CONFIDENTIAL

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PRIME MINISTER

Gas Pricing Policy

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BACKGROUND

E(EA) considered this subject just before the Conference and the Secretary of State for Industry reported their conclusions to you in his minute dated 5th October. Your own comments were set out in Mr. Lankester's letter of 8th October; you were very reluctant to go along with a price increase from 1st April next of 10 per cent over and above the rate of inflation. The argument is, of course, entirely about the domestic and small commercial tariffs. Industrial and large commercial gas users pay non-tariff prices which are individually negotiated, oil-related, and much higher than the prices charged to domestic consumers.

2. Discussion now is timely because it is necessary to take a view on the future course of gas prices as a preliminary to the public expenditure Cabinet on 18th October, and as a basis for the discussion of cash limits for nationalised industries on 25th October. The gas pricing issue is not however solely one of public expenditure - though it is very important in this context - but is also of considerable importance for energy policy generally and for energy conservation in particular. In addition acceptance of the present proposals, or something like them, would unlock the way to further increases in electricity prices (on which there is a separate paper at this meeting) and of coal prices, both of which are affected by the present unassailable competitive strength of gas in the domestic market. Against this are the political difficulties of a steep increase with its implications for the RPI and the particular problem of fuel costs and the poor.

3. The economic arguments are clear enough. It is common ground that gas is severely underpriced to the domestic consumer. The reasons for this are historical and need not concern the Committee. What matters is that the rise in the price of oil has created a very big "economic rent" in North Sea gas production (notably from the southern gas basin) and that, under present arrangements, much of this rent goes to the domestic consumer rather than to the taxpayer or the off-

shore producer. In the parallel situation of North Sea oil a major part of the economic rent comes to the taxpayer through PRT etc. But the southern basis gas fields do not pay PRT and the producers' price is severely limited by the contract terms on which the in gas is purchased by the BGC. Mr. Howell is known to have toyed with the idea that the price paid for southern basin gas should be raised to free market levels and then taxed through PRT. But while this might ease presentation - by reducing BGC's profits - it would also involve giving the southern gas producers a major uncovenanted financial benefit and Mr. Howell is not pressing this idea at the moment.

4. It is also common ground that the present artificially low gas price is having undesirable side effects e.g. in over-stimulating the demand for gas (BGC is asking for an extra £400 million of investment in transmission and storage facilities over the next five years) and is cutting expensively into the markets for electricity and coal. More widely our present gas pricing policy is as open to attack as leading to economic distortion as is the oil pricing policy of the United States.

HANDLING

5. You might ask the Secretary of State for Energy to introduce his paper, and then call for comments from the Chancellor of the Exchequer (or the Chief Secretary if he prefers); from the Secretary of State for Industry (under whose chairmanship E(EA) discussed the proposal earlier); and the Secretary of State for Employment. Other Ministers and Sir Kenneth Berrill may wish to join in.

6. The issues which arise can be grouped as follows:-

(a) The extent of underpricing. Not strictly relevant to the immediate steps. Mr. Howell's view is that the right benchmark is the equivalent price of oil. This is certainly the easiest to estimate, being directly market-related. On that showing, gas is something like 30-35 per cent behind.

(b) The speed of adjustment. Mr. Howell suggests a phased move over three years. This would certainly help the PSBR. A longer period takes the adjustment outside the life of this Parliament (though if the real price of oil increases during the period further adjustments would be needed).

(c) Size of the first step. Your colleagues may well find, as you did, the prospect of a 23-27 per cent increase in gas prices next April a daunting one. If so, you will wish to go for a lower figure. But a strong case on merits can be made for various additional revenue in this way and in any case the issue is not a straight choice between revenue and prices. Given a PSBR target, and other things being equal, any alternative action taken by the Chancellor in the Budget is likely to be at least as unpleasant as putting up gas prices and often harder to defend.

(d) Timing of first move. It may be argued that the first step of the phased introduction of higher prices should be delayed - say to October next - in order to give consumers a chance to adjust. But this is unlikely to help much because most consumers are locked into their heating systems and anyway, even after the proposed price increase next year, gas would still be the best buy. And, of course, revenue would be lost.

(e) Signalling future price increases. The real problem is to persuade people, sufficiently far in advance, that gas will eventually lose its competitive edge over alternative fuels. Paragraph 6 of Mr. Howell's statement (Annex B) seeks to do this but ties the Government to a three-year programme in a situation where the price of oil - and hence the gap to be filled - is quite unpredictable. It might be better to phrase the statement in terms of "until the price of gas reaches an economic level".

(f) Excessive profits. There remains a cosmetic problem of very high profits for BGC. Mr. Howell proposes to come back to this issue later, and you might agree to this swiftly, ruling out of order any further discussion of this complicated issue at this stage. It is not relevant to the immediate decision before the Committee.

(g) PSBR or public expenditure? Some of your colleagues may stumble over the relationship between the gross or net profits of BGC (which is almost the only nationalised industry to pay significant quantities of Corporation Tax). Net profits affect the public expenditure totals: gross profits (including Corporation Tax) affect the PSBR. You may feel that the significant figure is PSBR: public expenditure cuts are a means towards reducing the size of the PSBR, and not (in this case anyway) an end in themselves although it is only the public expenditure figures which will chalk up in the Cabinet operations on Thursday.

(h) Cash limits. No decision on the cash limit is needed at this meeting. It would be included in the detailed proposals which the Chancellor is bringing forward on 25th October. Staff costs are approximately 20 per cent of BGC operating costs.

(i) Protecting the poor consumers. The arrangements which you have approved for this winter cover only electricity consumers and the proposed gas price increases would come in, at earliest, next April. Given that the intention in future is to concentrate help with fuel costs through the social security system you may feel that the reference at the end of Mr. Howell's draft statement (Annex B) to "keeping the position under review" is an unnecessary hostage to fortune.

CONCLUSIONS

7. These must depend very much on the course of discussion, and your own guidance to the Committee. The Secretary of State has set out eight very clear conclusions. The only one of these which may be significantly altered in discussion is (ii), and you may need to substitute another figure for the 10 per cent real terms increase proposed there. Otherwise, you might aim to endorse all the other recommendations subject only in the case of (v) to inviting Mr. Howell nearer the time to clear the text of his statement with you and other colleagues in the normal way.

JOHN HUNT

15th October, 1979