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PRIME MINISTER

GAS INDUSTRY PRIVATISATION

Following our discussion on 26 March, I have prepared the attached paper for our meeting on 15 April. This is in the form of a draft paper to E Committee, since you envisaged that a reference to that Committee might be necessary.

The paper has been agreed by John Moore. The Treasury's position is, of course, reserved on the employee participation point. But I believe it is vital that we make generous provision here, in order to establish a real employee stake in the business and win their support. Success in winning that support will have a favourable impact on the share price that can be obtained.

A further question we shall need to resolve quickly is whether Kleinwort Benson should be allowed to compete for appointment as merchant bank advisers on the sale. They have had the lion's share of privatisation work so far and there are, I think, good arguments in terms of our general approach to Government procurement for avoiding over-concentration. I was not fully satisfied with the performance of Kleinworts' on Enterprise Oil. If we decide that they should not be advisers for the BGC sale, I would propose to tell Kleinworts, immediately following announcement, that I did not expect them to enter the contest; and be ready to defend our decision on grounds of avoiding over-concentration.

In order to meet the timetable, I shall need to make a statement before the end of this month. If reference to E Committee is necessary I would hope it can be arranged as early as possible after the 15th: with special arrangements for security of papers. I would propose to make a statement as soon as possible after the E Committee meeting, and in any case not later than 29 or 30 April.

I am copying this minute and enclosure to the Lord President, the Chancellor of the Exchequer and the Financial Secretary. I would be grateful if particular efforts could be made to restrict circulation to an absolute minimum.

Peter Walker

Secretary of State for Energy

11 April 1985

GAS INDUSTRY PRIVATISATION

This paper sets out my proposals for privatising the gas industry.

2 With British Telecom and the coal strike out of the way, we now have the opportunity, if we act quickly, to put through this further, key denationalisation in the present Parliament. It will mark a decisive step in the creation of real ownership by the public and employees and in harnessing capital and other market disciplines for the benefit of consumers, processes which we have begun with the British Telecom and other flotations.

3 I shall need to make an announcement as rapidly as possible, and at latest by the end of April. This is essential in order that work can go ahead with all possible speed on drafting a bill for introduction in December. The aim would be to float the new company as soon as possible following passage of the legislation, in the autumn of 1986. Any delay in this programme would put at risk the completion of the exercise before the Election.

The Gas Business

4 Natural gas is a mature business with only limited further growth potential. The immediate prospects are good, but the cost of the raw material is rising steadily (See Annex 4) as new, higher priced supplies replace the original cheap gas. In the longer term the gas industry, in Britain as in other countries, will have to look further afield for its supplies and may well have to invest heavily in plant for manufacturing substitute natural gas (SNG) from coal - at more than twice the cost of the most expensive natural gas - to supply a declining market against competition from other fuels.

5 This is a different picture from British Telecom, which was a growth industry with improving prospects. Successful sale of gas will depend on convincing investors that there are still attractive returns to be made and that the business has adequate scope for reinvestment of profits, and for diversification within Monopolies Commission rules.

Gas Supply and Regulation

6 The main business of gas supply to the majority of small consumers is an inherent monopoly and will require regulation on price and on terms and conditions of supply (including an appropriate continuation of an obligation to supply). The principal regulatory features, for which we would provide in the legislation, are described in Annex 1. In summary these are:

(a) establishment of a regulatory body with a small permanent staff working within guidelines laid down, which would be capable of amendment by defined procedures. The regulatory body would have its own distinct functions but could, in practice, work closely alongside or be combined with OFTEL.

(b) a system of price regulation similar to that applied to BT. In the gas case the formula (RPI-X+Y) would provide that prices could rise no faster than inflation less a performance target (X) for reducing onshore costs within the company's direct control plus an additional term (Y) covering costs of offshore gas purchase. The formula would be averaged across the prices charged by the company and would be backed up by a duty not to discriminate between customers.

