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3005

PREM 19/3099

1157 MT.

PART 19

SECRET

CONFIDENTIAL FILING

Gas and Electricity Pricing Policy
Gas and Electricity Industries EFLs
Industrial Energy Policy
Future of the Gas Industry

NATIONALISED INDUSTRIES

PT1 : September 1979
PT19 : May 1990

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~22.5.90~~							
~~19.7.90~~							
~~20.7.90~~							
~~23.7.90~~							
27.7.90							
~~7.8.90~~							
~~10.8.90~~							
~~15.8.90~~							
~~22.8.90~~							
~~14.9.90~~							
~~18.9.90~~							
~~24.9.90.~~							
~~26.9.90~~							
~~29.9.90~~							
~~1.11.90~~							
~~8.11.90~~							
15.11.90							
PT19 ENDS							

PREM19/3099

PART 19 ends:-

BP to SCOT. OFF. 15.11.90

PART 20 begins:-

SSIGNERGY to LPC. 7.1.91

CONFIDENTIAL

8CL
CPU

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

15 November 1990

Dear Jim,

ELECTRICITY PRIVATISATION: FLOTATION TIMING

The Prime Minister was grateful for your Secretary of State's minute of 31 October, proposing firm dates for the flotation of the two Scottish electricity companies.

The Prime Minister understands that the Chancellor of the Exchequer and the Energy Secretary are also content with the proposed dates. Accordingly the Prime Minister is content to proceed with the timetable proposed.

I am copying this letter to John Gieve (H.M. Treasury) and John Neilson (Department of Energy).

Yours,
Barry

(BARRY H. POTTER)

Jim Gallagher, Esq.,
Scottish Office.

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chex.kf/tt2/44

Prime Minister

Confirmation that Treasury are content with Energy Secretary's proposals on the force majeure provisions + disclosure clause.

BHP 9/11

Treasury Chambers, Parliament Street, SW1P 3AG
071-270 3000

PRIME MINISTER

TRECs FLOTATION: IMPLICATIONS OF THE GULF SITUATION

I have seen John Wakeham's minute of 7 November.

2. As we have recognised, the threat of a war in the Gulf poses real problems for this privatisation in relation both to the force majeure provisions and to the disclosure of highly sensitive information. I am content to accept John's judgement that his proposals represent the best way forward, with Schroders being the judge of whether the shares are likely to open at a significant discount.

3. I am copying to Douglas Hurd, John Wakeham and to Sir Robin Butler.

[J.M.]

8 November 1990

NAT IND: Gas + Ele
A19

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KK

FILE

C/Econ/Trecs

10 DOWNING STREET
LONDON SW1A 2AA

cc FCO
HMT
CO

From the Private Secretary

8 November 1990

TRECS FLOTATION: IMPLICATIONS OF THE GULF SITUATION

The Prime Minister was grateful for your Secretary of State's letter of 7 November setting out his revised proposals for a force majeure provision in the agreement with the underwriters and sub-underwriters and for a disclaimer provision to be included both in the agreement with the underwriters and in the prospectus.

The Prime Minister is content to proceed broadly as proposed by your Secretary of State, subject to comments from colleagues.

I am copying this letter to the Private Secretaries to the Foreign Secretary, the Chancellor of the Exchequer and to Sir Robin Butler.

(BARRY H. POTTER)

John Neilson, Esq.,
Department of Energy.

CONFIDENTIAL

MS

CONFIDENTIAL

PM/90/083

PRIME MINISTER

TRECS Flotation: Implications of the Gulf Situation

1. Further to my earlier minute of todays date, I have now seen John Wakeham's second minute dated 7 November. I am content with his approach.

2. I am copying this minute to the Chancellor of the Exchequer, the Secretary of State for Energy and to Sir Robin Butler.

(DOUGLAS HURD)

8 November 1990
Foreign and Commonwealth Office

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PM/90/081

PRIME MINISTER

TREC Floatation: The Force Majeure Clause in the Underwriting Agreement

1. I have seen John Wakeham's minute of 31 October.

2. I am sure he is right that a force majeure clause will be necessary. On the specific foreign policy point I doubt whether even the Iraqis will be able to read it as a signal of our intention to take military action on a specific timing. They may of course take advantage of it for propaganda purposes - but I have no difficulty with this since it is part of our plan to show that the military option is there to be used if Saddam Hussein does not withdraw from Kuwait.

3. I do, however, have difficulty with some of the language in paragraph A(i) of John Wakeham's draft letter to Schroders. As I see it there is at present a state of armed conflict between Iraq and Kuwait. I should prefer (A)(i)(1) to read:

> "a state of armed conflict between Iraq and any state other than Kuwait".

Furthermore, if the "event which is evidence of such state of armed conflict" (in the amplifying matter below) means actual hostilities it would be better to say so, eg "actual armed hostilities in pursuance of such state of armed conflict".

/4.

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4. The language in A(i)(2) about an ultimatum might risk battles over interpretations of whether the foreseeably ambiguous turn of actual events, eg a certain kind of Security Council Resolution, did or did not constitute such an "ultimatum". My preference would be to omit this, unless advisers can come up with a substitute clause that does not raise the same problem. I have asked my legal advisers to contact their opposite number at the Department of Energy to discuss these points.

5. I am copying this to the Chancellor of the Exchequer, the Secretary of State for Energy and to Sir Robin Butler.

DH.

(DOUGLAS HURD)

8 November 1990
Foreign and Commonwealth Office

NAT IND: Gas + Electric
PT19.

Prime Minister ①

Content with Energy Secretary's revised proposals on force majeure provision for TRECs flotation; and on the discretionary provision in the prospectus? (They reflect have officials' advice). BTHP 7/4

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PRIME MINISTER

TRECS FLOTATION: IMPLICATIONS OF THE GULF SITUATION

There are two issues which potential developments in the Middle East give rise to. First the need to offer the underwriters and subunderwriters an adequate force majeure provision to enable the underwriting to proceed successfully and second the need to make it clear that the Government cannot disclose either to the underwriters or the public any information which it may have relating to developments in the Middle East. You have already agreed to my offering the former but the two issues are interlinked and this minute sets out the approach I believe we should adopt for both issues.

On force majeure, following my earlier minute to you, I have held further consultations with the lead underwriter and with the brokers to the issue. As a result of these consultations, and advice given to me by our financial advisers, I have concluded that if the underwriters and subunderwriters are not confident that the force majeure clause gives them adequate protection we will have to offer a lower price. This would not be in the taxpayers interest, particularly since in practice we are ourselves likely to wish to terminate the offer if there is an adverse development in the Middle East which were to lead to there being a real prospect of the offer opening at a significant discount. As the Chancellor has pointed out this would have significant implications for our wider share ownership objectives.

I therefore propose that the force majeure clause should be triggered if either

(i) there is an outbreak of hostilities in the Middle East; and

(ii) there is a fall in the market and the fall in the market is due to the developments in the Middle East; and

(iii) the fall in the market is likely to lead to a significant discount on the offer price;

or alternatively, on impact day there were a widespread rumour of an outbreak of hostilities and as a result of this, or an event on impact day, the offer failed to get more than 80% subunderwritten.

I have considered carefully who should be the judge of whether the offer is likely to open at a significant discount. I am advised by the brokers and by my financial advisers that the right approach is to leave this judgement to the lead underwriters. The brokers believe that this will result in our achieving a better yield and will result in our being able to market the issue more successfully than if we were to leave that judgement to be made by the Government or an independent party. I believe that we should accept this advice.

I have also, together with the Law Officers, been giving consideration to the potential disclosure problems for the prospectus and in relation to the underwriters that could arise in the event that, before or during the offer period, the Government had knowledge of impending developments in the Middle East which could have a material impact on oil prices and hence on the profit forecasts and prospects of the RECs.

The Law Officers advise that under Section 146 of the Financial Services Act investors should not reasonably expect to find disclosure of war plans in the prospectus. However, under Section 47 of the FSA it could be an offence to issue a forecast or other statements based on an assumption, for example about oil prices, knowing it to be invalidated by imminent developments in the Middle East. There would also be a problem under Common Law and in relation to the warranty to underwriters.

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Clearly it is out of the question to disclose war plans in the prospectus or to underwriters. There is a remedy, however, in the judgement of the Law Officers, in inserting a suitable disclaimer into the prospectus and the arrangements with underwriters. This disclaimer will need to be carefully drafted. Its exact terms are under discussion with the Law Officers but will essentially need to make it clear that the Government will not accept responsibility for disclosing information relating to the Middle East which could specifically affect statements or forecasts contained in the prospectus. I believe this disclaimer makes it all the more essential that we go forward with a force majeure clause that the underwriters and subunderwriters believe meets their legitimate concerns.

As I mentioned in my earlier minute our approach on force majeure may attract public attention, as it will have to be seen by all the 20 underwriters and the 300 subunderwriters. The disclaimer will subsequently appear in the prospectus. However, I believe that we should be able to get across the message that, in the interests of national and international security, the Government cannot disclose war plans in a prospectus. There must also be some risk that it could be misinterpreted as the Government forecasting that there will be developments in the Middle East. Again, as I indicated in my earlier minute, I believe we should be able to get across the message that this is simply prudent action to enable the issue to go ahead and to enable it to be underwritten.

I should be grateful if you and other colleagues would let me know tomorrow morning if you are content with this approach on force majeure and prospectus disclosure.

I am copying this letter to the Foreign Secretary, The Chancellor of the Exchequer and to Sir Robin Butler.

John

Secretary of State for Energy
7 November 1990

CONFIDENTIAL

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

2 November 1990

Dear John,

TREC: FLOTATION: THE FORCE MAJEURE CLAUSE IN THE UNDERWRITING AGREEMENT

The Prime Minister was grateful for your Secretary of State's minute of 31 October proposing that there should be a new form of force majeure provision in the underwriting agreement (as specified in the attachment to the letter). She has also noted that the Chancellor supports this proposal. The Prime Minister is content to proceed as your Secretary of State proposes.

I am copying this letter to Stephen Wall (Foreign and Commonwealth Office), John Gieve (HM Treasury) and Sonia Phippard (Cabinet Office).

Yours,
Barry

Barry Potter

John Neilson Esq
Department of Energy

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chex.jp/tt1/25 **CONFIDENTIAL**

CPU

Treasury Chambers, Parliament Street, SW1P 3AG
071-270 3000

PRIME MINISTER

TREC FLOTATION :
THE FORCE MAJEURE CLAUSE IN THE UNDERWRITING AGREEMENT

I have seen John Wakeham's minute of 31 October. / with BP?

I fully support John's proposal to proceed with a force majeure clause along the lines of the draft attached to his minute which deals specifically with the war risk. I can appreciate the sensitivity of underwriters to this particular risk. As John says, this sensitivity will also apply to individual investors and, a failure to provide comfort of the sort he proposes, could badly damage our objective for wider share ownership on this sale.

Like John, I consider it unlikely that a clause of this sort would be seen, domestically or internationally, as some indication of our intentions in the Gulf.

The alternatives to the clause are not attractive. We do not want the underwriting of the offer to fail. To postpone the issue in the absence of any other convincing explanation, could well be interpreted as an indication of the likely timing of events in the Gulf. In addition the loss of privatisation proceeds would make this year's PSDR some £2¾ billion worse.

As John anticipates, I am not in favour of a clause which required us to terminate the offer if the market fell 15 per cent regardless of the reason for the fall. This would create a most unfortunate precedent for subsequent privatisations. If such a

clause had been in place in the past, it could, for example, well have required us to terminate the 1987 BP offer. John is right to say that, with BP, it was fortunate that the collapse came before we had applications from many individual investors but, even it if had come later, there are other ways in which we could have dealt with the problem.

I consider the right way forward is to deal directly with the understandable concern of underwriters and investors about the possible impact of a Gulf war on the markets. I am content with the way John proposes to do this.

I am copying to Douglas Hurd and John Wakeham and to Sir Robin Butler.

John M.

[J.M.]
1 November 1990

CONFIDENTIAL

MR POTTER **1 November 1990**

TREC FLOTATION: THE FORCE MAJEURE CLAUSE IN THE UNDERWRITING AGREEMENT

Objectively, I am quite sure that underwriters and sub-underwriters cannot be obtained for the TREC flotation without a force majeure provision. Many fund management institutions say that, whatever the initial outcome of any military action, the situation in the Gulf would then be very unstable for sometime and world markets very nervous as a result.

Selling the stock is not an end in itself; encouraging the public to buy shares is in practice of equal importance. As Mr Wakeham says, it is inconceivable that many individual investors would apply if war were likely. The public must be given the same assurance as the underwriters.

Mr Guise makes the point that a war in the Gulf need not have a major impact on the business of the TRECs and that, on any longer term view, underwriters could expect to make money if they ended up with the shares. I agree; but the public would not be involved in the issue and we would be failing to achieve one of our consistent long term objectives.

Mr Guise accepts that it is too late to appoint another lead underwriter but he says that Schroders should be told quite clearly that, if they do insist on this clause, their underwriting fees should be substantially reduced. My feeling is that the investing institutions see the risks involved in a Middle Eastern war as being sui generis. I share that view and I think the decision to concede a force majeure clause is rational and not a surrender to a cartel.

Howell Harris Hughes

HOWELL HARRIS HUGHES

HHH.TREC.1/11/90

ccfh

THE RT HON JOHN WAKEHAM MP

n.b.p.m.
BHP
1/11

Department of Energy
1 Palace Street
London SW1E 5HE
071 238 3290

The Hon Francis Maude MP
Financial Secretary
HM Treasury
Parliament Street
LONDON
SW1P 3AG

7 November 1990

Dear Francis

REC FLOTATION: 100% SALE

Thank you for your letter of ~~26~~ 25 October.

I very much welcome the suggestion that the pathfinder prospectus to be published on 2 November should indicate our preference for a 100% sale of shares in the regional electricity companies. I believe that the steps that the companies have taken to make positive statements about their prospects, coupled with the satisfactory outcome on dividends, make a 100% sale the right course.

I also agree that, at the same time we make it clear that we have a preference for a sale of 100%, we should add that this remains subject to market conditions. Given the large number of people involved in the final drafting of the pathfinder, a low key press briefing along these lines has now been given, to pre-empt any suggestion that the Government was giving in to industry pressure.

The REC chairmen recognise that we might still be forced away from a 100% sale by exceptional market conditions, but they would be very disappointed if this happened. I too hope this can be avoided.

I am copying this to the Prime Minister.

Yours ever

JW

JOHN WAKEHAM

Prime Minister

CCGU ①

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Treasury has no objection to the proposed timetable.

Content?

BHP 14/11

Prime Minister

ELECTRICITY PRIVATISATION: FLOTATION TIMING

1. You will no doubt recall that colleagues agreed last February that, subject to market conditions, the flotation of Hydro-Electric and Scottish Power should take place in May or June of 1991.

2. In order to set in train the necessary arrangements, we must now fix a firm date for the flotation of the 2 Scottish electricity companies. In consultation with my advisers I have concluded that the offer for sale of Scottish Power and Hydro-Electric should be conducted to the following timetable:

Impact Day (share price announced)	Thursday 30 May 1991
Offers Close	Wednesday 12 June 1991
Basis of Allocation Announced	Monday 17 June 1991
Dealings start	Tuesday 18 June 1991

This will allow a sufficient length of marketing campaign following the flotation of the England & Wales generators but would be completed in time for Scottish investors to receive share certificates before the schools break up at the end of June.

3. I recognise that our commitment to privatise the Scottish companies within the lifetime of this Parliament is only likely to be met if you decide to go to the country after the Summer of 1991. I do not believe that alternative impact dates consistent with a successful flotation in May or June would offer any greater room for manoeuvre.

4. I am copying this minute to the Chancellor of the Exchequer and to John Wakeham.

MR

M R

Scottish Office
31 October 1990

EML00828.100

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Prime Minister

As you know, Mr Wakeham proposes a force majeure provision in the underwriting provisions. Treasury agree. Policy Unit veers mixed but, on balance, also favour Mr Wakeham's proposals. BTH 1/11

Copy No. 1 of 5

Prime Minister

TREC FLOTATION: THE FORCE MAJEURE CLAUSE IN THE UNDERWRITING AGREEMENT

Schroders, who are the lead underwriters for the flotation of the TRECs, have had a first round of discussions with other potential members of the underwriting group. While virtually all the would-be underwriters have expressed an interest in principle in becoming underwriters, almost all the banks concerned have made it clear that this willingness is dependent on there being a force majeure provision relieving them of their obligations in the event of an outbreak of hostilities in the Middle East.

Schroders have advised my Department that there is no realistic prospect of persuading a sufficient number of banks to underwrite without such a provision and hence no prospect of the issue being sub-underwritten. In these circumstances the issue could not go ahead. We have pressed Schroders very hard on this advice. I believe that it is well founded. I understand that Treasury Ministers have been made aware of this position.

As you will know, fairly standard force majeure clauses have been inserted in all recent underwriting agreements for privatisation issues. A draft of the latest text is attached at Annex A. In a nutshell, while the underwriters can ask to be discharged from their obligations, the Government retains complete discretion about whether to accede to their wishes. In addition the Government retains the right to pull the issue, should it so desire. You will recall that, when Wall Street fell by 22% in October 1987, the then Chancellor refused to pull the BP issue on grounds of force majeure, although the Government later provided a financial safety net. As a result of this past history, would-be underwriters are just not willing to rely solely on

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individual investors only come forward in small numbers. The media will undoubtedly want to know our response to the outbreak of war before they decide whether to recommend the shares. We will need to give them assurance in similar terms to the underwriters. A failure to do this would certainly badly damage our objective on wider share ownership.

This clause will need to be known not only to the 15-20 UK underwriters, but also 300-400 sub-underwriters and the overseas underwriters and, for the reason described above, to the Media. It will therefore be public knowledge. It is conceivable, but in my view unlikely, that such a clause would be taken by the Iraqis as a definite sign of our having plans to take military action against Iraq. Both you and President Bush have made the Allies' position absolutely clear on this issue on a number of occasions. This clause does not add or subtract from the basic situation. If we are not able to satisfy the underwriters, we shall have to postpone the issue until any war is over, or the market sees the threat of war as much diminished. It is just as likely that the Iraqis would interpret any such delay as portending the imminent outbreak of hostilities.

It would be possible to draft a force majeure provision which made no reference to hostilities in the Middle East, but which was dependent only on an objective test, eg the market had fallen by 15% between Impact Day and Allocation Day. However, such a fall might be caused largely or indeed wholly for reasons quite different from hostilities in the Middle East, eg the crash of one or more large US banks, which would be regarded as normal underwriting risks. We would therefore be setting a precedent which we have gone to great lengths to avoid in the past. Treasury Ministers, with their wider responsibilties for privatisation, would no doubt be particularly against such a reversal of policy. On the other hand, if there was such a fall

the Government's good will to pull the issue in what would normally be considered situations where a force majeure clause would be held to apply in the private sector, eg the outbreak of hostilities in the Middle East. The impact of such risks on the market are potentially so great and so uncertain that the underwriters would not be willing to underwrite even if the commission was a multiple of the current levels.

I should add that there is no uniformity of view about what impact an outbreak of hostilities in the Middle East would have on markets. The impact would inter alia depend on the nature of the hostilities, their duration and their outcome. At one end of the spectrum some bankers have argued that Wall Street would initially rise before falling. Others argue that markets have largely discounted the prospect of hostilities and are mainly influenced by concerns about the domestic economies of the major Western countries, including the position of the US banks. At the other end of the spectrum it is argued that there would be massive falls, say 25%, especially if a sizeable proportion of Middle Eastern oil resources were to be out of action.

My Department in consultation with Treasury officials and a very limited number of advisers have therefore drafted an additional Force Majeure/War provision, which would be acceptable to sufficient other would-be underwriters. I attach a copy at Annex B. My officials are consulting with Treasury officials about who would be the best expert to advise on the causes of the fall in the market.

Our response to a war in the offer period is important to individual investors as well as to the sub-underwriters. Over 6 million people have already registered with the Share Information Office. Past privatisations have shown that individual investors rely heavily on the endorsement of the shares by the Media. If that endorsement is not forthcoming,

in the UK market regardless of the reasons, there would be a case for arguing that we should not leave perhaps several million small investors stranded holding sizeable losses. It was fortuitous that Black Monday came right at the beginning of the BP offer period before many small investors had filed their applications. In any case such a failure might imperil the Generation companies flotation in February, except on unjustifiably generous terms, and undermine seriously our objective of wider share ownership.

I believe the right course is to include a new force majeure provision along the proposed lines in the under-writing agreement. I should be grateful if you and other colleagues would let me know if you are content with this approach. At the Pathfinder Press Conference on 2 November, if questioned, I shall restrict myself to indicating that the Government is considering very seriously the representations of the underwriters.

I am copying this to the Foreign Secretary, the Chancellor and to Sir Robin Butler.

Secretary of State for Energy

31 October 1990

8. TERMINATION

8.01 If, between the execution of this Agreement and the time when the conditions in Clause 2.01 are satisfied in respect of all the Companies, there shall have been any occurrence of such significance that the UK Underwriters conclude that it would be reasonable for them to be released and discharged from their obligations under this Agreement in respect of all or any of the UK Offers the Lead Underwriter shall, on behalf of the UK Underwriters, so notify the Secretary of State. Such notification shall include details of the occurrence and the reasons why it had led the UK Underwriters so to conclude. Following receipt of such notification, the Secretary of State shall determine whether or not all or any of the UK Offers should proceed and shall notify the Lead Underwriter on behalf of the UK Underwriters accordingly. In reaching such determination the Secretary of State may conduct such consultations in such manner and with such persons as he thinks appropriate.

8.02 If, between the execution of this Agreement and the time when the conditions in Clause 2.01 are satisfied in respect of all the Companies, there shall have been any occurrence of such significance as to lead the Secretary of State to the preliminary view that all or any of the UK Offers be withdrawn and obligations under this Agreement be terminated in relation thereto he shall notify the Lead Underwriter on behalf of the UK Underwriters that he has reached such a preliminary view. Such notification shall include such details (if any) of the occurrence as in the opinion of the Secretary of State it would not be contrary to public interest or otherwise improper for the Government to disclose. In reaching a determination whether or not all or any of the UK Offers should proceed, the Secretary of State may conduct such consultations in such manner and with such persons as he thinks appropriate. If the Lead Underwriter shall notify the Secretary of State of reasons why the UK Underwriters conclude all or any of the UK Offers should not be withdrawn, the Secretary of State shall take such notification into account. The Secretary of State shall notify the Lead Underwriter on behalf of the UK Underwriters of his determination whether or not all or any of the UK Offers should proceed.

Annex B

CONFIDENTIAL

Draft (2) 31.10.90

[Letter DEn to Schroders]

21st November, 1990

Dear ,

Offers for Sale of the
Twelve Regional Electricity Companies

I refer to the agreement (the "UK Underwriting Agreement") proposed to be entered into between the Secretary of State for Energy (the "Secretary of State") (1), the twelve Regional Electricity Companies ("RECs") (2), The National Grid Company plc ("NGC") (3), yourselves and the other underwriters named therein (the "Underwriters") (4), and the Directors of the RECs and NGC (5) pursuant to which the UK Underwriters will agree to underwrite the Offer for Sale of ordinary shares of the RECs. Words and expressions defined in the UK Underwriting Agreement have the same meanings when used in this letter. "Impact Day" when used herein means the date of this letter.

The purpose of this letter is to describe certain circumstances which, in consideration of the other of them entering into the UK Underwriting Agreement, the Secretary of State and the Underwriters have agreed shall be regarded as an occurrence which would cause the Secretary of State to determine, pursuant to Clause 8.01 or 8.02 of the UK Underwriting Agreements, that the UK Offers should not proceed.

The circumstances referred to above will have occurred if the requirements of (A) or (B) below are satisfied:-

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(A) Each of the following requirements is satisfied:-

(i) there being:-

(1) a state of armed conflict between Iraq and any other State; or

(2) an ultimatum issued to Iraq by [HM Government], failure to comply with which is stated to result in an immediate commencement of hostilities

and, in the case of (1), an event which is evidence of such state of armed conflict or, in the case of (2), the terms of such ultimatum, being reported in London on Reuters news service or otherwise becoming generally known to market makers making markets in the shares comprised in the Index (the "London market") between the time the UK Underwriting Agreement is released from escrow and the commencement of dealings in the Ordinary Shares of any of the RECs on The Stock Exchange; and

(ii) the level of the Index at 4.30 p.m. on the business day the Allocation Announcement is made (or if it is not made on a business day, on the next business day after the day on which it is made, such day being referred to as the "Allocation Day") is less than 85% of the level of the Index at 4.30 p.m. on the business day prior to Impact Day (being, for the avoidance of doubt); and

(iii) the fall in the level of the Index between Impact Day and the Allocation Day is predominantly attributable to the coming into existence of the state of armed conflict or the issue of the ultimatum referred to in sub-paragraph (i) above;

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and for these purposes the "Index" shall mean the FT-SE 100 share index and references to "business days" are to days on which dealings in shares take place on The Stock Exchange.

If the circumstances described in sub-paragraphs (i) and (ii) occur, the requirement of sub-paragraph (iii) shall be deemed conclusively for the purposes of this letter to have been satisfied if:-

(a) the Secretary of State and the Lead Underwriter (on behalf of the UK Underwriters) agree that such is the case (such agreement to be evidenced by a memorandum signed by or on behalf of the Secretary of State and the Lead Underwriter); or

(b) following a reference of the question to it as provided below [AN EXPERT] gives notice in writing [(in the form of the letter attached hereto as Annex A)] to the Secretary of State and the Lead Underwriter (on behalf of the UK Underwriters) not later than [ ] on [the day on which dealings in the Ordinary Shares of any of the RECs on The Stock Exchange commence] that in its opinion such is the case,

and in the absence of agreement in accordance with (a) or notice being given in accordance with (b) the requirement of sub-paragraph (iii) shall be deemed conclusively for the purposes of this letter not to have been satisfied.

If the circumstances described in sub-paragraph (i) occur and the circumstances described in sub-paragraph (ii) above have occurred or the Lead Underwriter considers it likely that such circumstances above will occur, the Secretary of State will if so requested by the Lead Underwriter consult with the Lead

Underwriter for the purposes of considering whether the fall in the level of the Index which has then occurred or is anticipated by the Lead Underwriter was predominantly attributable to the coming into existence of the state of armed conflict or the issue of the ultimatum referred to in sub-paragraph (i) above. If by [ ] p.m. on the Allocation Day the Secretary of State and the Lead Underwriter shall not have reached agreement on whether the fall in the level of the Index was so attributable either of them may refer the matter to [AN EXPERT], by giving notice in writing (in the form attached hereto as Annex B) to [ ], a copy of which shall be given to the other of them.

[The Secretary of State and the Lead Underwriter (on behalf of the UK Underwriters) acknowledge and agree that [ ] shall owe no duty to any of them in considering the matter referred to it as provided above, save that it shall act in good faith.]

(B) Each of the following requirements is satisfied:-

(i) between the time the UK Underwriting Agreement is released from escrow and 3.00 p.m. on Impact Day either:-

(a) there being:-

(1) a state of armed conflict between Iraq and any other State; or

(2) an ultimatum issued to Iraq by [HM Government], failure to comply with which is stated to result in an immediate commencement of hostilities

and the first occasion occurs of, in the case of (1), an event which is evidence of such state of armed

conflict, or, in the case of (2), the terms of such ultimatum, being reported in London on Reuters news service or otherwise becoming generally known to the London market; or

(b) there being in the London market a widespread belief or expectation that such a state of armed conflict was imminent and within seven days after Impact Day such state of armed conflict shall have come into existence; and

(ii) the number of Underwriting Units comprised in Priority Application Forms received duly signed and completed by [the last time for receipt of applications on public application forms] is less than 80% of the aggregate number of Underwriting Units.

The Underwriters have agreed that they shall keep the existence of this letter and its contents strictly confidential. The Secretary of State may disclose the contents of this letter to any person or persons and in such manner as he thinks fit.

Please sign and return the enclosed copy of this letter to confirm your agreement, on behalf of the Underwriters, to its terms.

Yours sincerely,

CONFIDENTIAL

DBS

File

bc: Policy Unit

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

29 October 1990

Dear John,

ELECTRICITY PRIVATISATION: SPECIAL SHARES

The Prime Minister has seen the correspondence between your Secretary of State, the Secretary of State for Industry, the Scottish Secretary and the Financial Secretary, culminating in your Secretary of State's letter of 22 October and the Financial Secretary's letter of 26 October.

The Prime Minister has commented that, in her view, the arguments put forward by the Industry Secretary and the Treasury in favour of time limiting the Government's special shares in the generating companies to five years after privatisation are persuasive.

I am copying this letter to Jim Gallagher (Scottish Office), Martin Stanley (Department of Trade and Industry), Philip Rutnam (Financial Secretary's Office, H.M. Treasury) and to Sonia Phippard (Cabinet Office).

Yours,

Barry

Barry H. Potter

John Neilson, Esq.,
Department of Energy.

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CONFIDENTIAL
COMMERCIAL IN CONFIDENCE

FINANCIAL SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon John Wakeham FCA JP MP
Secretary of State
Department of Energy
1 Palace Street
LONDON
SW1E 5HE

26 October 1990

Dear John

ELECTRICITY PRIVATISATION : SPECIAL SHARES

Thank you for your letter with BP? of 22 October.

I remain unconvinced. As Peter Lilley emphasised, timeless special shares are inconsistent with an important objective of our privatisation programme: to increase efficiency and competitiveness by exposing enterprises to private sector disciplines. In the case of the generators, I see no strategic case for a permanent special share. As I said previously, nor do I believe that there is a case in Scotland, although the different structural characteristics of the industry mean that the position in Scotland can be addressed separately.

But your letter seems to go on to concede these points. In asking that you keep in reserve a change in the terms of the special shares you are, I am pleased to see, prepared to contemplate time limiting these shares. I do not think that it follows that no change should be announced now. In the case of the TRECs, you were in a position to threaten a period of less than 5 years; you would be in the same position with the gencos if you announced now a change to 5 years for their shares. I commend this approach to you.

I am copying this letter to the Prime Minister, Malcolm Rifkind, Peter Lilley and Sir Robin Butler.

Yours ever

FRANCIS MAUDE

CONFIDENTIAL
COMMERCIAL IN CONFIDENCE

CONFIDENTIAL

cc PM.

PRIME MINISTER

ELECTRICITY PRIVATISATION: SPECIAL SHARES

You saw earlier the recent correspondence on special shares (Flag A). Policy Unit recommended that you support the Industry Secretary and Chancellor: they favour time limiting the duration of the Government's special shares in the two generating companies after privatisation, to five years.

As you know the Energy Secretary has argued for no time limit, so the Government could block directly unwelcome takeovers or amalgamation, rather than relying on the MMC. But his resistance to a limit of five years seemed a little diminished in the latest letter (Flag B).

I wanted to confirm you were content to support the Policy Unit line. A further letter from the Financial Secretary (Flag C), again commending a five year limit on special shares, has arrived.

i) Content to support the Industry Secretary and Chancellor in favour of special shares for 5 years only; or

Yes

ii) Content to support the Energy and Scottish Secretaries in favour of unlimited special shares?

BHP

I think the Treasury's view and the Policy Unit's effective note are conclusive

BARRY H. POTTER
26 OCTOBER 1990

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n.b. P.M. PHP 26/10

cc PC

FINANCIAL SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon John Wakeham FCA JP MP
Secretary of State
Department of Energy
1 Palace Street
LONDON
SW1E 5HE

October 1990

Dear John

REC FLOTATION: DIVIDEND FORECAST

Thank you for your letters of 18 October, and 24 October.

The outcome of dividends is, as you say, very satisfactory. It is a considerable achievement for you and your officials.

There remains the finalisation of the sections of the prospectus dealing with the companies future prospects. Assuming this comes out satisfactorily, I could see advantages in making clear that we have a preference for a sale of 100% of the TRECs equity. At the same time we would have to make clear that, despite this preference, market conditions could yet force us to sell a smaller proportion. I take it that, if we had to sell a smaller proportion in response to market conditions, the companies would not resile from the agreements reached on their dividends and prospects.

