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PRIME MINISTER

7 June 1985

BRITISH GAS PRIVATISATION

The gas privatisation exercise has got off to a smooth start. The Department of Energy team has a good grasp of the complex task facing them and the main issues to be resolved.

The proposals submitted to E(A) are largely uncontentious.

The nature of the regulatory régime is of crucial importance. Now you are being asked only to reject an approach to regulation based on profit control. US experience provides an overwhelming case against a regulated rate of return on the capital asset base of utilities like gas. Far from such utilities having the incentive to construct and utilise capital assets well, this system encourages them to waste money on any half-justifiable capital project simply to increase the asset base, and then to put the prices up - a real licence to waste and print money. We favour a tough, price-related commercial discipline and accept that this will mean foregoing some revenue from privatisation: it is better to give customers a good deal, especially as we are not splitting BGC up and are vulnerable to criticism of monopoly power.

By the same token, we fully support the measures to foster a degree of competition at the fringes of BGC's gas

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markets. The decision to enable other private sector companies to become licensed public suppliers, with the same rights and obligations as British Gas, in areas not already covered by British Gas, is significant. It could provide a useful fillip to small-scale gas exploration on land. Plenty of rural households have no access to supplies from British Gas. We could also use the legislation to enhance the thrust of the Oil and Gas Enterprise Act, for example, by requiring British Gas to publish details of the tariff structure for third-party access to their onshore gas transmission network.

Peter Walker takes it for granted that the Gas Levy will be carried over to the new company, and that it will remain at its current level. It makes sense to keep the Levy in reserve as a means of adjusting to future oil price shocks - up or down.

The question of whether or not to liberalise gas imports and exports awaits the outcome of consultations between Energy and the Treasury. This will be a key issue to be settled later.

The scope of that part of the legislation defining the obligations which a privatised British Gas will inherit is uncontroversial. The UK gas industry has developed over many years, largely in the private sector, and the ground rules are well proven.

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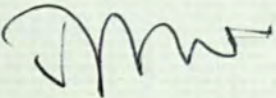
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You could point out that the list of other issues at the end of the paper makes no reference to limiting the scope of British Gas' activities after privatisation. By all means, let the upstream sector expand into oil and, if commercially attractive, venture overseas. At the retailing end of the business, British Gas should be free to maximise the return from their valuable High Street properties. However, there will be worries about British Gas using its financial strength to reduce competition, for example, by moving aggressively into the manufacture of gas appliances. The Government may need to draw attention to the general safeguards on competition and monopoly power. The converse worry is that British Gas will use its considerable resources and some of its management effort to move into areas unrelated to the gas business. This may be a matter for the articles of association.

Conclusion

We are off to a good start. Much of the legislation should be uncontentious, albeit cumbersome. The regulatory régime is crucial, but the key decisions will not be ready for reference to E(A) until the late Summer or early Autumn.


JOHN WYBREW

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