(c) various detailed requirements governing connection of customers into the system, maintenance of supply and withdrawal of supply (an issue with potentially important regional implications).

7 The company would be a Companies Act company with rights and duties in gas supply defined in the statute and probably conferred by a licence. The licence would need to run for a substantial term but the possibility of licensing others in appropriate circumstances - with corresponding obligations eg. on safety - would not be excluded. The provisions of the Oil and Gas (Enterprise) Act for common carriage of gas by the company and for direct sale of gas by competitors would be continued, possibly with some adjustments and improvements. The strictly "gas utility" part of

the company's business would be operated within a ring fence, separately accounted to the regulator and policed by him. It will be for consideration whether Government should be able to step in, in the last resort, eg. if the company collapsed, to maintain gas supply and secure the safety of the system. Government would assume no obligation to the shareholders in this event.

Other activities

8 The British Gas Corporation's other activities are neither natural nor statutory monopolies. They would be passed to the new company which, freed from the Gas Act restrictions, could be expected over time to take a more thoroughly commercial approach to their operation and development. Among the more important points:

Showrooms: The new company would be unlikely to want to maintain the retail outlets in their present form, once restriction to gas retailing with its relatively poor economics ceased. The way forward would most likely lie in more flexible joint venture arrangements with other more experienced retailers and, in some cases, probably a more diverse range of retailing by the company itself.

Installation and Servicing: The company could also be expected to take a more searching look at its servicing operation and the underlying economics. Some gradual shake-out would be on the cards and probably some growth in activity by independents. It would be necessary to provide that BGC's non-chargeable emergency service to deal with gas leaks on the consumer's side of the meter continues: this would be funded by a charge on the regulated gas supply business. The registration of independent installers would be surrendered by BGC to the Health and Safety Executive and my Department will be assessing urgently with HSE the detailed arrangements needed to meet the new circumstances.

Offshore Assets: A similar new emphasis on cost-effectiveness and profitability should emerge offshore. The residual BGC assets have a disproportionate importance as one of the few areas of interest and potential to which we can point investors in writing the prospectus for the new company.

9 Activities in these areas will be subject in the normal way to the controls of the MMC and the Office of Fair Trading.

Gas Imports and Exports

10 Privatisation raises important issues in this area. I am considering urgently the implications for imports and exports of a decision to privatise BGC.

Employee Participation

11 We need to win the support of employees and existing management for the change and demonstrate, by contrast with nationalisation, that a stake in the enterprise through the market brings a sense of participation, direct benefits and a degree of protection against unwelcome takeover. It would, I think, be right to aim for this purpose at actively encouraging a management/employee buyout to the extent of around 10-15% of the equity. Success in meeting these objectives will have a very considerable impact on the price we can obtain for the business.

12 A possible approach is set out at Annex 2. There was misunderstanding in the BT case which we cannot afford to repeat. To forestall employee opposition we need to establish by the time of the announcement what can be offered to employees. This would greatly assist achieving maximum proceeds from the flotation.

Proceeds

13 BGC's turnover is £6½ billion. Its pre-tax profits are running at £1 billion and its net assets employed are some £4½bn (both historic

cost basis: see Annex 3).

14 The Corporation is at present practically debt free. The issue would be divided between debt and equity. On varying assumptions the total value of the business is in the region of £5-7 bn. Actual proceeds would, of course, be much affected by the state of the markets, the extent of management and employee resistance, the degree of controversy about the likely success of the new company, the Election shadow and the risk of re-nationalisation. This sort of share is eminently suited to wider share ownership and, as with BT, the offer would probably include vouchers and/or bonus shares.

Timetable

15 The timetable (Annex 5) is already tight in the extreme. It can only be achieved given prompt decisions based on the simplest practicable solutions, early announcement and rapid preparation of what will be a complex and controversial Bill for introduction in December. The aim would be to obtain Royal Assent by the summer of 1986 and to float the company in the second half of next year on a partly paid basis, with further calls during 1987.