You mention the pressure you face on the "force majeure" clause. I understand our officials are examining the position with the City advisers. Wherever we come out on this clause, the timetable in your letter makes clear that an outbreak of war in the Gulf between now and mid December could severely jeopardise our ability to complete the privatisation in this period.

Finally, I should confirm for the record that I am content that the offer should be a standard fixed price one.

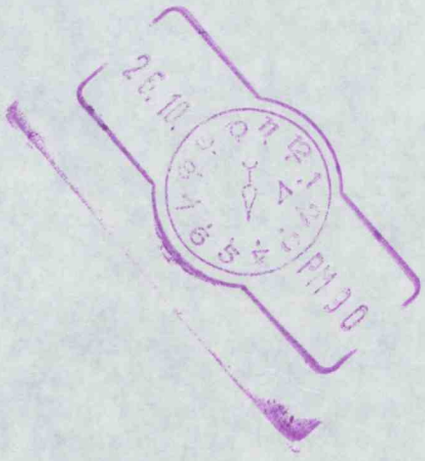
I am copying to the Prime Minister.

Yours ever,

FRANCIS MAUDE

NAT IND: Cost Elec

Pt 15



PRIME MINISTER

ELECTRICITY PRIVATISATION: SPECIAL SHARES

You are aware, from earlier correspondence, of a difference in view between the Energy Secretary and the Scottish Secretary on the one hand, and the Chancellor and Industry Secretary on the other, about the future of special shares for the two generating companies in England and Wales after privatisation.

In brief, both the Energy and Scottish Secretaries want the proposed special shares to be timeless. The effect would be to give central Government a permanent power to prevent certain takeovers. Both the Industry Secretary and the Chancellor favour time-limiting the special shares to five years. So does the Policy Unit (note attached at Flag A).

The Energy Secretary's latest letter is at Flag B. It makes three points:

(i) that the Government cannot rely on the MMC to prevent undesirable takeovers or the two generating companies getting together;

(ii) that it would be illogical to grant a timeless special share to the Scottish companies but not to those in England and Wales and;

(iii) that the special shares were important in achieving the agreement on the first year profits and dividends of the regional electricity companies.

You will see from the Policy Unit note that none of these arguments is viewed as persuasive.

- Content to support the Industry Secretary and Chancellor in favouring time-limited special shares?

- Content to support the Energy and Scottish Secretaries in favour of timeless special shares?

- Prefer not to intervene at this stage in the correspondence?

BHP

BARRY H. POTTER

23 October 1990

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(slh)

ST. ANDREW'S HOUSE
EDINBURGH EH1 3SX

CONFIDENTIAL

Rt Hon Peter Brooke MP
Secretary of State for Northern Ireland
Northern Ireland Office
Whitehall
LONDON
SW1A 2AZ

23 October 1990

Dear Peter

PRIVATISATION OF NORTHERN IRELAND ELECTRICITY

I have seen the paper circulated to E(A) colleagues with your Private Secretary's letter of 28 September. I have also seen Peter Lilley's letter of 8 October and Francis Maude's minute of 9 October.

My own interest lies principally in the establishment of an interconnector between Scotland and Northern Ireland. There may, however, be more general lessons to be learned from experience hitherto in Scotland as well as in England & Wales.

I must confess to some disappointment that your proposals for supply competition are so limited, apparently on system security grounds. Notwithstanding the absence of a complex pooling and settlement arrangement in Scotland, I have been prepared to allow the franchise limits on supply competition to be reduced in parallel with those in England & Wales. In the absence of supply competition, I tend to share Peter Lilley's misgivings about the creation of an integrated utility. At the same time, I entirely sympathise with your difficulties in following the England & Wales route. I believe your plans could be more acceptable if they set out a clear timetable for the opening up of supply competition.

As far as the interconnector with Scotland is concerned, connection to the Scottish transmission system, and thereby to England & Wales, would clearly be conducive to competition in generation. Without competition in supply, NIE would no doubt treat the generating companies in mainland GB as alternative providers of generating capacity to NIE itself. Structuring ownership of the interconnector so as to deny NIE control of it would not, however, prevent the exercise of monopoly power. Indeed, there may be a good case for NIE to own any interconnector, since it will then require to make a return on the investment, which it will fail to recoup if the interconnector is not properly utilised. I can see no reason

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why giving NIE responsibilities as a properly regulated transmission licensee should operate any less effectively than in Scotland, where ownership of the interconnector circuits by ScottishPower cannot be used to prevent National Power or PowerGen from competing for customers.

In summary, I have no objection to your proposals for a vertically integrated NIE with some generation assets sold separately. To mitigate monopolistic behaviour once NIE is privatised, however, I believe further steps could be taken to free up the arrangements for supply competition. Moreover, I believe that there are material advantages in ensuring that ownership of any interconnector with Scotland is wholly vested in NIE.

I am copying my letter to members of E(A) and Sir Robin Butler.

Yours ever

Malcolm

MALCOLM RIFKIND

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PRIME MINISTER

22nd October 1990

SPECIAL SHARES

The main threat from a supply monopoly is not its power to do evil but its power to be incompetent. The difficult road to electricity privatisation has, unfortunately, led to a generating duopoly of two producers between which there will be little true competition for many years. Ultimately, a free market should develop as the distribution companies and industrial electricity consumers develop alternative sources of supply.

During the period before a free market develops, customers will have no power to impose efficient management on the generating duopoly. Such pressures must come from somewhere other than the Regulator if National Power and PowerGen are to develop the internal efficiencies and productivity which will enable them to live with genuine competition as it evolves. Since such pressures will not come from consumers for many years, they can only come from shareholders whose ultimate sanction against an incompetent management is to dismiss it. Therefore, shareholders in electricity production should not be permanently prevented from accepting a take-over bid if they regard their company's assets to be inefficiently deployed by the incumbent management.

A perpetual special share will remove that power of acceptance unless some future Secretary of State restores it by an arbitrary act, probably taken under political pressure

rather than sound commercial logic. Any special share should therefore be time limited so that the Secretary of State's power to resist take-over automatically terminates after five years. If Jaguar had been given a perpetual special share the DTI would have spent ages as the referee in a public fight between Ford in one corner and John Egan with General Motors in the other!

Conclusion and Recommendation

Both the DTI and the Treasury argue strongly in favour of time limiting the special share in the generating companies. If Hanson had been the buyer of PowerGen this would have been obligatory. Indeed, it was the threat of Hanson which curbed the PowerGen management into proposing more positive cash flow projections - a perfect illustration of how the possibility of replacement concentrates the mind of management! Furthermore, John Wakeham's own letter mentions how the TREC's came into line when the threat of losing their 5 year special share appeared. The time limiting of PowerGen and National Power's takeover immunity should be welcomed in the City and the commercial world generally, particularly by those critics who have attacked the proposed duopoly.

It is quite wrong to allow the special pleadings of Scotland, which apparently has no faith in the OFT/MMC system for protecting the national interest, to impose a bad decision upon the rest of Britain. A perpetual special share means lifetime protection from take-over and I know of no situation where that has enhanced management efficiency. If the customers are to have no real power over their electricity suppliers, let us at least give some to the shareholders. Any special share in PowerGen or National

Power should have a maximum life of 5 years and that should be announced well in advance of negotiations about first year dividends. Wakeham will then have the additional card of threatening an even shorter period of protection if management are difficult.

GEORGE GUISE

CONFIDENTIAL

cc PU

THE RT HON JOHN WAKEHAM MP

Department of Energy
1 Palace Street
London SW1E 5HE

071 238 3290

The Hon Francis Maude MP
Financial Secretary to the Treasury
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

22 October 1990

Dear Francis

ELECTRICITY PRIVATISATION: SPECIAL SHARES

Thank you for your letter of 27 September. I have also seen Peter Lilley's letters of 3 and 4 October.

I continue to believe that there are strong strategic reasons for retaining permanent special shares in the two generators in England and Wales; that competition in the generating market itself will impose sufficient disciplines on the management of the two companies that to rely on the MMC (or the EC Commission, now that the rules have changed for certain takeovers) would at best be cumbersome and at worst uncertain; and that, if the two Scottish companies were to have permanent special shares, it would be difficult to justify a different treatment for the generators in England and Wales.

There is one further factor that suggests that now would be the time to make the change you suggest. As I think you know, the negotiations over first year profits and dividends with the TRECs were particularly difficult. One of the few credible threats I had to persuade the Chairmen to be more reasonable was to change the terms of the special share, or to do away with it altogether. I am confident that the equivalent negotiations with the two generators will be as or more difficult. I am not prepared to give away now a potentially very valuable negotiating weapon.

I am sending a copy of this letter to the Prime Minister, Malcolm Rifkind, Peter Lilley and Sir Robin Butler.

Yours ever

John

JOHN WAKEHAM

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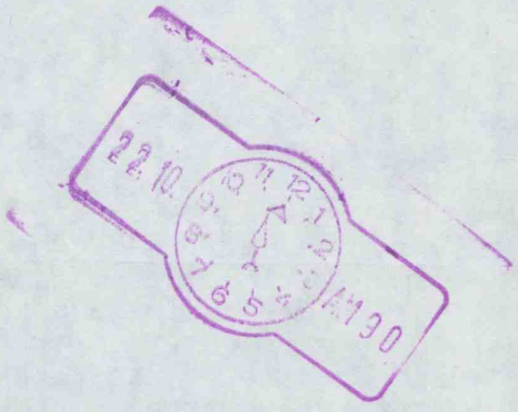
NAT IND: Gas + Elec A 19



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Prime Minister

Confirmation of the figures on likely proceeds from the privatisation of the twelve Regional Electricity Companies. Treasury are content. BTHP 18/10

(2)

THE RT HON JOHN WAKEHAM MP

SECRETARY OF STATE FOR ENERGY

Department of Energy
1 Palace Street
London SW1E 5HE

071 238 3290

The Rt Hon John Major MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON
SW1P 3AG

18 October 1990

Dear John.

REC FLOTATION: DIVIDEND FORECAST

Over the last few weeks a lot of work has been directed at the profit and dividend forecasts of the RECs. I have now reached agreement with all twelve RECs and am writing to record the outcome of these discussions.

The basis of my discussions with the RECs was their profit forecast for 1990/91 and the financial profile for the next few years. In reaching agreement consideration was given to five key parameters:

- dividend cover on the published pro forma earnings. I was advised that around 2 was an appropriate level;
- dividend cover on a reasonable view of maintainable earnings where a cover of 2.5 was felt to be appropriate;
- dividend cover on current cost earnings which would need to be greater than 1 on a sustainable basis;
- gearing, our advisers recommended that levels above 50% were to be treated with caution but that the actual maximum depended upon the profile over time;
- interest cover which should not drop below 4.0 for any long period of time.

CONFIDENTIAL

The financial profiles and key parameters were discussed with Kleinwort Benson and your officials and they both agreed that an aggregate dividend of £345 million was an appropriate level at which to open negotiations. Subsequently we have reconsidered the position and in the light of more information and some of the points made by the RECs believe that a more realistic assessment would be in the range £330 million to £340 million.

I have agreed final dividends of £326.5 million with the RECs having pushed them as hard as possible. This should be compared with the TRECs' opening position of £257 million and their position at the beginning of last week of about £290 million. In the case of one REC, London, it was necessary to reduce the amount of debt injected by £28.5 million in order to be able to secure a satisfactory dividend.

Kleinwort Benson have advised that the proposed dividend figures on a collective basis, are reasonable and lie towards the top end of the range of justifiable dividend levels. The disclosed dividend cover levels will in fact on average be below 2 but I am satisfied that this is acceptable.

The level of equity proceeds for an initial dividend of £326.5 million will of course depend on the yield at which the companies are floated and we will now need to ensure we achieve the best yields possible. However, assuming an 8½% pre tax yield, £326.5 million would produce equity proceeds on a 100% sale of about £5.1 billion. When added to the initial Government debt of the companies total proceeds of the sale of the TRECs would be about £8 billion. This compares with £1 billion less using the initial £257 million dividend proposed by the TRECs.

After two weeks very hard negotiations we have reached what I regard as a very satisfactory conclusion and will be proceeding on this basis.

We are now on the last lap of the flotation of the TRECs. The key dates are:

Publication of the Pathfinder	2 November
Pricing Decision	20 November
Impact Day	21 November
Start of/First Dealings	11 December

SECRETARY OF STATE FOR ENERGY

We shall need to keep in very close touch during this period about market conditions, which will inevitably have an impact on the stance adopted by the underwriters and sub-underwriters, who are likely to press us hard for a change in the force majeure clause to cover the eventuality of a war in the Middle East.

I am sending a copy of this letter to the Prime Minister.

Yours ever

John

JOHN WAKEHAM

CONFIDENTIAL

cc/pu.

THE RT HON JOHN WAKEHAM MP

1.5. P.M.
BHP
18/10

Department of Energy
1 Palace Street
London SW1E 5HE

071 238 3290

The Rt Hon Peter Brooke MP
Secretary of State for Northern Ireland
Northern Ireland Office
Whitehall
LONDON
SW1A 2AZ

18 October 1990

Dear Peter,

PRIVATISATION OF NORTHERN IRELAND ELECTRICITY

Thank you for copying to me the proposals in the paper attached to the letter of 28 September from your Private Secretary to the Prime Minister's office. I have also seen the comments of Peter Lilley, Francis Maude and the Prime Minister recommending further consideration of options D and E.

I believe you are right in attaching importance to the introduction of competition into generation. As you say, this points to your options D and E. Neither of these goes as far as the new regime in England and Wales, since that involves an entirely new spot market and competition in supply. Investment in new power stations will be driven by price signals, whereas in your options it is presumably driven by central planning.

However, whilst I can understand your preference for Option E, the retention of transmission, distribution and supply in NIE may make it difficult for potential new entrants into generation to believe that they will be able to compete on equal terms with the generation side of NIE.

As part of Option E, you propose that NIE should be prevented from bidding to supply new generating capacity. I can see the regulatory and competition advantages, but this raises the question whether investors will give value for NIE's generation assets if they are clearly wasting assets. I assume your advisers have given you comfort that any impact on proceeds would be minimal.

The arrangement may also remove NIE's incentive to seek timely tenders for new capacity if it is not allowed to participate itself: allowing a shortage to develop and the price to rise

would increase its profits and the value of its own plant, whereas it would not participate in the profits of providing new capacity.

Your paper recognises the problems of reconciling competition in supply with a statutory obligation on one supplier to meet all demands for electricity. As you say, we have got round this in England and Wales by introducing a single pool. In effect, there is an obligation on all competing suppliers to meet their customers' requirements by buying in the pool; and the pool price ensures that it is profitable to build sufficient capacity. But there is no unqualified obligation on a single supplier.

I therefore wonder whether an obligation to supply placed on the transmission, distribution and supply side (TDS) of NIE is compatible with competition in supply, even if this is limited to generators of 20 MW or below. As the annex to your paper says, TDS may argue that even limited competition will result in their having to recover, from a dwindling customer base, costs that are fixed by their obligation to meet all demands for electricity. Exit charges to recover these costs from customers going to other suppliers is one solution for TDS. Another is for TDS to set its charges for back-up supply to competing suppliers at a level that recovers the cost of meeting their obligation. Either way, there is a risk of TDS driving competitors off the system.

Competition in generation means competition in fuel supply. In constructing our regime, a lot of thought went into ways of providing some transition for British Coal into a fully competitive market. But I believe you are unlikely to be faced with similar problems.

I note your intention to publish a White Paper before the end of 1990. As you may know, dealings begin in the shares of the twelve regional electricity companies on 11 December. It is important to the marketing of the offer that media attention is not diverted before this date. I must therefore ask you to avoid publishing your White Paper before 12 December. Similarly the marketing campaign for the sale of the generators in England and Wales begins on 8 January. It would therefore cause me problems if the timetable for publishing your White Paper were to slip beyond Christmas. I shall be grateful if your officials will keep in touch with mine on your timetable for publication.

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

Yours ever

JOHN

JOHN WAKEHAM

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10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

15 October 1990

Dear Tony,

PRIVATISATION OF NORTHERN IRELAND ELECTRICITY

Thank you for your letter of 28 September setting out your Secretary of State's revised proposals for the privatisation of Northern Ireland Electricity. The Prime Minister has also seen the Financial Secretary's minute of 9 October and a copy of the Industry Secretary's letter of 8 October on this subject.

The Prime Minister has noted that, while your Secretary of State now favours Option E, both the Treasury and Department of Industry have reservations about pursuing this approach.

Accordingly, the Prime Minister believes that it would be appropriate, as suggested by both the Industry Secretary and the Financial Secretary, for officials to consider Option E further and to report back urgently on the relative merits of pursuing this approach vis-a-vis the earlier preference (Option D).

I am copying this letter to the Private Secretaries to members of E(A) and to Sonia Phippard (Cabinet Office).

Yours,

Barry

Barry H. Potter

Tony Pawson, Esq.,
Northern Ireland Office.

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SECRET

10 (2)

PRIME MINISTER

PRIVATISATION OF ELECTRICITY

I understand from Mr Wakeham's Private Office that negotiations with the 12 regional electricity companies on the financial terms of their flotation have now been completed.

Starting from projections of revenues, costs, tax liability and hence net profits, total dividend payments in the first year have been negotiated at around £325 million. Translating this into equity value depends on the implied gross dividend yield. Market response to the flotation will depend upon getting this right.

The Department of Energy consider a gross dividend yield of 8½ per cent is appropriate. Because the shares cannot realistically be expected to show strong capital growth (utilities would normally reflect GDP growth), a premium above the average dividend yield is to be expected. At present, the FT-All index gross yield is 5.7 per cent: the proposed premium of around 50 per cent is consistent with both the initial yield on water shares and the gap between US utilities and individual shares.

No There are arguments for a slightly lower yield, which Treasury might advance. If successful, they would imply a higher equity figure than the £5.1 billion implied by Department of Energy proposals. In short, more would come into the Exchequer from the privatisation.

Finally the proposed debt for the regional companies is £2.8 billion. This implies a favourable average gearing (debt: equity) of 1:2 - but the picture will vary from company to company. The implied valuation of assets in the balance sheet is therefore of the order of £8 billion.

A formal DEn letter is expected.

BHP

BHP

12 October 1990

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SECRET

PRIME MINISTER

NORTHERN IRELAND ELECTRICITY

The proposed privatisation of Northern Ireland electricity (NIE) is running into difficulty. The problems mainly reflect several changes of mind about the right approach within the Northern Ireland Office.

Originally, the Northern Ireland Secretary favoured privatising NIE as a single unit (known as Option A). The transmission, distribution and supply (TDS) network plus the various generating stations would have been privatised as one company. Other departments, including the Treasury, were unhappy; and under the influence of the Northern Ireland PUS, Mr. Needham, a reappraisal was undertaken.

Then NIO came forward with a revised plan - the so-called Option D. This would involve:

(i) a single TDS company;

(ii) splitting the generating side into two or more separate companies, to be privatised by trade sale.

Last month Mr. Brooke wrote setting out these proposals (Flag A). You approved (Flag B); so did colleagues.

Now, unexpectedly, Mr. Brooke has written again (Flag C) but favouring a different option - the so-called Option E. This comprises:

(a) TDS plus most of the generating capacity in one company;

(b) one or more separate generating companies (to be privatised by trade sale) consisting of the Kilroot Power Station plus possibly two smaller generating facilities; but

(c) the company at (a) to be prevented from bidding for the construction of new generating capacity;

(d) new supply firms to be allowed to compete by contracting with generators; but this would be confined to small scale supply, so that no 'pool' need be established.

The reasons for this latest change of mind seem to be as follows.

* Option A is the safe approach. It is certain; would spread share ownership in Northern Ireland; and would attract NIE management support and trade union acquiescence. But it simply privatises the monopoly: it does nothing to promote competition or stimulate improved performance in an inefficient (by English standards) organisation. For these reasons, Mr. Brooke has rejected Option A.

* He sees the choice as lying between Option D and option E. Option D is the more radical but the most risky. NIE management argue that TDS, with no generating capacity of its own, would be more vulnerable to supply interruption (perhaps politically or union motivated). It is this alleged need to retain some generating capacity plus TDS in one company that has persuaded Mr. Brooke to go instead for Option E.

* Option E is seen by Mr. Brooke as representing a later Option D. Greater security of supply would be obtained initially by keeping major power stations within the TDS company. But in time (quite a long time), the TDS company would lose control of generation and possibly supply as its power stations were retired. Thus it would evolve into Option D. Unlike Option D, NIE management would be prepared to support some form of Option E.

Clearly Mr. Brooke has become worried about political or union-motivated interruption of supply. He is placing considerable weight on this, and on the support of NIE management, in favouring Option E.

But the Treasury (Flag D) and the DTI (Flag E) do not like Option E because:

- there would be no real injection of competition: the new generating company (or companies) would for at least twenty years be the smaller source of supply facing a monopsonistic buyer. This would not lead to improved efficiency.

- to keep control of prices, profits, etc. heavy regulation is required.

- given the barriers to entry, there must be doubt whether new generating companies and suppliers would develop.

The parallel would therefore be more like British Gas than the privatisation now underway of electricity in England and Wales.

In short, Treasury and DTI are not persuaded that Option E is close to Option D: rather - they fear - it could end up as Option A.

Mr. Brooke seeks approval for his proposals or discussion at E(A). Treasury and DTI want a further meeting at official level, because Option E emerged at a late stage and has not been fully evaluated. George Guise (Policy Unit) agrees. This should not mean delay in publication of the proposed White Paper (previously targetted for end year).

Consider

✓ Content for officials to come forward with the revised proposals and reconsider them

OR

Prefer to go to an immediate E(A) discussion?

BHP

BARRY H. POTTER

10 October 1990

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CONFIDENTIAL

FROM: FINANCIAL SECRETARY
DATE: 9 October 1990

PRIME MINISTER

PRIVATISATION OF NORTHERN IRELAND ELECTRICITY

WITH BI

I have now seen the further paper that has been circulated to E(A) colleagues on the structure of a privatised NIE.

As you know Norman Lamont supported the conclusion Peter reached in his minute to you of 19 July, that privatising NIE in its present form would not be desirable, and that splitting generation would offer a better chance of introducing competition, and would avoid the need for intrusive regulation. I am not convinced by Peter's arguments for abandoning the potential benefits of that approach.

I fully understand Peter's concern to ensure there is a secure and economic electricity supply in Northern Ireland, but I cannot see why option D should in practice impose significant risks. On the contrary, it is only by introducing real competition into electricity generation in Northern Ireland that the economy will derive the full benefits of privatisation.

Option E does not offer a satisfactory alternative. Peter suggests that, under this option, NIE might control as many as 3 of the 4 power stations in Northern Ireland - and perhaps an interconnector with Scotland as well. If that came about, what we would have achieved is the sale of the present NIE monopoly, hiving-off only Kilroot. As Peter says such a structure would require heavy regulation: it was just this possibility that we found so unattractive when we considered the privatisation of NIE in the Summer.

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CONFIDENTIAL

Peter's paper also sets out proposals for introducing competition into electricity supply. I am disappointed that these proposals are also very restrictive: I think that we need to look further to see if a phased approach to the introduction of competition is possible here.

Any change from the present structure of Northern Ireland electricity would obviously be a step into uncharted territory. It is understandable that NIE would prefer as little change as possible. But before any decision is taken about the future of this industry, I think that we need to be sure that the new structure incorporates the maximum feasible competition. If Peter is concerned about the risks that competition might bring I suggest that his officials discuss the point further with mine.

I understand that Peter wishes to publish a White Paper before the end of the year. I agree that this would be a useful target, and suggest that our officials take forward the issues in discussion before we attempt to reach a final decision.

I am copying this minute to members of E(A) and Sir Robin Butler.

FRANCIS MAUDE

dti

the department for Enterprise

The Rt. Hon. Peter Lilley MP
Secretary of State for Trade and Industry

CONFIDENTIAL

The Rt Hon Peter Brooke MP
Secretary of State for
Northern Ireland
Northern Ireland Office
Whitehall
London
SW1A 2AZ

Department of
Trade and Industry

1-19 Victoria Street
London SW1H 0ET

Enquiries
071-215 5000

Telex 8811074/5 DTHQ G
Fax 071-222 2629

Direct line 071 215 5622
Our ref NP1090
Your ref
Date 8 October 1990

Dear Peter

PRIVATISATION OF NORTHERN IRELAND ELECTRICITY ("NIE")

I have seen your proposals for the privatisation of NIE, as outlined in the paper enclosed with your Private Secretary's letter dated 28 September.

Your decision to propose a departure from the public flotation of the transmission, distribution and supply business; and splitting the electricity generation into two or more businesses to be privatised by trade sales; is both surprising and disappointing. When the Prime Minister's Private Secretary wrote on 25 September, reporting her agreement to that original proposal and suggesting that the issues could be agreed in correspondence, it did seem likely that there would be no reason to challenge the basic principles of your recommendations.

Faced with your new recommendation for the structure of the industry, it is necessary to point out that it is so little different from the single integrated utility option ("A") - which comprised your first working assumption for the industry and which you have now decided to abandon - that the additional benefit to be derived from the new recommendation must be open to question.

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Structure of the industry

Your recommended option (option "E") would create a vertically integrated private company comprising : generating capacity (including Ballylumford, which provides 50% of current capacity and has a life of 20 - 25 years); the transmission and distribution system; and the supply function. One generating station would be sold separately, and perhaps the two oldest stations also, if feasible. The rest of NIE would be privatised in its existing structure.

NIE would therefore retain ownership of some generation and the supply business - the competitive, or potentially competitive, elements of the business. It would also retain ownership and control of the monopoly element - the transmission and distribution network. In practice, we have the precedent of British Gas to show the difficulties of concentrating competitive and monopoly elements in the hands of one company.

The remaining generating capacity might well be unattractive to potential investors, given that NIE would be the only customer for their output. And NIE would still have control of all the transmission and distribution system plus its own generating capacity.

Promotion of competition in new capacity

I am not convinced that your recommended option will achieve the benefits to consumers which you seek through encouraging new independent generators to compete for the provision of new capacity.

On the one hand, to prohibit a major generator from participating in the tendering process would seem to undermine the intention of providing "the basis for future competition in new generating capacity". Moreover, it seems likely that such a prohibition would lead to career and morale problems in NIE's generating business since it would effectively limit the life of the business.

On the other hand, if the regulator - in the not too distant future - were obliged to authorise participation by NIE in a competition for new capacity, there would be a real danger that the vertically integrated structure which you have sought to avoid would be exacerbated. The resulting combination of

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NIE's market power and the burdensome regulation needed to prevent its abuse may well dissuade new entrants to the electricity generating market in the province.

You will understand, therefore, that I cannot accept your recommended structural option for these reasons.

Concerns over dependence on commercial contracts

Turning to your rationale for recommending the new option "E", it is not immediately apparent what advantage will be gained over the more competitive option "D" in terms of reliance on contracts. If, as you propose, the Kilroot, Belfast West, and Coolkeeragh generating stations are all split from the rest of NIE and sold, around half of the available generating capacity in the province would be in independent ownership, and would require fully commercial contracts to be in place. It is difficult to see what advantage is conferred on the TDS business (in terms of security of supply or prices) by allowing it to keep the other half of the generating capacity if it depends on all of the capacity being made available in order to maintain supplies. Except, of course, the commercial benefit which would accrue to NIE in terms of profits and opportunity to abuse a privileged position in the market.

For these reasons, option D still appears to offer the greatest opportunities of creating a competitive market in new generating capacity, and of facilitating real commercial pressure on the market to produce better prices and a more competitive economy in the province.

Interconnector

I agree that the ownership of any interconnector should be structured to avoid control by NIE.

Supply competition

I also welcome your proposal for initial competition in supply for generators of 20MW or less. It would be preferable, however, to allow the regulator discretion to introduce full supply competition without the requirement to modify licences, with the attendant need to refer the issue to the MMC. While I can recognise concern over the complexity and cost of the pooling and settlements system in England and Wales, it seems reasonable to expect that the cost of a system in Northern Ireland could be on a more modest and streamlined scale, given

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the relative sizes of the markets and the limited number of players in the province. You may also wish to consider whether a limited form of pooling and settlements system may not be required from the outset.

Further action

Since your preferred structural option only emerged as a possibility rather late in the day, I propose that officials discuss the matter in the forum of the Steering Group, and report back on their findings at an early date.

I am sending copies of this letter to the Prime Minister, other members of E(A), and Sir Robin Butler.

Yours ever

Peter

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dti

the department for Enterprise

The Rt. Hon. Peter Lilley MP
Secretary of State for Trade and Industry

CONFIDENTIAL, COMMERCIAL IN CONFIDENCE

The Rt Hon John Wakeham MP
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Our ref JW10036
Your ref
Date 4 October 1990

Dear John,

ELECTRICITY PRIVATISATION: SPECIAL SHARES

I have seen a copy of Francis Maude's letter to you of 27 September.

I entirely agree with Francis Maude that the case for timeless special shares in the generators was effectively negated when the decision was taken to exclude the nuclear business from the sale. Also, given the acceptance of the principle of a five year limited protection for PowerGen in the event of a trade sale, there can be no justification for now promoting a timeless special share.

The case for a time-limited special share to permit a period of adjustment to the private sector, and to allow a track record to be established, is recognised. But a principle objective of our privatisation programme is to increase the efficiency and competitiveness of enterprises by exposing them to private sector disciplines, including those imposed by the capital markets. Going beyond a time-limited share would undermine that objective.

I hope that you can now agree that time-limited special shares are the most appropriate instruments to provide the correct balance between helping to ease the transition of the generating companies into the private sector, and ending Government involvement in the future commercial decisions of private sector companies.

I am sending copies of this letter to the Prime Minister, Malcolm Rifkind, and Francis Maude.

Yours ever

Peter

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NAT IND: Gas + Elec
pt 19

Prime Minister ②
To be aware. Both the Financial Secretary & Industry Secretary want to make the special shares in Powergen & National Power time-limited. The Energy Secretary resisted earlier. But he may not wish to reconsider. Scottish office will also resist - because they are worried that one of their privatised companies might take over the other. (However if it tried to it would be subject to an MMC reference.)

BTHP
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dti
the department for Enterprise

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COMMERCIAL IN CONFIDENCE

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Secretary of State for Trade and Industry

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Our ref PE10033
Your ref
Date 3 October 1990

Dear John

ELECTRICITY PRIVATISATION : SPECIAL SHARES

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I entirely agree with Francis Maude that the case for timeless special shares in the generators was effectively negated when the decision was taken to exclude the nuclear business from the sale. Also, given the acceptance of the principle of a five year limited protection for PowerGen in the event of a trade sale, there can be no justification for now promoting a timeless special share.

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Yours ever

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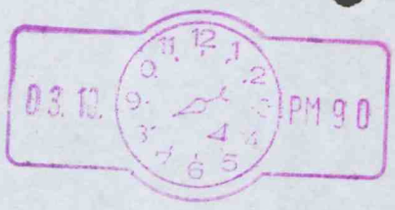
Pt 19



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From: THE PRIVATE SECRETARY

NORTHERN IRELAND OFFICE
WHITEHALL
LONDON SW1A 2AZ

B H Potter Esq
10 Downing Street
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SW1A 0AA

28 September 1990

Dear Barry,

PRIVATISATION OF NORTHERN IRELAND ELECTRICITY

Thank you for your letter of 25 September to Stephen Leach, whom I have succeeded as Mr Brooke's Private Secretary.

As we discussed, I attach my Secretary of State's proposals for Northern Ireland Electricity privatisation. Like the Prime Minister, Mr Brooke hopes that these can be agreed in correspondence, but for convenience they are in the form of an E(A) paper in case colleagues wished to discuss them in Committee.

I am copying this letter and attachment to the Private Secretaries to members of E(A) and to Sonia Phippard (Cabinet Office).

