PRIME MINISTER 29 July 1985

GAS PRIVATISATION

In 1982 when he was Secretary of State for Energy, Nigel Lawson saw the Government's task as 'setting a framework which will ensure that the market operates in the energy sector with a minimum of distortion and that energy is produced and consumed efficiently'.

That is still a good touchstone with which to test Peter Walker's proposals for regulating a privatised BGC. Having decided to leave BGC as an integrated whole, it is important that wherever possible we should establish points of contact between BGC's monopoly gas supply activity and external market forces.

Judged by this standard, we are still satisfactorily on course, although it is a pity that the question of liberalising gas imports and exports has been left until later.

1. Ring Fence: Yes; it is essential that the monopoly gas supply component of BGC's business (currently 90% of total revenue) is ring fenced, so that its financial and operational performance is wholly transparent.

2. Competition from other gas suppliers: It is a nice idea to permit other companies to become public gas suppliers in areas where BGC has not laid supply pipes. This could be a welcome stimulus to exploration for small onshore gas deposits aimed at developing new gas markets in those rural areas not currently served by BGC. This would provide peripheral competition for BGC.

3. Competition from other gas producers: Peter Walker wants to keeps a competitive curb on BGC in the industrial sector by

making it easier for other private-sector gas producers to supply industrial customers through BGC's transmission network, under the common carriage provisions of the Oil and Gas (Enterprise) Act.

The measures Peter Walker plans could help those onshore producers who have already developed a separate local market as public gas suppliers and want to make inroads into BGC's industrial business. However, even if BGC are required to provide back-up supply cover, direct competition from offshore gas producers is unlikely to become a significant feature of the market. The snag is that offshore gas producers will not want to develop a new field until they have a firm supply contract. On the other hand, most industrial customers are unlikely to be interested in committing, say, five years ahead to a dedicated gas supply contract. They prefer greater flexibility.

4. The tariff market - (RPI - X+Y): This is the British Telecom model for inducing efficiency by setting a challenging price target. A special feature in the case of gas is the 'Y' component, ie the facility to pass directly through to consumers the increasing real terms cost of gas supplies.

Previously we have baulked at letting BGC simply pass what will become an increasingly large proportion of their costs directly to customers. The problem is that not to do so would seriously expose BGC's cash flow to the vagaries of exchange rate and oil price fluctuations. (For consumers there should be some comfort in the fact that BGC will be under pressure to contain gas supply costs in order to compete in the deregulated industrial market - see below). Otherwise, the Department of Energy appear to be alert to the practical problems of defining and setting X and Y.

5. The industrial contract market: Large commercial and industrial customers supplied not under a fixed tariff but

individually-negotiated contracts account for 30% of BGC's total revenue.

Peter Walker proposes effectively to deregulate this market, subject to a degree of protection for those customers who are inflexibly committed to gas, and are therefore vulnerable to BGC exploiting its monopoly position. He will argue that deregulation in this area will make British Gas shares more attractive to investors. The Treasury are fearful that BGC will thereby escape a rigorous commercial discipline.

In our view, this sector of the market could become a real battleground for inter-fuel competition between gas, electricity and oil. More than any other feature of the regulatory regime it should bring external market forces into play. To enhance that competition we would propose removing the provision whereby the Electricity Supply Industry is not allowed to discriminate between customers and conclude individual supply contracts with major industrial consumers. We would also complement inter-fuel competition in the industrial market by making BGC compete with European gas consumers - albeit more in theory than practice over the next decade - for UKCS gas supplies.

6. The Bill: Looks satisfactory.

Conclusion

So far so good, but liberalised gas imports and exports will be the real acid test of our resolve to bring external market forces into play.

JMW

JOHN WYBREW