Conclusion

16 I invite my colleagues to agree:

(a) that the gas industry should be privatised on the basis set out in this paper;

(b) that I should make an announcement to this effect by the end of April; and

(c) that work should proceed on preparing the necessary legislation for introduction in the 1985/86 Session and, in parallel, on preparing the subsequent flotation.

ANNEXES

ANNEX 1

REGULATION OF THE GAS SUPPLY UTILITY

1 Much of the regulatory framework for a private gas utility can make use of existing provisions for BGC. A new system will be needed to control the industry's prices.

Non Financial Provisions

2 The operational requirements for a private gas company will remain largely unchanged and customers and the public will continue to expect similar standards of service, eg. in emergencies and on safety. The rights and duties for a private gas utility will therefore be similar to those laid down by the Gas Act 1972 as amended. The main points are:-

(i) a general obligation to maintain a gas supply system within certain rules on what is regarded as economic, as at present.

(ii) a duty to supply individual customers. At present BGC must supply all customers within 25 yards of a main who do not consume more than 25,000 therms/year (in practice all domestic and small commercial customers). To avoid duplication of supply pipe systems BGC has a monopoly right for such customers. Both right and duty will be carried over, subject to the provisos that if the company failed to meet its obligation others could enter the market and, possibly also, that small consumers off the company's existing grid could be supplied by competitors.

(iii) Gas Supply Code. The provisions concerning the present industry's everyday operations (eg. laying of pipes, metering, billing) are set out in a schedule to the Gas Act 1972. These would be carried over to the new company.

(iv) non discrimination. Provision will be needed to require that the company does not discriminate between customers.

Annex 1 - Contd.2.

(v) Safety and emergencies. There is extensive legislation on gas safety (responsibility for which now rests with HSE). Some adjustment and reinforcement of the present provisions are likely to be needed but can be achieved within existing powers.

(vi) carriage of third party gas and direct supply by competitors. The present provisions of the Oil and Gas (Enterprise) Act would remain in place. These include unrestricted freedom to supply customers consuming more than 2m therms/year and freedom, subject to HSE consent on safety grounds, to supply those taking between 25,000 and 2m therms/year.

(vii) Code of Practice on disconnections. The company would need to give undertakings similar to the voluntary code agreed with the energy industries on disconnections.

3 The Government may also need reserve powers to intervene and secure the safety of the system in the event of the commercial collapse of the company. No financial obligations would be assumed towards the company or its shareholders. Provisions will also be required on planning permissions for plant and buildings and wayleaves for new pipelines and other issues such as the rating of the industry's buildings and installations.

Financial Aspects

4 A new framework will be necessary for the control of the industry's prices.

5 A price control system would operate on prices to consumers (including the company's onshore gas supply costs and the element of gas purchase cost). The system would not extend, however, to the operation of the ancillary businesses upstream and in retailing, where general legislation (eg. on fair trading) already provides the framework for all participants.

6 The system of control operated by the regulator would extend to all gas sales by the company including contract sales to industry.

7 The control system for the industry's prices will have to take account of the fact that gas accounts for a large part (49% in 1983/4) of the cost structure and that the price which is paid for this will in the short term be determined by factors (eg. oil prices, exchange rates) entirely outside the company's control. By contrast, the remaining costs, ie. those for delivery of gas onshore, are directly within the company's control and recent BGC experience suggests that there remains considerable scope for real reductions through greater efficiency. This points to a system which allows gas prices to consumers to take account of the company's acquisition costs, but puts firm downward pressure on the onshore cost components which should reduce over time in real terms. The system would be analagous to the RPI - X system for control of BT's prices, but with the addition of a further element of cost (which could be made explicit on bills) representing the cost of gas. It would act as a direct spur to efficiency in control of onshore costs and should give incentives to keen purchasing through the public exposure of the gas purchase price element.