Yours sincerely,

Tony Pawson

A J D PAWSON

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THIS DOCUMENT IS THE PROPERTY OF HER BRITANNIC MAJESTY'S GOVERNMENT

E(A)(90)
28 SEPTEMBER 1990

COPY NO:

CABINET

MINISTERIAL STEERING COMMITTEE ON ECONOMIC STRATEGY

SUB-COMMITTEE ON ECONOMIC AFFAIRS

PRIVATISATION OF NORTHERN IRELAND ELECTRICITY (NIE): OPTIONS FOR RESTRUCTURING THE INDUSTRY

Memorandum by the Secretary of State for Northern Ireland

INTRODUCTION

1. In my minute of 19 July, I reported progress on the privatisation of NIE. The Prime Minister subsequently asked for E(A) to be consulted on the future structure of the industry.

2. The alternatives are either to sell NIE as a single unit by flotation or to split all or part of the generation side from transmission, distribution and supply and sell it either by flotation or by trade sale. Annex A contains factual information on NIE; a note on competition in electricity supply; and broad estimates of sale receipts and costs. My objectives in this matter are:

i. the introduction of competition which results in the lowest possible prices for consumers;

ii. further diversification of the Northern Ireland economy, in this instance by bringing new players with new ideas into the power sector;

iii. wider share ownership and especially local participation in the ownership of the industry; and

iv. the minimum level of regulation.

The original proposal was to sell NIE as a unit. However, it has become clear that it will be difficult for me to achieve the most significant of my objectives by this route and I have therefore examined other structures for the privatised industry. My conclusion is that a major proportion of generating capacity in Northern Ireland (at least Kilroot Power Station) should be split off from NIE at privatisation and that when new capacity is needed in future NIE should be excluded from the competition to provide it, unless the Regulator considers at the time that there are reasons which justify its inclusion.

3. Competition for the provision of new generating capacity is the form of competition which is likely to bring the greatest benefit to consumers in Northern Ireland. The capital investment required for new generating plant is very high and the tendering process could produce substantial reductions which would be passed on to consumers. I believe that the structure of the privatised industry must be such as to promote this kind of competition as strongly as possible. The other forms of competition seem likely to be less significant. Competition between existing power stations is unlikely because of the small number of power

stations and the differences in their age, size and fuelling. The scope for supply competition also appears to be limited. The following paragraphs examine the main structural options for the privatised NIE in the light of these considerations.

THE OPTIONS

4. The main options are:

Option A: public flotation of the whole as a single, integrated utility (ie in its present form);

Option B: public flotations of the Transmission, Distribution and Supply (TDS) side of NIE and of the Generation side (Gen) as separate companies;

Option C: a public flotation of TDS and a trade sale of Gen to a single company;

Option D: a public flotation of TDS and a trade sale of Gen to two or more separate companies by competitive auction; and

Option E: trade sale of at least the most modern power station (Kilroot) and sale of the rest of NIE, with minimal feasible generating capacity, by flotation.

5. Option A: the main advantage of this option is that it is much the most certain way of privatising NIE; the organisation is well known in its present form and there is little doubt that it could be successfully floated, with acceptable proceeds, in 1992. It would also offer scope for maximising the number of Northern Ireland shareholders and the cost of the sale would be kept low. There would be no

need for complex contracts between TDS and Gen and no duplication of central functions, so costs could be kept down.

6. However, this option has serious disadvantages. First, it is likely to discourage competition for the provision of new generating capacity, because potential independent generators will doubt the objectivity of TDS in running a competition for new capacity even with intrusive regulation. Second, it implies very close regulatory control, with the prospect of the Regulator's role being in the end almost indistinguishable in the public's perception from that which Government now performs. Finally, I believe that to leave NIE in its present form on privatisation would not give the organisation the impulse or incentive it needs to make it find more efficient and cheaper ways to provide its product in the future.

7. Option B: with this structure, TDS would be in different ownership from Gen and would have no reason to favour it over other generators in competitions to provide new capacity. Potential new generators would be more likely to compete for entry to the market (though Gen would nevertheless have a dominant position vis-a-vis new entrants) and the Regulator's involvement could be less extensive than under Option A. The split would shake up the organisation and create pressures for more efficient operation and cost reduction on both sides. It would, however, also introduce some additional running costs because of the need to finance a second senior management team and Board, together with separate headquarters and a separate company registry.

8. Generation is the risky part of the electricity supply industry and the separation of Gen from TDS would make its sale more difficult. A combined TDS and Gen business would

be a safe income stock which could be mass marketed to all categories of investor. Gen on its own would not be suitable for small investors and would have to be sold primarily to the institutions. This would reduce the level of Northern Ireland participation in the ownership of the generation business. My advisers tell me that it is also likely that investors would not pay as much for a separate Gen and that overall receipts might be reduced by some £40/£50 million. In addition, the extra costs of arranging two flotations could be around £2 million. The split would also delay the privatisation programme since new top management arrangements would have to be put in place before the development of the privatisation proposals could proceed. It is unlikely that the industry would be ready for sale before April 1993. Difficulties would arise from having a monopoly generator facing TDS, at least in the initial period before substantial new generators could enter the market.

9. Option C: Option C overcomes a number of the difficulties of Option B by selling all of the exiting generating plant to a trade purchaser, perhaps with provisions for a management/ employee share option scheme. The right purchaser would be able to provide solid capital backing for Gen and is likely to pay more than investors would pay under Option B (the purchaser would be buying total control of Gen, which separate investors under Option B would not have). Aggregate receipts under Option C could be about the same as for Option A. The additional costs for a second flotation would not arise and it would be unnecessary to install in advance new top management in Gen as the purchaser would wish to resolve that issue in his own particular way. Aggregate running costs for TDS and Gen should not exceed the costs incurred under Option A; indeed corporate ownership of Gen might force greater efficiency savings than a flotation. Option C also offers the possibility that TDS

could obtain more favourable terms in its contracts with Gen for bulk electricity supplies; the contracts would be toughly negotiated with a trade purchaser rather than framed to attract the institutions, and this would benefit consumers. It might also be possible to sell Gen by October 1992.

10. Against this, Option C would further reduce the opportunity for the Northern Ireland public to participate in the ownership of the generation business and the difficulty of having a monopoly generator for an initial period would remain. This option is almost certain to attract increased opposition from the trade unions and local MPs, all of whom are already opposed to the privatisation of NIE in principle and would probably find trade sale of a monopoly generator less acceptable still.

11. Option D: Option D provides for a trade sale of Gen in two or more lots. As in Option C, the plant could be sold with tougher contracts than would be possible under a flotation. The aggregate receipts for the business as a whole would be around the same as for Option A. The generating plant could be sold at an early stage, perhaps as early as April 1992. A further advantage of this option is that it would introduce immediately an element of competition in the form of competitive auctions for the generating plant and ensure that there would be more than one generator from the outset. This would provide a sound basis for future competitions for new capacity and underscore the possibility of having a less complex regulatory regime. Splitting the generation side into smaller lots may also make it easier for employees and Northern Ireland investor groups to be involved in bids than would be the case under Option C. Furthermore, the disaggregation of Gen is more likely to expose potential savings which could make the aggregate running cost of this option lower than Option A.

12. On the debit side of Option D is that it is uncharted territory and would make the success of the privatisation less certain. The TDS side of the business would have a duty to supply but no generating capacity of its own nor access to a pool. This would be a unique situation so far as I am aware and NIE believes that this would create risks to the security of supply and to prices. TDS's ability to meet consumer demand would depend entirely on long-term contracts with generators in which there would be potential for dispute and disruption. This option could therefore increase the level of risk in the restructuring. It would also reduce TDS's ability to invest in generating capacity outside the Province or to maintain its present earnings as a consultant on generation in the third world.

13. Option E: This option would immediately create two generators in Northern Ireland and provide the basis for future competition for new generating capacity. As in Option D, the new owners of Kilroot Power Station would be responsible for building the second phase (Kilroot II) and so the sale of Kilroot would also be, in effect, a competition to build new capacity, which would be valuable. The costs of the sale would also be similar and the scope for local participation in ownership of the industry would probably be greater than in Option D. The level of uncertainty and the risk of disruption would be less than in Option D because the restructuring would be less extensive and, in the early years at least, there would be less dependence on contracts. In any of the split options, there is a risk of strike action by the Unions who might fear a loss of jobs, and opposition from the Board and management of NIE who prefer sale as a unit (Option A). However, this option is close to an arrangement that NIE management has indicated it could accept and so should prevent delays to the privatisation process and help to counter union objections.

14. Option E would however leave NIE a substantial generator and could re-introduce the need for substantial regulation, since TDS would have incentives to bias day-to-day operations and, much more importantly, future competitions for new capacity, in favour of its own generation side. Therefore, unless there is a restriction on NIE's right to participate in new capacity competitions, this structure would be prone to the major weakness of Option A, in that it could deter potential new generators from entering the market. If NIE is barred from competing to build future power stations, however, we will eventually achieve the complete separation of TDS and generation which Option D seeks, but only in the longer term. Such a bar could be lifted if the contractual system proves not to be workable or if a real competition for new capacity cannot be created at some future time.

CONCLUSIONS ON STRUCTURE

15. If the privatisation of NIE is to be of real benefit to the Northern Ireland economy and to consumers in the longer term, it is essential that new independent generators should be encouraged to compete for the provision of new capacity when it is required. In seeking to create a structure which will favour such competition, I must, however, at the same time, avoid taking unnecessary risks with this vital industry or imposing costs which will not be offset by potential benefits. I believe that Option A would inhibit new capacity competition and must be rejected. Options B and C would be better in this respect but less than perfect: they would promote no competition in the short-to-medium term, while in future capacity competitions potential new generators would be likely to be deterred by an existing monopoly generator. I believe therefore that the choice of structure lies between Options D and E.

16. The advantages of Option D are that it would ensure full and open competition for new capacity in the future and create an element of competition in the privatised industry from the outset, by breaking up the generating monopoly. But this option has the disadvantage that it would be an all-or-nothing commitment to an untried structure, with the risks and uncertainties that that entails, as outlined in paragraph 12 above. My conclusion is that it is too radical a change to attempt in a single step, given the vital nature of the electricity industry and the serious consequences if things go wrong.

17. I therefore feel that I must allow NIE to retain some presence in generation. I cannot, at this stage, reach a firm view on how substantial that presence need be. NIE have argued that they should retain all the present generating capacity other than Kilroot and there has been a presumption that they would own the Scotland/Northern Ireland interconnection if that project proceeds. If that were the outcome, then the risks that NIE would exploit monopoly power would necessitate intrusive regulation as in Option A. However, it may be possible to reduce NIE's continuing generating presence significantly below that level, thus creating a more competitive structure and reducing the need for regulation. I therefore propose to explore whether Belfast West and Coolkeeragh power stations can be sold separately or in conjunction with Kilroot, and I will seek to structure ownership of any interconnector so as to deny NIE control of it.

18. The benefit of Option E is that it will break up NIE's generating monopoly, and create immediate competition for completion of Kilroot II. It will also allow the feasibility of reliance on contracts between TDS and a generator to be tested in practice before there is any

full-scale commitment for every station on the system. If the contracts prove satisfactory, the system might then evolve, with the benefit of experience, towards the structure envisaged in Option D.

19. Under Option E, NIE would remain a substantial generator and the problem of arranging fair and unbiased competitions for new capacity in future would therefore have to be tackled. It would be possible to do so by means of a licence condition prohibiting NIE from entering such competitions, which would mean it had no incentive to favour any of the bidders and the latter would therefore not be discouraged by fear of bias. Over time, as its existing stations reached the end of their lives, NIE would cease to be a generator. There are some dangers in such a prohibition (for example, if there were only one bidder for construction of new capacity, NIE could be compelled to take the price offered, even though it might be able to provide the capacity cheaper itself); but, since the prohibition would be a licence condition, it could be revoked to allow NIE to bid if that should happen or if other circumstances should arise which would justify NIE's inclusion. The licence would spell out carefully what these circumstances might be.

20. There is evidence that there are real cost improvements to be made as against NIE's present performance and splitting the organisation offers the best prospect of securing these. It is difficult to quantify the savings but there are a number of areas which might be expected to be tackled vigorously. NIE's manning levels, for example, are high compared to other UK electricity companies. Statistics published by the Northern Ireland Economic Council show that by comparison with other regions of the UK, NIE has significantly more employees per 1,000 customers, has higher labour costs per employee and has higher labour costs per

unit. I understand that substantial reductions are expected in the workforce in Great Britain after privatisation and, in light of the above, I would expect that there must be scope for similar cost savings in Northern Ireland also. The introduction of new ownership at Kilroot, with different ideas on manning levels and labour practices, could provide a stimulus and an opportunity for NIE to review the position in its own power stations. The costs of the TDS side would, of course, be controlled by the Regulator, but I would hope that, in negotiations with NIE about the structure and about the rules for participation in competitions, it might be possible to obtain a commitment in advance to the efficiency savings which could be made in TDS.

21. Any change in the present structure of NIE will carry some risks, but for the reasons given I have concluded that change is essential. It would be easy to leave things as they are, but it is in the long term interest of consumers and the Northern Ireland economy to create a more competitive environment. I must however balance the risks of change against the potential benefits and I have reached the view that it would be dangerous to try and introduce very sweeping change too rapidly. I would therefore propose to proceed with Option E, as set out in paragraphs 13-14 and 17-19 above, and announce it in a White Paper.

SUPPLY COMPETITION

22. Allowing consumers to choose who supplies electricity to their premises - supply competition - can be the most effective means of making the electricity industry responsive to customers' needs. However, extensive supply competition involves many competing suppliers wishing to use the transmission and distribution network to serve their customers. Without central control this can undermine merit order despatch and threaten the network's stability. One

possible consequence is the collapse of the whole system, causing a total black-out; if this were to happen it could take several hours to restore supplies.

23. In England and Wales this problem has been tackled by the introduction of a centralised and highly complex pooling and settlement arrangement to control the despatch of electricity from generating plant. In Northern Ireland such an arrangement would not benefit consumers because the small number of relatively large generators on the system would be able to manipulate it to increase their profits at the expense of consumers. Other potential difficulties would arise out of the obligation to supply which will be placed on the established supplier, in this case TDS.

24. I believe that the appropriate arrangement for Northern Ireland would be to limit supply competition to small generators of up to about 20MW who would be able to despatch electricity whenever they wished. This would avoid the complexities of a pool, though for reasons of network stability the aggregate amount of electricity the small generators could supply would have to be limited.

25. Though limited initially, the arrangement for supply competition could be allowed to develop as the system grows. The draft legislation being prepared at present would enable the Regulator to introduce more extensive forms of supply competition in the longer term by licence amendment following an MMC reference.

RECOMMENDATIONS

26. Colleagues are invited to endorse my conclusions that:

(a) at least Kilroot Power Station should be split off from the rest of NIE (TDS and the three older power

stations) and sold separately; if feasible, Belfast West and Coolkeeragh should also be split off from NIE;

(b) the ownership of any interconnector with Scotland should if possible be structured to ensure that NIE does not control it;

(c) NIE with a residual generating capacity should be sold by public flotation, Kilroot should be sold to a trade purchaser with a contract to complete Phase II, and suitable arrangements should be made for Belfast West and Coolkeeragh;

(c) NIE should be prohibited by licence from entering competitions for new generating capacity unless the Regulator decides that there are valid reasons for lifting the prohibition; and

(d) provision should be made for supply competition to be introduced in a limited form for generators of 20MW or less.

27. I would plan to announce the arrangements for the privatisation of NIE in a White Paper to be published before the end of the year. Colleagues would of course be kept informed.

NORTHERN IRELAND OFFICE PB

28 September 1990

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Pt 15

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E(A)

MEMORANDUM FROM THE SECRETARY OF STATE FOR NORTHERN IRELAND

PRIVATISATION OF NORTHERN IRELAND ELECTRICITY (NIE): OPTIONS FOR RESTRUCTURING THE INDUSTRY

INTRODUCTION

1. In response to my minute in July reporting on the privatisation of NIE, the Prime Minister asked for a discussion at E(A) on the future structure of the industry.

2. The alternatives are to sell NIE either as a single unit or by splitting the generation side from transmission, distribution and supply and, if the latter, to sell generation either by flotation or by trade sale. My objectives in this matter are:

i. the introduction of competition which results in the lowest possible prices for consumers;

ii. further diversification of the Northern Ireland economy, in this instance by bringing new players with new ideas into the power sector;

iii. wider share ownership and especially local participation in the ownership of the industry; and

iv. the minimum level of regulation.

The original proposal was to sell NIE as a unit. However, it has become clear that it will be difficult for me to achieve the most significant of my objectives by this route and I have therefore examined other structures for the privatised industry. My conclusion is that there should be a split and that generation should be sold by trade sale, preferably to more than one buyer.

3. The form of competition which is likely to bring the greatest benefit to consumers in Northern Ireland is competition for the provision of new generating capacity. The capital investment required for new generating plant is very high and the tendering process could produce substantial reductions which would be passed on to consumers. I believe that the structure of the privatised industry must be such as to promote this kind of competition as strongly as possible. The other forms of competition seem likely to be less significant. Competition between existing power stations is unlikely because of the small number of power stations and the differences in their age, size and fuelling. The scope for supply competition appears to be limited (para below). The following paragraphs examine the main structural options for the privatised NIE in the light of these considerations.

THE OPTIONS

4. The main options are:

Option A: public flotation of the whole as a single, integrated utility (ie in its present form);

Option B: public flotations of the Transmission, Distribution and Supply (TDS) side of NIE and of the Generation side (Gen) as separate companies;

Option C: a public flotation of TDS and a trade sale of Gen to a single company;

Option D: a public flotation of TDS and a trade sale of Gen to two or more separate companies by competitive auction; and

Option E: (proposed by NIE): trade sale of one major power station (Ballylumford or Kilroot) and sale of the rest of NIE by flotation.

5. Option A: the main advantage of this option is that it is much the most certain way of privatising NIE; the organisation is well known in its present form and there is little doubt that it could be successfully floated, with acceptable proceeds, in 1992. It would also offer scope for maximising the number of Northern Ireland shareholders and the cost of the sale would be kept low. There would be no need for complex contracts between TDS and Gen and no duplication of central functions, so costs could be kept down.

6. However, this option has serious disadvantages. First, it is likely to discourage competition for the provision of new generating capacity, which, as mentioned above, is potentially the most beneficial form of competition in Northern Ireland. Second, it implies very close regulatory control, with the prospect of the Regulator's role being in the end indistinguishable from that which Government now performs. Finally, I believe that to leave NIE in its present form on privatisation would not give the organisation the impulse or incentive it needs to make it find more efficient and cheaper ways to provide its product in the future. It is for these reasons that I decided to look again at the possibility of splitting NIE.

7. Option B: with this structure, TDS would be in different ownership from Gen and would have no reason to favour it over other generators in competitions to provide new capacity. Potential new generators would be more likely to compete for entry to the market (though Gen would nevertheless have a dominant position vis-a-vis new entrants) and the Regulator's

involvement could be less extensive than under Option A. The split would shake up the organisation and create pressures for more efficient operation and cost reduction on both sides. It would, however, also introduce some additional running costs because of the need to finance a second senior management team and Board, together with separate headquarters and a separate company registry.

8. Generation is the risky part of the electricity supply industry and the separation of Gen from TDS would make its sale more difficult. A combined TDS and Gen business would be a safe income stock which could be mass marketed to all categories of investor. Gen on its own would not be suitable for small investors and would have to be sold primarily to the institutions. This would reduce the level of Northern Ireland participation in the ownership of the generation business. My advisers tell me that it is also likely that investors would not pay as much for a separate Gen and that overall receipts might be reduced by some £40/£50 million. In addition, the extra costs of arranging two flotations could be around £5-10 million. The split would also delay the privatisation programme since new top management arrangements would have to be put in place before the flotations could proceed. It is unlikely that Gen would be ready for sale before April 1993. Difficulties would arise from having a monopoly generator facing TDS, at least in the initial period before substantial new generators could enter the market.

9. Option C: Option C overcomes a number of the difficulties of Option B by selling all of the existing generating plant to a trade purchaser, perhaps with provisions for a management/ employee share option scheme. The right purchaser would be able to provide solid capital backing for Gen and is likely to pay more than investors would pay under Option B (the

purchaser would be buying total control of Gen, which separate investors under Option B would not have). Aggregate receipts under Option C could be about the same as for Option A. The additional costs for a second flotation would not arise and it would be unnecessary to install in advance new top management in Gen as the purchaser would wish to resolve that issue in his own particular way. Aggregate running costs for TDS and Gen should not exceed the costs incurred under Option A; indeed corporate ownership of Gen might force greater efficiency savings than a flotation. Option C also offers the possibility that TDS could obtain more favourable terms in its contracts with Gen for bulk electricity supplies; the contracts would be toughly negotiated with a trade purchaser rather than framed to attract the institutions, and this would benefit consumers. It might also be possible to sell Gen by October 1992.

10. Against this, Option C would further reduce local participation in the ownership of the generation business. The difficulty of having a monopoly generator for an initial period would remain. This option is almost certain to attract increased opposition from the trade unions and local MPs, all of whom are already opposed to the privatisation of NIE in principle and would probably find trade sale of a monopoly generator less acceptable still.

11. Option D: Option D provides for a trade sale of G in two or more lots. As in Option C, the plant could be sold with tougher contracts than would be possible under a flotation. The aggregate receipts for the business as a whole would be around the same as for Option A. The generating plant could be sold at an early stage, perhaps as early as April 1992. A further advantage of this option is that it would introduce immediately an element of competition in the form of competitive auctions for the generating plant and ensure that

there would be more than one generator from the outset. This would provide a sound basis for future competitions for new capacity and would further underscore the possibility of having a relatively simple regulatory regime. Splitting the generation side into smaller lots may also make it easier for employees and NI investor groups to be involved in bids than would be the case under Option C. Furthermore, the disaggregation of Gen is more likely to expose potential savings which could make the aggregate running cost of this option lower than Option A.

12. The main point on the debit side of Option D is that it is uncharted territory and would make the success of the privatisation less certain. It would open up issues, the outcome of which cannot be confidently predicted but which have the potential to delay the privatisation significantly or even frustrate it. The trade unions might see it as a precursor to serious job losses in the power stations and threaten, or actually take, strike action. (The existing top management might become less co-operative regarding the whole privatistation process than it has been so far. Sale of generation in two or more pieces could bring in bidders such as the Republic of Ireland's Electricity Supply Board (ESB) or Electricté de France, both state-owned undertakings whose ownership of part of the industry would run counter to the very concept of privatisation; and in the case of the ESB, the political dimension would certainly be exploited by the unions. The very process of breaking up generation may reveal technical or commercial problems which are at present unforeseen. I return to these issues after considering the final option.

13. Option E: this option (trade sale of a major power station and flotation of the rest of NIE as a unit) has been proposed by NIE, as an alternative to its preferred solution,

Option A. Like Option D it would create two generators in Northern Ireland and provide the basis for future competition for new generating capacity. If the station sold were Kilroot, the new owners would be responsible for the building of the second phase (Kilroot II): the cash flow of the rest of NIE would be improved and overall privatisation proceeds might be about the same as in Option D. The costs of the sale would be also similar and the scope for local participation in ownership of the industry would probably be greater than in Option D.

14. Option E would however leave TDS a substantial generator and would re-introduce the need for heavy regulation, since TDS would have incentives to bias competitions for new capacity and the day-to-day operations in favour of its own generation side. This structure therefore shares to a significant extent the major disadvantage of Option A, in that it could deter potential new generators and squeeze the most beneficial form of competition out of the system.

CONCLUSIONS ON STRUCTURE

15. If the privatisation of NIE is to be of real benefit to the Northern Ireland economy and to consumers in the longer term, it is essential that new independent generators should be encouraged to compete for the provision of new capacity when it is required. In NI that could mean that 20/30% of total capacity could pass into separate ownership in the first new capacity competition after privatisation. The best way of ensuring that such competition does arise is to separate TDS from Gen at the outset to provide a more level playing field for potential new entrants. I believe that this tells decisively against the original proposal to sell as a unit, and also against NIE's Option E.

16. The reduction in receipts and the additional costs that would arise from the flotation of an independent Gen makes Option B an unattractive route. I also believe that, of all the "split" options, this is the one that would imply the highest running costs. I would therefore prefer to sell Gen to trade purchasers and I believe that this would send the strongest signal to potential new generators that there is room for them in the industry. A multiple split of the existing generating plant under Option D has additional advantages over the single generating company in Option C in that it breaks up the generating monopoly and creates a competitive element in the industry from the outset.

17. There is evidence that there are real cost improvements to be made as against NIE's present performance and splitting the organisation offers by far the best prospect of securing these. It is difficult to quantify the savings but there are a number of areas which trade purchasers might be expected to tackle vigorously. NIE's manning levels, for example, are high compared to other UK electricity companies. Its wage levels are aligned with those of the GB industry and are high in comparison with the generality of wages in NI; and the proportion of staff with wages in the higher ranges may be greater than elsewhere. Moreover there is likely to be a significant overhead charge for providing central services to the generation side, which could be considerably reduced if the power stations were run by separate owners as part of their wider business. Option D should therefore add short-to-medium term benefits to those that would arise in due course from competition for new capacity.

I have asked for this to be expanded in final paper with more evidence. GRB

18. The problem of the uncertainty of Option D already mentioned is not negligible, but I do not believe it should deter me from choosing that option. Any change in the present structure will carry some risks, but for the reasons given I

have concluded that change is essential. It would be easy to leave things as they are, but it is in the long term interest of consumers and the Northern Ireland economy to create the most competitive, least cost structure for this industry. I therefore propose to proceed with Option D. In doing so, I will explore the possibility of stimulating interest in management/employee buy-outs, purchases by NI investor-groups and combinations of these and external sales in order to maximise the level of local participation in the generation side of the business.

SUPPLY COMPETITION

19. Allowing consumers to choose who supplies electricity to their premises - supply competition - is the most effective means of making the electricity industry responsive to customers' needs. However, extensive supply competition involves many competing suppliers wishing to use the transmission and distribution network to serve their customers. Without central control this can undermine merit order despatch and threaten the network's stability. One possible consequence is the collapse of the whole system, causing a total black-out; if this were to happen it could take several hours to restore supplies.

20. In England and Wales this problem has been tackled by the introduction of a centralised and highly complex pooling and settlement arrangement to control the despatch of electricity from generating plant. In NI such an arrangement would not benefit consumers because the small number of relatively large generators on the system would be able to manipulate it to increase their profits at the expense of consumers. Another potential difficulty with supply competition arises from the obligations to supply traditionally placed on the established supplier. [The established supplier arranges

long-term contracts with generators in order to meet the expected demands of customers. The loss of some major customers to competitors can then mean that the established supplier is left bearing the costs of the redundant contracts, and these have to be spread among remaining customers, so making the supplier increasingly uncompetitive.]

deleted

21. I believe that the appropriate arrangement for NI would be to limit supply competition to small generators of up to about 20MW who would be able to despatch electricity whenever they wished. [These generators/suppliers would be charged standard terms for use of the transmission and distribution wires, and there would be arrangements under which they could buy power from the large generators to cover occasions when they were unable meet their customers' demands because of plant breakdown or some other reason.] This would avoid the complexities of a pool, though for reasons of network stability the aggregate amount of electricity the small generators could supply would have to be limited. [This limit would also mean that the problem of redundant contracts would not arise to any significant extent.]

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22. Though limited initially, the arrangement for supply competition could be allowed to develop as the system grows. The draft legislation being prepared at present would enable the Regulator to introduce more radical forms of supply competition in the longer term by licence amendment following an MMC reference.

RECOMMENDATIONS

23. Colleagues are invited to note the conclusions of this memorandum that:-

a. NIE(TDS) should be separated from Gen;

b. NIE(TDS) should be sold by public flotation and Gen should be sold to two or more trade purchasers; and

c. provision should be made for supply competition to be introduced in a limited form for generators of 20MW or less.

PB

NAT IND:
Gas + Electricity
Pt 13

cc PM. D

Northern Ireland Office

Whitehall, London SW1A 2AZ

Telephone: Direct Dialling 071-210 .....
Exchange 071-210 3000

PRIVATISATION OF N.I. ELECTRICITY

Annexes to AJD Pawson's
letter to BH Potter Esq
dated 28 September 1990

With Compliments

With apologies for the omission.

S.C. Lackie
Private Office (L)

ANNEX A

CONTENTS

1. NIE FACT SHEET
Capacity, fuel, demand, consumers, sales and employees

2. COMPETITION
Forms of competition in the electricity supply industry and their expected effect on Northern Ireland

3. SALES RECEIPTS AND COSTS
Summary of the estimated sale receipts and costs associated with each of the main options for re-structuring NIE.

NIE FACT SHEET

1.0 Generation Capacity

Power Station	MW (Fuel)	Commissioning dates	Retirement dates
Ballylumford	960 (oil)	1968/74	2007/15
	120 (GTs)*	1975/76	c.2024
Belfast West	240 (coal)	1954/58	1994/98
Coolkeeragh	360 (oil)	1959/67	1996/2004
	60 (GTs)*	1972	c.2024
Kilroot 1	400/520 (coal/oil)	1981/82 **	c.2024
	60 (GTs)*	1980/81	c.2024

* Gas turbines burning distillate

** Converted from oil to dual coal/oil firing in 1989

1.1 Total commissioned Capacity

2200MW - when Kilroot 1 is burning coal
2320MW - when Kilroot 1 is burning oil.

1.2 Fuel Diversity

oil dependency - when Kilroot 1 is burning coal - 71%

1.3 Maximum demand

1399MW (1990)

1.4 Consumers and Sales

	Consumers	Units (million)
Domestic	519398 (87%)	2234 (40%)
Farming	31350 (5%)	292 (5%)
Small commercial and industrial	44665 (7.5%)	731 (13%)
Large commercial and industrial	3238 (0.5%)	2401 (42%)
Total	598651	5658

1.5 Employees

Managerial	45
Technical/Engineering	879
Administrative & Clerical	1431
Industrial	3106
	5461
Trainees	178
	5639

2. COMPETITION

2.1 The transmission and distribution functions of the electricity supply industry are natural monopolies and therefore offer no opportunities for the introduction of competition.

2.2 Competition arises, or can be introduced, in the tendering process for new capacity, the despatch of electricity from power stations in merit order, and the supply of electricity to consumers.

2.3 New capacity. Competition for new capacity puts pressure on tenderers to contain capital costs, to maximise the availability and efficiency of plant, to negotiate tough contracts with fuel suppliers and to keep profits down to a normal level. The capital investment required for new plant is very high and the tendering process could produce substantial reductions which could be passed on to consumers. This form of competition could bring big benefits to consumers in Northern Ireland. However, the competitive pressure ends when the tendering process is completed and it is important therefore to ensure that the winner has no recourse to contract re-openers, except under clearly defined and limited circumstances, after the power station has been commissioned and there are no longer any competitors to constrain the generator's bargaining position.

2.4 Merit order. Merit order competition gives generators the incentive to keep running costs to a minimum, to sell power at prices close to running costs, and to maximise the availability of the plant. The lower the selling price and the higher the availability, the more the plant is called upon to run. Consumers benefit from the lower prices and the most frequently used generators maximise their profits. Merit order competition will

not, however, exercise the same downward pressure on costs in the small Northern Ireland system as would be expected in a much larger system. There are only four power stations in Northern Ireland and it will be easy for the generators to work out fairly accurately where the stations stand in the merit order and the extent to which this might be altered by factors within the control of the station managers. If the generators know that costs cannot be cut sufficiently to alter the merit order they will have no incentive to make reductions which offer no prospect of additional reward.

2.5 Supply. Supply competition is the most effective means of making the electricity industry responsive to consumers' needs. Having the opportunity to select alternative suppliers places consumers in a strong position to negotiate supply contracts that suit their particular requirements. To make this system work all suppliers must have access to the transmissions and distribution wires on standard terms. Use of the wires must also be subject to central control otherwise electricity could not be despatched in merit order and the stability of the system would be threatened.

2.6 In Northern Ireland it will be difficult to develop an effective and efficient means of central control that would enable several suppliers to use the transmission and distribution wires at the same time. England and Wales have adopted a pooling and settlment arrangements under which generators sell their electricity to the pool at a price bid by them on a daily basis. The generators must keep their bids as low as possible in order to maintain or increase their prospects of being run continuously or frequently. A pool would not apply that sort of downward pressure on prices in Northern Ireland because of the limited effect merit order competition has on a very small system. It has already been noted

in paragraph 2.4 above that generators in Northern Ireland will know where they stand in the merit order and will be able to make a fairly accurate assessment of the lead they might have on their competitors. In these circumstances generators could pitch their bids to the pool closer to their estimate of their nearest competitors costs, even though they could have bid lower. Prices to consumers would therefore rise.

