10 DOWNING STREET

Prime Minister

I feel uneasy about the number and importance of the issues which have yet to be resolved.

The choice is between an early announcement which prevents leaks or a later announcement which runs the risk of leaks but puts the Government in a position to answer some of these major issues.

AT 24/4.

11

SECRET

P.01535

PRIME MINISTER

Privatisation of the Gas Industry
(E(A)(85) 24)

Flag A

BACKGROUND

The 1983 Manifesto promised "to seek ... means of increasing competition in, and attracting private capital into" the gas industry.

Proposals

2. The Secretary of State for Energy proposes, in E(A)(85) 24:

a. Flotation of the British Gas Corporation (BGC) as a Companies Act company largely in its present form, in Autumn 1986;

b. The creation of a new regulatory body to control gas prices and investigate complaints of discrimination against consumers. (Terms and conditions of supply and obligation to supply would be dealt with in the necessary legislation);

c. Price regulation on the basis of a formula (annual price rise = RPI (rate of inflation) - X (target reduction in onshore costs) + Y (increase in gas costs);

d. No regulation of BGC's other activites (appliance retailing, installation and servicing, offshore assets);

SECRET

e. Employee participation in the share issue;

f. An announcement this month, followed by legislation in 1985/86 session (Second Reading December, Royal Assent July/August 1986.)

MAIN ISSUES

3. If BGC is to be privatised, there are many important questions which will need to be resolved. Some of these are mentioned in paragraph 11 below, in order to aid assessment of the practicalities. The main issues which need to be addressed at this meeting are as follows:

i. The scope for privatising BGC.

ii. The form and timing of privatisation. //

iii. The need for and form of regulation. //

iv. Employee participation. //

v. How to accommodate the necessary legislation in the 1985/86 session.

Scope for privatisation

4. The British Telecom (BT) flotation has demonstrated that it is possible to float very large monopoly utilities successfully. There are however a number of differences between the BT and BGC situations. BT is operating in a growth market, with the added attraction of important high technology developments. BGC has limited growth prospects and will face increasing competition from

other energy sources as the cost of gas rises (recently at about double the rate of inflation.) It seems very unlikely that BGC can look forward to substantial increases in profitability through the application of new technology to the gas distribution business.

The Government should not be [illegible] present this privatisation as a repeat of BT. Exaggerated claims about competition will discredit the exercise

5. In the case of BT, there is a prospect of some competition. The economics of the gas industry mean that there is little or no prospect of competing suppliers emerging other than for very large industrial consumers (already allowed under the Oil and Gas Enterprise Act 1982; but so far not forthcoming.) Mr Walker suggests that BGC might be licensed to carry out gas supply, which would hold out the prospect of a later change of licensee. However the need to attract potential investors, and the nature of gas supply contracts with producers, which are usually for the life of the field (typically 15 years for significant fields) mean that any licence would have to run for a substantial term. Other suppliers might also be licensed, but would be unlikely to have anything other than a marginal presence in the market. Generally the advantages of gas privatisation would arise from wider share ownership and early Government capital receipts rather than from the effective application of market disciplines or the exploitation of new technological or market opportunities.

~~5~~6. There are a number of areas where the position of BGC as a nationalised industry allows the Government to intervene in the national interest. This is of course a double-edged sword, in that the Government is held responsible for BGC's actions. Privatisation would mean setting a clearer public limit to the Government's role; the precise nature of that limit will have an impact on the potential proceeds. Merchant banking advice will be needed, but examples of areas where the Government would probably have to step back are:

(a) Gas Imports. The Government decided that the purchase of Sleipner gas from Norway was not in the overall national interest, although BGC considered it to be clearly in their commercial interest. A future import deal could discourage development of the UKCS and lead to the loss, or at least lengthy postponement, of significant tax revenues.

(b) Pipeline routes. If the Sleipner deal had gone ahead, the Government would have wished to influence the pipeline route, in order to maximise tax revenues and to collect gas from other fields. Although the powers in the Petroleum to Submarine Pipelines Act would be available to promote the Government's objectives in such circumstances, there could be difficulty in using them where this could be shown to be clearly disadvantageous to BGC.