8 The details of the system and other controls such as on quality of service will need to be further elaborated. Details of the role of the regulator in implementing the system (eg. frequency of examination of industry, arrangements for determining the correctness of charges for gas costs) will need to be settled.

9 Extra provisions will also be needed to back up the non-discrimination duty (para 2 (iv)) in order to assure individual customers that they were not paying too much for their gas and hence subsidising others. The precise regime will need to be related to the details of the non-discrimination duty but might involve:-

(i) a reporting system which would show costs and profits by main markets on a predetermined accounting basis.

SECRET

(ii) some broad rules (eg. that all broad categories of sales should at least cover costs) to which the regulator could hold the company.

(iii) provision for the regulator to examine with the company complaints and report on them.

10 In order to carry out these and any other duties the regulator would need a range of powers:-

(i) to examine the industry's finances (ie. rights to examine the books similar to an auditor).

(ii) to rule on prices to be charged and then breakdown by market etc. for both gas and non-gas costs.

(iii) to examine accounting principles and practices used by the company.

(iv) to investigate complaints on discrimination

ANNEX 2

EMPLOYEE PARTICIPATION

I believe that we should illustrate that privatisation results in employees having a direct interest in the success of their firms, never known under nationalisation. It is for that reason that I would suggest that around 10% of the equity should be given to the management and the staff. I believe that half of this should be in the form of providing free shares, or matching offers, and the other half should be placed into a Trust Company in which the management and staff would be the sole shareholders and would appoint their own Board of Directors. This Trust Company should own 10% of the equity, 5% provided from the Government and the other 5% financed by appropriate gearing. Staff leaving the gas industry would be able to sell their shares on an agreed formula of the valuation, and staff joining the gas industry could use existing Government saving schemes to become shareholders in the Trust Fund

If the total value of the business were £6bn and the capital structure set up on a 50 : 50 debt/equity ratio, the value of the equity would be about £3bn. With about 100,000 employees this would mean free and matching shares of about £1,500 per employee, a further £1,500 per employee allocated to the trust company which would itself borrow a similar sum to buy shares. This should bring the total employee stake via both personal and trust company holdings in the main company to a maximum of £4,500 per employee or 15% of the total equity.

This benefit would work out at something similar to about six months' salary and would be of a magnitude that would make the employees enthusiastic about the prospects of privatisation. I believe that such enthusiasm would have a considerable impact upon the price realised from privatisation and would therefore, to some extent, be self-financing.

BRITISH GAS CORPORATION STATISTICS (1983/4 ACCOUNTS)

CURRENT COST FIGURES

	1983/4 £m
Profit	
Current cost profit before tax and interest	667.9
Taxation	(350.4)
Net interest receivable	99.4
Current cost profit after tax and interest	416.9
Assets	
Current cost fixed assets before depreciation	26136.6
Depreciation	(14260.5)
Net current assets	1333.9
Total current cost assets	13210.0

Activity Analysis	Turnover	Current Cost Profit	Net Fixed Assets
Gas supply*	5964.0	660.5	11843.7
Appliance marketing	229.1	4.7	27.9
Installation and contracting	229.3	2.7	4.5
Total	6422.4	667.9	11876.1

