the similar ratification of the engineers' pay settlement on Tuesday, 18 June.

The Electricity Council has been refusing to discuss the clerical workers' pay claim while NALGO members were taking industrial action to try to secure a 35 hour week. In view of this, NALGO has now agreed to lift its industrial action so that pay negotiations can begin. The Electricity Council will therefore meet the unions representing professional, administrative and clerical staff at a meeting of the National Joint Council on Wednesday, 19 June. They will be seeking to achieve the lowest possible settlement consistent with the settlements for the manuals and the engineers.

I am copying this letter to the Prime Minister, other members of E(PSP), George Younger, Nicholas Edwards, Douglas Hurd and Sir Robert Armstrong.



PETER WALKER

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Copy No. 9. of 18

DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

E(A) folder

3

The Rt Hon Peter Walker MP
Secretary of State for Energy
Department of Energy
Thames House South
Millbank
LONDON SW1P 4QJ

10 June 1985

Dear Peter

GAS INDUSTRY PRIVATISATION

I have seen your memorandum (E(A)(85)30) [see Pt 6] dated 24 May about the privatisation of BGC and I look forward to this week's discussion in the sub-Committee.

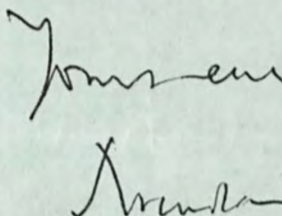
At the earlier meeting of E(A), and again in Cabinet, I argued that the BGC should be restructured before privatisation, with the gas showrooms and the installation business established as separate subsidiary companies. I remain convinced that failure to do this would make your proposals less attractive.

In my view it is important, in the interests of free competition, to exclude the possibility of cross-subsidy between the various sectors of the gas industry. Setting up the showrooms as separate, subsidiary companies, with their own set of published accounts would be one way of providing the degree of transparency necessary to reveal hidden cross-subsidies. It would also provide a clearer and more efficient management structure and expose these businesses to the full effect of market forces.

By confining the operations of the regulatory agency to the gas supply business only, you have already gone some

way towards recognising that different parts of the gas industry require separate treatment. My proposal would reinforce what you are already suggesting and help to make privatisation of a large monopoly more palatable to our supporters. I recognise that there may be other ways of excluding cross-subsidy but I think colleagues would find it helpful if we were to have a preliminary discussion of the possibilities on 11 June.

I am copying this letter to members of E(A), Sir Geoffrey Howe and Sir Robert Armstrong.



NICHOLAS RIDLEY

NAT IND: Gas Pt. 11

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Reference No E055

PRIME MINISTER

Gas Industry Privatisation Regulation

FLAG A (E(A)(85)30)

BACKGROUND

FLAG B Following discussion in E(A) on 25 April (E(A)(85)9th Meeting, Item 2), the Cabinet on 2 May invited the Secretary of State for Energy to submit a further paper to E(A) on the major aspects of gas industry privatisation, including:

(a) the form of regulation;

(b) the continuing obligations and responsibilities of the privatised gas industry; and

(c) the treatment of gas imports and exports.

2. The Secretary of State for Energy's paper (E(A)(85)30) is the result. It deals with (a) and (b) and promises recommendations on (c), which Mr Walker is discussing with Treasury.

Proposals

3. Mr Walker's paper proposes:

(a) regulation through a regulatory body (OFGAS) on gas supply (ie transmission and distribution of gas) where BGC has a monopoly, and not on those areas (production and exploration, gas purchasing, gas appliance retailing, installation and servicing of appliances) where BGC does not;

(b) a ring-fence around the main gas supply business to exclude cross-subsidy to other activities;

(c) that BGC's prices be regulated using a version of RPI (rate of inflation) - X (target reduction in onshore costs) + Y (increase in gas costs) rather than profit control;

(d) obligations the new company will have to fulfil - essentially BGC's present obligations in respect of gas supply, pipelaying, disconnections, free emergency services, and carriage of third party gas;

(e) to enable others to become licensed gas suppliers with the same rights and obligations in areas not already covered by the company.

MAIN ISSUES

4. The main issues with which Mr Walker's paper deals are:

(a) the regulatory regime;

(b) the legal obligations the new company will have to meet.