(c) Exports. A definite decision will be needed on whether or not to allow exports, and if so on what basis. Unless the form of the regulation is such as to make BGC completely indifferent to the price it pays for gas supplies (which could result in higher outflows of profits from the exploitation of the UKCS), there is likely to be strong pressure from UKCS licensees for the lifting of the landing requirement from new UKCS gas supplies, in order to limit the privatised BGC's ability to exercise monopoly power.

(d) Gas Levy. BGC earns significant windfall profits on old PRT-exempt contracts. The Gas Levy recoups some of the benefit (currently about £525 million a year) for the Exchequer, and will continue to do so until the fields in question become exhausted in the early 1990s. At present, the rate of Levy can be varied by Order. It will probably be necessary to fix the rate of the Levy prior to privatisation. Freezing the rate would accelerate the real reduction in Exchequer take as the fields tail off, and would leave the new company with access to significant economic rent. Prescribing an increasing rate of Levy would feed through to reduced profits (and reduced sale proceeds) or increased prices (which would increase the political difficulty of selling privatisation to consumers.)

(e) In recent years, the Government has put pressure on BGC to moderate price increases to industrial consumers (and has compensated it by reducing the Levy.) Mr Walker now proposes to prohibit the privatised BGC from discriminating against particular classes of consumer. This need not mean all consumers paying exactly the same, but it seems likely to preclude any new Government policy to favour commercial and industrial consumers. Meanwhile the restriction on BGC's commercial freedom resulting from the requirement of non-discrimination could tend to reduce the privatisation proceeds.

(f) The cost averaging element in the form of price regulation would have the effect of precluding a policy of marginal cost pricing (which would generally be expected to be the efficient approach in circumstances of rising gas supply prices). This effect could be partly overcome if there were a large increase in gas prices before privatisation (which would also have the effect of increasing the total proceeds).

(g) BGC's former oil interests have largely been disposed of, and BGC confined to gas exploration. A privatised BGC would probably need to be given freedom to retain and develop any future oil discoveries.

7. A completely arms-length relationship is probably impossible, given the safety implications. Mr Walker says that it is for consideration whether the Government would need to retain powers to step in if the company collapsed. If so, this need not mean assuming obligations to the shareholders, although the position on this will need to be made very clear, in order to avoid creating an implied guarantee.

Form and Timing of Privatisation

8. BGC's non-gas supply activities - appliance retailing (9,000 staff; turnover £219 million); installation, servicing and contracting (30,000 staff; turnover £278 million); and offshore assets - are not natural monopolies. They could in principle

be hived off and sold or floated separately. This would be likely to lead to greater competition than Mr Walker's proposal for separate accounting to prevent cross-subsidisation from the gas production and supply business (which accounts for 99% of BGC's profits.) However the physical (as opposed to paper/accounting) separation of these aspects of what is currently run as a highly integrated business would take a considerable amount of time and effort. More radical options, such as turning BGC into a pipeline authority and licensing a number of regional gas distribution companies, would be likely to be even more complex and time consuming. Mr Walker therefore argues that privatisation of BGC in its present form is the only possible option for action in this Parliament. It will also have the advantage of making the core business more attractive, by providing a base (after some pruning and re-organisation) for diversification, and the opportunity for unregulated profits (particularly offshore).

Regulation

9. Finding the right regulatory framework is the key to securing both a successful flotation and consumer acceptance. The arrangements have to provide reasonable assurance of the probability of profit to attract potential investors, whilst providing BGC's sixteen and a quarter million customers with sufficient confidence that they will not face sharp price rises as a result of privatisation. Mr Walker's suggested formula, which would be policed by a body similar to (or associated with) OFTEL, would allow prices to rise by the rate of inflation minus a target for reduction of controllable onshore costs (which account for only about a third of total costs), but plus rises in gas costs (which are linked to oil prices and currency movements, and are largely outside BGC's control.) The apparent simplicity of such a system is attractive, but much would depend on the effectiveness of the arrangements for ring-fencing gas supply and on the toughness of the onshore cost control target.

