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PRIME MINISTER

GAS INDUSTRY PRIVATISATION

Following our discussion on 10 May, I have examined further options for partial privatisation in two specific areas - appliance retailing and servicing and offshore gas production. Papers dealing with these are attached.

2. There are constraints on our freedom of action:-

(a) the undesirability of opening up a second front with the nationalised industries in present circumstances;

(b) the need to guarantee, whatever decisions we take, that there will be gas servicing and safety cover available to consumers throughout the country;

(c) the limited prospects - as the papers bring out - of finding takers for the peripheral parts of the business. Gas servicing, in particular, is not an attractive business for investors and the major offshore assets have highly specialised features which limit their appeal; and

(d) the risks - enhanced by the back history of 1981 described in the third paper attached - that unions, management and consumer interests would combine to resist change and mobilise public opinion against it.

3. The options realistically available for partial privatisation in these areas are, I believe, extremely limited. The major

choice remains between a radical change of ownership for the gas business, as discussed in the previous paper, and continuing the existing nationalised industry set-up.

4. If we chose the nationalised industry option, I would propose to concentrate action on appliance retailing which offers genuine prospects for pursuing our competition objectives and promoting a more diverse market. I believe the way forward is through a further reduction in BGC's involvement in this sector and that this can be achieved in partnership with the private sector. This would include making best use of existing gas industry property sites in joint ventures with High Street retailers and, probably, BGC continuing to give ground in some areas to others. BGC's installation and customer service operation would remain in being and be made generally available to all retailers.

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

SECRETARY OF STATE FOR ENERGY
11 JUNE 1984

APPLIANCE RETAILING AND INSTALLATION AND SERVICING

Appliance Retailing

BGC has a chain of about 600 showrooms which sell gas appliances, provide facilities for the payment of bills and the arrangement of appliance servicing, and give advice on the use of gas generally. Net assets employed in appliance retailing had a book value (current replacement cost) of £86m at 31 March 1983 within this, the major saleable asset is the property, much of which is leasehold and which is probably valued in the books at approaching £75m. The operation employs about 5,000 staff.

2. BGC's overall market share for appliances is declining but remains about 50% by volume. It is concentrated in the lower value appliances - cookers, wall heaters and fires (see Annex A for more detailed figures). The major growth market of the 1970s in central heating was taken by the private sector and BGC's share of this has remained low (currently about 15%).

3. The activity is barely profitable. In 1982/83, after revision of the accounts following the MMC report, it made a loss of £1.7m on a turnover of £226m and this year is expected to show a small profit. The showrooms range from high volume, high turnover High Street sites, through those in deprived inner urban areas, where much of the activity centres on accepting payment of bills, to small town general contact and sales points. The longer term tendencies are towards more customer inquiry and similar business being handled by the Post Offices etc and a concentration of appliance display and over-the-counter sale in the larger town centres. In the past year BGC have closed 70 unprofitable showrooms and expect to close another 70 over the next 1½-2 years. The limited information available to the Department suggests that, with sales restricted to gas appliances, few of the retained sites will be very profitable:

most probably just about break even, with the best making a few per cent on turnover.

4. The sale value of the existing operation is concentrated in the value of the sites and there would be unlikely to be much goodwill value attached. A purchaser would rightly look to turning the premises to a wider range of more profitable uses and these opportunities would be a main factor in determining value.

Installation and Contracting

5. In addition BGC currently employ about 30,000 staff on customer service which covers installation and servicing of appliances as well as the provision of an emergency service. Emergency service is a necessary part of the provision of gas supply and would remain the responsibility of BGC. The assets of the installation and servicing activities are valued at current cost in BGC's books at about £70m. The activity had a turnover of £212m and made a loss of £5m in 1982/83. This year it is expected to show a small profit.

6. BGC does not have a monopoly in appliance installation and servicing. But it does undertake over half the work in this area. Unlike appliance retailing which has drawn some new entrants (eg Comet and others), installation and servicing holds few attractions for investors and the existing competition comes mainly from small contractors who are not able to offer a comprehensive service.

Options for Privatisation

7. Whatever decisions are taken, it will be necessary to ensure that gas customers throughout the country continue to have available an emergency service, adequate general servicing facilities and access to appliances. Failure to meet this would

inevitably generate rapid and widespread criticism of any proposals for change that Government brought forward and might well necessitate abandoning the exercise.