Regulatory Regime

5. The regulatory regime should offer potential investors a reasonable prospect of profits and give BGC's 16¼ million customers enough confidence that privatisation will not mean sharp price increases.

6. Mr Walker proposes that OFGAS should police the gas supply functions of the new company where the new company will have a monopoly; but not those other areas where it will not (but where the new company will be subject to the usual controls of the MMC and the Office of Fair Trading). These other areas are appliance retailing (9,000 staff; turnover £219 million); installation, servicing and contracts (30,000 staff; turnover £278 million); and offshore assets. The new company would presumably decide on the development of those other areas in the light of its own commercial judgement. (If privatised,

BGC might, for instance, decide to retain and develop any future oil discoveries, or even seek to recover former BGC oil assets (Wytch Farm, Enterprise Oil) already disposed of, although this latter is a theoretical rather than real possibility).

7. Mr Walker's proposed price regulation formula is fairly simple and similar to OFTEL's. It is RPI (rate of inflation) - X (target reduction in onshore costs) + Y (increases in gas costs) (on the grounds that Y is beyond the short term control of the industry). Mr Walker believes regulation via profit control would be too interventionist, a disincentive to efficiency and a deterrent to potential investors.

8. Because marginal supplies of gas cost more than the average, this form of price regulation will have an impact on BGC different from its impact on BT (which faces marginal costs in undertaking new business which are generally below the average). Because of this, BGC will not have the same scope for increasing profits by increasing its business volume that BT enjoys. In terms of economic theory, price control by reference to average costs may even result in reductions in profitability as business expands, since BGC will not be able to load its higher marginal gas costs on to new customers. The result could be a situation in which gas prices were below those of competing fuels, despite the fact that additions to the supply of these fuels were cheaper than additions to the supply of gas. If such a situation were to arise, there could be net overall losses to the UK economy, as well as a fall in the relative profitability of BGC. This form of price regulation also has the effect of removing any scope for price discrimination between different classes of customers. At present BGC, unlike the suppliers of electricity, has no obligation to avoid such discrimination, and as a result has been able to structure its prices to certain very large users, whose energy costs represent a particularly high proportion of total costs, so as to help them to remain internationally competitive. Finally, a form of price control which simply allows BGC to pass its gas purchase costs on to the consumer could have the effect of making the Corporation

[Handwritten margin note: This is the position at present.]

relatively indifferent to the level of those costs, since its profits would be little affected by its success or otherwise in securing new supplies of gas at keen prices.

9. It may well be in practice that substantial problems will not arise in these areas. Undoubtedly a cost reduction objective (as is implied by 'X') is preferable to profit control; and X can only be specified in the light of a detailed analysis of the shape of the business. But it would seem desirable to have some analysis of the impact of the proposed form of price regulation on the shape and profitability of the business before Ministers commit themselves fully to Mr Walker's proposed form of price regulation. We understand that the Department of Energy are working on a paper which would meet this remit, which they hope to have ready before the Summer Recess.

Legal Obligations

10. The fewer, and the less onerous, the obligations of the new company, the more attractive it will be to prospective investors. But removal of obligations would be likely to attract public criticism. The legal obligations Mr Walker proposes for the new company are set out in paragraph 9 of his paper. Essentially they are the same obligations (as regards the gas supply system, free emergency service, rules on disconnections, laying of pipes) which BGC has under the Gas Act or existing voluntary codes. Mr Walker also proposes that the legislation should enable others to become licensed public gas suppliers with the same rights and obligations in areas not already covered by the new company. (Other suppliers are, in fact, unlikely to play more than a marginal role in the market).

FURTHER WORK

11. Mr Walker recognises that further work is needed on several other important issues before decisions can be taken. These are:

(a) should price regulation apply to all BGC's gas sales;

(b) how the Gas Levy should be transferred to the new company;

(c) relationship between OFGAS and OFTEL;

(d) role of the Consumer Councils;

(e) gas imports and exports;

(f) the role of HSE in safety aspects under the new regime;

(g) transfer of pension funds from BGC to the new company.