Employee Participation

10. Mr Walker believes that employee participation would aid the flotation by reducing employee resistance, and would improve post-privatisation performance. No details are given; concessionary purchase might reduce the potential sale proceeds. (In previous informal discussions Mr Walker has suggested that the path to a successful privatisation could be made easier by conceding to BGC's employees a stake in the company several times larger than that provided in other major privatisations.)

Other Issues

11. A number of important issues will need to be resolved before the legislation can be finalised. Among those likely to need collective consideration are:

(a) The import/export regime (see paragraph 6 above).

(b) The future of the Gas Levy (see paragraph 6 above).

(c) Pipeline Regulation (see paragraph 6 above).

(d) The licensing regime (Who issues? Other licensees? What happens if BGC fails?).

(e) New safety arrangements. (Mr Walker suggests that the Health and Safety Executive (HSE) take over BGC's present role.)

(f) The future of the Consumer Councils (to be absorbed within the new regulatory body?)

(g) A separate regulatory body, or combined with OFTEL?

(h) Whether to prevent foreign takeover.

E(A)(85)24 makes no proposals for handling these issues (except (e) above).

12. Prior to flotation, Ministers will need to decide:

a. The details of price regulation.

b. Details of the licence.

c. Whether to float 100% of the new company. (It is not clear in E(A)(85)24 whether Mr Walker proposes this. Can the market absorb £5-7 billion in 1986-87?)

d. The balance sheet structure (as between debt and equity).

e. Details of employee participation.

Legislative Timetable

13. The necessary legislation will be complex and controversial. It cannot be accommodated within the present legislative programme without dropping at least one other major bill. The most obvious candidate is the Nationalised Industry Bill, which would also be controversial, on which major policy issues have yet to be settled, and which some Ministers oppose. The NI Bill is to be discussed at the E(NI) meeting immediately following the E(A) discussion.

14. Mr Walker proposes to make an announcement before the end of the month, presumably to pre-empt any leaks. Ministers may wish to consider whether such an announcement should be postponed until more of the detailed issues have been resolved.

HANDLING

15. As discussed above, a large number of difficult issues will need to be settled if BGC is to be privatised in this Parliament. Although not all of these questions have to be resolved immediately, the more of them the Government are able to answer, the greater the conviction the privatisation proposals will carry. It will probably be convenient to address first the general principle of whether BGC should be privatised in its present form, and the practicability of doing so, before moving on to discuss some of the main detailed questions and to consider whether the way ahead is clear enough for the Government to undertake a public commitment to privatisation.

16. You will wish the Secretary of State for Energy to introduce his paper. Thereafter the Chancellor of the Exchequer might be asked to respond. All Ministers present are likely to wish to comment. In particular the Secretary of State for Trade and Industry will wish to probe the implications for domestic and industrial gas prices and the gas appliance manufacturing industry; the Secretary of State for Employment the implications of the new safety regime for the HSE; the Foreign Secretary the effect on relations with gas suppliers, principally Norway, but potentially also the Netherlands, the USSR and Middle Eastern countries. The Lord Privy Seal and the Lord President can advise on the Parliamentary prospects, particularly timing. The Attorney General can advise on any legal aspects, eg. in relation to a potential export regime.

CONCLUSIONS

17. You will wish the Sub-Committee to reach conclusions on the following:

(i) whether to privatise BGC in the present Parliament;

(ii) if so, whether this should be either:

(a) broadly along the lines and in the timescale proposed in E(A)(85)24; or

(b) on some other basis.

(iii) what, if any, guidance to give on:

(a) the form of regulation;

(b) BGC's non-gas supply activities;

(c) employee participation;

(d) further collective consideration of the various matters needing to be resolved;

(iv) how to accommodate the necessary legislation in the 1985/86 Session;

(v) the timing of any announcements.

PLG

P L GREGSON
Cabinet Office.
24 April 1985