8. The main options for appliance retailing are:

(a) <u>to require BGC to end retailing and sell its existing assets to the private sector</u>. This would achieve privatisation. But it would mean substantial gaps in the market, because no doubt whoever purchased the retailing chain would do so with a view to a property break-up. The reality is that many of the premises concerned would be used for other purposes. In many parts of the country there would be permanent loss of the facilities at present provided by BGC showrooms. In the absence of arrangements between BGC and successor retailers, its existing customer service operation would cease to be viable and would be run down, leading to a further, more serious loss of facilities probably with consequences for safety. This course would be strenuously resisted as it was in 1981. It does not represent a practicable way forward.

(b) <u>to require BGC to form its retailing assets into separate companies, a majority interest in which would be sold to the private sector</u>. This would introduce private capital and could be a means of harnessing new private sector managerial talent and making profitable and diversified use of the existing retailing sites. The minority BGC share could underpin an agency arrangement between BGC and the new companies under which they would perform, for payment, services related to the main gas supply business - eg accepting payment of bills, providing advice, while they in turn made use of installation services, warehousing etc provided by BGC. The existing restrictions on diversification in the Gas Act need no longer apply if the operation were outside the public sector and it is likely that a much wider range of goods would be on offer in the shops. More profit-oriented managements would probably accelerate the programme, initiated by BGC of closures of showrooms which are uneconomic or only marginally economic or apply the sites to wholly new purposes. The process of setting up the new companies would inevitably be a complex and lengthy business.

(c) to require BGC to form its retailing assets into separate companies, a minority interest in which would be sold to the private sector. This would be broadly similar to (b) but would mean the operation remaining in the public sector. The advantages of diversification would not be achieved unless the present Gas Act restrictions were lifted. Overall BGC control would also probably limit the interest shown by private sector investors and further depress the price achievable.

(d) promoting competition within the nationalised industry framework. BGC could be pressed to accelerate its programme of showroom closures (eg the remaining 70 to be closed within 1 rather than 2 years) and to pursue in a radical way options for joint ventures with the private sector. These would include in particular arrangements for making best use of the major city centre sites in partnership with High Street retailers and could extend also into franchising and gas use of others' floorspace in appropriate cases. The approach would also involve a new emphasis on BGC linking up their installation and servicing facilities with appliance sales made by other retailers. This combination of elements should lead, within a reasonable space of time and without undue disruption, to a more diversified market and improved choice for consumers.

9. The options for privatising installation and customer service are very much more limited. The labour intensive nature of the business and its poor profitability record make it most unlikely that alternative owners and managements would be found, able and willing to take the existing comprehensive operation on and run it in something approaching its present form.

10. Gas installation and servicing work is the area that touches most closely on safety and the training of fitters and maintenance of standards has rested substantially with BGC. HSE, who are responsible for safety, propose to limit installation in future to qualified fitters and are considering introduction of compulsory registration. Any changes that are introduced will need to ensure at least a maintenance of existing standards and safeguards for the consumer.

11. The main options in this area are:

(a) to include customer service with appliance retailing under options (b) or (c) at para 8. This would considerably diminish the attractiveness of the companies being floated. There would be no clear assurance of the long term continuation of the successors in gas servicing. Unless the emergency service were transferred to them, the costs of its continued operation by BGC would increase significantly. Privatising this part of the business would encounter the fiercest union opposition and there would be heavy costs in redundancy payments.

(b) to require the Corporation to put more work out to contract. Some such work is already sub-contracted. This could be stepped up, though beyond a point it could run into similar difficulties to those at (a).

(c) to leave installation and servicing with BGC requiring them to make the facilities generally available to retailers. This would ensure continuity of existing cover to consumers, which is the basic underpinning required for making real progress towards increased competition in appliance retailing (options (b)-(d) at para 8 above).