2.7 A further difficulty with supply competition is that it is likely to make the established supplier's obligation to supply more expensive. In order to fulfil the obligation to supply, the established supplier must have in place sufficient long-term contracts with generators to meet the expected demands of consumers. New suppliers can enter the market only by attracting consumers away from the established supplier. As they gain market share, the established supplier will accumulate a growing surplus of capacity in contracts for which he must continue to pay. Some control over the amount of surplus capacity could be exercised by revoking the established supplier's obligation to supply consumers who opt to take electricity from other supply companies. This need not be a permanent exclusion,but the consumers would have to be required to give a substantial period of notice which would allow the established supplier sufficient time, if required, to make adequate provision for them before restoring the supply of electricity. Nevertheless, surpluses would occur from time to time and the cost of carrying them would have to be borne by the established supplier's consumers.

2.8 The only means of avoiding or minimising the problem in Northern Ireland would be to limit supply competition to small generators of, say, 20MW who could despatch electricity whenever they wished. They would be charged standard terms for the use of the transmission and distribution wires, and would also have to have available arrangements for buying electricity from the established

supplier, again on stndard terms, to cover situations in which they were unable to generate enough electricity to meet their customers demands.

2.9 For reasons of network stability the aggregate amount of electricity supplied by small generators would have to be limited, but the arrangements could be allowed to develop as the system grows. Legislative provisions would also be made at the outset which would enable the Regulator to introduce more extensive forms of supply competition in the longer term by licence amendment following an MMC reference.

3. SALES RECEIPTS AND COSTS

The table below sets out the estimated sales receipts and costs for each of the options considered in the memorandum, and shows the expected ranking order of each option in terms of effectiveness in reducing running costs. The estimates of receipts must be treated as no more than rough approximations.

	estimated* receipts	costs of sale, contract negotiations, etc.	effectiveness** in reducing running costs
	£m	£m	
Option A	300	10	4
Option B	250	12	5
Option C	300	15	2
Option D	300 plus	15	1
Option E	300 minus	15	2

* The level of receipts realised will depend heavily on the price of electricity at the time of the sale and on the details of the regulatory regime and contracts. In general, predictions of receipts from trade sales can be expected to be more accurate than predictions of receipts from flotation.

** It is difficuly to estimate at this stage the savings in running costs that could be achieved under each option. Option D should achieve the largest savings and would be expected to reduce costs by at least £2m per annum more than the lowest ranked option, Option B.

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Warn Energy (Scot.)
DTI reply.

BHP
28/9

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon John Wakeham FCA JP MP
Secretary of State for Energy
Department of Energy
1 Palace Street
LONDON
SW1E 5HE

27th September 1990

Dear Secretary of State,

ELECTRICITY PRIVATISATION: SPECIAL SHARES

Following the exchanges between Peter Lilley and Malcolm Rifkind earlier this year, I have looked again at the correspondence on this subject, and see that the issues were left unresolved.

I am not convinced by Malcolm's arguments against time-limited special shares in Scotland, but the structural characteristics of the industry in Scotland are sufficiently different from those in England and Wales to justify a fresh look at the position in England and Wales independently of what is decided for Scotland.

I therefore propose again that we extend to National Power and PowerGen time-limited special shares of the kind envisaged for the Regional Electricity Companies.

The strategic case for timeless special shares in the generators fell when we withdrew the nuclear stations from the sale. The proposed 5 year protection in the purchase agreement for PowerGen was an implicit acceptance of the principle of time limiting. I therefore see no difficulty publicly in announcing a new approach. That would of course be justified by the benefits which flow from development of a competitive generating sector in England and Wales subject to conventional capital market pressure.

I am sending a copy of this letter to the Prime Minister, Malcolm Rikfind and Peter Lilley.

Yours Sincerely

Francis Maude

FRANCIS MAUDE

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(Approved by the Financial Secretary and signed in his absence.)

NAT IND. Gas + Elec
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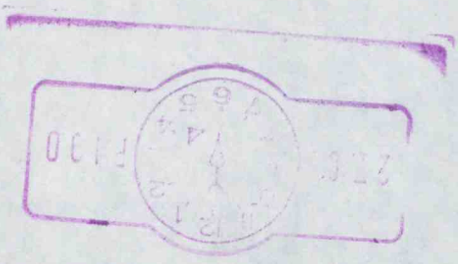

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2 MARSHAM STREET
LONDON SW1P 3EB
071-276 3000

My ref:

Your ref:

Barry Potter Esq
Private Secretary to
The Prime Minister
10 Downing Street
LONDON
SW1A 2AA

26 September 1990

Dear Barry

PRIVATISATION OF NORTHERN IRELAND ELECTRICITY

You indicated on 3 September that the Prime Minister was willing for the environmental issues relating to this privatisation to be considered by E(A) alongside the economic ones.

I have subsequently seen John Neilson's letter of 4 September. As he indicates, Mr Trippier has recently secured the agreement of colleagues to proposed allocations of the national sulphur reductions required by the Large Combustion Plants Directive and we are now consulting publicly on these. We therefore agree with John that there will be no need for E(A) to consider these issues.

Yours

Phillip

PHILLIP WARD
Private Secretary

NAT IND: Gas + Elect Pt 19.

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10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

25 September 1990

Dear Stephen,

PRIVATISATION OF NORTHERN IRELAND ELECTRICITY

Following an earlier round of correspondence, the Prime Minister proposed that the privatisation of Northern Ireland Electricity (NIE) should be considered at E(A). The item is on the agenda for the discussion on 4 October.

The Prime Minister has had an opportunity to see an early draft of a paper for E(A). She is now persuaded that the Government should go ahead with privatisation along the lines favoured by your Secretary of State. She understands this would involve a public flotation of the transmission/distribution business; splitting electricity generation into two companies; and aiming for a trade sale of each company.

Accordingly, and in view of the pressures on Ministerial diaries in the week before the Party Conference, the Prime Minister would like to see whether this matter can be cleared in correspondence. The next step would therefore be for your Secretary of State to circulate his final proposals and seek colleagues' approval.

Subject to comments from colleagues on E(A), the Prime Minister hopes it will prove possible to agree the proposed approach in correspondence.

I am copying this letter to the Private Secretaries to members of E(A) and to Sonia Phippard (Cabinet Office).

Yours,
Barry

BARRY H. POTTER

Stephen Leach, Esq.,
Northern Ireland Office.

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NAT IND:

Gas + Electricity

Pt 13.

PRIME MINISTER

PRIVATISATION OF NORTHERN IRELAND ELECTRICITY

You may recall there was an earlier round of correspondence about the privatisation of Northern Ireland electricity (NIE).

The Northern Ireland Secretary favoured breaking up the distribution and electricity generation components of NIE and privatising them separately. This view was supported by Treasury and DTI. But Policy Unit was not persuaded that the size of NIE was sufficient to justify a break up into separate companies prior to privatisation.

In the attached paper, George Guise (Policy Unit) advises that, following further examination, he is now persuaded the Government should go ahead with privatisation along the lines favoured by Mr. Brooke. The proposed option (option D in the draft paper) would involve a public flotation of the transmission/distribution business; splitting electricity generation into two companies; and aiming for a trade sale of each company. This would go ahead in 1992.

Assessment

The policy choice is between an easier and earlier privatisation of NIE as a single company; and a later, perhaps more difficult privatisation, which would bring potentially stronger and wider economic benefits.

If NIE is sold as a single company, it will retain its monopoly. There is evidence that NIE is inefficient and overmanned. Privatisation as a single company would do nothing to break down the monopoly - including the effective monopoly power enjoyed by the trade unions. (Correspondingly the ability to make monopoly profits would make the shares more attractive.)

Privatisation in the form proposed by Mr. Brooke is the right economic solution. It brings competitive pressures to bear on the generators; it would force the generators to compete for the

transmission network; and it would remove the cosy relationship with the trade unions. Moreover the premium from the trade sale should mean total proceeds at about the same level as a public flotation of NIE as a single entity (which would earn a "monopoly" bonus).

The draw-backs are the uncertainty about arranging a trade sale - in particular the risks of no buyer; and thus being forced back either to privatisation as a single unit, or public flotation of one or both generators. The latter would probably lead to lower proceeds than sale as a single entity.

Policy Unit, Treasury and DTI are all content to proceed with the three company option (D) as set out in the attached paper.

No decision is required on substance at this stage. But there is pressure for the matter to be cleared in correspondence, rather than going to an E(A) discussion next week.

(i) Content for the issue to be cleared in correspondence?

Yes

or

(ii) Prefer the E(A) discussion to go ahead next week as planned?

or (in view of the pressures on your diary)

(iii) Prefer to postpone the E(A) discussion until after the Party Conference?

BHP

BHP

24 September 1990

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BARRY POTTER

21st September 1990

PRIVATISATION OF NORTHERN IRELAND ELECTRICITY (NIE)

Discussions with the Northern Ireland Office and the Treasury have made me less sceptical about the preferred method of proceeding. This is to arrange for a trade sale of Generation in two or more lots coupled with a flotation of the Distribution and Supply business. Three activities in separate ownership would therefore be created. My initial fear was that the whole enterprise was not sufficiently large to warrant sub-division on this scale and that the NI Office might be pressing for competition at an uneconomic cost for doctrinaire reasons. I attach a draft E(A) paper from the Northern Ireland Secretary in substantially final form which has Treasury support.

I am now satisfied that a thorough analysis of the alternatives has been made and that Richard Needham's suspicions that the present industry is an inefficient, cosy monopoly are justified. Manning levels are higher than elsewhere in the UK with a greater proportion of staff in the higher wage categories.

The paper gives a closely ~~researched~~ reasoned analysis of five different options. In particular, it does not gloss over the difficulties of its preferred option D and paragraph 12 sets these out. Proceeds will be lower because less monopoly profit will be locked in. The Trade Unions and Northern Ireland Electricity (NIE) will not like it because it will lead to more efficiency and therefore less manning. These are all indirect arguments that the NIO has made the right

decision in selecting option D.

NIE, advised by BZW, continue to fight a rearguard action in favour of minimum break up. I have been assured that the Northern Ireland Secretary is fully aware of their argument and indeed has arranged to see them on Monday. However, I doubt whether that meeting will result in any major change in the Department's proposal which I support.

Conclusion and Recommendation

It would be politically easier and create less hassle to privatise NIE as a single entity. However, Peter Brooke and Richard Needham have concluded that would not serve consumer interests of improved economics and efficiency. The present proposals result from a proper analysis of the best method of introducing competition and have the support of the Treasury and the DTI. I do not believe any other Department will object and it should therefore be possible to deal with the matter in correspondence without the need for convening E(A).

GEORGE GUISE

Cab. 11.

n.5.P.M.
BHP
19/9

TONY BALDRY MP

Department of Energy
1 Palace Street
London SW1E 5HE
071 238 3169

The Rt Hon Christopher Patten MP
Secretary of State for the Environment
Department of the Environment
2 Marsham Street
LONDON
SW1P 3EB

18 September 1990

Dear Chris,

IMPLEMENTATION OF THE EC LARGE COMBUSTION PLANTS DIRECTIVE: EFFECT ON ELECTRICITY PRIVATISATION

I have seen Malcolm Rifkind's letter to you of 7 September in which he seeks agreement that, in the context of flotation, tradeable permits should remain an option in the medium term and that officials should bring forward proposals for a tradeable permit regime. I am responding in John Wakeham's absence.

As John indicated in his letter of 9 August, there is no objection, in principle, to tradeable permits over the longer term. However, I believe we should not go beyond what is currently envisaged for the electricity industry, either in the Environment White Paper or by the emission control system proposed in the Environmental Protection Bill. To indicate that we are currently working up new proposals would, at this stage, only serve to undermine the credibility of the Environmental Protection Bill and create uncertainty in the minds of investors both north and south of the border.

I am copying this letter to the Prime Minister, Geoffrey Howe, John Major, Douglas Hurd, Malcolm Rifkind, Peter Brooke, Peter Lilley and to Sir Robin Butler.

Yours ever

Tony

TONY BALDRY

NAT IND
Gas & Elec

Pt 19

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NBM 18/9

FINANCIAL SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Christopher Patten MP
Secretary of State for the Environment
Department of the Environment
2 Marsham Street
LONDON
SW1P 3EP

18 September 1990

Dear Secretary of State

IMPLEMENTATION OF THE EC LARGE COMBUSTION PLANTS DIRECTIVE: EFFECT ON ELECTRICITY PRIVATISATION

I have seen Malcolm Rifkind's letter of 7 September and earlier correspondence on this issue. will BP?

On the detailed issues, I understand that officials are now close to agreement on how the emission limits should be shared between the industry North and South of the border; and that, on the basis that this leaves a reasonable prospect that the interconnector will be enhanced, aggregate proceeds should not be significantly jeopardised as a result.

For the medium term, I am strongly attracted by a tradeable permits regime. But for now, I share John Wakeham's concerns that we must not do anything to create uncertainty in the minds of investors about how the LCPD is likely to affect the generators over the next few years. For that reason, although I agree that the ESI should not be excluded from the scope of further considerations, as indicated in the Environment White Paper, I should be wary of asking officials to work up options now unless John and his advisers were also content from the standpoint of flotation.

I am copying this letter to the Prime Minister, Geoffrey Howe, John Major, Douglas Hurd, Malcolm Rifkind, John Wakeham, Peter Brooke, Peter Lilley and Sir Robin Butler.

Yours Sincerely

Francis Maude

pp **FRANCIS MAUDE**
(Approved by the Financial Secretary and Signed in his absence.)

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ECP

THE RT HON JOHN WAKEHAM MP

N.S.P.M.
BHP
7/9

Department of Energy
1 Palace Street
London SW1E 5HE
071 238 3149

Barry Potter Esq
Private Secretary to
the Prime Minister
10 Downing Street
LONDN
SW1A 2AA

14 September 1990

Dear Barry

NORTHERN IRELAND ELECTRICITY

Thank you for your letter of 3 September.

I thought it would be helpful to mention that, while the question of interconnection between Northern Ireland and Scotland clearly falls to be considered as part of the E(A) discussion of Northern Ireland electricity, the allocation of SO_2 limits between England and Wales on the one hand and Scotland on the other, together with the implications for Scottish-English interconnection, is being dealt with in correspondence initiated by the Department of the Environment about the proposed national plan for implementing the EC Large Combustion Plant Directive. We do not therefore expect it will need to be touched on at E(A).

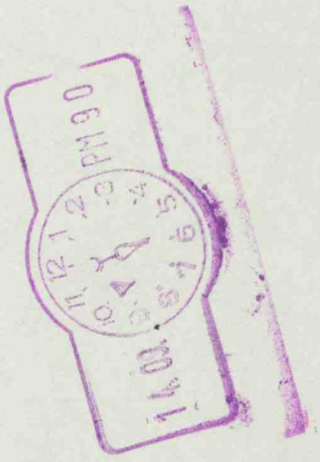
I am copying this letter to the recipients of yours.

Yours
John

J S NEILSON
Principal Private Secretary

CONFIDENTIAL

MAT INDS : Case Elec Pt 19



ST. ANDREW'S HOUSE
EDINBURGH EH1 3DG

N.S.P.M.
at this stage.
PHP
7/9

The Rt Hon Christopher Patten MP
Secretary of State for the Environment
Department of the Environment
2 Marsham Street
London
SW1P 3EB

September 1990

Dear Chris,

IMPLEMENTATION OF THE EC LARGE COMBUSTION PLANTS DIRECTIVE: EFFECT ON ELECTRICITY PRIVATISATION

I was grateful for David Heathcoat-Amory's letter to me of 10 August, in reply to my letter to you of 18 July. I have also seen John Wakeham's letter of 9 August. However, I think that there may be some misunderstanding about my proposals.

I am, of course, aware of the discussions which took place between officials in 1988 and I am not seeking any changes to the Environmental Protection Bill. The case for tradeable emissions permits in the electricity supply industry is bound up with medium and long term considerations, to which the logistical problems concerning the Bill and the response to the Commission about our plans for implementation of the Directive do not seem to me to be particularly relevant. All I am seeking at this stage is agreement that we should regard tradeable emissions permits as a sensible option to be considered in the medium term, bearing in mind the evidence emerging from experience overseas of considerable efficiency gains over direct regulation, and should be prepared to say so publicly.

I do not agree that a tradeable permits regime would make our enforcement regime any less robust. Certainly, it is more complex than the arrangements which we are putting into place at present; but those arrangements are open to the criticism that they are crude and inflexible. We have the opportunity to build in flexibility without loss of control, through a mechanism which has the advantage of being market based rather than bureaucratic, and there are very strong reasons for doing so in the context of the ESI.

I am not sure that there is a great deal between us on this matter. The Environment White Paper will indicate that you wish to explore the use of

tradeable emissions permits for industry in general and I do not see how we could justify excluding the ESI from the scope of that consideration. Consequently, I hope that we can agree that we should say in the context of flotation that tradeable permits are an option and that officials should bring forward proposals for a tradeable permits regime, so that we can judge its merits as a medium term solution to our difficulties.

I am copying this to the Prime Minister, Geoffrey Howe, John Major, Douglas Hurd, John Wakeham, Peter Brooke, Peter Lilley and to Sir Robin Butler.

Yours ever,

MALCOLM RIFKIND

NAT (ND)
GEO & ELEC
PE 19

CONFIDENTIAL

Ale CM
cePM
TPM

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

3 September 1990

Dear John,

PRIVATISATION OF NORTHERN IRELAND ELECTRICITY (NIE)

The Prime Minister has seen your Secretary of State's minute of 31 August commenting on Mr Lang's minute of 7 August to the Prime Minister, about the possible electricity interconnector between Scotland and Northern Ireland.

The Prime Minister is content for the economics of the interconnector, including the environmental implications, to be considered at the forthcoming E(A) discussion.

I am copying this letter to the Private Secretaries to other members of E(A).

Yours,
Barry.

BARRY H POTTER

John Neilson Esq
Department of Energy

CONFIDENTIAL

CONFIDENTIAL

Prime Minister

The economics of the interconnector can be picked up at the E(A) discussion. No action needed for the present. BHP 31/8.

Prime Minister

PRIVATISATION OF NORTHERN IRELAND ELECTRICITY (NIE)

I have seen a copy of Ian Lang's minute to you of 7 August commenting on one from Peter Brooke about the possibility of an interconnector between Scotland and Northern Ireland. This correspondence touches on the likely effect of the EC Large Combustion Plants Directive on the economics of the enhancement of the England/Scotland interconnector.

There is a presumption that an enhanced England/Scotland interconnector will enable the UK to achieve the sulphur dioxide (SO_2) reductions, required by the EC Large Combustion Plants Directive, more economically than would be the case from the construction of new generation capacity - such as Combined Cycle Gas Turbine (CCGT) plant. This is not necessarily the case. Preliminary studies carried out by my officials suggest that the costs of enhancing the current interconnector would be similar to those associated with investment in an additional CCGT of equivalent capacity. We should also not lose sight of the fact that CCGT power stations emit virtually no SO_2 and roughly half the carbon dioxide of conventional coal fired power stations; consequently, their construction would provide additional reassurance with respect to our obligations under the EC Directive.

Any relaxation of the emission ceilings for the Scottish generators which resulted in a commensurate tightening of those for National Power and PowerGen would impact on the proceeds expected from their flotation.

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

Secretary of State for Energy

31 August 1990

CONFIDENTIAL

NAT ind: Gas + Elec

A

FROM THE MINISTER OF STATE, SCOTTISH OFFICE

ST. ANDREW'S HOUSE
EDINBURGH EH1 3DG

CONFIDENTIAL

Prime Minister (2)

This letter explains why developing the Scotland-England interconnector – and a fortiori a new interconnector to N. Ireland – requires more (low sulphur) coal burn in Scotland. Can be picked up at the forthcoming E(A) discussion on privatising Northern Ireland Electricity.

BHP 30/8

Dominic Morris Esq
Private Secretary
10 Downing Street
LONDON
SW1A 2AA

28 August 1990

Dear Dominic,

PRIVATISATION OF NORTHERN IRELAND ELECTRICITY

Thank you for your letter of 15 August.

My Minister's note of 7 August was indeed based on the premise that the Scottish ESI would need to burn more coal in order to make the enhancement of the interconnector economic. With the new Torness power station fully on stream and with the arrival of sour gas from the Miller field at Peterhead in 1992/93, combined with the existing hydro schemes, the 2 Scottish electricity companies will have available to them sufficient generating capacity using clean energy sources to meet the needs of consumers in Scotland for most of the time without operating the coal-fired stations. The companies' shared coal capacity at Longannet and Cockenzie will be needed only to meet peak demand on the Scottish system or for periods when full output from other plant is not available, for instance during maintenance.

However, if additional electricity is generated in Scotland for export, this will have to come mainly from the coal-fired stations since the other generating capacity will be devoted to meeting Scottish needs except during troughs in demand. Against this background, utilisation of the 3.9 MW of coal-fired generating capacity (using low sulphur Scottish coal) is largely dependent on the ability of the Scottish companies to export profitably to markets outside Scotland.

As you know, utilisation of this coal capacity has been very low in recent years given the substantial surplus of capacity on the Scottish system. The Scottish companies will continue to have a requirement for some coal purchases from British Coal if they are able economically to export electricity across the present interconnector to England & Wales. The economics of upgrading the present interconnector, however, are crucially dependent on the Scottish companies' ability to burn more coal to meet the additional demand. If they are unable to do so, the project is almost certain to prove financially not viable.

CONFIDENTIAL

EMK00224.080

A fortiori, these arguments apply to any new interconnector to Northern Ireland, although there could also be environmental benefits if such a link avoided the need for additional coal-fired generating capacity in Northern Ireland.

Scottish Office officials are in correspondence with the Department of the Environment about the inflexible approach which that Department is presently adopting to emissions reductions. DoE appears unprepared to contemplate increased emissions in Scotland, even if the burning of low sulphur coal in surplus Scottish capacity were shown to be more economic than additional investment in clean generation in England & Wales. My Minister is very concerned that this inflexibility will stifle competition in the electricity industry and could well involve the sacrifice of substantial Exchequer proceeds from the sale of the Scottish companies. Provided we can meet the requirements of the Large Combustion Plants Directive at UK level, we should be able to accommodate variations at regional level within the United Kingdom.

I trust the foregoing explains our concerns more fully. In a nutshell, the economic viability of any enhancement of the transmission system between Scotland and England & Wales on the one hand, and the construction of a new link with Northern Ireland on the other, hinges on the ability of the Scottish companies to generate electricity for export at competitive prices. That ability in turn is crucially dependent on the cost of operating the coal-fired stations for this purpose and, indeed, the price paid for coal in Scotland relative to fuel prices elsewhere.

Yours sincerely

Ken Thomson

KENNETH THOMSON
Private Secretary

EMK00224.080

NAT IND: Gas + Elec
A19

SECRET

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

23 August 1990

Dear Terry,

POWERGEN

Your Secretary of State met the Prime Minister today to consider developments at Powergen.

Following a brief discussion it was agreed that the proposed trade sale of Powergen to Hanson or another buyer would not proceed. Instead, Powergen would be floated as previously planned.

Your Secretary of State would consider further the presentation of the decision to proceed with the flotation. The emphasis should be on the emergence of more realistic figures on flotation proceeds, in particular higher figures than previously expected. It should also be made clear that the net proceeds to the Exchequer, taking account of the tax advantages to Hanson in a trade sale, would be greater from the flotation. The advantages of wider share ownership would also be relevant.

It was agreed that your Secretary of State should make an announcement along these lines later today.

I am copying this letter to John Gieve (HM Treasury).

Yours,
Barry

BARRY H. POTTER

T. Carrington, Esq.,
Department of Energy.

SECRET

HANSON AND DEPARTMENT OF ENERGY END POWERGEN DISCUSSIONS

Hanson plc announced today that its negotiations with the Department of Energy for a trade purchase of PowerGen have ended.

Lord Hanson stated: "I understand that the Secretary of State for Energy plans to sell PowerGen by public flotation. We have no wish to compete with this."

He added: "The negotiations have been friendly and the decisions reached today are mutually agreed to be in the best interests of all the parties concerned."

August 23, 1990

C.F.

Department of Energy - Draft #3

POWERGEN FLOTATION CONFIRMED

The Government has reconfirmed its original intention of privatising PowerGen by means of a public flotation. The discussions between the Government and Hanson PLC have ended.

The Secretary of State indicated to Lord Hanson that the Department had received further advice about the likely level of proceeds to the taxpayer from a public flotation in the light of PowerGen's Board's recent reassessment of the company's prospects. He further indicated that, to be considered, a bid from Hanson would have to be significantly in excess of the likely net flotation proceeds and the Secretary of State has concluded that the terms on which a trade sale could be completed now offer insufficient benefit compared with flotation in February 1991.

In the light of this result of the likely from flotation

and the wider benefits from extending share ownership,

The National Archives

DEPARTMENT/SERIES PREM 19 PIECE/ITEM 3099 (one piece/item number)	Date and sign
Extract details: Barry H Potter to Prime Minister 22 August 1990	
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From: THE PRIVATE SECRETARY
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COPY

NORTHERN IRELAND OFFICE
STORMONT CASTLE
BELFAST BT4 3ST

Tel. Belfast (0232) 63011

Mr Barry Potter
10 Downing Street
LONDON
SW1A 2AA

21 August 1990

N. 6. P. M.
BHP
22/8

Dear Mr Potter

23? Recap.

NORTHERN IRELAND ELECTRICITY (NIE)

Your minute of 28 July acknowledged my Secretary of State's further progress report on privatising NIE and proposed a discussion on structure of the privatised industry in the early autumn. A paper examining the factors relevant to a proper structure is being prepared and my Secretary of State will produce a paper on this matter as soon as possible for discussion at that meeting.

Comments on the progress report were also received from the Chief Secretary, the Secretaries of State for Energy, Trade and Industry and Wales and the Minister of State at the Scottish Office. Most of their comments relate to the structure of a privatised NIE and my Secretary of State will deal with them in the paper now being prepared.

The Chief Secretary also referred to the public expenditure implications of delay that could arise from any decision to split NIE and expressed his disappointment that other work had taken priority over the future tariff structure of the industry. My Secretary of State is content with the Chief Secretary's suggestion that if slippage in the privatisation timetable means that we have to make PE provision for NIE in 1992/93 this should be addressed in the 1991 Survey. I can also confirm that the modelling work necessary in determining a future tariff path has now begun.

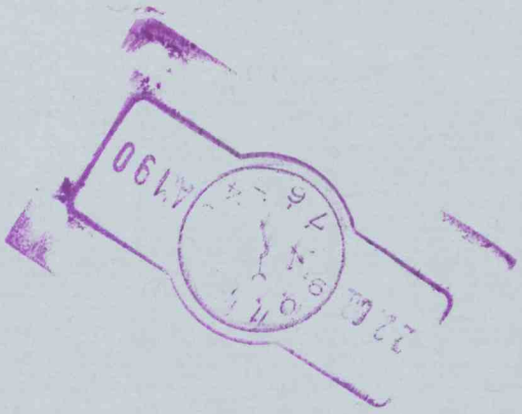
My Secretary of State is grateful for the general welcome given to his proposals for future generation options. The matters raised in

Mr Lang's minute will, I assume, be dealt with in the context of decisions on translating national SO_2 emission reduction targets into regional targets. However, as Mr Lang notes, these issues do affect consideration of an electricity interconnector between Scotland and Northern Ireland.

I am copying this letter to the Private Secretaries to the members of E(A) and to Sonia Phippard (Cabinet Office).

Yours Sincerely
Elizabeth Hume

ELIZABETH HUME (MISS)



22 OCT 1974
A190

MAT INDS: Gas + Elec Pt 19

The National Archives

DEPARTMENT/SERIES PREM 19 PIECE/ITEM 3099 (one piece/item number)	Date and sign
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10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

15 August 1990

PRIVATISATION OF NORTHERN IRELAND ELECTRICITY

The Prime Minister has seen your Minister's note of 7 August. She has commented that this appears to be based on the premise that the Scottish ESI needs to burn more coal. Surely they do not? Will the present interconnector take all the new nuclear? And what about the gas generated electricity from Peterhead?

DOMINIC MORRIS

Kenneth Thomson, Esq.,
Mr. Lang's Office,
Scottish Office.

CONFIDENTIAL

Barry d/r
This has just returned from Cornwall. You may wish to pursue it.
CRS

But they do NOT need to burn more coal. Will the present interconnector take all the new nuclear? And what about gas from Peterhead (?)
MT

PRIME MINISTER

ELECTRICITY PRIVATISATION

I attach a rather opaque minute from Ian Lang. It is merely for you to note ahead of the autumn E(A) and does not require any action.

The background is that the UK targets for reducing sulphur dioxide emissions are broken down by the DOE for each territory in the UK. Scotland has a rigorous target because its electricity baseload is met from nuclear power and hydro-electricity. Coal is used only as a marginal fuel for peak periods and of course for the interconnector to England. It follows that if the Scotland/England interconnector is upgraded, and still more if there is an interconnector between Scotland and Northern Ireland, the Scottish Electricity Supply Industry will burn more coal. If rigorous emission limits continue to apply to them, additional coal-generated electricity will be expensive (because capital investment in flue gas desulphurisation would be needed quickly). Coopers & Lybrand have advised the Scots that small differences in emission limits therefore make a big difference to the economics of the interconnector.

The unspoken messages in Mr. Lang's minute are therefore:

- The Scots need a less rigorous emission limit if they are to go ahead with upgrading the Scotland/England interconnector (and if they do not upgrade, it could knock up to £500 million off the privatisation proceeds for the Scottish ESI).

- An additional interconnector to Northern Ireland is not as straightforward as it looks.

DM

DOMINIC MORRIS
14 August 1990

CONFIDENTIAL

cc P.U.
P.C.

DEPARTMENT OF THE ENVIRONMENT
2 MARSHAM STREET LONDON SW1P 3EB
071-276 3000

PARLIAMENTARY UNDER SECRETARY OF STATE

NBPM at this stage (as original letter not copied to PM) - see if the Scots come back.
CAS

My ref: P/PSO/31014/90

Your ref:

10 AUG 1990

Dear Secretary of State

IMPLEMENTATION OF THE EC LARGE COMBUSTION PLANTS DIRECTIVE: EFFECT ON ELECTRICITY PRIVATISATION

Thank you for your letter of 18 July to Chris Patten about the implementation of the Large Combustion Plants Directive, which raises the question of tradeable emission permits. I am replying in his absence abroad.

with CAS

When our officials discussed options for implementing the Directive after it was agreed in 1988, the introduction of tradeable emission permits was one of the options considered, but was ruled out for the present purposes. The principal reasons for this were the complexity of building the concept into the system of integrated pollution control - which is to form the basis for implementing the parent "framework directive" on industrial air pollution - and the likely difficulty of establishing an enforcement regime which was sufficiently robust for a directive of this high political profile. I have to say that I do not believe we could reopen such a fundamental issue at this stage. It would completely alter the structure under which the Inspectorates will enforce the Directive - a structure which has been built into the Environmental Protection Bill, now in its final Parliamentary stages. Essentially each Inspectorate will be given, through the national plan for emission reductions, clear instructions in terms of emission limits it must secure from plants under its control. While the national plan can be changed from time to time we must ensure we have a stable document which will convince the EC that we are complying with the Directive.

The draft Environment White Paper floats the idea of use of a range of economic instruments such as tradeable emission permits, and Chris is keen to pursue these ideas in the longer term. However, new arrangements of this kind would not be workable without primary legislation and at this very late stage it would be virtually impossible to introduce appropriate provisions in the Environmental Protection Bill. It would also require us to unpick the structure of the current draft plan and so put us in serious danger of missing the 31 December deadline for submitting the plan to the Commission. I imagine that this would also pose grave difficulties for the timetable for floatation of the electricity industry in England and Wales.

