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SECRET

Reference No E055

PRIME MINISTER

Gas Industry Privatisation Regulation

FLAG A

(E(A)(85)30)

BACKGROUND

FLAG B

Following discussion in E(A) on 25 April (E(A)(85)9th Meeting, Item 2), the Cabinet on 2 May invited the Secretary of State for Energy to submit a further paper to E(A) on the major aspects of gas industry privatisation, including:

(a) the form of regulation;

(b) the continuing obligations and responsibilities of the privatised gas industry; and

(c) the treatment of gas imports and exports.

2. The Secretary of State for Energy's paper (E(A)(85)30) is the result. It deals with (a) and (b) and promises recommendations on (c), which Mr Walker is discussing with Treasury.

Proposals

3. Mr Walker's paper proposes:

(a) regulation through a regulatory body (OFGAS) on gas supply (ie transmission and distribution of gas) where BGC has a monopoly, and not on those areas (production and exploration, gas purchasing, gas appliance retailing, installation and servicing of appliances) where BGC does not;

(b) a ring-fence around the main gas supply business to exclude cross-subsidy to other activities;

(c) that BGC's prices be regulated using a version of RPI (rate of inflation) - X (target reduction in onshore costs) + Y (increase in gas costs) rather than profit control;

(d) obligations the new company will have to fulfil - essentially BGC's present obligations in respect of gas supply, pipelaying, disconnections, free emergency services, and carriage of third party gas;

(e) to enable others to become licensed gas suppliers with the same rights and obligations in areas not already covered by the company.

MAIN ISSUES

4. The main issues with which Mr Walker's paper deals are:

(a) the regulatory regime;

(b) the legal obligations the new company will have to meet.

Regulatory Regime

5. The regulatory regime should offer potential investors a reasonable prospect of profits and give BGC's 16¼ million customers enough confidence that privatisation will not mean sharp price increases.

6. Mr Walker proposes that OFGAS should police the gas supply functions of the new company where the new company will have a monopoly; but not those other areas where it will not (but where the new company will be subject to the usual controls of the MMC and the Office of Fair Trading). These other areas are appliance retailing (9,000 staff; turnover £219 million); installation, servicing and contracts (30,000 staff; turnover £278 million); and offshore assets. The new company would presumably decide on the development of those other areas in the light of its own commercial judgement. (If privatised,

BGC might, for instance, decide to retain and develop any future oil discoveries, or even seek to recover former BGC oil assets (Wytch Farm, Enterprise Oil) already disposed of, although this latter is a theoretical rather than real possibility).

7. Mr Walker's proposed price regulation formula is fairly simple and similar to OFTEL's. It is RPI (rate of inflation) - X (target reduction in onshore costs) + Y (increases in gas costs) (on the grounds that Y is beyond the short term control of the industry). Mr Walker believes regulation via profit control would be too interventionist, a disincentive to efficiency and a deterrent to potential investors.

8. Because marginal supplies of gas cost more than the average, this form of price regulation will have an impact on BGC different from its impact on BT (which faces marginal costs in undertaking new business which are generally below the average). Because of this, BGC will not have the same scope for increasing profits by increasing its business volume that BT enjoys. In terms of economic theory, price control by reference to average costs may even result in reductions in profitability as business expands, since BGC will not be able to load its higher marginal gas costs on to new customers. The result could be a situation in which gas prices were below those of competing fuels, despite the fact that additions to the supply of these fuels were cheaper than additions to the supply of gas. If such a situation were to arise, there could be net overall losses to the UK economy, as well as a fall in the relative profitability of BGC. This form of price regulation also has the effect of removing any scope for price discrimination between different classes of customers. At present BGC, unlike the suppliers of electricity, has no obligation to avoid such discrimination, and as a result has been able to structure its prices to certain very large users, whose energy costs represent a particularly high proportion of total costs, so as to help them to remain internationally competitive. Finally, a form of price control which simply allows BGC to pass its gas purchase costs on to the consumer could have the effect of making the Corporation

This is the position at present.

relatively indifferent to the level of those costs, since its profits would be little affected by its success or otherwise in securing new supplies of gas at keen prices.