ANNEX A

BRITISH GAS APPLIANCE RETAILING

% SHARE OF MARKET BY VOLUME

	1977/78	1979/80	1983/84 (estimated)
Freestanding Cookers	93	88	86
Built in Cookers	79	64	47
Wall Heaters	86	80	73
Fires	78	67	60
Water Heaters	62	58	53
Total excluding central heating	80	70	65
Central Heating	25	15	15
Total including central heating	65	51	50

% SHARE BY VALUE

All Appliances excluding central heating	80	72	70 (for 81/2)
All Appliances	48	29	26

PETROLEUM EXPLORATION AND PRODUCTION

BGC's petroleum interests are listed at Annex A. They range from minority interests (held with US oil companies) in gas fields in production to interests in unexplored territory both onshore and offshore. Most of BGC's oil assets have already been removed (either to Enterprise Oil or in the case of Wytch Farm by sale), but a limited amount of oil prospective territory remains.

2. Discounted cash flows for the interests are given in Annex A. The largest item is the Morecambe gas field currently being developed by BGC as a seasonal peak lopping gas supply. The operation of the field, like that of the gas storage facility being developed at the depleted offshore gas field, Rough, will be closely bound up with the day-to-day running of the onshore transmission system. Decisions would be needed on whether to include only Morecambe or both Morecambe and Rough in any disposal.

3. A degree of involvement in gas production is the international norm among gas transmission and distribution companies. In the USA some 7% of gas is bought by the major transmission companies from their own affiliates. Similar connections exist in Australia, New Zealand and most of Western Europe. In the case of the Netherlands, the partners who run gas distribution (including Shell and Esso) are virtually identical with the main gas producers. BGC obtain some 7% of gas from their subsidiaries.

4. The options for privatisation are:

(a) to require BGC to dispose of all of its petroleum licence interests. This would achieve full privatisation of these interests. It could be done either by creating a new company and selling its shares on the market, or by selling the interests piecemeal to the highest bidder, taking account of BGC's existing licence partners' pre-emptive purchase rights. Advice would be needed on the likely proceeds under each route. A company concentrated on gas, and at least initially a captive supplier to BGC, would be a less attractive prospect for investors than an equivalent oil venture. The BGC staff (perhaps a few hundred) could either be transferred to the new company or made redundant. Either route would be complex and involve lengthy negotiations to establish gas purchase terms and then sell the assets. The main practical problems would arise over Morecambe Bay which BGC has developed to meet its special seasonal requirement and for which no gas purchase contract exists. A purchaser is likely to offer a fairly low price for the asset - discounts of up to 50% are regular for oil companies - and require a high price for the gas, particularly given uncertainty about seasonal year to year offtake. It may be difficult to defend the deal as a good bargain for the public sector. The gas industry management would object strongly arguing that involvement in gas exploration and production is an integral part of its main function - the distribution and supply of gas in Great Britain - both directly in providing gas and indirectly in enabling it to be a well informed purchaser of gas from others. In the absence of compensation - perhaps the book value of the assets would be appropriate - BGC would be able to argue, particularly in the case of Morecambe, that it was paying for the gas twice - once in development expenditure which had not been recovered and secondly to the new vendor. The course would be politically contentious and would be strongly criticised by consumer interest: the cost of arm's length purchase of present BGC gas, if passed on fully to consumers, would require a tariff increase of the order of 3%. It could not be defended on competition grounds (BGC is only one offshore producer among many) and would have to be justified to the public on the privatisation and PSBR merits.

(b) to require BGC to put its exploration and production assets into a company in which a majority of shares could be sold to the public. This would take the assets into the private sector, but would allow BGC to retain a minority interest. A new management would be needed and an arm's length trading relationship would have to be set up. Some of the disadvantages of (a) would remain - eg probable difficulty of justifying the terms of the bargain. With only a minority share BGC would not retain access to inside operational information and would still be likely to oppose the change. The attractiveness of the package of assets to the private sector might be low and hence the price achieved depressed.

(c) to require BGC to put its exploration and production assets into a company in which it retained a majority interest. This would avoid BGC losing access to information about offshore exploration and production, but at the cost of leaving the operation in the public sector. Control by BGC might reduce opposition to the proposal but could also reduce the attractiveness of the shares to investors. An arm's length trading relationship would still be needed.