100% RECYCLED PAPER

Since your letter was received, my officials have started discussions with colleagues in other Departments on the draft plan for implementing the Directive. The draft plan proposes emissions limits for the electricity supply industry, refineries and other industry. The emission limits proposed for Scotland have been revised upwards in an attempt to meet the concerns expressed by your Department and should now allow some scope for Scottish generators to compete in England and Wales via the electrical interconnectors between England and Scotland. I hope that you will be able to agree that this gives you sufficient flexibility to allow cross border competition. I am sorry I cannot be more helpful.

I am copying this letter to recipients of yours.

Yours sincerely

Simon Hale

pp DAVID HEATHCOAT-AMORY

(Agreed by the Minister and signed in his absence)

Malcolm Rifkind Esq MP

CONFIDENTIAL

100% RECYCLED PAPER

Please find file
CHS

cc/PU.

SWYDDFA GYMREIG
GWYDYR HOUSE
WHITEHALL LONDON SW1A 2ER
Tel. 071-270 3000 (Switsfwrdd)
071-270 0538 (Llinell Union)
Fax: 071-270 0561

WELSH OFFICE
GWYDYR HOUSE
WHITEHALL LONDON SW1A 2ER
Tel. 071-270 3000 (Switchboard)
071-270 0538 (Direct Line)
Fax: 071-270 0561

Oddi wrth Ysgrifennydd Gwladol Cymru The Rt Hon David Hunt MBE MP *From The Secretary of State for Wales*

CT/12321/90

10th August 1990

Dear Peter

NORTHERN IRELAND ELECTRICITY

Thank you for copying to me you recent minute to the Prime Minister updating your proposals for the privatisation of Northern Ireland Electricity.

I am content with your proposals to investigate a split structure for the privatised industry; to appoint Professor Littlechild as the regulator of the NI industry and to explore the feasibility of the different options for future electricity generation.

I am copying this letter to the Prime Minister, other E(A) colleagues, and to Sir Robin Butler.

Yours ever

David

The Rt Hon Peter Brooke MP
Secretary of State for Northern Ireland
Northern Ireland Office
Old Admiralty Building
LONDON
SW1A 2AZ

The National Archives

DEPARTMENT/SERIES PREM 19 PIECE/ITEM 3099 (one piece/item number)	Date and sign
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THE RT HON JOHN WAKEHAM MP

SECRETARY OF STATE FOR ENERGY

Department of Energy
1 Palace Street
London SW1E 5HE

071 238 3290

The Rt Hon Chris Patten MP
Secretary of State for the Environment
Department of the Environment
2 Marsham Street
LONDON
SW1P 3EB

9 August 1990

Dear Chris

IMPLEMENTATION OF THE EC LARGE COMBUSTION PLANT DIRECTIVE: EFFECTS ON ELECTRICITY PRIVATISATION

Malcolm Rifkind sent me a copy of his letter to you of ~~18~~ July.

I can see that in principle there would be some attractions in a system of tradeable permits for SO_2 emissions from existing plant. However, you will want to consider the implications for the Environmental Protection Bill, which was I believe drafted on the basis of a control system which would not include tradeable permits.

I should also be concerned if a proposal to change the presently planned regime for controlling SO_2 emissions from the electricity industry was to give rise to uncertainties which could affect the flotation of the generators in England and Wales. Any consideration of the idea of introducing tradeable permits would need to take account of potential effects on flotations south, as well as north, of the border.

I am copying this letter as before.

Yours ever

John

JOHN WAKEHAM

PRIME MINISTER

PRIVATISATION OF NORTHERN IRELAND ELECTRICITY (NIE)

1. In Malcolm Rifkind's absence it may be helpful if I comment on the possibility of an interconector between Scotland and Northern Ireland raised in Peter Brooke's minute of 19 July reporting progress on the privatisation of HIE. I have seen Norman Lamont's minute of 23 July strongly endorsing the option and Peter Lilley's subsequent intervention.

2. In principle I, too, endorse the option, but I should mention one point of concern. There is a potential conflict between the sound case which exists in terms of our objectives for a privatised ESI, for proceeding with an interconnector and the possible impact of the EC Large Combustion Plants Directive on the Scottish companies' ability to export electricity. The way in which the reductions in SO_2 emissions which we are committed to achieving at a national level are translated into limits on emissions by the ESI in Scotland will have a direct impact on the scope for exports by the Scottish companies after 1993. If this were done in a way which was unfavourable to the ESI in Scotland it could place in jeopardy even the well advanced current plans to enlarge the capacity of the existing interconnector between Scotland and England.

3. Malcolm Rifkind has recently written to Chris Patten outlining some of our concerns on this front. We need to take the Northern Ireland position into account in those discussions. For the moment I simply wish to flag up the connection between the 2 sets of issues in advance of E(A) consideration.

4. Assuming that these difficulties can be resolved we will be concerned to ensure that proposals for an interconnector with Northern Ireland have no adverse impact on our consideration of the capital structure with which the Scottish companies can be floated. I understand that, at an earlier

stage of discussion, it was suggested that NIE might take sole responsibility for the capital investment received. Any other course would be likely to increase the level of debt write-off which the Scottish companies would otherwise require.

I am copying this minute of members of E(A) and to Sir Robin Butler.

Jim Revolle

pp

I L

(Approved by the Minister of State and signed in his absence.)

7 August 1990

CONFIDENTIAL AND MARKET SENSITIVE

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

2 August 1990

POWERGEN

The Prime Minister was grateful to your Secretary of State for his further minute. She has since also seen the Chancellor's minute of 1 August. She agrees with the Chancellor's view. She has commented that the risks of such a fee, even a small one, are so great that she would expect Lord Hanson not to press the matter. If, against expectations, he were to do so, your Secretary of State would need to consult again with the Prime Minister and the Chancellor.

I am copying this letter to Tancred Tarkowski (H.M. Treasury).

DOMINIC MORRIS

John Neilson, Esq.,
Department of Energy.

CONFIDENTIAL

MARKET SENSITIVE

DOMINIC MORRIS

POWERGEN

I have consulted the Prime Minister about your minute of 1 August: and she has also read the Chancellor's minute. She has commented that she agrees with the Chancellor: the risks of such a fee, even a small one, are so great that she would expect Lord Hanson not to press the matter. If against expectations he were to do so, she, the Chancellor and the Energy Secretary would have to consult again: but with her and the Chancellor on the same side, she would expect Lord Hanson to accept the decision.

M D Stacey

Duty Clerk

pp C. D. POWELL

2 August 1990

CONFIDENTIAL

MARKET SENSITIVE

CONFIDENTIAL

MARKET SENSITIVE

PRIME MINISTER

POWERGEN

You had agreed, on the strength of John Wakeham's further minute, that he should consider Hanson's request for what amounts to a commitment fee for the Hanson bid. I attach a further minute from the Chancellor which suggests that John Wakeham's opening response should be to refuse a commitment fee and that, only if it is clear that otherwise the trade sale to Hanson would fall through, should John Wakeham be ready to offer a small commitment fee.

My own view is that while the Chancellor's caution is quite right (and reflects your own), it is always unwise in negotiations to put forward a threat when one does not ultimately mean to deliver it. That is what the Chancellor's proposed negotiating position amounts to.

Content, as before, to leave it to John Wakeham's discretion to negotiate a reasonable (ie low) commitment fee with Hanson?

Or

Endorse the Chancellor's proposed negotiating mandate? Yes.

DOMINIC MORRIS
1 AUGUST 1990

(MRM)

MARKET SENSITIVE

CONFIDENTIAL

MARKET SENSITIVE

2

Prime Minister

Agree to X or Y?

CDP 2/8

PRIME MINISTER

POWERGEN

You had agreed, on the strength of John Wakeham's further minute, that he should consider Hanson's request for what amounts to a commitment fee for the Hanson bid. I attach a further minute from the Chancellor which suggests that John Wakeham's opening response should be to refuse a commitment fee and that, only if it is clear that otherwise the trade sale to Hanson would fall through, should John Wakeham be ready to offer a small commitment fee.

My own view is that while the Chancellor's caution is quite right (and reflects your own), it is always unwise in negotiations to put forward a threat when one does not ultimately mean to deliver it. That is what the Chancellor's proposed negotiating position amounts to.

X | Content, as before, to leave it to John Wakeham's discretion to negotiate a reasonable (ie low) commitment fee with Hanson?

Or

Y Endorse the Chancellor's proposed negotiating mandate?

DM

DOMINIC MORRIS
1 AUGUST 1990

(MRM)

I agree with John Major – the risks of such a fee, even a small one are so great that I would expect Hanson not to press the matter. If he does I shall be very surprised but we should have then to consult again i.e. Chancellor, S.of.S & me. But with two of us very doubtful on the Treasury side I hope Hanson will accept the decision.

MARKET SENSITIVE
CONFIDENTIAL

chex.ps/tt/25

Treasury Chambers, Parliament Street, SW1P 3AG
071-270 3000

PRIME MINISTER

POWERGEN

In his minutes of 30 and 31 July John Wakeham proposes a fee of 0.5 per cent should be paid to Hanson in certain circumstances. I see difficulties with this.

2. It could be argued that Hanson is providing us with a service in making a firm offer for PowerGen and in being ready to leave this offer on the table for a couple of months. This provides us with a clear basis on which to take a decision between a trade sale and a flotation. If we decide in favour of a trade sale, it gives us confidence that the process will result in PowerGen being sold at an attractive price while enabling us to seek an even better price. Hanson is leaving himself exposed to the risk of adverse developments over the period. Any fee would be for this service and for these risks, not for Hanson's expenses or for underwriting as such. We would clearly not want to suggest a readiness to meet the costs of any company bidding in the trade sale, which might weaken our position with failed bidders for other kinds of Government business.

3. But I am doubtful about the proposal for three reasons. Firstly, the political fallout if we pay a fee will be considerable. This has been worsened by Gordon White's premature mention of the possibility of a fee. Secondly, unlike an

underwriter, James Hanson wants the shares (and will not get the fee if he wins the trade sale). Thirdly, Hanson approached us about the trade sale and not the other way around.

4. In all the circumstances the advantage would be to avoid a fee. John may like to point out to Hanson that, whatever the merits of the case, this premature mention, and the press reaction, have made the fee a very difficult issue. He might ask Hanson in the circumstances not to press the matter. If, however, Hanson insisted on a fee, we could reconsider if John felt it absolutely necessary and was satisfied that the fee was an absolute minimum.

5. I am copying to John Wakeham.

Terence Burkinshaw

pp [J.M.]

1 August 1990

[Approved by the Chancellor of the Exchequer and signed on his behalf.]

NAT IND: Gas + Elec
Pt 19

01.03. PM 90

Treasury Chambers, Parliament Street, SW1P 3AG
071-270 3000

PRIME MINISTER

POWERGEN

In his minutes of 30 and 31 July John Wakeham proposes a fee of 0.5 per cent should be paid to Hanson in certain circumstances. I see difficulties with this.

2. It could be argued that Hanson is providing us with a service in making a firm offer for PowerGen and in being ready to leave this offer on the table for a couple of months. This provides us with a clear basis on which to take a decision between a trade sale and a flotation. If we decide in favour of a trade sale, it gives us confidence that the process will result in PowerGen being sold at an attractive price while enabling us to seek an even better price. Hanson is leaving himself exposed to the risk of adverse developments over the period. Any fee would be for this service and for these risks, not for Hanson's expenses or for underwriting as such. We would clearly not want to suggest a readiness to meet the costs of any company bidding in the trade sale, which might weaken our position with failed bidders for other kinds of Government business.

3. But I am doubtful about the proposal for three reasons. Firstly, the political fallout if we pay a fee will be considerable. This has been worsened by Gordon White's premature mention of the possibility of a fee. Secondly, unlike an

4.

underwriter, James Hanson wants the shares (and will not get the fee if he wins the trade sale). Thirdly, Hanson approached us about the trade sale and not the other way around.

4. In all the circumstances the advantage would be to avoid a fee. John may like to point out to Hanson that, whatever the merits of the case, this premature mention, and the press reaction, have made the fee a very difficult issue. He might ask Hanson in the circumstances not to press the matter. If, however, Hanson insisted on a fee, we could reconsider if John felt it absolutely necessary and was satisfied that the fee was an absolute minimum.

5. I am copying to John Wakeham.

Yours sincerely

pp [J.M.]

1 August 1990

[Approved by the Chancellor of the Exchequer and signed on his behalf.]

CONFIDENTIAL AND MARKET SENSITIVE

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

31 July 1990

POWERGEN

The Prime Minister has seen your Secretary of State's minute describing the background to the possible commitment fee to Hanson Plc.

I should be grateful if this letter is seen only by those with a strict need to know.

The Prime Minister is most concerned that, if any fee is to be paid to Hanson Plc in connection with the proposed trade sale of Powergen, it must be for a simple, clear and defensible purpose. It is imperative that the justification for the fee leaves no room for any contention that it is in the nature of a "sweetener".

The Prime Minister is not persuaded that the rationale for the fee, as set out in your Secretary of State's minute, is sufficiently clear and convincing. Specifically, the minute can be read as suggesting:

(i) the proposed fee for Hanson Plc is to recoup the expenses incurred in drawing up an indicative price for Powergen;

(ii) is a consultancy fee for work undertaken up to this point;

(iii) is in the nature of a genuine underwriting fee.

The Prime Minister believes it would be difficult to explain why the taxpayer should pay any conventional underwriting fee. There is always a cost involved in making a bid: but, if the bid is lost, the targeted company does not usually meet these costs.

The Prime Minister can see there could be a case for a fee, if it is to protect Hanson Plc against the contingency that it might wish to withdraw its offer some period later, but is required by the terms of its contract to keep it open to the Government. If that is the purpose, she would hope that the proposed arrangement can be set out in a simpler and clearer fashion.

BARRY H. POTTER

John Neilson, Esq.
Department of Energy.

CONFIDENTIAL

①

Prime Minister

This is rather better. 'X' is the key point — and needs to be brought out clearly in 'Y'. Content for me to make this point to Bernard I? BHP 31/7

Yes - the amt still needs to be reasonable (i.e. not large) having regard to all the circumstances

Prime Minister

POWERGEN

I have seen your Private Secretary's letter with your comments on my minute to you of 30 July.

I wholly agree that any fee paid to Hanson plc must be for a clear and defensible purpose. It is essential to the credibility of a trade sale that there must be no suggestions of a "sweetener". There is no suggestion here of a re-run of the Rover situation. I have made it clear from the beginning that, while the initial approach came from Hanson, others must be given the opportunity to bid on the basis of equal access to information.

I also agree with you that, were this a normal trade sale, there would be no question of an underwriting or commitment fee. Prospective purchasers would prepare their bids at their own cost, a competition would take place and we would then decide, in the light of the bids on offer, whether or not to proceed to completion.

But this is not a normal trade sale. I have thirteen other electricity companies to privatise. Once we commit ourselves to proceeding with a tender for PowerGen, we have in effect precluded the option of floating the company. Were the tender to be a failure (for example, because of a change in market circumstances), the repercussions on the flotation of the other companies would be extremely serious. I cannot take this risk. My financial advisers tell me that we must therefore be certain that we can carry the trade sale through to a successful completion.

This is what we achieve by obtaining a firm bid from Hanson in August. We then know that, whatever the outcome of the tender, we can complete the trade sale at an acceptable price and without

significant repercussion on the flotation of the other companies. If Hanson could withdraw its offer at a later stage, we should have lost the essential underpinning of the trade sale.

It is therefore, as you say, because of the need for Hanson to keep open its offer for a period of up to 3 months without the option of withdrawing that I may need to agree to their request for a fee. As I mentioned in my minute of 30 July, my advisers are currently considering how any fee could most attractively be structured.

I have had further discussions with Bernard Ingham about the presentation of this.

If pressed on this publicly again, I shall emphasise:

- my aim of completing privatisation of the electricity industry this Parliament;

- the need to deal with each transaction in an orderly and timely way with minimal repercussion on subsequent sales;

- that underwriting the trade sale of PowerGen is essential to achieving this;

- and that in these circumstances it would not be unreasonable to pay a fee to Hanson in return for being committed to a price for the period of the tender.

I am copying this minute to the Chancellor of the Exechequer.

JS Neilson

pp **SECRETARY OF STATE FOR ENERGY**
31 July 1990

(approved by the Secretary of State and signed in his absence)

CONFIDENTIAL

CC PM.

THE RT HON JOHN WAKEHAM MP

N.J. P.M.
BHP
31/7

Department of Energy
1 Palace Street
London SW1E 5HE
071 238 3290

The Rt Hon Peter Brooke MP
Secretary of State for Northern Ireland
Northern Ireland Office
Whitehall
LONDON
SW1A 2AZ

30 July 1990

Dear Peter

PRIVATISATION OF NORTHERN IRELAND ELECTRICITY

Thank you for copying to me your recent minute to the Prime Minister reporting further on your proposals for privatising Northern Ireland Electricity.

I believe these proposals go in the right direction. We must avoid criticism that we are simply creating a private sector monopoly. I have, as you say, already indicated that I would be content with the regulatory regime proposed and that Stephen Littlechild be appointed as Regulator. I fully support your intention to examine the feasibility of the generation options you described. I know my officials are closely in touch with yours on all these matters.

I am copying this letter to E(A) colleagues and to Sir Robin Butler.

Yours ever

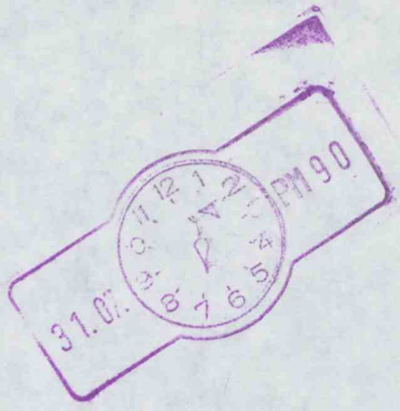
JW

JOHN WAKEHAM

CONFIDENTIAL

NAT IND: Gas + Elec

Pt 19



PRIME MINISTER

POWERGEN

I attach a copy of a note on the possible commitment fee ("sweetener") to Hanson plc. I asked Mr. Wakeham's office for a note on your behalf.

The facts are that, while Hanson have suggested a commitment fee, no agreement with Department of Energy has been made.

That said, Mr. Wakeham is proposing to agree a commitment fee; and Treasury officials are said to be content. Hanson will not get the fee if, either the original bid is accepted or the company makes a successful higher bid.

The minute bears careful examination. The proposed fee is described in three different ways.

(i) In the third paragraph its purpose is described as being "... to recognise the exposure to risk faced by Hanson ...".

(ii) Within the same paragraph it is described as giving Hanson the opportunity "... to recoup the expenses involved ...".

(iii) In the fifth paragraph it is described as a "... commitment fee...".

In short, it is unclear whether the proposed fee is to meet expenses incurred in drawing up the indicative price for Powergen; in effect a consultancy fee (ie expenses plus profit) for work undertaken up until this stage; or a genuine underwriting fee.

Much of the minute suggests that it is the last of these - an underwriting fee. But the analogy with genuine underwriting on a flotation issue seems a little forced. In most cases, the underwriter accepts a risk that he will be left with part of - but not all - the shares being floated or issued under rights. The situation with Powergen is that either Hanson will have all the shares or none. Comparisons with recent underwriting prices do not seem relevant.

The proprietary and political dangers are clear.

I understand John Wakeham is technically on holiday as from tomorrow but he will be around for two or three days.

(i) Content for me to minute the Department of Energy tomorrow seeking clarification of their proposals? or

(ii) Do you want to call John Wakeham in for a brief meeting tomorrow?

BARRY H. POTTER
30 July 1990
c:\wpdocs\economic\powergen (kk)

PRIME MINISTER

POWERGEN

I understand you would like some background on the question of a possible commitment fee to Hanson plc.

As I said in my minute to you of 28 June, Lord Hanson had said to me when we first met to discuss the possible sale that he thought that if he were to make a firm bid in advance of a tender he should get some sort of a commitment fee.

I think this is not unreasonable. On the timetable I am working to, I would expect Hanson to sign an agreement with the Government before the end of August under which we would have an option to sell PowerGen to Hanson at an agreed price if we do not get a better deal (from another bidder or from Hanson) in the tender. In effect, Hanson would be underwriting the tender, which may not be complete for a further 2 months or so.

The purpose of the fee would be to recognise the exposure to risk faced by Hanson in committing to a fixed price for a period of at least 3 months. The fee would only be payable if we decided to sell to a different bidder. In such circumstances, Hanson would have no opportunity to recoup the expenses involved other than by means of a commitment fee.

The fee fulfils a similar function to that provided by underwriting a public flotation offer: ensuring that from the date of signing of the underwriting agreement the privatisation of the company can be completed whatever changes there may be in external circumstances.

I am satisfied that a commitment fee can be defended on these grounds. In discussions with Schroders, Hanson have suggested a

fee of 0.5 per cent of the underwritten price. Both my financial advisers tell me that this would be fair and reasonable. Not only is the underwriting period considerably longer than for a flotation (2 months compared with 2 weeks), but the fee is substantially below the level of commissions paid in flotations (0.5 per cent compared with 0.86 per cent in total for water and up to 2 per cent in normal City practice). And, unlike the position in a flotation, Hanson will not get the fee if he makes a successful higher bid.

My inclination is therefore to agree to this fee. I understand Treasury officials are content. It would be helpful to let Hanson know as soon as possible that we have agreed to the fee so that they can firm up their underwriting price. I have, however, asked my advisers to consider whether this can be presented in a more attractive form. For example, Hanson might receive no fee for the first fortnight that their bid lay on the table, but then be paid a fixed amount per week for the following eight weeks.

I am copying this minute to the Chancellor of the Exchequer.

JS Nelson

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

30 July 1990

dti

the department for Enterprise

CONFIDENTIAL

ccpu

The Rt. Hon. Peter Lilley MP
Secretary of State for Trade and Industry

The Rt Hon Peter Brooke MP
Secretary of State for Northern Ireland
Northern Ireland Office
Old Admiralty Building
London SW1A 2AZ

Direct line 071 215 5622
Our ref PB4ARC
Your ref
Date 27 July 1990

Dear Peter

NORTHERN IRELAND ELECTRICITY (NIE)

Thank you for sending me a copy of your recent ~~minute~~ Rap to the Prime Minister on this subject. I have also seen the response dated 23 July from the Prime Minister's private secretary, proposing that the issues are discussed at E(A) in the early autumn.

The structure of the privatised industry is of paramount importance in determining whether there will be effective competition in the industry in years to come. Further discussion at E(A) is to be welcomed.

I recognise the severe political and presentational difficulties which would be inherent in attempting to transform NIE from a Publicly controlled monopoly supplier into a private sector profit maximising monopolist. I agree that splitting the generation business from the transmission, distribution, and supply business (TDS) will go some way towards alleviating these difficulties.

Under your proposal, however, the TDS company would have a profit-maximising incentive to seek out competitively priced sources of supply but only a regulatory incentive to pass on these benefits to final customers. The development of full competition, where economically desirable, is preferable to regulation. I recognise that there will be a continuing

requirement for regulation of the monopoly elements of the industry such as the transmission and distribution (or "wires") businesses, but in the arrangements for electricity privatisation in England, Wales, and Scotland, competition in supply (sales to final customers) has produced a market where there is beginning to be a real choice for the large industrial customers. Given their freedom to strike contracts with local Public Electricity Suppliers, with National Power or Powergen, or with new independent generators, there have already been many instances of substantial savings on power costs for industrial customers, with commensurate enhancement of their own competitive positions.

I understand that your officials are considering whether the structural arrangements for the privatisation of NIE could incorporate provision for competition in supply to final customers. Such competition would provide real choice for customers. It would help to exert pressure on both existing and possible future generators to adopt a competitive stance, and to become more efficient. The arrangements for the privatisation should, therefore, at least make it possible for supply competition to emerge. I hope that the results of the preliminary deliberations by officials will be made available in advance of the E(A) meeting in order that this aspect can be discussed there. We will also need to consider the EC competition and state aids implications of the arrangements.

It is sensible that the Director General for Electricity Supply in Great Britain should be appointed as regulator for the industry in Northern Ireland. In Great Britain, the Director General has a clear duty to promote competition in the industry. His duties in respect of the industry in Northern Ireland should be broadly comparable in order to avoid criticism from Northern Ireland customers. In short, he should be concerned with regulating the monopoly elements of the industry and developing competition where it is economically desirable to do so. It would be helpful if the Director General could be involved with your further thinking in advance of the E(A) meeting, both take advantage of his experience in the regulation of the Great British industry, and to ensure that the regulatory regime in Northern Ireland is broadly compatible with that in Great Britain.

Recycled Paper

dti

the department for Enterprise

CONFIDENTIAL

I warmly welcome your proposal to proceed with urgent investigations of the options for a Scottish interconnector and a natural gas supply for Kilroot II.

I am sending copies of this letter to the Prime Minister, other E(A) colleagues, and to Sir Robin Butler.

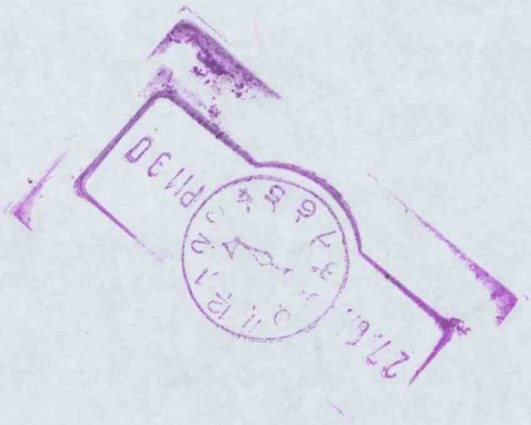
Yours ever

Peter

CONFIDENTIAL

Recycled Paper

NAT IMP : Gas + Elec Ltg



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DEPARTMENT/SERIES PREM 19 PIECE/ITEM 3099 (one piece/item number)	Date and sign
Extract details: BARRY H POTTER TO PRIME MINISTER DATED 27 JULY 1990	X
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c. Future

10 DOWNING STREET

LONDON SW1A 2AA

From the Principal Private Secretary

27 July 1990

THE FUTURE OF NUCLEAR POWER IN THE UK

In my minute to Sir John Fairclough recording Lord Tombs meeting with the Prime Minister on Wednesday 25 July, I mentioned that Lord Tombs offered to write to the Prime Minister setting out his views on how nuclear power could be integrated into a privatised electricity supply industry. I attach a copy of the note on which I would be grateful for advice and a draft reply. Could this reach me by Friday 10 August.

Andrew Turnbull

John Neilson, Esq.,
Department of Energy.

The National Archives

DEPARTMENT/SERIES PREM 19 PIECE/ITEM 3099 (one piece/item number)	Date and sign
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Prime Minister ②
To note. Chief Sec. and Fin. Secretary prefer to privatise NIE as separate generation & transmission companies. Policy unit advised in favour of privatisation as a single company. But NIE privatisation will be discussed at EC(A) in due course. So no need for a substantive response at this stage.
BHP 27/7

CONFIDENTIAL

FROM: CHIEF SECRETARY
DATE: 26 July 1990

PRIME MINISTER

PRIVATISATION OF NORTHERN IRELAND ELECTRICITY (NIE)

Peter Brooke's minute of 19 July reported progress on the privatisation of NIE.

2. My officials have been closely involved in the discussions which have been taking place on the structure of the privatised industry. Once detailed discussion began about the regulation of NIE as a single integrated utility in the private sector it soon became clear that this would be a difficult and costly task, and that the opportunities for increasing competition and efficiency would be very limited.

3. I think it was right to reassess the advantages and disadvantages of a different structure, and on present evidence I support a decision to proceed on the basis of a vertical split of NIE to separate generation from distribution and supply. This would help to remove any bias in favour of the generation company in the competition for new capacity, and provide a greater incentive for the distribution company to seek the cheapest source for electricity. This must increase efficiency and be to the benefit of consumers in Northern Ireland.

4. It will be necessary to consider the implication for proceeds of the different options, but I am encouraged to see that the cost is likely to be moderate if the generation company is offered for sale by private treaty. On the other hand, there are implications for wider share ownership to consider, and I agree that this is something which Peter and I will need to discuss once Rothschilds have firmed up their advice.

CONFIDENTIAL

5. My officials are involved in the work which is proceeding on regulation, and once there is agreement on the future structure of the industry I hope fast progress can be made, despite the resistance which is likely to come from NIE to any split. I am content with the proposal to appoint Professor Littlechild as the Regulator of the Northern Ireland industry.

A number of interesting options for future generation have emerged in the form of an interconnector with Scotland, and a gas pipeline from GB which would be shared with the Republic. Either might well be preferable to going ahead with Kilroot II as planned, particularly if the substantial cost of FGD proves unavoidable. I hope work on these alternatives can proceed quickly, as I understand that a decision about new capacity will need to be made before the end of the year. The interconnector especially offers a very good opportunity of introducing competition in the near future, and would allow us to take advantage of overcapacity in Scotland.

6. I note that these developments suggest that the target date for privatisation of Spring 1992 may slip, and that this may have some public expenditure implications for 1992-93. As the timetable is as yet uncertain I would suggest that further discussion of this should take place in the context of the 1991 Survey.

7. I am disappointed that other work has taken priority over the future tariff structure of the industry, to which I attach considerable importance. Following my agreement to the tariff increase from April 1989 I had requested that we should be in a position to take decisions about the future tariff path before the summer recess. It is essential that there should be no further delays in completing the necessary modelling work, and I look forward to seeing detailed proposals for tariffs for the period up to privatisation, which reflect the need to achieve the long run sustainable price.

8. I am copying this minute to E(A) colleagues and to Sir Robin Butler.

NL

NORMAN LAMONT

NAT IND : Gas + Elec c PT19

The National Archives

DEPARTMENT/SERIES PREM 19 PIECE/ITEM 3099 (one piece/item number)	Date and sign
Extract details: JOHN WAKEHAM TO NORMAN LAMONT DATED 25 JULY 1990	X
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DSG

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

23 July 1990

Dear Stephen,

NORTHERN IRELAND ELECTRICITY

The Prime Minister was grateful for your Secretary of State's undated minute providing a further progress report on proposals for privatising Northern Ireland Electricity (NIE).

The Prime Minister was grateful for the further work which your Secretary of State has undertaken in exploring the options for privatising NIE. She has noted that there is a range of factors relevant to consideration of the right future structure for the industry.

The Prime Minister considers there is merit in exploring further with colleagues the possible structure of the privatised industry and would accordingly propose that the matter be discussed at E(A) in the early autumn.

I am copying this letter to the Private Secretaries to the members of E(A) and to Sonia Phippard (Cabinet Office).

Yours,

Barry

Barry H. Potter

Stephen Pope, Esq.,
Northern Ireland Office.

CONFIDENTIAL

KW

SECRET

DSG

7

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

23 July 1990

Dear John,

ELECTRICITY PRIVATISATION: EMPLOYEE SHARE SCHEMES

The Prime Minister has seen copies of the letters between your Secretary of State and the Chancellor on the employee (and pensioner) share schemes in the post-privatisation electricity companies (Mr. Wakeham to the Chancellor of 16 July; the Chancellor to Mr. Wakeham of 19 July; and Mr. Wakeham to the Chancellor of 20 July). She has also seen Mr. Rifkind's letter of 18 July to the Chancellor.

The Prime Minister considers the general proposition put forward by your Secretary of State - that the scheme must be more generous than that created for the water industry - is correct. It will be important to make the employee share scheme arrangements sufficiently advantageous to ensure that the privatisation can proceed smoothly. The Prime Minister considers that it should be possible, given the relatively small difference in cost between your Secretary of State's proposals and those of the Chancellor, to resolve this matter satisfactorily by further bilateral discussion.

I am copying this letter to John Gieve (H.M. Treasury), Jim Gallagher (Scottish Office) and Sonia Phippard (Cabinet Office

Yours,

Barry

Barry H. Potter

John Neilson, Esq.,
Department of Energy.

SECRET

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chex.kf/jg/90

SECRET

seen by BHP

6

Treasury Chambers, Parliament Street, SW1P 3AG
071-270 3000

23 July 1990

John Neilson Esq
PS/Secretary of State for Energy
Department of Energy
1 Palace Street
LONDON
SW1E 5HE

Dear John.