9. It may well be in practice that substantial problems will not arise in these areas. Undoubtedly a cost reduction objective (as is implied by 'X') is preferable to profit control; and X can only be specified in the light of a detailed analysis of the shape of the business. But it would seem desirable to have some analysis of the impact of the proposed form of price regulation on the shape and profitability of the business before Ministers commit themselves fully to Mr Walker's proposed form of price regulation. We understand that the Department of Energy are working on a paper which would meet this remit, which they hope to have ready before the Summer Recess.

Legal Obligations

10. The fewer, and the less onerous, the obligations of the new company, the more attractive it will be to prospective investors. But removal of obligations would be likely to attract public criticism. The legal obligations Mr Walker proposes for the new company are set out in paragraph 9 of his paper. Essentially they are the same obligations (as regards the gas supply system, free emergency service, rules on disconnections, laying of pipes) which BGC has under the Gas Act or existing voluntary codes. Mr Walker also proposes that the legislation should enable others to become licensed public gas suppliers with the same rights and obligations in areas not already covered by the new company. (Other suppliers are, in fact, unlikely to play more than a marginal role in the market).

FURTHER WORK

11. Mr Walker recognises that further work is needed on several other important issues before decisions can be taken. These are:

(a) should price regulation apply to all BGC's gas sales;

(b) how the Gas Levy should be transferred to the new company;

(c) relationship between OFGAS and OFTEL;

(d) role of the Consumer Councils;

(e) gas imports and exports;

(f) the role of HSE in safety aspects under the new regime;

(g) transfer of pension funds from BGC to the new company.

12. These raise the following issues:

(a) Price Regulation
Should all BGC's gas sales be subject to price regulation? Mr Walker's paper suggests that some categories like interruptible gas supplies to industry could be exempted because of the option of alternative supplies. By contrast, Annex I of Mr Walker's earlier paper (E(A)(85)24) assumed (paragraph 6) that all BGC's gas sales should be regulated. In practice, given BGC's continuing obligations to supply, and the nature of the price control proposed for the generality of consumers, it would not undermine the overall approach to exempt certain supplies from the price control and could help to overcome some of the potential difficulties noted in paragraphs 8-9 above.

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(b) Gas Levy
BGC receive significant windfall profits on old PRT-exempt contracts. The Gas Levy recoups some of these (currently 4p a therm bringing in about £525 million a year) for the Exchequer, and will do so until the fields concerned become exhausted in the early 1990s. At present, the rate can be varied by Order. Appropriate measures will need to be taken to carry over the Gas Levy into the new company. Freezing the rate would accelerate the real reduction in Exchequer take as the fields

tail off, and would give the new company significant economic rent. Increasing the rate would reduce the new company's profits (and reduce sale proceeds) or, alternatively, lead to increased gas prices (inviting criticism that privatisation means higher gas prices). Mr Walker believes the level of the Gas Levy can only be determined nearer the time of sale, but feels it would almost certainly have to be at its current level. It would be useful to have in due course some ball-park numbers illustrating what is at stake on this issue.

(c) Relations between OFGAS and OFTEL

Mr Walker has asked officials to explore how OFGAS and OFTEL might pool experience.

(d) Role of the Gas Consumer Councils

Mr Walker doubts whether existing Gas Consumer Councils would fit in with the new regulatory body. OFGAS might wish to establish independent machinery to handle consumer complaints, or the industry itself might do so. Unless something is arranged, consumer lobbies will be critical. Mr Walker does not say which solution he prefers, although he recognises something will have to be done.

(e) Import/Export of Gas

Mr Walker merely indicates in this paper that he is consulting the Treasury about this issue; the Foreign and Commonwealth Secretary has asked that his Department be included in the discussions. There has been some study of the possibility of a controlled export regime for UKCS gas, but it seems unlikely that this would prove compatible with the Treaty of Rome; control over imports has hitherto been achieved by means of informal pressure on BGC (notably in the case of the proposed purchase of Sleipner gas). As Mr Walker notes, the existing power to control the installation of submarine pipelines will remain, and this will give the Government some leverage against future proposals for gas imports; but it seems unlikely that this power could serve for an extended period to prevent a privatised BGC from importing a stream of non-UK gas, and there would be a high risk of challenge in the European Court if the Government sought in this way to block gas imports.