12. These raise the following issues:

(a) Price Regulation

Should all BGC's gas sales be subject to price regulation? Mr Walker's paper suggests that some categories like interruptible gas supplies to industry could be exempted because of the option of alternative supplies. By contrast, Annex I of Mr Walker's earlier paper (E(A)(85)24) assumed (paragraph 6) that all BGC's gas sales should be regulated. In practice, given BGC's continuing obligations to supply, and the nature of the price control proposed for the generality of consumers, it would not undermine the overall approach to exempt certain supplies from the price control and could help to overcome some of the potential difficulties noted in paragraphs 8-9 above.

FLAG C

(b) Gas Levy

BGC receive significant windfall profits on old PRT-exempt contracts. The Gas Levy recoups some of these (currently 4p a therm bringing in about £525 million a year) for the Exchequer, and will do so until the fields concerned become exhausted in the early 1990s. At present, the rate can be varied by Order. Appropriate measures will need to be taken to carry over the Gas Levy into the new company. Freezing the rate would accelerate the real reduction in Exchequer take as the fields

tail off, and would give the new company significant economic rent. Increasing the rate would reduce the new company's profits (and reduce sale proceeds) or, alternatively, lead to increased gas prices (inviting criticism that privatisation means higher gas prices). Mr Walker believes the level of the Gas Levy can only be determined nearer the time of sale, but feels it would almost certainly have to be at its current level. It would be useful to have in due course some ball-park numbers illustrating what is at stake on this issue.

(c) Relations between OFGAS and OFTEL

Mr Walker has asked officials to explore how OFGAS and OFTEL might pool experience.

(d) Role of the Gas Consumer Councils

Mr Walker doubts whether existing Gas Consumer Councils would fit in with the new regulatory body. OFGAS might wish to establish independent machinery to handle consumer complaints, or the industry itself might do so. Unless something is arranged, consumer lobbies will be critical. Mr Walker does not say which solution he prefers, although he recognises something will have to be done.

(e) Import/Export of Gas

Mr Walker merely indicates in this paper that he is consulting the Treasury about this issue; the Foreign and Commonwealth Secretary has asked that his Department be included in the discussions. There has been some study of the possibility of a controlled export regime for UKCS gas, but it seems unlikely that this would prove compatible with the Treaty of Rome; control over imports has hitherto been achieved by means of informal pressure on BGC (notably in the case of the proposed purchase of Sleipner gas). As Mr Walker notes, the existing power to control the installation of submarine pipelines will remain, and this will give the Government some leverage against future proposals for gas imports; but it seems unlikely that this power could serve for an extended period to prevent a

to another Sleipner.

privatised BGC from importing a stream of non-UK gas, and there would be a high risk of challenge in the European Court if the Government sought in this way to block gas imports.

These considerations suggest that it would not be appropriate for the new legislation to include any specific provisions on gas imports and exports. But the Government's decisions on this point will be of great importance in determining the acceptability of privatisation to the consumer and to UKCS licensees, in assuring the success (or otherwise) of the privatised company, and in influencing future UKCS activity and tax revenues therefrom. Although BGC's legal monopsony was broken by the Oil and Gas Enterprise Act 1982, their de facto monopsony remains in force; if BGC were allowed to import gas without hindrance, this could greatly strengthen their hand in negotiating with developers of new UKCS gas reserves. This would be advantageous to the consumer but damaging to UKCS activity and tax revenues. Equally if imports were prevented, UKCS licensees would be in a much stronger position in negotiation with BGC, to the disadvantage of the consumer and the benefit of the Exchequer. In practice the only course may prove to be to permit both imports and exports.

This issue will be very important to the success of privatisation, but neither Mr Walker nor Mr Lawson apparently wishes to press it to a conclusion in the near future. No early statement is likely to be needed from the Government about it,* although more considered views will be needed in time for the second reading of the Bill. It may be sufficient, therefore, to invite Mr Walker to put a paper to the Sub-Committee on this point in October.

(f) Safety

Department of Energy officials are discussing with HSE how safety should be handled under the new arrangements (including making Corgi - the Confederation of Registered Gas Installers - currently largely run and funded by BGC, autonomous under the HSE).

*but an FT editorial on 10 June suggests it as a topic for study by the House of Commons Select Committee on Energy.

(g) Transfer of Pension Funds
These will be taken over by the new company. Department of Energy officials are discussing with BGC.