WITH BP.

In the light of your Secretary of State's letter of 20 July the Chancellor is now content with the package your Secretary of State proposes. He is grateful for the agreement that the water package should be uprated to the date of the generator flotation. That would, he believes, take the limits for the value of the matching and discount offers to £440 and £250 respectively. As you know, the Secretary of State for Scotland has written asking that his package should be inflated from December 1990. The Chancellor is writing today in response to say that he could agree to this only if the English package was uprated from the date of the water sale to December 1990. Otherwise, the Scottish package should be uprated from the generator sale to the Scottish sale.

Copies of this go to Barry Potter and Sonia Phippard.

Yours

JG.

JOHN GIEVE
Principal Private Secretary

chex.kf/jg/91 **RESTRICTED**

cc PM

Treasury Chambers, Parliament Street, SW1P 3AG
071-270 3000

23 July 1990

The Rt Hon Malcolm Rifkind QC MP
Secretary of State for Scotland
Scottish Office
Whitehall
LONDON
SW1A 2AU

Dear Secretary of State

ELECTRICITY PRIVATISATION: EMPLOYEE INCENTIVES

Thank you for your letter of ~~18~~ July. WITH BP!

I recognise that you may wish to see your package uprated to maintain its real value by comparison with the England and Wales package; and I have asked John to adjust his uprating accordingly. I would be content for your package to be uprated for inflation from December 1990 to May 1991 if John Wakeham were prepared for his package to be uprated from the date of the water sale to December 1990. Otherwise, your package should be uprated from February 1991 to your sale date.

I have no objection to your proposed PQ answer, assuming that it is made after John's announcement. I am copying this letter to the Prime Minister, John Wakeham and Sir Robin Butler.

Yours sincerely

JSt. Grieve

for **JOHN MAJOR**

[Approved by the Chancellor]

CONFIDENTIAL - MARKET SENSITIVE

THE RT HON JOHN WAKEHAM MP

SECRETARY OF STATE FOR ENERGY

COPY NO 1 OF 3

Prime Minister (1)

Content with Mr Wakeham's draft statement?

Yes - BHP 20/7

very good.

P.S. Conrad = Hanson
Pegasus = Paragon

Department of Energy
1 Palace Street
London SW1E 5HE
071 238 3290

Barry Potter Esq
10 Downing Street
LONDON
SW1 2AA

20 July 1990

Dear Barry

I enclose a copy of the draft statement my Secretary of State intends to make on Monday.

I am copying this letter and attachment to John Gieve (Treasury).

Yours
John

J S NEILSON
Principal Private Secretary

CONFIDENTIAL - MARKET SENSITIVE

D R A F T S T A T E M E N T

Mr Speaker, with permission I should like to inform the House that I have been approached by Conrad plc which has expressed a firm interest in making an offer for Pegasus plc.

I am convinced that the interest is serious. I have informed the Chairman of Pegasus of this approach. I have also asked him to make full information available to Conrad.

The Government has taken no final decision to proceed with a trade sale. I have a duty to the taxpayer to get the best return from the sale of the electricity companies. I therefore propose to pursue discussions with Conrad in parallel with continuing preparations for the flotation of Pegasus.

I should make it clear at the outset that, if Conrad decides to make a bid, I shall invite other companies to tender for Pegasus on a similar basis. Bids will fall to be considered under the competition legislation in the normal way.

The House will rightly want to know what a sale of this sort would mean for the management and workforce of Pegasus and for the electricity supply industry generally. As the owner of Pegasus on behalf of the taxpayer, I intend to lay down conditions which any single purchaser of the business must abide by. All of Pegasus's rights and obligations, including its fuel purchase and electricity supply contracts, will continue unaffected by the sale.

In particular, Pegasus is party to the collective industrial relations arrangements for the industry: any new owner will take on the same rights and obligations as Pegasus has now. Pegasus will continue to participate in and be bound by the rules of the Electricity Supply Pension Scheme. There will be no change in the pension arrangements for present pensioners and employees of Pegasus. Arrangements will also be made for Pegasus employees to receive benefits broadly comparable in financial terms to those they would have received in a public offering of the company's shares. I shall be talking to the trades unions tomorrow.

Further conditions will include a time-limited restriction on the purchaser's ability to dispose of all or a substantial part of Pegasus's business and a commitment to complete certain expenditure on environmental plant. There will also be a provision, in line with my proposals for the rest of the electricity industry,

to ensure that the taxpayer shares in profits from later property disposals.

The private sector has always thrived on competition to the benefit of customers, employees and shareholders. I believe that Conrad's approach is a very justified vote of confidence in the new electricity supply industry. Pegasus will be a major player in that market however it is finally decided to bring it into private ownership.

10 DOWNING STREET

Prime Minister

POWERGEN

There are two ways of handling the problem John Wakeham has identified

(i) to put his statement on after the Scottish + Welsh RSG statements so he would not have to give the statement to the Opposition after 4:00 pm. (ie. after the markets have closed).

or

(ii) to give it only to the Kinnock on Privy Councillor terms.

Of these I think (i) is the neater. Agree?

Yes - it will also have to be on a totally confidential basis not

JM

CONFIDENTIAL
MARKET SENSITIVE

THE RT HON JOHN WAKEHAM MP

Department of Energy
1 Palace Street
London SW1E 5HE
071 238 3149

Tim Sutton Esq
Principal Private Secretary to the
Lord President of the Council
Privy Council Office
70 Whitehall
LONDON
SW1A 2AT

20 July 1990

Dear Tim

As you know my Secretary of State is expecting to make an oral statement on Monday 23 July containing information which is market sensitive. He is of course aware that it is normal practice to release to the Opposition copies of a oral statement in advance. In this case, however, if copies were released to the opposition in advance they would be privy to market sensitive information before it was made available to the international financial markets. My Secretary of State would therefore be most grateful for guidance from the Lord President and the Chief Whip as to how the Opposition should be handled.

I am copying this letter to Dominic Morris, Murdo Maclean, Douglas Slater, Warwick Hawkins and Sonia Phippard.

Yours
John

J S NEILSON
Principal Private Secretary

CONFIDENTIAL
MARKET SENSITIVE

5(A-C)

PRIME MINISTER

ELECTRICITY PRIVATISATION: EMPLOYEE SHARE SCHEMES

There is a difference of view between John Wakeham and the Chancellor on the generosity of the proposed share schemes for employees (and pensioners) when the various electricity companies are created at privatisation.

At Flag A is John Wakeham's letter of 16 July setting out his proposals; at Flag B is the subsequent correspondence; and at Flag C is a note from Policy Unit.

Background

John Wakeham is seeking considerable improvements on the employee share schemes offered when the water industry was privatised. The DEn proposals are as follows:

a) Free shares: the amount for each employee would be £140 per annum: that is double the £70 figure for water industry employees;

b) Matching shares: a maximum of £230 worth of shares (it was £200 for the water industry): the ratio however would be as under the water privatisation - two free shares for every one purchased.

c) Discount: a 20 per cent discount on share purchases up to £1,300, (as against the 10 per cent discount on shares up to £2,350 under the water privatisation).

d) Priority shares: an increase of £3,000 on the ceiling under water to £15,000.

John Wakeham argues in favour of these improved arrangements as follows.

i) Privatisation is involving a massive disruption to the electricity industry. The employees need to be rewarded.

ii) The co-operation of Eric Hammond has been important in securing progress on privatisation. A good employee share scheme would secure further co-operation.

iii) An announcement of the employee share scheme now would do much to overcome any hostility to the proposed Powergen sale.

iv) The employee share scheme has to be generous because it is not possible to offer an employee share option arrangement - ESOP. (This is because the balance sheets of the regional electricity companies could not bear the further borrowing and hence debt necessary to establish ESOPs).

The Chancellor argues against the proposed schemes because :

- it is deadweight expenditure: it reduces the net proceeds from privatision (though only by £8m);

- it is wrong in principle to exceed so substantially the generosity of the arrangements for water privatision; and

- there is no need for any announcement now; indeed, as the proposals are less then the unions are bidding for, it may add to the problems on the sale of Powergen, not alleviate them.

A further complication is that Malcolm Rifkind has backed John Wakeham's proposals but seeks even more generous terms in Scotland. This would increase the values of shares allowed for six months inflation between the privatisation of electricity in England and in Scotland.

Assessment

There are two main issues.

a) Should the Government make an announcement now?

b) Should the scheme be as generous as Mr. Wakeham proposes?

Both Policy Unit and Treasury adduce good arguments for making no announcement next week. Moreover, there is clearly a trade-off between the generosity of the employee share scheme and the availability of an ESOP. If Powergen is now sold to Hanson, it is possible that an ESOP arrangement might be created - at least for Powergen. There seems no reason to rush an announcement on employee share schemes: you may conclude it is better to reflect further on the proposals.

That said, John Wakeham has put forward some convincing arguments for a more generous scheme than under the water privatisation. But just how generous it needs to be does merit further consideration.

Conclusion

i) Content to delay any announcement and consider further what employee share schemes would be appropriate; or

ii) Content to proceed as John Wakeham proposes?

BHP

BARRY H. POTTER
20 JULY 1990

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SECRET

4/A-B)
2 of 5

CC HMH

THE RT HON JOHN WAKEHAM MP

SECRETARY OF STATE FOR ENERGY

Department of Energy
1 Palace Street
London SW1E 5HE
071 238 3290

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

20 July 1990

Dear John

- file with BHP

Thank you for your letter of 19 July arguing that the only concession we should make on electricity employees' shares is to equate the value of water plus inflation to the time of the generator flotation.

I understand your reaction and would not press you so hard on this had it not been for the fact that Eric Hammond came in to see me. He argued cogently that the responsible approach by the electricity unions over the years, the very real gains in productivity, the disruption the employees were now facing and the tremendous support we had had from the industry during the privatisation process was altogether different from any other privatisation and justified a generous approach on employees' shares. He is bound to press his arguments much more forcefully when the developments in Pegasus are announced on Monday.

The proposal I put to you was designed to enable us to present it as a very generous package whilst minimising the cost. Nor should we not underestimate the fact that it would have the management's support. If I were able to tell Eric when we inform him of Pegasus that we had moved so clearly towards him, I am sure we would have a greater chance of getting his support.

Indeed, particularly after the Pegasus announcement, there is a high probability that he will want to see the Prime Minister and press her about him if we do not.

SECRET

B

SECRETARY OF STATE FOR ENERGY

I hope therefore that you will recognise the sense of what I am proposing. The cost is relatively small (some £8m) and the benefit to us could be very significant and I must be able to use this weapon when presenting the Pegasus arrangement. If it would help I should be prepared to accept inflating the package for Water to the generator flotation.

If you continue to see difficulties I really think we should discuss urgently before the Pegasus announcement.

I am copying this letter to the Prime Minister and Sir Robin Butler.

Yours ever

John

JOHN WAKEHAM

NAT IND: Gas & Electricity Pt 19

PRIME MINISTER 20 JULY 1990

ELECTRICITY PRIVATISATION - EMPLOYEE AND PENSIONER SHARE INCENTIVES

Mr Wakeham seeks the agreement of colleagues for his proposals in respect of share incentives for employees and pensioners of the electricity supply industry. His letter of the 16 July suggested that an announcement be made before the recess preferably by the 23 July.

Timing of the Announcement

It would now be wise to defer any announcement until we know how the employees react to the statement which is to be made next week on Pegasus.

The Free Offer

Mr Wakeham proposes a free share offer worth £140 + £2 per continuous year of service within the industry. Mr Major argues that we should stick to £70 in nominal terms (plus the same service element) which is what employees in the Water industry got.

Mr Wakeham has the support of the management for the £140 figure in recognition of the much greater dislocation which employees of the industry experienced before vesting. There was a massive reorganisation which went far beyond what happened in the Water industry. Some "premium" over the water offer is justified for that reason and might be useful if we had to counter objections to Pegasus.

It would also help when it comes to presenting a package which does not include the ESOPs for which Mr Eric Hammond had argued

so strongly.

Indexation of the Package for Scotland

Mr Rifkind argues that the Scottish employee package should be uprated for inflation from the English and Welsh issue in December 1990 to the time of the Scottish flotation in May/June 1991.

The terms of Mr Wakeham's package are defined by an estimate of inflation for the period to next May anyway. The Scottish employees should not receive the additional index linking; it would be a bad precedent and it has very limited significance in the real world. If they are going to sell the shares, the short term volatility of the markets matters more than six months of inflation; if they are long term investors, it can hardly be an issue at all.

Mr Major would prefer that the scheme as a whole is linked to the generators sale rather than to RPI for the period up to May. He will only accept Mr Wakeham's scheme if Mr Rifkind accepts that the nominal terms should be the same in Scotland as in Enland and Wales.

ESOPs

It is very unfortunate that the nature of this privatisation makes it impossible for the Government to use ESOPs.

However, the amount of debt which the distributors are being asked to assume makes it difficult for them to take on additional external borrowing to finance ESOP schemes. Mr Hammond has suggested that the Government should lend them the money (about £1 billion on his proposal) against the security of the shares. A much smaller scheme along those lines might perhaps have been conceivable but Treasury opposition to delayed receipts is

understandable.

The lack of an ESOP is one reason why the free share offer might be more generous than was the case with the Water industry. It is also important that the ultimate package is presented in a way which emphasises our strong long term belief in the value of the ESOP concept.

Conclusion

(a) That any announcement should be deferred until the Pegasus statement has been made.

(b) That Mr Wakeham's case for giving more free shares in the electricity than the water companies is justified by the scale of the industry reorganisation, by the disappointing lack of ESOP schemes and possibly by the need to meet opposition to the Pegasus announcement.

(c) That there is no case for indexing the value of the Scottish employee package for the period December 1990 - June 1991.

(d) That we should be careful to reaffirm our long term belief in the value of the ESOP concept even though the specific conditions of the electricity privatisation have not made it possible to use it.

Howell Harris Hughes

HOWELL HARRIS HUGHES

(012)

(1)

PRIME MINISTER

NORTHERN IRELAND ELECTRICITY: PRIVATISATION

At **FLAG A** is a minute from Peter Brooke setting out revised proposals for privatising Northern Ireland Electricity (NIE).

Contrary to earlier intentions, he is now proposing that NIE should be privatised as two separate companies: for generation and for transmission/distribution respectively.

The minute accepts that this will increase costs in the short term. But Peter Brooke argues there are longer term benefits: it might attract new companies into electricity generation and so reduce costs to consumers; and it might defuse potential public criticism that, if NIE is privatised as a unit, the monopoly will be preserved.

In principle this may seem an attractive proposal. Treasury Ministers were earlier in favour of such an approach - though Treasury Ministers have not yet responded to Peter Brooke's latest minute.

But there are two counter-arguments.

i. Such a proposal would delay the privatisation for a further year. So the privatisation proceeds would slip beyond 1992/93.

ii. As the Policy Unit note at **FLAG B** points out, there is a danger of losing some economies of scale if the industry is fragmented. The Northern Ireland economy is small: it is not clear that any new generating company would ever be attracted into the industry. If not, there would be no gain from extra competition. But there could be costs in terms of potentially lower privatisation proceeds and possible loss of scale economies if NIE is not privatised as a single unit.

CONCLUSION

Peter Brooke is seeking approval of his broad strategy at this stage. There seem to be sufficient grounds for at least considering the matter further. And there seems no need to take a decision in the last few days before the Summer Recess.

i. Content to take this to ministerial consideration at E(A) in the autumn? Yes mr

ii. Or do you wish to aim for a discussion within the next few days? No

iii. Or content for Peter Brooke to proceed as he proposes? No

BHP mr

BARRY H. POTTER
20 July 1990

a:\NIE (MRM)

CC 96

SECRETARY OF STATE FOR NORTHERN IRELAND

PRIME MINISTER

MAP A+18

When I wrote to you in March about electricity prices in Northern Ireland, you asked for a further report in due course on progress with the proposals for privatising Northern Ireland Electricity (NIE).

Structure of Privatised Industry

The working assumption up to now has been that NIE would be privatised as a single unit. I have, however, become particularly concerned about the obstacles it may put in the way of the entry of new competitive generators into the industry in the longer term and about the political and presentational difficulties of this monopolistic structure. I have decided therefore to look again at the possibility of splitting NIE into separate companies for generation and transmission/distribution.

In pure economic terms, there are some arguments against a split. Broadly, they are that a split will not of itself create considerable competition in generation; that it will increase operating costs; that the more risky generating side may have to be sold privately rather than by flotation; that there will be additional professional fees; and that the privatisation will be delayed by some months. The arguments for a split are that it would give the distribution company a real incentive to find the most cost effective sources of supply; and, most importantly, that it would make it more likely that new independent generators will enter the market (since they would be confident of receiving unbiased treatment from a separate distribution company).

The advantage of splitting NIE is that it defuses the criticism to which sale as a unit is open - that we are merely changing the ownership of the industry, while perpetuating a monopoly and doing nothing to introduce competition or improve performance, and that this can only be to the detriment of consumers.

CP/SOFS/9151

The competition benefits of splitting NIE would accrue only in the longer run when generators compete to provide new capacity. There would be some additional financial costs in splitting compared with sale as a single unit, and I have just had a preliminary assessment of these from my merchant banking advisers, N M Rothschild (without involving NIE). This suggests that the costs would be moderate if the generating company were sold by private treaty, but that there would be a significant reduction in expected proceeds if it were sold by public flotation. Apart from the financial costs, I also have to consider the potential benefits of offering electricity users in Northern Ireland the opportunity to influence the electricity generating company, as shareholders, which a flotation would provide. I will need to probe these issues further, but, unless this work exposes some major difficulty (in which case I would consult colleagues again), I would propose to move forward on the basis that NIE be sold as two separate companies. I would also propose that the question of the method of sale of the generating company be dealt with directly between myself and the Chief Secretary.

Privatisation Timetable

Under the present timetable, based on NIE remaining as a single unit, privatisation would take place in Spring 1992. A White Paper would have to be published before the end of this year and a draft would be brought to you and colleagues for consultation in the Autumn. The necessary legislation (an Order-in-Council) would need to have passed through Parliament by Summer 1991.

However, a split of NIE would mean that this timetable could not be maintained and the sale would be delayed. This in turn would mean that I would need to seek appropriate PES cover for NIE for 1992/93. (On the assumption of a sale in Spring 1992, there would be no need for such provision).

Regulation

The work that has been done on regulation also has assumed sale as a unit, but the approach which has been developed could be readily adapted to a split business. The aim is to encourage the privatised industry to behave in an economically efficient way, and to achieve this by giving it appropriate incentives rather than by involving the Regulator intrusively in all the major investment and operating decisions. The principal means of applying incentives could be a price control formula, which would act as a proxy for market pressures and require the industry to reduce costs in order to maximise profits. The formula will be tested by extensive modelling work over coming months.

I have considered also the institutional arrangements for regulation of the privatised industry. There will be obvious advantages if the NI Regulator can draw on the expertise and the information that will be available to the office of the Regulator in GB. I would propose therefore to appoint as Regulator of the Northern Ireland industry the same person who is Regulator of the industry in Great Britain (at present Professor Littlechild). I have discussed this with John Wakeham who is content and Professor Littlechild has also indicated his agreement, provided he can appoint a deputy on the ground in Northern Ireland (as he has done in Scotland).

Future Generation

I also need to take early decisions on NIE's future generating capacity.

NIE forecasts that new capacity is needed for the winter of 1995/96 and my predecessor announced in July 1988 that the completion of the Kilroot power station (Kilroot 11) as a dual

coal/oil fired station would be the means of providing this. There is uncertainty whether Kilroot II would need to have flue gas desulphurisation (FGD) equipment fitted in order to comply with the EC Large Combustion Plant Directive. If it did, the capital cost and the annual operating costs of the station would both increase substantially. Nevertheless, even if we believed that FGD was not legally required (I am seeking Cabinet Office advice on this point), there could be strong political grounds for installing it, given present public feeling on environmental issues and Government's own policy of care for the environment. There is however an option that would allow the FGD issue to be avoided entirely; that is, if Kilroot II were fired by natural gas. The proposed gas pipeline between GB and the Republic of Ireland may offer such an opportunity and I am therefore pursuing this possibility.

A second option for new capacity is interconnection with the Scottish grid. Initial soundings with Scottish Power have been encouraging and suggest that a supply could be arranged on terms competitive with Kilroot II. Interconnection is attractive in the context of privatisation, as a possible source of competitive pressure on the Northern Ireland generating stations. I believe that this is a very important consideration and I am therefore developing the interconnector option urgently also.

Two new tranches of generating capacity will be needed to meet Northern Ireland's electricity demand by the end of the century. Kilroot II and a Scottish interconnector are more attractive than alternative options and our strategy should include them both. On initial appraisal the economics of a coal/oil fired Kilroot II and a Scottish interconnector appear to be very close and it is unlikely to matter much, in terms of cost, which is commissioned first. It may not be possible for a Scottish interconnector to be built in time to meet NIE's capacity shortfall (Winter 1995), and this suggests that Kilroot should proceed first. On the

other hand, I believe that there is a real danger that a Scottish interconnector may not be built at all if it is not committed before privatisation, since the privatised industry would not welcome the competition it represents. In the circumstances, and since they seem likely anyway to be needed within a short interval of each other, there could be a case for both projects starting at an early date. I therefore propose to instruct NIE to take forward discussions with Scottish Power with a view to defining by, say, the end of September the terms on which an electricity supply could be made available so that I can then decide which option to pursue first. I should by then be better informed on the terms of any gas supply.

Tariffs

I had hoped to be able to report on an agreed tariff structure for NIE but this work has had to take second place to regulation matters and consideration of the structure of the Industry. The necessary modelling work has now started and I will report further in the Autumn.

Conclusions

The characteristics of NIE make this a difficult privatisation. Nevertheless, I believe that good progress has been made and I will report further in due course. In the meantime, I invite you and colleagues to agree:

(a) my proposals on the structure of the privatised industry (noting the possible effects of these on the privatisation timetable) (paras 2 to 7);

(b) the general approach to regulation that I propose and my intention to appoint the Director of Electricity Supply in GB to be the regulator of the NI industry (paras 8 and 9); and

(c) my proposals to take forward urgently investigation of the options of a Scottish interconnector and a natural gas supply for Kilroot II (paras 11 and 12).

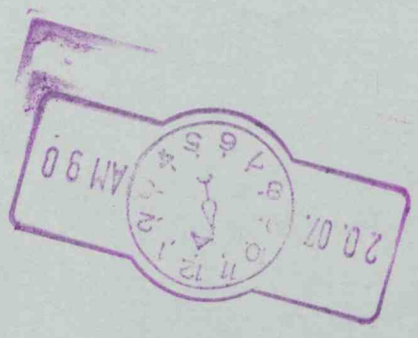
I am copying this minute to E(A) colleagues and to Sir Robin Butler.

P.B.

PB

July 1990

NAT IND: Gas & Electricity Pt 19



CONFIDENTIAL

PRIME MINISTER

20 July 1990

NORTHERN IRELAND ELECTRICITY

It is normally better to privatise a business by increasing competition rather than as a monopoly. Competition generally drives prices down and benefits the consumer. Hence the underlying cost structure of the economy is improved. This generalisation derives from the assumption that any monopoly contains components of profit which derive solely from the monopoly itself. If it were to be broken up such in-built components of profit would disappear because of reduced prices to consumers. On the grand scale this is certainly true - look at British Gas and British Telecom which were privatised with these monopoly profits still locked in!

However, when the scale is small, the minimum size of operation in order to achieve efficient production and distribution is also important. A competition zealot might insist that no village in England should ever be allowed only one shop or one filling station. The consequence would be under-utilised capacity leading to a higher fixed cost per item sold than would otherwise be the case.

Despite the excellent arguments of the Northern Ireland paper and the commendable way in which they are seeking to avoid monopoly, despite even the strong support of the Treasury for splitting NIE, I suspect that the above argument of critical size applies. In a country of 1.5 million people served by 4 power stations, each with dedicated wiring systems to consumers, rather than a national grid, the imposition of competition may be a net cost rather than a net benefit.

Much can be achieved through privatising NIE as a single entity and sticking to the original timetable for spring 1992 provided a proper regulator is in place. Local private electricity generation in America is often regulated such that local power stations fuelled from local sources are not permitted to earn a return on capital higher than a modest or 'utility' level.

This may not be the ideal way to provide a commodity in a large economy but it is not clear that the Northern Ireland economy is "large" in that sense. It would of course always be possible to introduce competition in the provision of new generating capacity as the existing capacity become obsolete. This would require supply contracts to be written so as not perpetually to exclude new entrants.

CONCLUSION AND RECOMMENDATION

You should commend the enthusiasm with which the Northern Ireland Office, under Peter Brooke and Richard Needham, are addressing electricity privatisation. You should also welcome a thorough analysis of ways of introducing competition. You should however warn that competition should never be introduced for doctrinaire reasons if it is going to be a permanent net cost imposition.

GEORGE GUISE

Annex - note from Peter Stredder, now working at BZW who are advising NIE. It is predictable that NIE should be opposed to its own break-up but Peter's arguments should be weighed.

ANNEX

BARCLAYS de ZOETE WEDD
L I M I T E D

12th July 1990

George Guise
POLICY UNIT
10 Downing Street
London
SW1

Dear George

NORTHERN IRELAND ELECTRICITY: PRIVATISATION

As promised a attach a note setting out the reasons why we see no advantage in restructuring the electricity industry in Northern Ireland for privatisation by separating generation from transmission distribution and supply. As you would expect, my prejudice was that competition should be introduced. However, I am convinced that because of the small size of the system in Northern Ireland (its generation is only one eighth the size of Power Gen) competition between generating stations would not provide incentives to efficiency because marginal improvements in operating efficiency would not change the amount of time a station would run and therefore the profits a generator could make by improving operating efficiency.

The way to bring real benefits for consumers is to introduce competition between competing companies to build and operate new generating stations because marginal improvements can make the difference between winning and losing a competition.

Yours ever

Peter

PETER STREDDER

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MEMBER OF THE SECURITIES ASSOCIATION

NIE PRIVATISATION

Northern Ireland Electricity (NIE) has four main generating stations with 2.26 GW of capacity, serving a population of 1.5 million. This is about the same size as Scottish Hydro-Electric, which is to be privatised as a single entity and about one eighth the size of the smaller of the generating companies in England & Wales.

It is proposed to privatise NIE as a single entity. The advantages of retaining an integrated structure outweigh the disadvantages because in NIE's small system there is a monopoly in wholesale generation over most parts of the load curve. This is because the operating costs of NIE's four generating stations differ sharply from each other, according to when they were built and the fuel they use. The "merit order" which ranks stations according to their operating costs is therefore determined by the design of each station and relative fuel prices. Marginal changes in operating efficiency do not affect this merit order. Therefore, in a competitive system individual generators would not increase the amount of time they run by improving operating efficiency because this would not affect their place in the merit order. Thus competition between generators in a wholesale market would not add to the pressure to reduce costs that will be introduced with privatisation.

Thus the most important possible reason for changing the integrated structure does not apply in Northern Ireland. By contrast, competition to build and operate new generating stations would provide incentives to generators to offer contracts to NIE at the lowest possible cost. This is the main feature of the proposed privatisation structure in Northern Ireland. Competitions, supervised by the Regulator, will be held to choose who should own and operate each new power station. Because of the small size of NIE's system, such competitions will take place relatively infrequently and it will only be financially feasible for generators to supply in Northern Ireland if they have a long term contract with NIE.

The annex sets out the more detailed arguments for and against a number of possible structures for a privatised NIE. The conclusion is that, in the short term, there are serious costs and risks associated with any form of split. Because of the small size of the electricity system in Northern Ireland it is not possible to offset these by effective competition between generators in a wholesale electricity market. In the long term, there are potential benefits from competition for new generation. The possible loss of effective co-operation and of the benefits of integrated management can be minimised through an appropriate contractual and regulatory framework. The conclusion is therefore that successful privatisation, providing appropriate economic incentives, is most likely to be achieved with the integrated structure.

ANNEX I

POSSIBLE STRUCTURES FOR NIE

This annex compares three possible structures for privatising the electricity industry in Northern Ireland:

- an integrated structure;

- a straightforward horizontal split into a generating company NIE(G) and a transmission/distribution/supply company ("NIE(TDS)") under separate ownership ("Simple Split"); and

- a structure with NIE(TDS) supplied by two separate generating companies which would be controlled by contract but not by direct regulation, with all three companies in separate ownership ("Three-Way Split").

Whilst other structures are possible, these capture the essential features that need to be tested.

It is also proposed that NIE(TDS) has a monopoly of the right to supply consumers with electricity. At the present time, it would be uneconomic to allow third party supply rights: this arises from the need to set up and manage a central pool; the need to regulate the cost of top-up and back-up supplies; and the small number of consumers in a position to negotiate for supplies of significant size. The legislation envisaged would, however, allow for the future introduction of supply competition by licence amendment, e.g. if this economic position should change substantially.

Efficient on-going Management

The electricity industry requires close co-operation between its various parts. In order to achieve this under a contractual framework, NIE(TDS) needs to negotiate contracts from a position of strength, as would be the case if a number of generators were competing for a new contract. With an integrated structure, common senior management should ensure that contracts are operated in the required co-operative spirit. However, with a split system, contract negotiations will take place under the time and other pressures associated with privatisation and it may prove very difficult to secure effective co-operation after privatisation.

The Integrated Structure may, in certain circumstances, give perverse incentives on NIE (TDS) to mis-manage dispatch. The opportunities to mismanage dispatch are unlikely to be material in practice. Because NIE's system is small, it is evident when generating sets have been dispatched out of merit order and to determine whether such out of order dispatch is legitimate or not.

Competitions for New Generation

The integrated structure provides a perverse incentive on NIE(TDS) to bias decisions in favour of NIE(G) if NIE(G) is able to make a successful bid which secures for NIE's shareholders an excessive rate of return. If NIE(G)'s bids can be policed by the regulator to ensure that they do not involve such returns, there is no reason why NIE should wish to bias decision in this way. With a simple split, the bias is removed, but NIE(G) (as a regulated utility) is still in a different position from competitors and there may be non-financial bias in the competition. The three-way split does not require regulatory intervention to ensure effective competition in new generation. It would, however, give away value if Kilroot II were to be committed after the privatisation.

Set-up Cost

The Integrated Structure will be easily the cheapest to create. The split structures require elaborate real contracts, which will be time-consuming and difficult to negotiate. There will also be substantial one-off and significant continuing costs of a split structure arising from the establishment and operation of new "headquarters" functions.

Management

Splitting of NIE (simply or three-way) will impose significant burden on NIE management, which it may not be able to handle adequately. This is particularly the case given that the split will occur simultaneously with a need to negotiate new contractual arrangements and immediately before privatisation.

Unions

It will be important to consider union reactions, particularly given the attitude of the work-force at Ballylumford. In other privatisations, unions in utilities have been opposed to privatisation, but resistance has been weakened by the incentives offered to the labour force. If NIE(G) is to be sold by private treaty, these incentives will not be available. The unions would undoubtedly oppose a split, possibly by taking industrial action.

Privatisation Structure

NIE(TDS) can be publicly floated in all structures. NIE(G) can only be floated if there is a regulatory structure protecting it from the worst downsides of contract risks. It would also be necessary to give NIE(G) the right to sufficient future generating stations to ensure that it had a viable long term business. This would reduce competition. However it might make flotation possible with the Simple Split. Sale by private treaty will be practicable under all structures and necessary for the generators in a three-way split.

Privatisation Timetable

Privatisation can be effected by March 1992 with the Integrated Structure. It is unlikely to be practicable until late 1992 or 1993 with the split structures, even if the management problems can be resolved satisfactorily.

Privatisation Process/Tariffs

The value of the generating company or companies created in a split structure will essentially be determined by the terms of their contracts with NIE(TDS). The risks faced by two generating companies will be higher than those faced by a single generating company or integrated company because a loss of availability of one generating set will not necessarily be balanced by the use of another set. This greater risk will either be reflected in higher prices to consumers of lower sales proceeds.

It is not clear whether GB electric utilities will want to own a generator in Ulster. If not, it will be difficult to obtain fair proceeds for sale of the generator(s) by private treaty. It will, in any event, be difficult to get fair value for possible - but uncertain - years at the end of the economic life of a power station - e.g. particularly at Belfast West.

