P 01789

CONFIDENTIAL

PRIME MINISTER

Gas Industry Privatisation

FLAG A (E(A)(85)65)

BACKGROUND

FLAG B

At its meeting on 31 July (E(A)(85)17th Meeting, Item 1), the Sub-Committee broadly endorsed the legislative provisions and price control arrangements proposed by the Secretary of State for Energy in the context of the privatisation of the British Gas Corporation (BGC). Mr Walker was asked to report back to the Sub-Committee on a number of matters:

(a) the treatment of prices charged to larger industrial consumers, which are negotiated between BGC and the customer and have not hitherto been subject to a published tariff;

(b) the treatment of BGC's purchases of gas, where the possible need for any public supervision could be affected by

(c) future arrangements for imports and exports of gas;

(d) the transparency of the separation of BGC's post-privatisation business into three main elements (exploration and production, distribution and supply of gas to industrial and domestic consumers, and appliance retailing and servicing).

2. Mr Walker's further paper (E(A)(85)65) responds to these remits, except for (c) on which he promises a further paper before the Bill reaches the stage of Second Reading (scheduled to take place before the Christmas Recess). Mr Walker also seeks final policy endorsement for the contents of the Bill, and of the licence which will lay down the detailed price and other provisions governing the operations of the new company. (The Bill

He told you that he will leave back benches to move an amendment to bring in greater transparency is summarised in Annex 1, price provisions in Annex 2, and other conditions under which BGC will operate in Annex 3). Finally his paper contains material about the progress of work towards the offer for sale, in the light of the economic prospects for the business. No specific decisions are required on these aspects on this occasion, although Ministers will need to take note of BGC's intention to increase prices to tariff customers by about 4 per cent next April.

MAIN ISSUES

3. The main issues are

(a) arrangements for the supervision of prices charged to consumers, and in particular the treatment of larger industrial consumers;

(b) the transparency of future accounting arrangements for the different parts of BGC's business;

(c) the treatment of gas producers (i.e. including the question of supervision of BGC as a purchaser of gas and the proprietor of the distribution network).

Price Regulatory Regime

(i) Tariff consumers

4. Mr Walker proposes no essential changes from the arrangements previously put forward in E(A)(85)52, which would provide for regulation of prices charged to domestic and other consumers using less than 25,000 therms a year by means of a Telecom-type formula RPI -x (a requirement to achieve efficiency savings on distribution costs which are under BGC's control) +y (changes in the costs of gas which are not under BGC's control. Prices would be set in relation to forecast costs, with provision for subsequent adjustments if exchange rate changes (which impact directly on gas costs specified in some contracts in US dollars) or other factors produce a different outcome. It appears that these arrangements are acceptable to all the Ministers concerned.

Preliter methods pricing.

(ii) Contract consumers

5. Mr Walker proposes that price regulation should not extend to contract consumers. Instead BGC should give an undertaking limiting rate of price increase for an initial 3 year period; thereafter they would publish schedule (maximum) prices against which rebates would be negotiated, and would be bound by broadly drawn assurances about equitable treatment of customers. Extension of price control into the contract area would only come about if the Director-General of Fair Trading or the Secretary of State initiated a reference to the Monopolies and Mergers Commission and the Commission then recommended a change in the terms of the licence. (In this respect Mr Walker appears to be proposing a looser form of regulation than he put forward in paragraph 13 of E(A)(85)52, when he apparently contemplated allowing the initiative to rest with the Director-General of Gas Supply (DGGS).)

E-exports

?, Ofgas initiate action.

6. Mr Walker's arguments are

(i) there is effective competition in the industrial market from fuel oil, gas oil and coal. BGC have more gas available than they can sell at current prices;

(ii) on the basis of soundings with the CBI, etc there is no demand from consumers for price regulation as in the tariff area - they would rather be free to negotiate with BGC;

(iii) the Director-General of Gas Supply would have a vested interest in extending the coverage of his price regulatory powers, and would be bound therefore to propose this if the initiative were left with him;

(iv) BGC would strongly oppose any interference with their commercial freedom in this area, which has hitherto been left entirely to their discretion by the Government. This would prejudice their support for privatisation, which is essential for the success of the Government's policy;

(v) there would be serious adverse consequences for BGC's prospects for profit growth and business development, which would greatly reduce the potential proceeds from privatisation.

