

PRIME MINISTER

I think it would be best to have a quick word with Peter Walker - without involving the letter not

B.G.C.

The report of Sir Eric Sharp's conversation with Sir Denis Rooke in the letter below is very disturbing.

Without mentioning the source, I have told Mr. Walker's Private Secretary that we have had a report of this kind. He was dismayed; but suggested that Sir Denis Rooke is looking for non-executive Directors to join the Board and may have been wanting to persuade Sir Eric Sharp to do so on the basis that B.G.C. was going to be an effective company not constrained by bureaucratic interference.

This seems to me in all probability far too charitable. On substance, there is little or nothing we can do to tighten the regulatory framework at this stage. And the Head of OFGAS is already chosen. (Mr. Hay Davison would anyway be unsuitable because he was the accountant at Arthur Andersen who was in charge of the audit for De Lorean.)

But Mr. Walker should surely discuss with Sir Denis Rooke the presentation of the regulatory framework. We cannot have Sir Denis Rooke running it down. *I don't believe he will do so in public.*

Mr. Walker's Private Secretary thinks that Mr. Walker will need chapter and verse before he will be willing to discuss the presentation with Sir Denis Rooke.

Brian Griffiths would be content for Sir Eric Sharp's letter to be sent to Mr. Walker. We would also need to explain to Sir Eric Sharp the course of action we would intend to take and ask his permission. Subject to that, you could send the letter to Mr. Walker inviting his comments on Sir

I don't think he can do this.

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Denis Rooke's remarks and asking him to discuss with Sir Denis Rooke the line to be taken on the regulatory framework arrangements (without of course mentioning the source of the concern).

Agree?

DN

DAVID NORGROVE

6 June 1986

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GAS REGULATION

It certainly won't help the cause of gas privatisation for Sir Denis Rooke to make intemperate remarks about the feebleness of OFGAS and its Director General. Nonetheless, it may be worth reminding ourselves that the principal curb on Sir Denis' monopolistic tendencies will be competition, either from other private-sector gas producers/suppliers or from competing fuels. The regulators - OFGAS or OFT - may have to blow the whistle from time to time, but they will not need to act as surrogates for real competition:

1. In the procurement of gas supplies from producers

Fortunately, the battle for a liberal gas import/export régime has been won. As indicated by the new Norwegian gas deal, the Continental gas market is again looking buoyant. Moreover, the pipeline arrangements for transporting the Norwegian gas to Continental markets are likely to facilitate the export of British North Sea gas. We have little to fear from British Gas as a monopsony gas purchaser.

2. The industrial contract market (around 30% of BGC's gas sales)

The regulatory framework has been designed to give free play to competitive market forces in this sector. That is what BGC's large contract customers wanted. Competition from private-sector gas producers should be stimulated by the new

arrangements to facilitate third party use of BGC's distribution network on non-discriminatory commercial terms.

Interfuel competition on the margin should be fierce, especially given lower oil prices, lower industrial electricity tariffs and falling coal prices. Gas has a 35% share of the market, compared to 20% for coal, 16% for electricity, 9% for heavy fuel oil and 14% for gas oil. Moreover, for the next decade or more these market shares will be unusually susceptible to change under the influence of competitive forces, since the heavy industrial boilers installed in a wave in the 1960s will be coming up for renewal.

Provision has been made to expose attempts by British Gas to recoup higher margins from 'captive' contract customers in order to offset losses where competition is fierce. The roles of the Gas Consumers' Council and the OFT will be important in this area.

3. In the tariff market for 16 million small consumers (domestic, small industrial and small commercial)

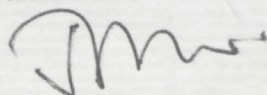
The regulatory arrangements are necessarily more protective in this sector of the market. A ceiling on tariff levels for the first five years (RPI-X+Y) will prevent BGC exploiting its strong established position and should compel the pursuit of efficiency and cost savings.

That apart, competition between fuels should be more intense than might be supposed. A large number of decisions is taken each year to invest in new heating systems or appliances, either for the first time or as replacements. Last year, 1.2 million households bought an electric or gas space heater. Gas has a 60% share of the domestic energy market but has been facing considerable competition from electricity. In the cooker market, for example, the introduction of new electric appliances, such as microwave ovens, has led to reduced use of existing gas cookers. In small well-insulated properties, electric storage heaters present real competition to gas heating systems.

The principle of non-discrimination means that, if BGC is forced to make tariff reductions in response to competitive pressure on the margin, the reductions will apply throughout the sector.

Conclusion

Even if Sir Denis Rooke doubts the firmness of the referees he would be foolish to underestimate the strength of the competition which British Gas will meet on the field. The benefits of vigorous competition on the margin will have to be passed to all customers, either through common tariffs or the arrangements to ensure even-handedness in the contract market.



JOHN WYBREW



10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

9 June 1986

Thank you for your letter of 6 June
to the Prime Minister. I shall bring this
to her attention.

(David Norgrove)

Sir Eric Sharp, C.B.E.

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Sir Eric Sharp C.B.E.
Chairman & Chief Executive

6th June 1986

The Rt. Hon. Margaret Thatcher, MP.,
Prime Minister,
10 Downing Street,
LONDON. SW1

Dear Prime Minister

Professor Brian Griffiths suggested that you would be interested in the discussion he and I had on the privatisation of British Gas, with particular reference to the sensitive post of Head of OFGAS - the regulatory body.

Briefly I said

1. Monopolies which move from the public to the private sector need to be regulated.
2. The regulatory authority, apart from its clear duty to supervise the operating licence, has three principal objectives:
 - (a) to protect the consumer (who has no alternative choice);
 - (b) to prevent abuse by the monopoly of its market power;
 - (c) to promote competition wherever possible.
3. Whatever duties and powers the regulatory body has, it is absolutely essential that the man appointed to head the regulatory body must be sufficiently numerate, market orientated and tough to stand up to the entrenched strength (and arrogance) of monopolists who regard loss of market share as an affront.

My personal experience after years of patient, difficult and protracted negotiation with BT over Mercury has confirmed the above views. Fortunately the Government made a brilliant choice in Professor Bryan Carsberg as Director General of OFTEL, who has done an outstanding job in the regulation and liberalisation of telecommunications and the development of competition to the occasional irritation and even anger of BT.

The problem with the privatisation of Gas is that unlike other privatisations the Chairman has not concealed his antipathy towards

The Rt. Hon. Margaret Thatcher, MP.,

6th June 1986

privatisation in general and in particular with Gas and made it plain in discussion with me only a few nights ago that he is well satisfied with what he has secured from Government and he ill concealed his contempt for OFGAS which he now feels will be an innocuous force. The duty to promote competition (i.e., the Portillo amendment) in his words is meaningless.

This did not surprise me as this is a classical response of monopolists. However, it reinforces more strongly that the utmost care must be taken in the appointment of the Head of OFGAS and that in no circumstances should the appointment be 'approved' by the Chairman or sponsored by the Department concerned knowing that the Chairman would find the candidate acceptable (i.e., malleable).

Men who can run a regulatory body dealing with tough monopolists are rare birds but there are one or two about - may I suggest Ian Hay Davison who was until recently Chief Executive of Lloyd's before he fell out with the establishment, i.e., Peter Miller, the Chairman of Lloyd's, because he was disturbing too many traditions and hallowed practices.

I am copying this to Brian Griffiths, who prompted me to pen these thoughts.

With all good wishes

Yours sincerely

Ian Hay