In the case of a regulated generator (e.g. with the Simple Split or Integrated Structure), the regulator may be able to recapture part of any excess profit from the consumer. Sale by flotation may also fail to maximise value. The "loss" of value will, in this case, be passed to the public who purchase shares.

MEETING RECORD

SECRET AND PERSONAL

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SUBJECT ce MASTER

3(a-c)

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

20 July 1990

Dear John,

PRIVATISATION OF POWERGEN

The Prime Minister held a further discussion on the privatisation of Powergen with your Secretary of State this morning. The meeting was also attended by the Chancellor and Mr. George Guise (No.10 Policy Unit).

I should be grateful if recipients of this letter could ensure that it is seen only by those with a strict need to know.

Your Secretary of State said that considerable progress had been made on the idea of a possible trade sale. Negotiations on an indicative price were well underway with "Conrad". Last night "Conrad" had put forward a price of £1.5 billion. He had indicated this would not be sufficient; and this morning "Conrad" had raised the price to £1.65 billion. Once again he had indicated this was not adequate; and further work was now being undertaken by "Conrad" to see whether they could raise the price further. In practice it was unlikely the indicative price would be raised much further. But the additional work would help remove any residual areas of uncertainty about the valuation of Powergen and hence the indicative sale price.

This indicative sale price had to be compared to that available from flotation. Kleinwort Benson had indicated that proceeds from a flotation of Powergen at a theoretical maximum might amount to £1.57 billion. In practice they considered a figure of £1.3 billion in a straight flotation was the highest realistic expectation. Powergen's view had been that a flotation, taking account of a proposed debt injection, would generate net proceeds of around £700 million, though Powergen had also indicated that under different debt and accounting treatments that figure might rise to as much as £1.1 billion. He considered however, that Powergen with a prospectus under the influence of their City advisors, would generate no more than £1 billion on flotation. It was this estimate of flotation proceeds which could best be compared with the prospective proceeds from the trade sale.

If an announcement that the Government had been approached with the offer of a trade sale were made on Monday 23 July, it might be possible to make arrangements such that a binding legal contract on "Conrad" to offer an underwriting price could be

signed on 17 August. In addition to the higher prospective proceeds from sale of Powergen, it was also necessary to take into account the repercussions for the privatisation of National Power. On balance the effect should be beneficial and increase the expected proceeds from flotation of National Power.

It was now necessary to consider whether to make an announcement on Monday. A final decision could be left till Monday morning in the light of further consideration of the indicative price by "Conrad". The form of any statement to Parliament would be that the existence of a potential trade sale would be made clear; the identity of "Conrad" would be announced; and the Government would then indicate it was interested in further bids, with "Conrad" in effect having offered an underwriting price: but the flotation option would also be kept open.

The following were the main points made in discussion.

(i) The additional privatisation proceeds from a trade sale made that a potentially attractive course. It would be helpful to include an employee share option scheme in any final arrangements.

(ii) There was bound to be some political criticism of a further proposed change in privatisation plans for electricity. The identity of "Conrad" might not be helpful in this regard. But there was an excellent defence: the Government could not but explore a trade sale offer in the interests of taxpayers.

(iii) Although the indicative price would not be made public, there was a danger that it would leak.

(iv) Under the proposed arrangements, once "Conrad" entered into a formal agreement, it would in effect provide an underwriting price. But "Conrad" had an incentive to quote a realistic indicative price now: this price would in due course become the underwriting price. Others, including possible overseas buyers and "Conrad", would be able to bid once the underwriting arrangement was firmly in place.

(v) If the trade sale of Powergen went ahead, there would still be the flotation of the transmission companies as well as National Power. Some area boards (which would be transformed into the transmission companies) were seeking to avoid an injection of debt into their balance sheet and were trying to secure money directly through grants. This was to avoid the future burden of interest payments. But it was right to create balance sheets at the outset which reflected normal commercial practices. The implied level of gearing and the amounts of debt under consideration were well within the normal accepted levels in business. The terms of such debt would be considered further.

Summing up a brief discussion, the Prime Minister said that a final decision on whether to announce the possible trade sale of Powergen should be made on Monday morning. The discussions had gone very well and the Prime Minister was most grateful to your Secretary of State for his excellent handling of the negotiations. It would be important to prepare a rigorous defence of the proposed trade sale for use at any statement in the House on Monday.

I am copying this letter to John Gieve (H.M. Treasury).

Yours,
Barry

(BARRY H. POTTER)

John Neilson, Esq.,
Department of Energy.

chex.jp/tt1/22

SECRET

2A (A-B)

Treasury Chambers, Parliament Street, SW1P 3AG
071-270 3000

19 July 1990

Rt Hon John Wakeham FCA JP MP
Secretary of State for Energy
Department of Energy
1 Palace Street
LONDON
SW1E 5HE

Dear Secretary of State,

ELECTRICITY PRIVATISATION: EMPLOYEE INCENTIVES

Thank you for your letter of 16 July.

I have a number of concerns about your proposal. First, your proposed increase in the free offer breaks a well established precedent that the free offer should be limited to £70 in nominal terms, plus a service element. This norm has been carefully guarded as free shares are simply a deadweight cost. They do nothing to encourage employees to invest in shares with their own money.

Secondly, any package within the range of acceptability to us will be seen by the unions as inadequate. I recognise that your package has management support but I do wonder whether that support justifies breaking the £70 limit on free shares.

Thirdly, we have to consider this package against the possible response of employees to an announcement on Pegasus. I fear it may be in danger of falling between two stools.

These considerations prompt me to suggest that the package should be no more than water plus inflation (to the gencos); that it should not be announced at or near 23 July; but that we hold back to consider whether we need to respond to an adverse reaction to Pegasus. Except in extreme circumstances, however, the presumption between us would be against an increase.

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Finally, I see that you have adjusted the parameters of the scheme for an estimate of inflation to next May. The parameters should instead be inflated to the generators' sale, which is arguably generous to TREC employees. I would be prepared to contemplate inflation up to May if Malcolm Rifkind were willing to accept that the same nominal parameters (or parameters implying the same nominal value) applied to the Scottish sale.

I am copying this letter to the Prime Minister.

Yours sincerely

pp JOHN MAJOR

[Approved by the Chancellor of the Exchequer and signed on his behalf]

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PRIME MINISTER

PRIVATISATION OF POWERGEN

You are meeting the Energy Secretary and the Chancellor, at 0915 tomorrow to discuss further the privatisation of PowerGen.

You will recall that the meeting on Monday, 2 July, agreed the following strategy.

i) The Department of Energy would give information on PowerGen to Hanson in the second week of July.

ii) Hanson would give an indicative price for PowerGen within ten days.

iii) If you and the Chancellor were content, the Energy Secretary would announce to Parliament that the Government proposed to invite bids for the trade sale of PowerGen; Lord Hanson's indicative price would then become an underwriting price for three weeks. He would pick up all shares at that price unless others (or in response Hanson) bid higher.

It was proposed that the announcement would be made next Monday, 23 July. This would indicate only that an approach for a trade sale had been received; that it was sufficiently attractive to be a better option than flotation; that the prospective purchaser was Hanson; and that the Government would now embark on the procedures at (iii) above.

Progress

The first steps have gone well. When Lord Hanson was provided with the information on PowerGen he found it necessary to seek further data. As you know, this necessitated bringing the Chairman of PowerGen into the picture on Monday, 16 July. I understand that, despite the earlier concerns, Mr. Malpas responded very positively to the proposal and has co-operated

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fully.

During negotiations today, Hanson offered a price of £1.5 billion. This is higher than the Kleinwort Benson estimate of acceptable flotation proceeds (£1.3 billion); than the original PowerGen estimate for the flotation (£700 million); and than PowerGen's revised - now that the likelihood of a trade sale has emerged - flotation estimate (£1.1 billion).

The Energy Secretary has asked Hanson to improve their initial offer, and negotiations are still continuing this evening (minute written at 9.30 p.m.).

Conclusion

The earlier meeting concluded that a trade sale appeared to be the better option. (As background, I attach the record of the earlier meeting and an earlier advice note.) A price at about the level expected at that meeting has been offered. It may be raised further.

Mr. Wakeham needs a decision tomorrow on whether a good enough price has been reached to justify making a Statement on Monday. (He is right to propose that until Hansons have signed a binding agreement, work should continue in parallel on flotation.)

BHP

BHP

19 July 1990

jd c:\wpdocs\economic\powergen

Prime Minister
A DEN code!
Pegasus = Powergen
Conrad = Hanson.

COPY NO OF 3

NO COPIES TO BE TAKEN

PRIME MINISTER

PEGASUS

When we met on 2 July we discussed the difficulties I was having with Pegasus which constituted a clear threat to the prospects of being able to float the company at a sensible price, and we agreed that I should follow up the approach I had received from Conrad about his buying Pegasus in a trade sale. We agreed that if this looked promising I should make an announcement about it in Parliament before the House rose for the summer recess.

Conrad were first supplied with some preliminary information from published sources. As you know, I then called in the Chairman of Pegasus on 16 July and told him that I had had an approach from Conrad, and that in the taxpayers' interest I must explore it. He readily agreed to help. Senior Pegasus management is shaken by the prospect of not being privatised as an independent company, as they had previously expected. However, they have co-operated fully in making information available to Conrad. There have been intensive discussions between Conrad and Pegasus, involving my Department and my advisers, throughout this week.

With the need for a statement on Monday in view, our aim has been to get a price indication from Conrad today on a sufficiently firm basis to enable us to decide immediately whether the option of a trade sale should be pursued further.

In assessing the price offered by Conrad, we need to take account of the following factors:

(i) its relationship to the price we could have expected to receive from a public flotation; we have been advised that we should expect to receive a premium for control; on the other hand, Pegasus could influence the prospectus so as to keep the price down;

(ii) the effect on the price at which Pegasus' competitor can be floated; the counterpart of a premium for control of PowerGen is a discount on its competitor;

(iii) the effect on the achievement of the Government's other objectives, including wider share ownership;

(iv) the political situation. There is a general expectation of a public flotation of both generators. A trade sale of Pegasus will look like a departure from our previous course. Conrad is known to be a friend of the Government; before proceeding on the basis of an offer from his company, we need to be clear that it offers a substantial advantage, compared with what would be achievable in a public flotation. Great care will also be needed to maintain the morale of the Pegasus workforce and senior management.

Conrad's initial offer, received today, was £1.5 billion.

Kleinwort Benson advise that the lowest proceeds from flotation which would be acceptable if privatisation could not be achieved in any other way would be of the order of £1.3 billion. This compares with their view that proceeds of £1.5 to £1.6 billion, taking account of £270 million of debt, should be achievable on the basis of the Department's financial projections. Kleinwort's further advise that, while this figure does not reflect a premium for control, an offer by Conrad to underwrite at this level could be acceptable, though negotiators should press for a higher price.

On the other hand, there is much uncertainty about what could have been achieved if Pegasus had maintained their view of profits and accounting for FGD. Proceeds on their basis could be as low as £700 million, though in the light of the pressure put on them by our exploration of Conrad's approach they now believe that proceeds of £1.1 billion would be achievable. They have dropped their demand for a £395 million cash injection.

A trade sale to a strong company like Conrad would strengthen competition in the electricity generation industry, one of the major objectives of privatisation. The flotation of 15 other

companies creates plenty of opportunities for wider share ownership. But for a trade sale to be politically and publicly acceptable it will need to be seen to offer a substantial premium over what we could have expected to achieve by means of a public flotation.

Kleinwort's valuation, including debt, is £1.5 to £1.6 billion. We have a first offer from Conrad of £1.5 billion. I have seen Conrad today and given him a strong indication that he needs to do better if we are to continue to pursue the trade sale option. I may hear more before our meeting tomorrow.

My recommendation to you is that we should take a view tomorrow on the basis of the latest information on whether we have a good enough price to justify making a statement on Monday.

I envisage that until Conrad has signed a binding agreement to purchase we should continue to work in parallel on flotation, and should make it clear publicly that we are doing so.

I am sending a copy of this minute to the Chancellor of the Exchequer.

JS Neilson

pp **SECRETARY OF STATE FOR ENERGY**
19 July 1990
(approved by the Secretary of State and signed in his absence)

CONFIDENTIAL

SCOTTISH OFFICE
WHITEHALL. LONDON SW1A 2AU

The Rt Hon Chris Patten MP
Secretary of State for the Environment
Department of the Environment
2 Marsham Street
LONDON
SW1P 3EB

18 July 1990

Dear Chris,

IMPLEMENTATION OF THE EC LARGE COMBUSTION PLANTS DIRECTIVE: EFFECTS ON ELECTRICITY PRIVATISATION

I am aware that discussions have been going on for some time now about the contribution of the electricity industry to meeting the overall UK commitments on reducing emission limits under the Directive.

Like you, I am most anxious that we should meet those commitments and be able to demonstrate effectively to the Commission that we have done so. I think that we can best do that by constructing an emission limits regime which is in harmony with our objectives in restructuring the electricity industry as a contribution to the creation of a more competitive energy market. Certainly it is essential to avoid any conflict between these two important elements of our programme, particularly in the period preceding flotation of the electricity companies.

I start from the point that Scotland should have a very good story to tell on emissions. The high proportion of nuclear and hydro generation in Scotland will allow us to meet some 60% of our own electricity consumption from non-fossil fuels when Torness is fully operational. The prospects for future gas burn will decrease our reliance on coal burn even further.

However, at a UK level there is a good case for ensuring that coal burn in Scotland can be used to help meet demand in England. In view of the relatively low sulphur content of Scottish coal, the substitution of electricity generated in Scotland for an equivalent amount in England & Wales, where much higher sulphur coal is generally produced, would result in a net benefit for overall UK emissions.

In addition to the environmental case for the export to England of coal fired electricity generated in Scotland, there are important considerations related to ensuring competition within the newly created market for electricity. Our electricity privatisation proposals were predicated on the

assumption that cross border competition would be encouraged. To inhibit electricity exports would undermine the case which we presented on the shape of the privatised industry. It would also seriously weaken the position of the Scottish companies, and will undoubtedly influence the perceptions of investors and could well damage the prospects for and proceeds from flotation.

In order to avoid a conflict of objectives we must ensure that the emission limits regime is sufficiently flexible to allow for agreements for the export of electricity generated in Scotland.

In securing flexibility in the emissions limit regime I think that we need a mechanism which links commercial and environmental considerations. I believe that this would be best met by a system of tradeable permits for emissions, such as is proposed in the draft Environment White Paper for industries other than the ESI. This would enable extra headroom to be created for exports utilising low sulphur coal but only on the basis of exports being justified on commercial grounds and of a commercial assessment of the merits of burning low sulphur coal against all other options for generating the electricity.

I am copying this letter to the Prime Minister, Geoffrey Howe, John Major, Douglas Hurd, John Wakeham, Peter Brooke and to Sir Robin Butler.

Yours ever,

MALCOLM RIFKIND

CCPU

RESTRICTED

SECRETARY OF STATE FOR SCOTLAND

SCOTTISH OFFICE
WHITEHALL, LONDON SW1A 2AU

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

18 July 1990

Dear John,

EMPLOYEE AND PENSIONER SHARE INCENTIVES

— will request if required.

I have seen John Wakeham's letter to you of 16 July.

There are strong links between the constituent parts of the industry on both sides of the border, and I have received representations from both the Scottish industry and SESTUC identical to those put forward in England & Wales. However, the Scottish industry has consistently sought indexation of the value of employee share offers to allow for the different timing of the ESI flotations.

I am sure it is right that John should announce details of the share offers in England & Wales at this stage and I thoroughly commend his proposals for the free offer. I cannot accept, however, that the value of the matching and discount offers in England & Wales should be justified by reference to inflation projected to the date of the Scottish flotation, since that implies that the Scottish package will be identical **in cash terms** to that in England & Wales. Such an approach would result in Scottish employees and pensioners receiving worse treatment than their southern counterparts, which could have a particularly negative impact on the climate in which the flotation will be conducted. I am particularly anxious not to reinforce the perception that the Scottish industry has in some way lost out by coming at the end of the flotation queue.

I do not propose to finalise the precise structure of the Scottish employee package until much closer to flotation in May or June of 1991. I should nevertheless be glad of your agreement in principle that the value of the employee and pensioner package for Scotland should be equivalent **in real terms** to that of the England & Wales package with an uprating for inflation from, say, December 1990. In order to avoid any potential difficulties which such an arrangement might pose for John, I should be prepared to delay any detailed announcement until after the GenCo flotation. While for reasons of consistency the Scottish offer should be similar to that for England & Wales, the longer timescale will allow us to

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reflect further on the nature of the offer to be made to employees of Scottish Nuclear Ltd.

In order to reassure Scottish employees as to the value of the benefits they will receive in due course I feel bound to make an interim announcement, coinciding with John's, that the share offer for Scottish employees will be broadly in line with that for England & Wales. The text of my proposed announcement is attached.

I am copying this letter to the Prime Minister, John Wakeham and Sir Robin Butler.

MALCOLM RIFKIND

MCN05226.070

ARRANGED PARLIAMENTARY QUESTION

To ask the Secretary of State for Scotland, what share incentives will be offered to employees and pensioners when the 2 Scottish electricity companies are privatised.

MALCOLM RIFKIND: My Rt Hon Friend has today announced details of the employee and pensioner share incentives to be made available when the electricity companies in England & Wales are offered for sale to the public. Although precise details of equivalent incentives in Scotland will not be determined until nearer the time when the 2 Scottish electricity companies are floated, I expect the special arrangements for both retired and existing employees of the Scottish electricity industry to be broadly in line with those on offer in England & Wales.

CC(90)

THE RT HON JOHN WAKEHAM MP

SECRETARY OF STATE FOR ENERGY

Department of Energy
1 Palace Street
London SW1E 5HE

071 238 3290

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

16 July 1990

Dear John

EMPLOYEE AND PENSIONER SHARE INCENTIVES

I am writing to you to set out the employee and pensioner share incentives I now propose for the electricity sales. The employee communication programme for the Regional Electricity Companies (RECs), National Power, PowerGen, Nuclear Electric, The National Grid Company, (NGC) and The Electricity Association (EASL) should begin very shortly, so the structure and overall level of the offer ought to be settled soon. If you agree, I would like to announce the terms of the employee and pensioner offer next week, and the industry will send out a newsletter to their employees shortly afterwards.

Both the industry in England and Wales and the ESTUC have put proposals to us on their perception of the level and structure of the employee and pensioner offer that would compensate employees for the massive restructuring that has taken place within the industry to enable the privatisation to take place. A summary of these proposals, together with those agreed for the water flotation is attached at Annex B.

If the ESTUC's proposals were agreed it would involve a massive increase in the cost to HMG of incentives over previous privatisations. For example, the ESTUC have requested that every employee and pensioner should receive £2,000 of free shares. This compares with the water offer (only to employees) of £70 plus £2 for each completed year of service. I have discussed ESTUC's proposals with them and they have made it clear to me that they would find an offer at the same level as water 'derisory' and that they would very strongly oppose an offer such as this all the way up to the flotations. I do not believe that we should give in to this sort of pressure. But I think that if we were to go forward with proposals that could be portrayed as identical to that of water in real terms we would hand the Unions a golden opportunity to cause difficulty. In a separate

discussion Eric Hammond pressed very hard for more generous treatment of electricity staff on the grounds of the major disruption they were being asked to face and our interest in increasing employee share ownership.

We have discussed with the industry both their original and their revised proposals. The industry have argued that they wish the incentives to be seen to be fair to the employees in order for the management to be able to fully support the offer. The management are acutely aware that ESTUC, who have expressed very strong views to me on the level of incentives, will wish to try and drive a wedge between the management and the Government unless the management are completely behind the employee offer. I am sure that you are aware that the electricity industry has undergone a massive restructuring in preparation for its privatisation, and that such an exercise would never have been possible without the outstanding management and commitment from the staff of the industry. This co-operation will continue to be needed especially over the weeks ahead as we take the companies through the most crucial stages.

The industry have taken a constructive attitude in discussing their proposals for the employee offer and, as is apparent from Annex B, they have revised their proposals to us following detailed discussion with them. I am now confident that the structure set out in Annex B represents a realistic employee offer that the industry will be able to present to employees with their full endorsement, in recognition of the great disturbance being faced by employees of the industry pre-vesting, and as an incentive to future commitment to the companies as they enter the private sector. Such an offer will also go a long way to countering any adverse comment by ESTUC, who will be very disappointed that there will be no ESOPs in the privatised companies.

I therefore conclude that the employee offer should be worth a maximum of £890 per employee (assuming an average length of service in the industry of 15 years for the free offer). This reflects my desire to adjust the benefit in the water offer to take account of likely price changes between November 1989 and May 1991 - the Scottish flotation- and then to add £70 to the free offer for the reasons given above. The detailed structure of the proposed employee and pensioner offer is set out in the attached Annex A, and the numbers are in Annex B.

I am sending a copy of this letter to the Prime Minister, Malcolm Rifkind and Sir Robin Butler. I would like to be free to announce the structure of the employee offer before the recess, preferably by 23 July.

Yours ever

John

JOHN WAKEHAM

ANNEX A

Structure of the employee offer

I am proposing an employee offer with the usual four elements of the free, matching, discount and priority offers. Detailed proposals on each element of the offer is set out below:

Free offer - I propose an offer of £140 plus £2 per continuous year of service within the industry. It is this part of the employee offer where the industry and ESTUC are most concerned to see an additional recognition of the difficulties faced by the electricity industry. From a presentational point of view ESTUC have focussed on the free offer and an increase in this part of the employee offer would ensure the support of the management in presenting the offer in a positive light and deflecting ESTUCs arguments for a larger offer still.

Matching offer - I propose an offer inflated to a maximum of £460; the employee would therefore buy a maximum of £230 worth of shares and receive two free shares for every one he buys.

Discount offer - in both the Water and British Steel flotations the disocunt offer has been very poorly taken up by employees in comparison to, say, the take-up by employees of the discount offer in British Gas. This is disappointing and there is a good case for looking again at this aspect. In order to encourage employees to take part in the discount offer we consider that its structure should be altered slightly to make it a more attractive offer to employees. I therefore propose that the 10% discount that has usually been offered be increased to 20%, but up to a maximum of just over half the Water offer, £1300. Obviously we realise that employees will find this more attractive than the water and British Steel offers, so in calculating the likely cost of the offer we have correspondingly used considerably higher take-up rates than for the discount offers in these two previous privatisations.

Priority offer - The industry request was for a Priority offer of £20,000, which compares to the water offer of £12,000. I consider that an offer of £15,000 provides a suitable balance between the two.

Pensioner offer

I propose that pensioners receive the priority offer to the same value as the employee priority offer of £15,000. This offer would be extended to pensioners living within the EC. Pensioners in NGC and EASL would receive shares in the board in which they live.

NGC and EASL free offer

You are aware that there are a number of aspects of the employee offer where there are difficulties due to the unusual structure of the electricity privatisation. One of these areas is with the National Grid Company (NGC) and the Electricity Association (EASL) which are companies jointly owned by the RECs. The

employees of NGC and EASL will receive shares in a bundle of all 12 of the RECs. Therefore, although it will be possible to match closely the value of shares an REC employee receives in the matching, discount and priority offers, for the free offer it will be very difficult to do so. This is because the size of the free offer is such that the value of a bundle of 12 shares does not divide easily into it, or at all into the £2 service related element of the offer.

We have considered ways of solving the problem so the NGC and EASL employees receive the exactly the same offer as the REC employees, but have concluded that it is not possible to do so. Instead we therefore propose that NGC and EASL employees receive bundles of free shares as close in value as possible to the value they would have received had they been an REC employee with the same length of service. This means that it will be necessary to round up or down to the nearest bundle of 12 shares. Some employees will be better off than their REC counterparts and others will be worse off, but it is the only option available to us.

Nuclear Electric

We also need to decide what arrangements to put in place for the employees of Nuclear Electric. In my statement on nuclear power last November I gave, with your agreement, a commitment to protect the ability of NE staff to benefit from the sale of the rest of the industry. This was essentially to secure the support of the staff for the creation of Nuclear Electric. Overnight they had lost the prospect of the longer term benefits of working in the private sector, which we had been at such pains to promote. The unions were, for example, concerned that Nuclear Electric staff would fall behind their counterparts in the other generators in terms of pay and career prospects. If we had not given reassurance, through such commitments as on flotation benefits, we might well have lost their co-operation. Vesting would then have been delayed and privatisation in this Parliament would have been lost. In fact the staff responded to the challenge with great dedication and a remarkable effort was made. Morale in Nuclear Electric is improving, but it would be easily punctured if I failed to meet the spirit as well as the letter of my commitments. The loss of goodwill would have an impact on the company out of all proportion to the costs of the flotation employee package. High morale is essential to the company's plans to restructure, and so reduce the costs of the old CEGB organisation. Nuclear Electric also need to keep their better staff. The division from NP has left them weak in key areas such as finance and the move out of Sudbury House to Barnwood is affecting retention. Overall it is difficult to over-emphasise the importance of morale and low staff turnover to generational effectiveness and hence to costs and safety.

Whilst it is not possible to treat Nuclear Electric staff equally with those in other companies for technical reasons, I believe it is essential to give them comparable benefits which would not be perceived as unfair.

I have decided that NE staff should receive shares in National Power and that the value of the offer and the eligibility of NE staff and pensioners should be the same as for other employees. I estimate the total cost at 8.03 m at likely rates of take-up.

I have chosen National Power because of the historic link between NE and NP, and because there is a risk of having to scale down the employee offers if NE is linked to the RECs. The Stock Exchange have also indicated informally that this would be their preferred option. There is however still a risk that we might need to scale down the NP priority offer to stay within the Stock Exchange's 10% limit.

The arrangements for NE cannot, however, be an exact copy of those in the other companies for tax reasons. Any scheme for Nuclear Electric employees cannot be approved by the Inland Revenue because the staff will not be receiving shares in their own or a parent company. Nevertheless I believe it is essential that NE employees are protected against tax if I am to fulfil my commitments to them. As I have described above, I believe the consequences of failing to honour those commitments would be serious. John Lyons and Eric Hammond have made it clear that the employees would feel significantly disadvantaged if protection was not achieved. On this point, I agree with them. In setting the level of benefits for the other companies I have sought to determine the minimum package necessary to secure employee acceptance, and I have taken into account the fact that they have no tax liability. If that protection against tax is not extended to NE staff the benefits to them fall well below that minimum. The offer of free and matching free shares would, for example, be worth only £378 to a higher rate tax payer, a loss of £252, and £472.5 to a lower rate payer, a loss of £157.5. The cost of meeting the tax liability is also small, at £2.15 million out of the total cost I mention above, in relation to the consequences of failing to do so. However, I do not believe it is necessary for the tax liability to fall directly on Government. I propose to ask Nuclear Electric to meet the liability. My officials and those of the company will discuss the detailed arrangements with the Inland Revenue.

The tax question also complicates decisions about the type of shares to be offered to NE employees and the restrictions on immediate disposal. In an approved scheme, employees cannot sell for two years and incur a tax penalty on any sale in advance of five years. The shares in such a scheme are generally fully paid. I do not believe it is sensible to attempt to reflect these arrangements precisely for NE through the creation of a share trust. Such a trust would involve considerable complexity. We should, for example, need to provide, for rights issues or capital restructuring by National Power. The trust would also have an income in that it would have to deduct a proportion of the proceeds of any sale in advance of 5 years in order to reflect the tax penalty of an approved scheme. Such amounts would be due to NE, as it will meet the initial tax liability. The Trust would therefore need to be accountable to my Department and to Parliament. The administrative costs of such arrangements would be significant in relation to the benefits.

I do not therefore believe it is sensible to attempt to put NE staff under the same restrictions as other employees, although I accept that there should be some penalty on their ability to benefit from early trading. I therefore propose to offer NE staff partly paid free and matching shares as in the public offer in the same numbers as the fully paid shares on offer to other employees, and for the later instalments to be waived as long as they hold onto the shares. This arrangement ensures that NE

employees suffer a considerable financial penalty from early sale but does not formally bind them to hold the shares.

I have considered carefully whether this arrangement gives NE employees too great a benefit. I do not believe this to be the case. Whilst they have the same basic offer and tax advantages but lesser inhibitions to early sale, they will not benefit from share save or similar share schemes offered by companies. Remuneration generally is also likely to be more tightly constrained. I also believe that the reasons for requiring employees to retain shares in their own companies do not apply to staff receiving shares in another company with which all ties are severed. My officials and yours have also looked at a wide range of alternative arrangements, all of which incur, in our view, an unacceptable degree of administrative complexity and cost or are unacceptable. I believe that the package I propose delivers my undertakings without undue practical difficulty and will be fair to employees across the industry without imposing an unacceptable cost on Government.

Sharesave schemes

In the newsletters to their employees, the Companies wish to talk about the Sharesave schemes they are intending to set up at flotation. The industry would like to be able to grant the first option at flotation as in the Water and Steel flotations. I see no reason to depart from these precedents and I would be grateful for your agreement to this course of action.

ANNEX B

PROPOSED EMPLOYEE BENEFITS FROM OFFER STRUCTURE

	My Proposal	(Maximum Value)	Industry proposal	Water
FREE	£140+£2/year	(170 average)	£100+2/year	£70+£2/year
MATCHING	2 for 1 up to £230	(£460)	2 for 1 up to £260	2 for 1 up to £200
DISCOUNT	20% on up to £1300	(260)	20% on up to £1900	10% on up to £2350
PRIORITY	£15,000	(£0)	£20,000	£12,000
TOTAL MAXIMUM VALUE		(£890)	(£1030)	(£735)

ANNEX B

VALUE AND COST OF EMPLOYEE BENEFITS FROM OFFER STRUCTURE

	My Proposal (double the free offer)	With same likely real value as water	Industry proposal	Water
FREE	£140+£2/year	£70+£2/year	£100+£2/year	£70+£2/year
MATCHING	£460 (2 for 1)	£460 (2 for 1)	£520 (2 for 1)	£400 (2 for 1)
DISCOUNT	£260 (20%)	£260 (20%)	£380 (20%)	£235 (10%)
MAXIMUM VALUE	£890	£820	£1030	£735 [1]
MAXIMUM COST TO HMG	£109m	£101m	£125m	
LIKELY VALUE [3]	£579	£509 [2]	£611	£442 [1] [2]
LIKELY COST TO HMG [3]	£71m	£62m	£75m	

Notes: [1] If electricity assumptions on service and take up used

[2] Change in RPI from Nov 89 to May 90 of 6.5%
Assumption of 8% inflation from May 90 to May 91
So combined change of 15% from Water flotation to Scottish electricity flotation

[3] Assumption that average length of service 15 years
95% take up free offer.
80% take up 95% of matching offer
27% take up 90% of 20% discount offer
27% take up 65% of 10% discount offer

C.I.

CONFIDENTIAL

THE RT HON JOHN WAKEHAM MP

SECRETARY OF STATE FOR ENERGY

Department of Energy
1 Palace Street
London SW1E 5HE
071 238 3149

MB.
MB/CAS
R 3/7 No - worth checking with Mark. CAS
Any similar initiations to P.M.
- I know of none?
BHP
5/7

CAS
B.H.P.
The Sergeant at Arms office allows exhibitions in the Upper waiting and can supply details of any this Autumn.
I know of none
ML-B

Stuart Lord Esq
Principal Private Secretary to the
Secretary of State for Social Security
Department of Social Security
Richmond House
79 Whitehall
LONDON
SW1A 2NS

5 July 1990

Dear Stuart

My Secretary of State has been asked by Tom Cox MP to give his approval to an exhibition which Mr Cox would like to hold in the Upper Waiting Hall of the House of Commons. Mr Cox has told my Secretary of State that this exhibition will be on "London Electricity". We have made some enquiries with London Electricity and understand that they have not taken a final decision to participate in this exhibition and, indeed, are unlikely to do so. The timing of the exhibition is not known but it is likely to be in the Autumn. This would be at a very sensitive time because it would be in the middle of the first flotation campaign for the electricity supply industry. It would clearly be risky if during that period an exhibition were being mounted in the Upper Waiting Hall by people who were hostile to privatisation. My Secretary of State should, therefore, be most grateful if you would let me know whether a similar request has been received by your Ministers so that he can consider how to take the request forward.