7. DTI and Treasury officials are apparently worried that BGC would thereby be seen to be subject to less stringent regulation than British Telecom, and that this would damage the reputation of privatisation in the eyes of consumers. They point out that there is substantial headroom within the present price of gasoil for increases in the price of 'firm' (i.e. non-interruptible) gas, and claim that the CBI's attitude is more equivocal than Mr Walker suggests. They would like to see at least

(i) a power of initiative resting with the DGGS to press for an extension of the coverage of price control;

(ii) a right in the licence for all industrial consumers to buy gas at the schedule prices;

(iii) safeguards in the licence against unreasonable price discrimination between different consumers;

(iv) the publication of separate accounts for the tariff and contract sectors of the distribution business (see paragraph 9 below).

8. A delicate political balance has to be struck between the need to assume adequate protection for consumers and the need to structure the privatised business in a way which is attractive to investors. BGC does not have prospects for volume growth and lower unit costs comparable with Telecom, and any substantial extension of price regulation into the 50 per cent of the distribution business where there is scope for entrepreneurial decision-making will undoubtedly much reduce its attraction to investors. On the other hand there may be some scope for small adjustments in the arrangements proposed by Mr Walker either by some general safeguards being inserted into the licence or through giving DGGS some role to initiate action.

Cost allocation

Mr Walker told you that he will leave backbenchers to move an amendment designed to produce greater transparency, E(A) should not be told this. DRN 13/11

Transparency of accounting arrangements

9. Ministers were concerned at E(A) in July that BGC might unfairly draw profits from their main distribution business to subsidise their appliance retailing and servicing business. Mr Walker now undertakes that the publication of separate accounts for the distribution business will be required under the terms of the licence, and that a convention will be established providing for separate publication of accounts for exploration and production and for retailing and servicing. Given the limited prospects for growth in the main distribution business, it would be unreasonable to prevent BGC from investing its profits upstream and downstream of that business. As to gas distribution, it is not clear that separate accounts for the tariff and contract sectors would achieve much; the allocation of the joint costs of the distribution system can only be done on the basis of assumptions, and in the end it is likely that this will have to be based simply on the volume of gas sold to each type of customer. In setting prices at the outset an allocation will have to be made and explained to the DGGS; thereafter BGC would not be free to change that allocation without his agreement. Under Mr Walker's proposals the baseline would be set before the DGGS was in operation; it might be prudent to agree that he should at any rate be consulted at the initial stage. As to a mandatory requirement for separate accounts for the upstream and downstream business, Mr Walker is likely to argue that this would be an unreasonable discrimination against BGC, who would thereby be placed under constraints more onerous than their competitors in these fields. In practice achieving the objective by convention should be sufficient.

Treatment of Gas Producers

10. There has been concern that a privatised BGC would be seen as in an unfairly strong position as a de facto (though no longer de jure) monopsony purchaser of UKCS gas, and that gas producers might need some regulatory protection to redress the balance. In practice, however, gas is increasingly becoming an internationally traded commodity, and there would be a serious risk that the

effect of controlling UKCS producer prices would be to choke off exploration and production. Another possible approach would be to allow exports of UKCS gas, which have so far been precluded by enforcement of the statutory requirement for UKCS gas to be landed in the UK. Separate consideration is promised of this question; not least because of EC difficulties it does not appear to be practicable or desirable to cover it in the Bill, although Ministers will need to know how to approach it by the time of Second Reading. (It appears that Mr Walker wishes to avoid committing himself either to permitting BGC to import gas or UKCS producers to export it; but both will know that failure to reach a reasonable compromise on the price of UKCS supplies to BGC risks precipitating EC litigation by one side or another which they would both prefer to avoid.)