OTHER ISSUES

13. Nearer the time of flotation decisions will need to be taken on:

(a) Employee Participation
Mr Walker is keen on this to get the support of employees for the new company and to provide protection against unwelcome takeover. In E(A)(85)24 he undertook to consult Treasury Ministers and other colleagues, but his latest paper does not report progress. If employees were given the opportunity to purchase a substantial part of BGC's equity at concessionary prices, the proceeds from the privatisation could be considerably reduced;

(b) the capital structure of the company (proportion of debt and equity) to be settled after a full financial assessment;

(c) should 100 per cent of the company be floated to reduce the risks of renationalisation;

(d) the golden share to prevent unwelcome foreign takeover;

(e) Mr Walker is also considering possible additions to strengthen the BGC Board.

TIMING

14. The timetable to which Mr Walker will need to work to prepare the necessary legislation is a tight one.

15. The Department of Energy hopes to get instructions to Parliamentary Counsel within the next few weeks. These instructions will need to cover the general regulatory framework proposed and probably the treatment of Consumer Councils.

They expect to have a paper summarising the shape and content of the Bill ready to put to the Sub-Committee in mid-July. Decisions on other issues (details of the price formula of the licence, the level of the Gas Levy, transfer of pension funds for instance), which do not affect the terms of the primary legislation, can be taken later in the year.

HANDLING

16. You will wish to invite the Secretary of State for Energy to introduce his paper. The Chancellor of the Exchequer might be asked to respond. The Secretary of State for Trade and Industry may wish to comment on the proposed regulatory regime and the treatment of Consumer Councils in the light of OFTEL, on any implications for gas prices, and on the interests of the gas appliance industry. The Secretary of State for Employment may have views on the safety regime and the role of the HSE.

17. You will wish to ask the Secretary of State for Energy how he proposes to handle the outstanding issues (see paragraph 12 above), and in what timescale. The timetable for decisions on these specific issues will vary, but you will wish to invite him to put papers to the Sub-Committee before the Summer Recess:

(i) summarising the shape and content of the Bill, and

(ii) setting out in detail the nature, form and coverage of the proposed price regulation, and analysing its impact on BGC's business.

He might be asked to put a further paper to the Sub-Committee in October on the question of imports and exports of gas.

CONCLUSIONS

18. You will wish the Sub-Committee to reach preliminary views on the following:

(a) the form of regulatory regime the Secretary of State proposes, particularly

(i) its scope - restricted to gas supply, and

(ii) the general price formula proposed;

(b) the obligations proposed for the new company;

(c) the further issues to be referred to the Sub-Committee, and the timetable for this (see paragraph 17 above).

JW

A J WIGGINS
Cabinet Office.
10 June, 1985.

PRIME MINISTER 7 June 1985

BRITISH GAS PRIVATISATION

The gas privatisation exercise has got off to a smooth start. The Department of Energy team has a good grasp of the complex task facing them and the main issues to be resolved.

The proposals submitted to E(A) are largely uncontentious.

The nature of the regulatory régime is of crucial importance. Now you are being asked only to reject an approach to regulation based on profit control. US experience provides an overwhelming case against a regulated rate of return on the capital asset base of utilities like gas. Far from such utilities having the incentive to construct and utilise capital assets well, this system encourages them to waste money on any half-justifiable capital project simply to increase the asset base, and then to put the prices up - a real licence to waste and print money. We favour a tough, price-related commercial discipline and accept that this will mean foregoing some revenue from privatisation: it is better to give customers a good deal, especially as we are not splitting BGC up and are vulnerable to criticism of monopoly power.

By the same token, we fully support the measures to foster a degree of competition at the fringes of BGC's gas

markets. The decision to enable other private sector companies to become licensed public suppliers, with the same rights and obligations as British Gas,in areas not already covered by British Gas, is significant. It could provide a useful fillip to small-scale gas exploration on land. Plenty of rural households have no access to supplies from British Gas. We could also use the legislation to enhance the thrust of the Oil and Gas Enterprise Act, for example, by requiring British Gas to publish details of the tariff structure for third-party access to their onshore gas transmission network.

Peter Walker takes it for granted that the Gas Levy will be carried over to the new company, and that it will remain at its current level. It makes sense to keep the Levy in reserve as a means of adjusting to future oil price shocks - up or down.