I am copying this letter to the private secretaries of other Cabinet Ministers and to Sonia Phippard (Cabinet Office).

Yours
John

J S NEILSON
Principal Private Secretary

CONFIDENTIAL

SECRET

SUBJECT cc MASTER

Lite
KW
CC HMT

1 (4-8)

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

2 July 1990

PRIVATISATION OF POWERGEN

The Prime Minister held a meeting with your Secretary of State and the Chancellor to consider your Secretary of State's minute of 28 June on the privatisation of PowerGen. The meeting was also attended by Mr Guise (No. 10 Policy Unit).

I should be grateful if you and copy recipients would ensure that this letter is seen only by those with a strict need to know.

Your Secretary of State said that in his Department's view an appropriate capital valuation of PowerGen's assets suggested the company should be privatised for around £1.6 billion. Under PowerGen's proposals for the construction of the balance sheet and a cash injection, the flotation would realise net proceeds of only £700 million. Even if the accounting conventions proposed by National Power were adopted, the proceeds would only be £1.1 billion.

It would be very damaging to allow a flotation of PowerGen which generated only £700 million. It would have adverse implications for the proceeds from the flotation of National Power. And it would be a lot less than the value of the potential earnings from existing assets. There were attractions in proceeding instead by means of a trade sale. This would generate much higher proceeds from the privatisation directly and would have a beneficial impact on the flotation of National Power. PowerGen should also become more efficient more quickly.

There were strong financial and economic arguments for proceeding with the trade sale therefore. However, there would be political and other difficulties. First it would represent a further change in the privatisation plans for electricity. Second, if a firm like Hanson were to buy PowerGen, that might be criticised because of the vertical integration opportunities open to Hanson. That would have to be looked at further. Thirdly, the employees might be unhappy - though an employee share ownership scheme might do much to assuage their concerns.

The present Chairman of PowerGen had not seriously considered the possibility that the Government might go for a trade sale rather than a flotation. The proposals would come as a deep shock to PowerGen management. But the Government could not defend a flotation which might generate only £700 million, when a trade sale offered much higher proceeds. Accordingly the

B

Government should now test the water on a trade sale in the way proposed in his minute.

The following were the main points made in discussion:

(i) While Hanson would be given the opportunity to quote an indicative price for PowerGen, other companies would then be able to come forward with bids. Possible candidates included RTZ and BTR.

(ii) It was possible that there could be bids from EC or Japanese companies. It should be possible to block any bids from state-owned firms, e.g. in France. But it would be more awkward to prevent a Japanese bid. On the other hand, the proposals put forward by the Energy Secretary involved a very tight timetable. The sheer speed of the proposed arrangements might prevent a Japanese bid in practice.

(iii) There appeared to be potential legal constraints on what information could be given to Hanson to enable the firm to quote an indicative price. The information given to the Government by PowerGen was apparently for the purpose of public sale. It was not clear that it could also be used to attract a trade purchaser. On the other hand it could be argued that the company belonged to the Government and therefore it was only reasonable for it to seek that information. The lawyers were now examining the position.

(iv) It would be important to announce the proposed change in policy as quickly as possible. It was essential that the announcement should be made before the Summer Recess.

Summing up a brief discussion, the Prime Minister said that she and the Chancellor were content for the Energy Secretary to test the water on a trade sale in the manner set out in his minute.

Separately, Ministers discussed the chairmanship of National Power. It was agreed that Sir Trevor Holdsworth should be formally approached to take up the appointment.

I am copying this minute to John Gieve (HM Treasury) only

BARRY H. POTTER

John Neilson, Esq.,
Department of Energy

C

PRIME MINISTER

29 June 1990

ELECTRICITY PRIVATISATION - EMPLOYEE SHARE OWNERSHIP

The umbrella organisation for the nine main power supply unions wants a statutory Employee Share Option Plan (ESOP) to be included in the privatisation package.

This remarkable change of heart creates an opportunity for the Government to give your idea of popular capitalism a great boost.

The union side has taken professional advice about the creation and funding of the ESOPs which it wants. Mr Wakeham has not so far been willing to discuss these proposals. He should be asked to have them costed by his financial advisers now.

With that information he could negotiate about the specific details; but if the issue is left for the successor companies to handle, as Mr Wakeham seems to prefer, we shall miss an opportunity to seize a major political initiative for long term employee share ownership.

Howell Harris Hughes

HOWELL HARRIS HUGHES

3A-D

(1)

PRIME MINISTER

PRIVATISATION OF POWERGEN

You are meeting the Chancellor and Mr. Wakeham on Monday to discuss the privatisation of Powergen. I attach a note from Mr. Wakeham (Flag A).

Problem

The problem is that Powergen (advised by Warburg) is seeking an excessively favourable starting position for privatisation - a large cash injection from Government and a balance sheet which undervalues its fixed assets.

First, Powergen is trying to keep the capital valuation of the company down to £1.1 billion (advice from DEnergy, on the basis of higher electricity price forecasts, is that it should be £1.6 billion). Second, Powergen is seeking a cash injection of £400 million as debt, from Government. This injection is sought partly because of an alleged need to make provision in the accounts for the future FGD obligations; (National Power, the other generator, is not seeking similar provisions in its accounts); and partly because Powergen believes a higher capital programme is required.

The combined effect of lower capital valuation and high cash injection would keep the net privatisation proceeds down to only £700 million. That is equivalent to the capital costs of only about 10 per cent of the total generating capacity being passed to Powergen (see Policy Unit note at Flag B).

Mr. Wakeham's Proposals

The proposed solution is a shift in policy from the flotation of Powergen to a trade sale.

Privately the Hanson Group have indicated a strong interest in buying Powergen - at a price of around £1.6 billion. Moreover, once willingness to entertain a trade sale is made clear, other purchasers may come forward - RTZ is a possibility. That could

push the selling price higher and hence increase the privatisation proceeds.

Accordingly, Mr. Wakeham is now proposing the following:

(i) give firm information on Powergen to Hanson in the second week in July;

(ii) Hanson then to give an indicative price for Powergen within ten days; (you and the Chancellor to be consulted on this price);

(iii) invite bids from other selected companies at end July (at which time the change in policy would become clear).

The Chancellor supports the broad approach put forward by Mr. Wakeham.

Assessment

The proposals have a number of advantages.

(a) There would be higher privatisation proceeds from the trade sale of Powergen; this would be helpful in PSBR terms and justified on a true valuation of the assets.

(b) There would be a spillover effect of National Power, raising likely privatisation proceeds from the flotation.

(c) Ownership of Powergen by Hanson is likely to generate much greater efficiency improvements than if the company is retained under existing management.

(c) Moreover an improved performance by Powergen would put more pressure on National Power to raise its efficiency, at least in the long term. In brief, if Hanson owned one of the companies, the duopoly would be less comfortable and there should be efficiency gains

for electricity customers.

There are some potential disadvantages also to be taken into account.

(i) It is another change in policy on electricity privatisation. The politics would require careful presentation.

(ii) A trade sale to Hanson or RTZ would worry employees and the unions. But a condition of the sale might be adequate plans for employee share participation (see Policy Unit note - flag C). The right terms could do much to mollify the workforce if not the unions.

(iii) There may be some public concern about Powergen being owned by Hanson (or RTZ). There are potential problems of vertical integration. Although this is largely blocked by the electricity distribution companies Powergen could sell electricity directly to big industrial customers. So Hanson could sell electricity to one of its companies, say London Brick, at a favourable price and hence competitive advantage. Hanson also owns Peabody, a US coal producer. Hanson could favour their own commercial interests in supplying coal to power stations in the future. Problems of unfair competitive advantage through vertical integration would have to be addressed by conditions in the sale and appropriate action from the Office of Fair Trading.

(iv) Opening up a trade sale could risk foreign ownership. Could and should that be blocked?

(v) There would be no opportunity under a trade sale to make shares available to the public and thus encourage wider share ownership. On the other hand the flotation of National Power would still afford opportunities for boosting share ownership.

On balance, the financial and economic arguments for going forward with the trade sale seem powerful - subject to the political and fair competition arguments being resolved.

It might be that the threat of a trade sale would make Powergen's existing management reconsider their line on the cash injection and balance sheet. But there are dangers: it would be quite open to Powergen to revise their profit figures later and so justify an "easier" balance sheet. In short, if the Government embarks on a trade sale, it must be prepared to go forward on that basis.

Other matters

The Energy Secretary may also raise the chairmanship of the other generator, National Power. As you know Sir Trevor Holdsworth is the Department of Energy's favoured candidate. But it is clear that the Department do regard him as a stop-gap - a name to assist privatisation.

You may want to discuss with John Wakeham whether Sir Trevor is genuinely the best he can find. Or whether he should look for another candidate as Chairman of National Power.

BHP

BARRY H. POTTER

29 June 1990

A:\economic\electricity (pmm)

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10.

No copies to be taken

Copy No 1 of 3

MS.

Prime Minister

As I think you know, PowerGen has been causing major difficulties, but I believe that there is an effective way of dealing with them. The purpose of this minute is to set out those difficulties and to outline my proposals prior to our meeting on Monday.

I have been having very difficult negotiations on the capital structure of the two generators, but particularly with PowerGen. The main points of difference have been:-

(a) PowerGen take an excessively pessimistic view about the likely level of electricity prices after the existing agreement with British Coal lapses;

(b) PowerGen are unwilling to contemplate cutting back their large investment in new plant, notably CCGTs, even if prices and hence their profits are low;

(c) PowerGen (but not National Power) propose to treat future expenditure on FGD in their opening accounts in a way which has a particularly adverse impact on proceeds.

Having discussed these issues at great length with PowerGen and advisers, Kleinworts have advised me that PowerGen's propositions are not acceptable and that I should insist on injecting £150 million of debt to obtain a reasonable return for the taxpayer of proceeds amounting of up to £1.5 billion - £1.6 billion. Depending on PowerGen's cash balances it may be possible to inject additional debt which would further increase proceeds. If I accepted PowerGen's views on profits and accounting for FGD, proceeds would amount to some £700 million, ie the cost of installing 2 GW of new

CCGT plant, which is a small proportion of their 18.7 GW of existing plant. (Proceeds would rise to about £1.15 billion, if PowerGen accept my position on accounting for FGD). I have told PowerGen that it is politically unacceptable for me to sell PowerGen at such a price.

Despite Bob Malpas' reservations, he told me early in May that he was willing, albeit very reluctantly, to go along with my capital structure proposals. However, following discussions with his Board, he reneged on our agreement, and told me that if I pressed my proposals, he and his Board would feel obliged to make their position known to potential investors, including their views of the possible consequences of my decision.

This faces us with a very serious situation. There are a number of options that I believe we must reject. First, we clearly cannot contemplate delaying the privatisation of PowerGen sine die. Secondly, I do not think it is a credible option to sack the present Board and install a new one. Nor is there any real chance at this stage of persuading the PowerGen Board to move away from the very pessimistic view of the world that they have adopted.

I believe the right way forward is to plan on a trade sale of PowerGen. Indeed I saw merit in such approach even before Bob Malpas reneged on his agreement with me, as I feared PowerGen might have taken such action in December 1990 or January 1991, when other options than accepting his terms would be very limited indeed.

While I was in the middle of my negotiations with PowerGen, I received an approach through Michael Richardson from James Hanson about purchasing PowerGen. Following a meeting Lord Hanson wrote to me to say that, subject to studying the figures, he would be interested in making a firm offer for PowerGen, perhaps at a premium price to what could be obtained through a flotation. Furthermore he believed that other British Companies (eg RTZ or BTR) would also be interested in making offers and he accepted that we would need to give such companies the opportunity to bid, although he might seek a commitment fee for putting a firm offer on the table at the outset.

I am convinced that James Hanson's interest is genuine and that he will play straight with us, although he will certainly look after his shareholders' interests.

I would therefore propose the following course of action to pave the way for a trade sale. We should aim to give Lord Hanson as full data as possible on PowerGen in the second week of July. Within a week or 10 days he would name an indicative price for PowerGen, subject to talking to PowerGen's management. Before proceeding any further I would wish to consult you and the Chancellor on this price. If, as I would hope, it was acceptable we could give him the all clear to approach PowerGen's management with a view to naming a firm price within a week. It is only at that stage that there is a high risk of a leak. But, before reaching that stage we should have been given an indicative price by Lord Hanson. Thereafter we would need to invite bids from other selected companies. I will, of course, provide you with further detailed advice on the timetable and also on the question of which other companies might be invited to tender for PowerGen.

I have been advised by Schroders and Kleinworts that I am right to explore a trade sale and indeed that it might be the only way of privatising PowerGen this Parliament at an acceptable price. I believe the Chancellor fully supports the approach I am putting forward. At this stage all I am seeking is your agreement that I should provide James Hanson with the detailed figures and invite him to name an indicative price, which I would then discuss with you and the Chancellor.

I would propose that for the time being we should continue work in parallel on the option of floating PowerGen in February. It is possible that an approach from Lord Hanson might change PowerGen's thinking radically, although the Board would then lose any real credibility. Furthermore, Lord Hanson (or possible rivals) might only offer a price that would give us no greater proceeds than PowerGen's current proposals. But, on the basis of the information currently available, my own judgement is that a trade sale offers the best chance of successfully privatising the whole industry this Parliament at a price that we can justify to the taxpayer. Even if

I am successful in regaining Bob Malpas' acceptance of my proposals now, I would be fearful that they would again renege in December/January, when we would be virtually at their mercy.

The discussions with National Power have been difficult, but not nearly as difficult as with PowerGen. They take a less pessimistic view of future electricity prices and do not plan to make provisions for FGD in their opening balance sheet with consequent damage to proceeds. I believe there is a reasonable chance of reaching an accommodation with them, especially when it becomes public some weeks hence about what might be planned for PowerGen.

I am sending a copy of this minute to John Major.

John

SECRETARY OF STATE FOR ENERGY

28 June 1990

SECRET AND MARKET SENSITIVE

PRIME MINISTER

27 June 1990

POWERGEN - MEETING WITH JOHN WAKEHAM: 2 JULY

There are two major areas of disagreement between Powergen and the Department of Energy:

(i) the Department, backed by Kleinworts, anticipates a recovery in wholesale electricity prices beyond 1994 leading to a capital valuation of Powergen's assets of £1.6 billion. Powergen backed by Warburgs believe that electricity prices will remain weaker for much longer leading to a capital valuation of £1.1 billion;

(ii) in addition to projecting a lower capital valuation, Powergen believe that, in order to achieve a successful flotation in the face of future FGD obligations, cash of £400 million must be injected into the company by the Government prior to flotation. This would reduce net proceeds to the tax payer from Powergen's disposal to a mere £700 million.

Powergen's position is outrageous. They are expecting the taxpayer to sell 20GW of installed generating capacity - a third of the UK total - for the capital cost of building a mere 2GW. Warburgs not only support this dismal view of the future electricity market but also encourage Bob Malpas, Chairman of Powergen, and Ed Wallis, its Chief Executive, to press John Wakeham for an unreasonably beneficial cash deal prior to flotation. This has now got to the stage of expecting the tax payer to part with assets for about half their true value.

Confronted by this pressure, the Department has established in secret that a trade sale of Powergen would be a serious commercial prospect and would probably achieve more than flotation - see attached letter from Schroders and Kleinworts to John Guinness. The identity of the

interested party, code named Conrad, will be given to you separately. It is a company with a tremendous record for making assets perform and has a keen nose for a bargain. It is no surprise that they want Powergen, even at a price of £1.6 billion or above.

COMMENT

The heart of the problem is not really market uncertainty about electricity prices. Every business faces market uncertainty and electricity business less than most. The overall demand is more predictable than most because the product cannot be stockpiled or lived without. The Powergen problem has arisen because we have a merchant bank (Warburgs) re-inforcing the prejudices and anti-market instincts of an engineering driven management which has grown up in the public sector. As is so often the case in an engineering dominated business, the capital expenditure programme is regarded as sacrosanct (cf Rover!)

Any normal privately owned business faces market uncertainty with a degree of flexibility about expenditure plans. When times are bad and revenues low they may have to delay capital expenditure or juggle projects over time, or even cancel some of their more ambitious aspirations. The Powergen management do not think like that and expect any market uncertainty to be underwritten by Government such that no tailoring will ever be necessary. In this attitude they are re-inforced by Bob Malpas with his BP/ICI vast corporation background. However, the FGD obligation at £800m is less than a third of total capital plans for the next decade.

If Powergen is disposed of via a trade sale, particularly to Conrad, there will be an uncomfortably high share of generation under one owner. However, this would also be the case if it is floated with entrenched management especially one protected by a golden share- even for a limited period. I would have more confidence in Conrad's ability to push through efficiencies leading to keener competitive practices than such an entrenched group. Indeed, it is probable that a sale to Conrad would actually improve competition in the supply market thereby keeping National Power and the distribution companies

on their mettle. (Jimmy Goldsmith once commented to me that British Gas could well be worth more broken up despite the capital value of the monopoly profits locked in by the flotation as a single entity. His argument was that the inefficient practices which such a monopoly breeds have a more negative effect than the value of the monopoly element!)

CONCLUSION

It is too early to give you a firm recommendation because we have no firm proposal. There are many positive aspects to a trade sale of Powergen, especially to an owner who would make the assets work hard and thereby stimulate competition. The flotation of National Power would also be greatly eased because the prior negotiations and subsequent marketing effort could be concentrated on one business.

Although negative union reactions could be forestalled by offering employees share participation in the new owner, it might be easier politically if Powergen like National Power and the distribution companies were privatised via flotation. We can still aim for this provided it can be achieved without a vast net cost to the taxpayer. However, in negotiation with Powergen, John Wakeham must have the ammunition to threaten a trade sale otherwise, he is negotiating with a pistol at his head. Neither Powergen nor Warburgs believe that the Government would seriously contemplate a trade sale and we must back him in disabusing them.

GEORGE GUISE

Mr Guinness - 1 cc: Mr Wilcock - 2
Dr Bird - 3
Mr Morris - 4
copy no 1 of 4

54/S

J. Henry Schroder Wagg & Co. Limited,
120 Cheapside,
London, EC2V 6DS.

Kleinwort Benson Limited,
PO Box 500,
20 Fenchurch Street,
London, EC3P 3DB.

Member of TSA

A member of TSA and of the AIBD

STRICTLY PRIVATE AND CONFIDENTIAL

John R.S. Guinness, Esq., CB,
Deputy Secretary,
Department of Energy,
1, Palace Street,
London SW1E.

Pegasus = Powergen
Conrad = Hansons.

20th June, 1990

Dear John,

We are writing to give you our joint comments on the situation surrounding the sale of Pegasus and on the feasibility of embarking on an attempt to create a trade sale alternative to flotation.

Background

1. The view of the Department, supported by Kleinworts, is that Pegasus' business could support debt of £150 million (before the recent disclosure of a possible £120 million addition to cash balances in the current year, which would increase the debt by a like amount). Pegasus' view, on a comparable basis, is that the business would need a cash injection of £395 million (before consideration of the additional £120 million referred to above). The principal reasons for the disagreement between the Department and Pegasus are (a) a difference of view on the outlook for electricity prices from 1994 onwards; and (b) Pegasus' belief that a significantly higher annual capital expenditure programme will be required.

2. Pegasus considers there is a need to make an accounting provision for FGD expenditure whereas the Department believes this is not necessary.

3. With the Department's assumptions about the prospects of the business, Kleinworts believe that Pegasus could then be floated to realise proceeds (including the £150 million of debt) of approximately £1.6 billion (or £1.45 billion on the basis of Pegasus' assumed tax rate). On Pegasus' view and on the same assumptions as to initial dividend cover and dividend yield, net proceeds would be approximately £1.15 billion (though these dividend cover and yield assumptions are probably not sustainable on Pegasus' view of future profits). Proceeds would reduce to approximately £700 million on Pegasus' assumptions if full provision for FGD were made.

4. Pegasus believes that the company would be unfloatable at the rating suggested by Kleinworts. While disagreement of this kind is normal in pre-privatisation discussions between Government and the company to be privatised, the consistency and force with which the company has adhered to its point of view suggests that the Government might not be able to command even grudging co-operation from Pegasus for a flotation on the basis the Department has proposed.

In short, Schroders and Kleinworts believe the Department is right to explore the trade sale option broadly on the basis described. The advantage in doing so is the prospect of obtaining a higher price than a flotation would realise and, in extremis, of procuring privatisation at all in circumstances where the proceeds offered by the alternative of flotation would be so low as to make that option untenable. The risk of doing so is that the attempt might, in certain circumstances, damage the flotation option possibly not only of Pegasus, but also of Nestor and the Distcos. A more detailed consideration of these points follows:

A. Advantages of a trade sale

(a) It is general experience that where a trade buyer exists he is willing to pay more than can be achieved in a flotation. This is because he may be able to enjoy synergies with his existing business which bring additional value into his reckoning (for example, Conrad has significant coal interests). He will also pay for the ability to control the business, having freedom to manage it solely for his own benefit (subject to the pressures on him from customers and, where relevant, regulators). We understand the Chairman of Conrad indicated that he would be "prepared to pay a premium" - we presume that this means a premium over the probable flotation price. In a flotation the shares have to be sold at a modest discount to the price at which they are expected to settle in the after market, in order to ensure a successful launch. This is particularly true of large sales, such as Pegasus.

(b) In (a) we used the phrase "where a trade buyer exists". It is important to form a view on the existence of interest before embarking on a trade sale attempt, since it is damaging and demoralising to seek a buyer who cannot be found. Our opinion is that Pegasus offers an opportunity which should be of interest to certain corporate buyers. The range of possibilities could be materially increased if foreign buyers were to be included. However, because of its size it is unlikely that Pegasus would be a candidate for purchase by a large number of companies. The fact that Conrad has shown serious interest gives important comfort that trade buyers exist as does its view that there would be rival bids.

(c) The arguments which lead to some sellers preferring a flotation to a trade sale do not appear to apply to Government in this case. (Such arguments include (i) the wish to sell only part of the business, (ii) the desire to create quoted paper which enables the company to raise equity capital in the market and to expand by share for share acquisitions and (iii) the wish to create the basis for a share option scheme to incentivise management.)

(d) An argument which has influenced Government in other sales where the trade sale option appeared to exist has been its preference for wider share ownership. We understand that in the circumstances of the electricity sale this would not be an overriding argument against the trade sale of Pegasus - given that wider share ownership will be facilitated by the flotation of the Distcos. Indeed it may well be necessary to proceed with a trade sale of Pegasus to enable the flotation of the Distcos to take place.

(e) If a higher price is obtained for Pegasus there may be a benefit to Government from the subsequent sale of Nestor. A valuation basis would have been established, as would the appetite of trade buyers to acquire generating capacity, which may (depending on the existence and nature of any 'golden share') improve the terms on which Nestor could be floated. This might be countered to some extent by a perception in the market that Pegasus under Conrad would be a more effective competitor.

(f) A successful trade sale of Pegasus should provide greater confidence for the success of the Distcos sale.

B. How great is the risk of damage to the flotation option?

(a) Until a trade sale was assured it would be potentially damaging for it to be known that a trade sale was being attempted. Revelation of efforts to make a trade sale could be interpreted as meaning that flotation was encountering difficulties. Moreover, a failure of the attempt would be taken as evidence that Pegasus (and, possibly, by implication Nestor too) was an unattractive business not of interest to commercially motivated buyers. It would be argued that subsequent flotation was being used to sell to the public a company which private business had turned down.

This situation could adversely affect the flotation of the Distcos (although we believe to a lesser extent than that of Nestor) if adverse publicity came at a time when Government was trying actively to promote that flotation.

(b) This suggests that it would be extremely important to ensure that the process remained confidential at least until such time as the Department was reasonably certain that a sale could be achieved. The process which is envisaged should give a reasonable chance of achieving this result, since it involves private disclosure to Conrad and a broadening of the discussions to include Pegasus only if and when Conrad has indicated a satisfactory price - though the Department will have a view from its experience to date how much confidence it can place in maintaining confidentiality.

(c) The period of greatest risk would occur when Conrad had analysed information provided by the Department and wished to obtain views from the management of Pegasus before being committed to a price. It would be desirable to keep this period as short as possible, say a week, which could suggest that the information provided by the Department should include a description of the position which Pegasus has taken, possibly, if applicable, with an account of the more accommodating line taken by Nestor.

(d) It seems very likely that the trade sale process will leak at some stage. The greatest danger is the week in which Conrad consults the Pegasus management, however, under our proposals Conrad would have given an indicative price range which it would be prepared to offer prior to this. The objective would nevertheless be to ensure confidentiality until the Department had secured from Conrad a binding commitment to buy the business of Pegasus in the absence of any other preferred purchaser. It would nevertheless be essential for the Department to develop and maintain a full brief for dealing with unexpected press knowledge of the trade sale process and to ensure that other parties to it contributed to the process of limiting any damage which might flow from a leak.

(e) There would almost certainly also be a serious adverse effect on the flotation of the Distcos if the position regarding the privatisation of Pegasus were still uncertain at the time the prospectus for the Distcos was finalised. Our timetable is designed to address this problem.

Whilst the risks outlined above may be considerable they must be seen in the context of the current position - namely that Pegasus' stance, if maintained, presently makes the flotation of Pegasus untenable from Government's point of view. Furthermore it is necessary to take into account the upside potential from a successful sale of Pegasus. In these circumstances exploring the trade sale route may be not only inherently attractive but also the only way of successfully privatising Pegasus.

Other issues

Certain other matters are worth noting at this preliminary stage.

1. Capital structure. Trade buyers may prefer to buy the business without debt since they have the capacity to gear the business up on the basis of group indebtedness whose terms reflect their group credit rating.

2. Terms of sale. It will be important for the Department to decide soon upon the basis on which it is willing to sell, particularly in relation to warranties, indemnities and limitations, if any, on the freedom of action of the buyer after purchase, so that protracted discussion can be eliminated.

3. Timing. Conrad may be prepared and able to act relatively quickly. Other potential buyers are likely to require longer (especially any overseas candidates). Given that the process as envisaged consists, by definition, of sequential discussions with Conrad and others, we believe that a sale could well not be completed until the autumn, at the earliest. The Department and its advisers will need to monitor the interplay, in political and publicity terms, between a trade sale announced at that time and the flotation of the Distcos.

4. Agreed incentive for Conrad to name a price. No agreement should be given to the Chairman of Conrad's idea that Conrad should be allowed to pre-empt other bidders in recognition that Conrad agreed to name its price first. It is likely that the Department would have to disclose any such arrangement to other potential buyers and it could materially reduce their interest in bidding. Although, it is not unreasonable for Conrad to say that it needs an inducement to give the Department the commitment which it is asked to give, the form of that inducement and indeed the overall process for procuring a trade purchaser require further thought. For example, the inducement might alternatively take the form of a commitment commission.

5. Commitment by Conrad. Conrad would probably be obliged to make an announcement to The Stock Exchange at the time a commitment to purchase Pegasus was entered into. It should be noted that, because of the relative size of Pegasus and Conrad, any formal commitment by Conrad is likely to be subject to the approval of Conrad shareholders.

We should be happy to discuss the contents of this letter at your convenience.

Yours sincerely,

David Challen

D.J. Challen
J. Henry Schroder Wagg & Co. Limited

Yours sincerely,

Tim Barker

T.G. Barker
Kleinwort Benson Limited

1. BP
2 CF

PRIME MINISTER

ELECTRICITY PRIVATISATION

The current plan is for electricity privatisation to begin with the distribution companies in November after the Autumn Statement. This would be followed by the flotation of National Power and Powergen the following spring.

Mr. Wakeham is worried that the two generating companies, perhaps acting in concert, would have an incentive to talk down their prospects in the period before the flotation in order to secure various concessions in the prospectus and in the regulatory regime. He is attracted, as I think is the Chancellor, to selling ~~National Power~~ Powergen, the smaller of the two companies, in September through a trade sale. He has had an indication from Lord Hanson that he would be interested in bidding if they were given an opportunity. The procedure would be to announce that the Government had received an approach from a single buyer but before deciding whether to accept it wished to invite offers from other bidders.

There are a number of advantages to this:

- when the flotation of the Discos came they would no longer be path breakers but would be continuing a process which had already been launched;

- it would divide the two generating companies. Powergen would find it more difficult to talk down its commercial prospects if the Government would be able to point to the commercial results of its rival.

There are difficulties:

- the result is somewhat unpredictable. It could be embarrassing if a major foreign company were the highest bidder or if the bid created a situation which the MMC would have to investigate.

Mr. Wakeham is a long way from recommending this but wanted you to be aware that it is a possibility.

ANDREW TURNBULL

22 May 1990

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Date 1 May 1990

Dear Jim

ELECTRICITY PRIVATISATION : SPECIAL SHARES

In your letter of ~~6 April~~ Map to Barry Potter, you reported your Secretary of State's concerns to retain timeless special shares for the electricity industry in Scotland. You indicated that he wishes to ensure that the two Scottish companies do not merge, and his view that the competition machinery might not be able to maintain this position. As the Department responsible for competition legislation, we thought that it might be helpful to explain the position under competition legislation more fully.

If there were any question of a merger or acquisition involving the two electricity companies in Scotland, it should be borne in mind that each company has assets of over £30m, and that the merger or acquisition would therefore be a "qualifying merger" under the Fair Trading Act 1973 (as would an acquisition whereby a 25% share of the market is created or increased). Under the Act, the Director General of Fair Trading ("DGFT") has a duty to offer advice to my Secretary of State on whether any merger qualifying for investigation should be referred to the MMC. The DGFT's advice would depend, as always, on the competition and other public interest issues involved in the individual case.

It is always open to departments to make their views clear to the DGFT on the need for a reference. The decision on whether or not to make a reference is then a matter for my Secretary of State alone. Successive Secretaries of State have made it clear that they would normally only refer a merger when it raised significant competition issues, but the Act allows reference on other public interest grounds. The Act provides for reference of both prospective and completed mergers.

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In the course of conducting any inquiry, the MMC take evidence from the parties, from third parties, and from the relevant Government Departments as appropriate. Once the MMC have reached a conclusion their findings fall to be considered by my Secretary of State. Only in cases where the MMC find that the merger is not expected to operate against the public interest does my Secretary of State have no powers to take action. Where the MMC reach an adverse finding, my Secretary of State can take action to remedy the position.

It is not possible to give an absolute assurance that any particular merger is or is not likely to lead to an MMC reference without looking at the details of the case on its own merits. That said, if there were any question of the two Scottish electricity companies merging, this would on the face of it involve a reduction in competition, because under the Electricity Act 1989 each company is able to compete in the other area. In advising the Secretary of State, the DGFT would take account of the Government's policy on reference to the MMC, and of any reduction in competition. If the DGFT did advise against reference, it would be unusual for a reference to be made against the advice of the DGFT, but it would still be open to my Secretary of State to do so. If the merger were referred, the MMC would - in considering the reference - have full regard to the competition issues and any other public interest issues at stake.

As indicated above, although used rarely, the legislation also allows for a reference to be made on general public interest grounds other than competition, and my Secretary of State is ultimately responsible for deciding whether a reference should be made. Given these powers, concerns over any acquisition of either company by another which has not been involved previously in the electricity industry or by a foreign company, could be sufficient to merit an MMC reference on public interest grounds even if there were no direct threat to competition, but as always this would depend on the details of the particular case. Concerns over any implications of the ownership of the grid may of course, be a factor.

We therefore believe that the competition legislation can provide a solution to your Secretary of State's concerns over the two electricity companies. Moreover, as he has already indicated in his letter of 15 February, my Secretary of State attaches importance to privatised companies being subject to the same disciplines as the rest of the private sector.

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the department for Enterprise

I am sending copies of this letter to Barry Potter (No 10); Tim Sutton (Lord President's Office); John Neilson (Department of Energy); Stephen Leach (Northern Ireland Office); Stephen Flanagan (Financial Secretary's Office); and Sonia Phippard (Cabinet Office).

Yours ever

Ben Slocock.

BEN SLOCOCK
Private Secretary

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