HISTORIC COST FIGURES

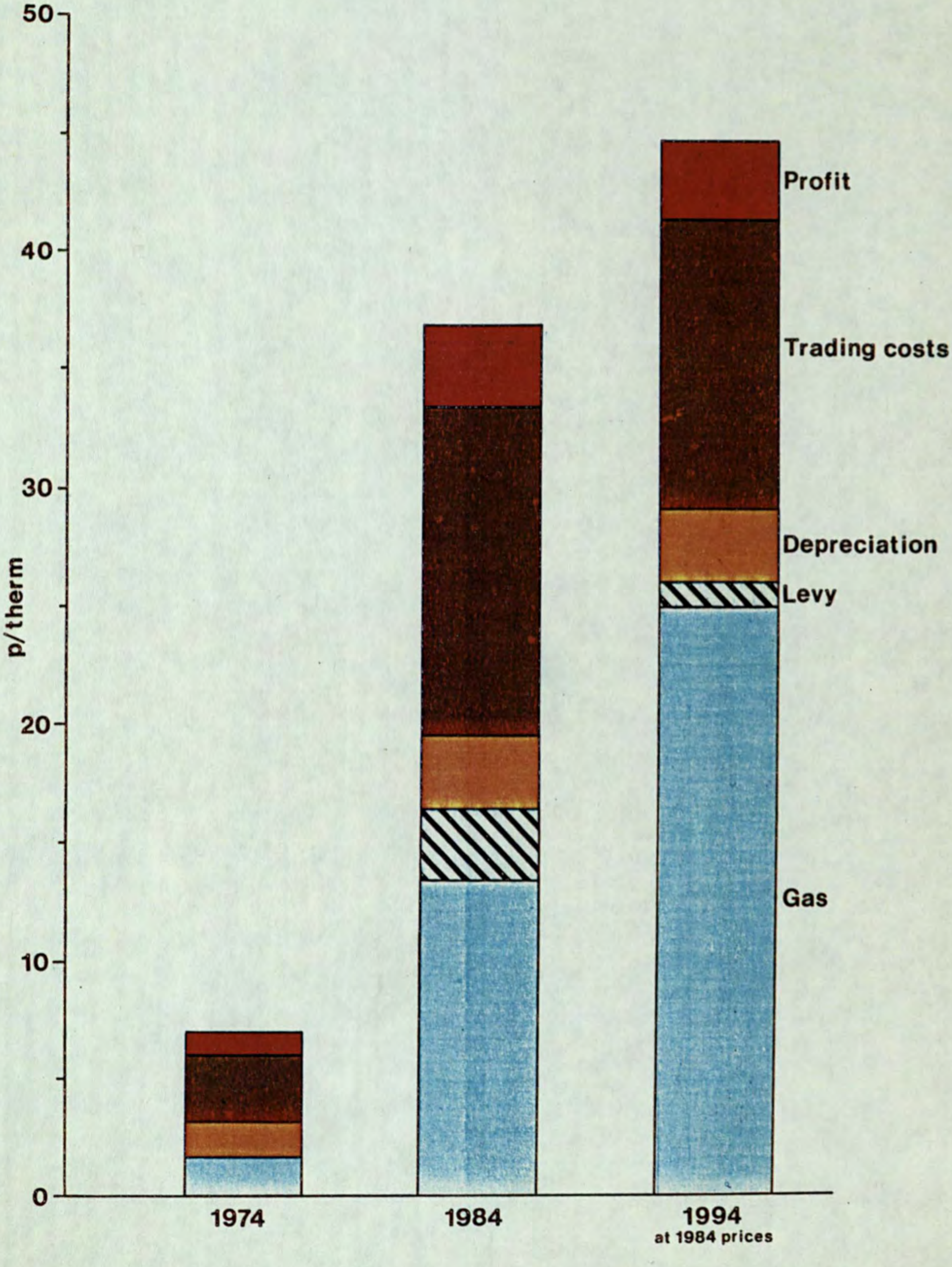
	£m
Net operating revenues	1244.8
Historic cost depreciation	228.1
Historic cost operating profit	1016.7
Average net assets employed at historic cost	4505.0

Other Statistics

Volume of gas sold (m therms)	17,281
Number of customers (m)	16,214
Average number of direct employees	99,200
Miles of mains in use	144,200
Number of appliances sold	1,323,000
Customer jobs completed	14,426,000

*Including miscellaneous other income

Figure 1 : Estimated cost breakdown for gas supply industry



ANNEX 5

TIMETABLE

1985

April	Announce Intention
May	Begin drafting Instructions to Counsel
December	Introduce in Parliament
	Second Reading debate

1986

January	Committee Stage begins
July/August	Royal Assent
Autumn	Earliest date for first tranche sale

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