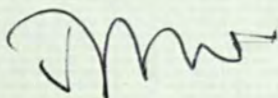
The question of whether or not to liberalise gas imports and exports awaits the outcome of consultations between Energy and the Treasury. This will be a key issue to be settled later.

The scope of that part of the legislation defining the obligations which a privatised British Gas will inherit is uncontroversial. The UK gas industry has developed over many years, largely in the private sector, and the ground rules are well proven.

You could point out that the list of other issues at the end of the paper makes no reference to limiting the scope of British Gas' activities after privatisatioin. By all means, let the upstream sector expand into oil and, if commercially attractive, venture overseas. At the retailing end of the business, British Gas should be free to maximise the return from their valuable High Street properties. However, there will be worries about British Gas using its financial strength to reduce competition, for example, by moving aggressively into the manufacture of gas appliances. The Government may need to draw attention to the general safeguards on competition and monopoly power. The converse worry is that British Gas will use its considerable resources and some of its management effort to move into areas unrelated to the gas business. This may be a matter for the articles of association.

Conclusion

We are off to a good start. Much of the legislation should be uncontentious, albeit cumbersome. The regulatory régime is crucial, but the key decisions will not be ready for reference to E(A) until the late Summer or early Autumn.



JOHN WYBREW

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CC NG

NDPM

NT 6/6

01 211 6402

The Rt Hon Nigel Lawson
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

6 June 1985

Dear Nigel

ELECTRICITY SUPPLY INDUSTRY PAY - ENGINEERS

Further to my letter of 15 May, I have now received a report from the Electricity Council on the meeting with the EPEA on Tuesday 4 June. In the event, following the successful ballot on the manuals offer, the meeting developed into a formal negotiating session with the union.

The Electricity Council followed the line set in my letter of 9 May and a settlement was finally reached along the following lines:

(i) Points 1 to 20 on the scale receive an increase in scheduled salaries of 5.9% (this covers all points that overlap the NJIC pay bands).

(ii) Points 21 to 26 receive an increase rising smoothly from 5.9% to 6.7% at point 26.

(iii) Points 27 to 40 (the top of the scale) receive an increase of 6.7%.

(iv) The level of responsibility pay will be frozen for a further twelve months and will not be increased until 31 January 1986.

(v) One increment will be added to the top of the Senior and Principal Engineers scales, and one point removed from the bottom of the two scales, with effect from 31 January 1986.

The overall effect of the settlement is an increase in average earnings of some 6.1%. The agreement reached is dependent on the NJIC settlement not being re-opened. I now understand that the NJIC will meet on Tuesday 11 June and the manuals' settlement is expected to be ratified at that meeting. If so, the settlement set out above should be ratified by the NJB at their next meeting on Tuesday 18 June. The settlement will remain confidential and no public statements will be made in the interim.

CONFIDENTIAL

CONFIDENTIAL

I am copying this letter to the Prime Minister, other members of E(PSP), George Younger, Nicholas Edwards, Douglas Hurd and Sir Robert Armstrong.

PETER WALKER

CONFIDENTIAL

NAT. IND.

GAS + Elec. Pt 10.

CENO NBPM AT 5/6

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

The Rt Hon Peter Walker MBE, MP
Secretary of State for Energy

5 June 1985

Dear Secretary of State,

ENERGY INDUSTRY PAY

I was grateful for your letter of 31 May, reporting on negotiations with the BGC's white-collar workers and for your subsequent letters of 3 June, telling me that the ESI manuals had accepted their pay settlement in their recent ballot and discussing the prospects for the BNFL and UKAEA negotiations.

I am concerned at the way in which UKAEA and BNFL negotiations are developing. Although the numbers of employees involved in each are relatively small, they are important in the broader pay scene - the UKAEA because their workforce are central Government employees and BNFL because of the considerable public sensitivity following events at Sellafield. As John Moore said in his letter of 29 May, it is important that these negotiations do not disturb negotiations with the industrial civil servants and NHS non-Review Body groups, undermine the special treatment given to ESI manuals or give a general signal that in the public sector, settlements are rising with the RPI. That would not only give the private sector the wrong message but would also store up difficulties for public sector negotiations in the next pay round - not least in the energy industries. And I know that neither of us would wish any union to believe that the threat of industrial action works.