(d) to merge BGC's remaining assets with an existing oil company. This would achieve full privatisation of the assets without the need for creating a new management structure. The merged company would be more broadly based from the outset, would have larger resources and should be less affected than a company at (a) by problems of being a captive gas supplier to BGC. Other disadvantages discussed at (a) would, however, probably still hold. Purchase by one of the larger oil companies would be the shortest route, though a merger could probably be arranged with a smaller company eg Enterprise Oil, on the basis of some combination of new equity sale and loan finance. The chief difficulty would be that of showing HMG had got a good price.

(e) to require BGC to farm out all licence interests above 5%. This would allow BGC to retain access to operational information but would otherwise be substantially the same as (a).

(f) to accelerate existing policy of requiring BGC to divest itself of its residual oil assets. BGC holds some remaining territory, onshore and offshore, where prospects are more for the discovery of oil than gas. These were not included in Enterprise Oil's territory either because they were not attractive enough or because they were too difficult to detatch eg because BGC was the operator. It would be possible to require BGC to dispose of this territory within a certain time. One route, which BGC has been examining for a small onshore oil discovery near to development under the operatorship of BP, would be to arrange an exchange of oil interests for gas interests held by private sector companies.

BGC's Petroleum Interests

	BGC Interest %	Operator	NPV of BGC's Interest (at 15%) (£m)
1. Producing Gas Fields			
Leman bank	14	Shell	50
Indefatigable	19	Amoco	30
2. Gas Fields Under Development			
Morecambe Bay	100	BGC	850
3. Other Gas Discoveries Offshore			
South Morecambe	100	BGC	50
Lomond (Condensate)	50	Amoco	10
47/9b	73	BGC	35
49/29a	40	Mobil	10
4. Other Interests			65
			1100

These are:

(i) 43 Offshore blocks, 17 operated by BGC
BGC Interest;
In 10 blocks BGC has a stake between 20% and 35%
In 17 blocks BGC has a stake between 40% and 50%
In 4 blocks BGC has a stake between 69% and 73%
In 12 blocks BGC has a 100% stake

(ii) 20 Onshore licences, 5 operated by BGC
BGC Interest:
In 11 licences BGC has a 25% stake
In 2 licences BGC has a 33% stake
In 4 licences BGC has a 50% stake
In 3 licences BGC has a 100% stake

(iii) The Rough depleted offshore gas field which is being redeveloped as a seasonal storage facility. (As this will be operated as an integral part of the onshore transmission system it has not been included in the valuation).

THE UNIONS AND PRIVATISATION: THE 1981 CAMPAIGN

The principal gas unions are GMBATU (manuals) and NALGO (staff); others with smaller memberships in the industry include the T&GWU and the AUEW.

2. Following the 1980 MMC report on gas appliance retailing the gas industry unions formed their own organisation to fight the hiving off of showrooms, GUARD or "Gas Unions against the Report for Dismantling BGC". GUARD has no formal contact with BGC but its membership is similar to the Union Side of the Planning Liaison Committee in which the Unions negotiate with BGC. Its secretary is the National Officer of NALGO (D Stirzaker).

3. The gas unions rejected the MMC's "radical option" (an end to BGC retailing) on the grounds of heavy job losses (estimated at around 31,000), adverse effects on standards of installation work and general safety cover to consumers, loss of availability of spare parts for older appliances and, they argued, likely higher prices to consumers. They also argued, less vigorously, against the MMC's "less radical option" (accounting changes and adoption of improved commercial practice). The gas unions had the backing, in this, of the TUC.

4. The announcement of 8 July 1981 that the Corporation would be required to withdraw from retailing over a five year period was followed on 18 July by a one day strike in the industry. This was supported by 95% of the workforce. The majority of those who stayed at work were management, who maintained gas supply and were, generally, able to ensure safety cover. (One consequence of the strike was the formation of the Gas Higher Management Association to provide for separate representation of senior grades in the future). Union action and campaigning ran in parallel with that of consumer interests led by the Gas Consumer

Councils and with BGC's own campaign against the decision. The latter included advertising ("Wonderfuel Gas"), and PR handouts to employees which were widely distributed, all designed to win public support for the status quo and heighten concern about the effects of change, particularly on safety: the handout made some play of comparisons between BGC's safety record and that of others in the UK and abroad. This was followed in late 1981 by Government agreement to defer action.

5. The interests that campaigned in the summer of 1981 believe that their efforts on that occasions paid off and, if brought together again, could be expected to show at least equal determination in opposing changes.

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