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PRIME MINISTER

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GAS INDUSTRY PRIVATISATION

Peter Walker's latest paper sets out a range of options in addition to his preferred course of denationalising BGC lock, stock and barrel.

The meeting on Thursday should decide whether you wish to proceed with Peter Walker's preferred scheme of denationalising a monopoly, or whether you should proceed with splitting up the different functions of BGC and privatising them, starting with gas production, retail and servicing where competition is already strong.

Having seen the arguments between the Treasury and the Department of Energy, we still recommend the latter course.

Peter Walker's four points

We would not be opening up a "second front" with BGC for some time. A decision now would require several weeks of preliminary work on splitting the Corporation and obtaining the agreement of E(A). The miners' strike will not go on indefinitely. We should also remember that the unions may well oppose the Peter Walker scheme of complete denationalisation, even though the existing management would be happier.

There should be gas servicing and safety cover available to customers. However, a decision to denationalise retailing and customer servicing does not mean that this cover would be withdrawn or unavailable. Private providers, as in the water industry for maintaining the domestic water system, would emerge and compete with the denationalised business. BGC could retain responsibility for safety of mains and trunks.

We should not worry about the alleged difficulty of finding takers for the peripheral parts of the business. Several major energy companies and a large number of individual and corporate investors would be interested in taking a stake in offshore gas assets. The only specialised feature which limits their current appeal is the price-rigging which goes on in the marketplace. As one of the main aims of the gas-pricing policy is to establish a market price in gas, this particular problem will disappear. Gas servicing as well could be attractive. Companies like Dynorod and Hat Group (plastering and other building trades) have solved the problems of running labour-intensive service businesses, and make good money out of them.

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There is a risk that unions, management, and even customer interests could combine to resist change, and mobilise opinion against it. However, we should - with the piecemeal denationalisation approach - be able to win over the customer interests. If customer retailing and servicing is tackled first, there will be a better and more wide-ranging service at a lower price, with more choice. Consumer groups won't oppose this; I have even heard representatives from the National Consumer Council argue in favour of such changes. The unions will resist it, but they will probably resist any type of denationalisation. The management may well be unhappy about this suggested route, but that would argue for making selected changes to the Board so that it contains people who are enthusiastic about the policy.

Conclusion

It is recommended that the meeting agree to:

(a) privatisation by splitting the functions off;

(b) a tight timetable for bringing the first proposals to E(A) which should include sale of the retail business and the gas production interests.

(c) The pipeline system and regional distribution companies could be considered later, once a market in gas has been established, and other companies are using the pipeline as a common carrier.

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ANNEX

1. <u>The detailed businesses reviewed in Peter Walker's paper</u>

<u>Appliance retailing</u>. Peter Walker suggests that any buyer will be an asset-stripper. He is worried about the comprehensive nature of the service being jeopardised by the change of ownership; yet his paper indicates that BGC Board policy is to close down a large number of marginal outlets, and to concentrate on the larger outlets, where the prime activity is appliance retailing.

A private sector takeover and new senior management in BGC's retail business could transform it. The showroom chain could be dramatically improved, with the goods being better displayed. It could be made profitable whilst the price of goods could be reduced, for BGC retail at the moment manages to combine quite high prices with low profitability. BGC service could retain counters and facilities in the former BGC retail outlets, but it would also be free to negotiate similar arrangements with other retailers. For example, leading department stores and the Post Office are looking for more franchisees, and might be very interested in a BGC customer service point. Similarly, the Post Office is interested in expanding its counter business.

<u>We recommend requiring BGC to end retailing and to sell its existing assets to the private sector</u>. Of the other options, the least objectionable is the requirement to form retailing into separate companies and sell a majority interest to the private sector. Even with this scheme, there is the potential for cross-subsidy between the businesses in BGC and for some abuse of monopoly power. The idea that BGC should only sell a minority interest in retailing would achieve practically nothing, and leaving it for BGC to sort out their business under option (d) begs the question about why they haven't improved it years ago, both to give their customers a better deal, and to make some profit.

2. <u>Installation and contracting</u>. The private sector can handle installation, servicing and contracting work. It does so in many other areas - eg electrical installation and contracting, and in the water industry.

It is desirable to transfer this work to a greater extent to the private sector, where the work force is likely to be better motivated and better organised, and where the quality of customer service is likely to rise. Customers find it annoying that when they wish to have their facilities maintained or repaired, they can't even be told roughly what time of day the fitter is likely to call; and often when the fitter arrives, he is only able to do one part of the work - needing to call on a private sector plumber, for example, when fixing a central heating system.

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Concern about safety could be dealt with by:

(a) leaving it to BGC to tackle the safety of anything on the street side of the customer's meter; and

(b) considering registration of qualified fitters who would be capable of doing the work in the private sector.

The strategic options set out are not exciting. There are two that are worth pursuing. One is option (a), to include it with appliance retailing. **Another option - which we recommend - would be the creation of a separate company or companies to handle servicing, and the sale of these companies to the private sector**.

3. Petroleum exploration and production. In the context of a policy to have a market in gas, the sale of the gas assets would be both easy and desirable. It helps competition by breaking BGC's stranglehold over gas from the North Sea to the customer. It helps the general policy of disengagement by the Department of Energy and BGC and it would raise substantial money for the Treasury. It might also assist in encouraging separate routing of gas by mechanisms other than the BGC pipelines, to develop more competition in the gas supply business which, to date, has failed to appear.

Option (a), a requirement to dispose of all its licence interests, would arouse antagonism from the existing management. BGC could get a realistic price for the gas. There is a lively market in gas and oil interests, and a fair market price could be arrived at through an offer for sale or an auction. The best price of all would probably be realised by selling the assets to more than one party.

There is little attraction in putting the assets into a company in which a majority of shares was retained by BGC. There would still be the same close linkage between the policy on exploitation of gas and the sale to customers, and there would still be the same cross-subsidisation. It would still be difficult to get accurate figures about the cost-effectiveness and value for money provided by the different elements of BGC's business, which is the core of the current problem.

Merging the assets with an existing oil company or oil companies is a variant of sale, and this should be left open if the general route to selling the oil assets is agreed, to be decided at a later stage when the bidding becomes clearer, and approaches can be made to potentially interested parties.

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The asset valuation of £1.1 billion seems to be a distinct under-estimate of their worth. The true answer could well be nearer to £2 billion. However, it is no bad thing to start off with a low estimate valuation, as the BGC style of resisting these changes is always to hold out the prospect of a very large figure and then claim, when a smaller figure is realised, that the public has been cheated.

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