Against this background, I was pleased to learn that the UKAEA intend to hold their offer to 5 per cent at their meeting today, and I am grateful to you for persuading the Chairman to do so. However, I am convinced that thereafter the management should not be prepared to countenance an offer as high as 5.9 per cent to achieve a negotiated settlement. I agree that the Authority's

settlements in recent years have been modest, but in my view this simply represented a realistic assessment of how their pay rates should move. It does not justify any catching up now. I am also not at all clear that the difficulties which the Authority may have in recruiting or retaining particular employees points in the other direction. As the AEA prepare to switch to trading fund status, I believe there is scope for slimming their manpower. We owe it to the next Chairman of the Authority to deliver an organisation which is competitive because both employee numbers and employees' wages are at the right level. That could then well provide the basis for justifiable future increases in pay.

For the reasons given above, I also believe that BNFL should be aiming for a settlement below 5¾ per cent. The Court case which they have to defend will inevitably focus public attention on their affairs, and may perhaps give the unions involved cause to think very carefully before taking any action which the anti-nuclear lobby is bound to exploit.

I am, of course, very willing to consider these points further as negotiations develop. But in all these circumstances, I would ask you to continue to press both BNFL and UKAEA to seek settlements below the figures they currently have in mind. I would be content for BNFL to move to 5½ per cent on rates, or just marginally above, while UKAEA should, I believe, be aiming below 5½ per cent. I am sure that when the negotiations are concluded, you will want the management in both cases to concentrate any publicity on the increase in average earnings which, I understand, would be lower.

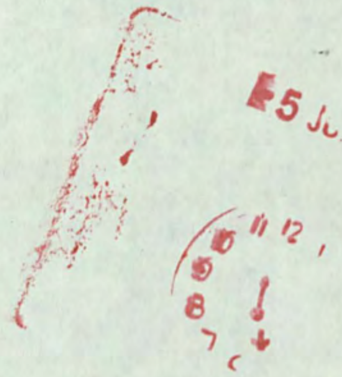
Copies of this letter go to the Prime Minister, to the other members of E(PSP), to George Younger, Nick Edwards and Douglas Hurd and to Sir Robert Armstrong.

Yours sincerely,

Philip Wynn Owen

pp NIGEL LAWSON
(approved by the Chancellor and signed in his absence)

Nat Ind: Gas + ~~electricity~~ Pt 11.



NBPM AT 3/6 1.

CDP 3/6.

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SECRETARY OF STATE FOR ENERGY

Gas Industry Privatisation

1. I have seen your memorandum E(A)(85)30 of 24 May.

2. I understand that we shall be discussing it on 11 June. But I wanted to record now my interest in the FCO taking part in the consultations mentioned in paragraph 10 of the memorandum about imports and exports. The control of gas exports could give rise to awkward issues under the EC Treaty.

3. Other matters might also have EC implications, for example arrangements concerning share ownership. So, conceivably, might proposals for price regulation. We shall need to consider these carefully too. We need to be sure that your important privatisation proposals do not encounter any hidden reefs.

4. I am copying this minute to other members of E(A).

GEOFFREY HOWE

Foreign and Commonwealth Office
3 June, 1985

cc NO

01 211 6402

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

3 June 1985

Prime Minister

ELECTRICITY SUPPLY INDUSTRY PAY

I am now in a position to report the outcome of the ballot on the pay settlement for manual workers. The membership have voted to accept the offer, but only by a very narrow majority. Out of 70,174 votes cast (excluding 51 spoiled papers) 35,991 voted to accept and 34,183 voted to reject the offer. This represents a majority of some 51%.

PP's please

Officially the Trade Union side have not accepted the Electricity Council's offer, but they next meet on Wednesday 12 June and the expectation is that they will ratify the agreement during that afternoon.

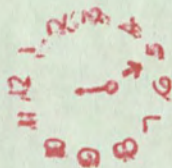
I am copying this letter to the Prime Minister, other members of E(PSP), George Younger, Nicholas Edwards, Douglas Hurd and Sir Robert Armstrong.

PETER WALKER

NAT. IND.

GAS + Electricity

Pt. 10



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