11. The approach now proposed by Mr Walker is to strengthen the rights of UKCS producers to transport their gas to their own customers using BGC's distribution system as the common carrier. BGC would be obliged to publish specimen prices for the transport of gas (which they have hitherto avoided doing), would undertake to make back-up supplies available on normal commercial terms if the supply from a field directly sold to an industrial purchaser were interrupted, and would undertake to buy residual quantities of gas from fields most of whose output was directly sold to customers using the common carriage facility. The DGGS would be arbitrator of prices for common carriage and back-up supplies in the event of a dispute; further consideration needs to be given to how a dispute would be resolved on the price to be paid for residual portions of directly sold fields, given that this is an area from which the DGGS is in general to be excluded.

12. Although it remains unlikely that any actual use will be made of the common carrier facilities, the new proposals represent a significant advance on present arrangements and a substantial concession by BGC towards a more equitable structure within which to negotiate prices with UKCS gas producers. It does not appear likely that any Minister will argue against Mr Walker's recommendations. A particular side issue of which the Solicitor-General

will be aware is the need for a special legislative provision to make enforceable BGC's existing UKCS gas purchase contracts; there is no need to discuss this.

Other matters

(i) Offer for Sale

13. Mr Walker notes that the flotation could raise between £6-8 billion, with a combination of equity and new debt (£2.5 billion). BGC appear on course for a 1985/86 pre-tax profit nearly 10 per cent up on 1984/85; and the BGC Board should be able to make a prospectus forecast for 1986/87 some 10 per cent up on 1985/86. There are uncertainties here - the oil price and the exchange rate - and Mr Walker is considering with Treasury the scope for using the forward and options markets to reduce their impact. These calculations assume the continuation of the Gas Levy and a 4 per cent gas tariff increase in April 1986.

(ii) Overseas Sales of BGC Shares

14. Mr Walker proposes preparatory work for possible sales in the USA, Japan, Canada, and Europe. Rothschilds, the Department's merchant bank advisers, believe this would be prudent; the Treasury are in agreement.

(iii) Special Share

15. Mr Walker proposes a limitation on the shareholding permitted to any one party or group with the Government retaining a 'golden' share to ensure that the limitation remains. This would be in line with previous privatisations, including Britoil, Enterprise Oil and British Telecom.

(iv) Employee Participation

16. Mr Walker proposes 'to do more' on employee participation than in previous privatisations, eg an incentive for pensioners of the gas industry. He believes this is necessary to counter a major TUC campaign against gas privatisation and union opposition from NALGO. Specific proposals have not yet been agreed with the Treasury. You may wish to draw him out on this.

Reg. regime. ? what has become of OFGAS

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(v) Gas Users' Council

17. Mr Walker proposes that the Secretary of State (for Trade and Industry) be required to appoint a Gas Users' Council to investigate complaints from tariff and industrial consumers. This Council would replace the present network of Regional Gas Consumer Councils under the umbrella of a National Council. In the case of Telecom the comparable consumer body is within OFTEL, but it does not appear that the Secretary of State for Trade and Industry will be arguing for a similar arrangement on gas.

HANDLING

18. You will wish the Secretary of State for Energy to introduce his paper. Thereafter it may be helpful to divide the discussion into three parts:

Separate accounting for contract & tariff markets

No x-subsid. Code of Practice

(i) coverage of consumer price regulation, including treatment of contract consumers, extent of role of DGGS and extent of requirements to produce separate accounts for different parts of BGC's business;

(ii) treatment of BGC's gas purchases, and the proposals on the common carrier arrangements;

(iii) other issues.

The Financial Secretary, Treasury and the Secretary of State for Trade and Industry will wish to speak on (i) and (ii). The Lord President of the Council, the Lord Privy Seal and the Chancellor of the Duchy of Lancaster will have views on the political and Parliamentary aspects.

CONCLUSIONS

19. You will wish the Sub-Committee to reach conclusions on

(a) the acceptability of the regime of price regulation, including

(i) the treatment of contract customers,

(ii) the role of the DGGS, and

(iii) the accounting arrangements to ensure adequate transparency for BGC's different activities;

(b) the treatment of gas purchase contracts, and the proposed changes in common carrier arrangements;

(c) in the light of (a) and (b), final endorsement for the content of the legislation and the terms of the licence;

(d) the establishment of the Gas Users' Council; and

(e) (on a provisional basis) arrangements for the offer for sale.

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J B UNWIN
Cabinet Office
13 November, 1985