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These considerations suggest that it would not be appropriate for the new legislation to include any specific provisions on gas imports and exports. But the Government's decisions on this point will be of great importance in determining the acceptability of privatisation to the consumer and to UKCS licensees, in assuring the success (or otherwise) of the privatised company, and in influencing future UKCS activity and tax revenues therefrom. Although BGC's legal monopsony was broken by the Oil and Gas Enterprise Act 1982, their de facto monopsony remains in force; if BGC were allowed to import gas without hindrance, this could greatly strengthen their hand in negotiating with developers of new UKCS gas reserves. This would be advantageous to the consumer but damaging to UKCS activity and tax revenues. Equally if imports were prevented, UKCS licensees would be in a much stronger position in negotiation with BGC, to the disadvantage of the consumer and the benefit of the Exchequer. In practice the only course may prove to be to permit both imports and exports.

This issue will be very important to the success of privatisation, but neither Mr Walker nor Mr Lawson apparently wishes to press it to a conclusion in the near future. No early statement is likely to be needed from the Government about it,* although more considered views will be needed in time for the second reading of the Bill. It may be sufficient, therefore, to invite Mr Walker to put a paper to the Sub-Committee on this point in October.

(f) Safety

Department of Energy officials are discussing with HSE how safety should be handled under the new arrangements (including making Corgi - the Confederation of Registered Gas Installers - currently largely run and funded by BGC, autonomous under the HSE).

*but an FT editorial on 10 June suggests it as a topic for study by the House of Commons Select Committee on Energy.

(g) Transfer of Pension Funds

These will be taken over by the new company. Department of Energy officials are discussing with BGC.

OTHER ISSUES

13. Nearer the time of flotation decisions will need to be taken on:

(a) Employee Participation

Mr Walker is keen on this to get the support of employees for the new company and to provide protection against unwelcome takeover. In E(A)(85)24 he undertook to consult Treasury Ministers and other colleagues, but his latest paper does not report progress. If employees were given the opportunity to purchase a substantial part of BGC's equity at concessionary prices, the proceeds from the privatisation could be considerably reduced;

(b) the capital structure of the company (proportion of debt and equity) to be settled after a full financial assessment;

(c) should 100 per cent of the company be floated to reduce the risks of renationalisation;

(d) the golden share to prevent unwelcome foreign takeover;

(e) Mr Walker is also considering possible additions to strengthen the BGC Board.

TIMING

14. The timetable to which Mr Walker will need to work to prepare the necessary legislation is a tight one.

15. The Department of Energy hopes to get instructions to Parliamentary Counsel within the next few weeks. These instructions will need to cover the general regulatory framework proposed and probably the treatment of Consumer Councils.

They expect to have a paper summarising the shape and content of the Bill ready to put to the Sub-Committee in mid-July. Decisions on other issues (details of the price formula of the licence, the level of the Gas Levy, transfer of pension funds for instance), which do not affect the terms of the primary legislation, can be taken later in the year.

HANDLING

16. You will wish to invite the Secretary of State for Energy to introduce his paper. The Chancellor of the Exchequer might be asked to respond. The Secretary of State for Trade and Industry may wish to comment on the proposed regulatory regime and the treatment of Consumer Councils in the light of OFTEL, on any implications for gas prices, and on the interests of the gas appliance industry. The Secretary of State for Employment may have views on the safety regime and the role of the HSE.

17. You will wish to ask the Secretary of State for Energy how he proposes to handle the outstanding issues (see paragraph 12 above), and in what timescale. The timetable for decisions on these specific issues will vary, but you will wish to invite him to put papers to the Sub-Committee before the Summer Recess:

(i) summarising the shape and content of the Bill, and

(ii) setting out in detail the nature, form and coverage of the proposed price regulation, and analysing its impact on BGC's business.

He might be asked to put a further paper to the Sub-Committee in October on the question of imports and exports of gas.

CONCLUSIONS

18. You will wish the Sub-Committee to reach preliminary views on the following:

(a) the form of regulatory regime the Secretary of State proposes, particularly

(i) its scope - restricted to gas supply, and

(ii) the general price formula proposed;

(b) the obligations proposed for the new company;

(c) the further issues to be referred to the Sub-Committee, and the timetable for this (see paragraph 17 above).

JW

A J WIGGINS
Cabinet Office.
10 June, 1985.