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PRIME MINISTER

This makes it unnecessary to read the paper.

Gas Industry Privatisation: Legislation and Price Regulation
E(A)(85)52

BACKGROUND

1. At its 11th Meeting on 11 June, E(A) endorsed the Secretary of State for Energy's proposals for the obligations to be imposed on the privatised company by legislation and the general approach to price regulation (RPI (rate of inflation) - X (target reduction in onshore costs) + Y (increases in gas costs)) he had put forward. E(A) thought that more consideration should be given to the possibility of strengthening the scope for competition in the supply of gas by improving the common carrier provisions of the Oil and Gas Enterprises Act. The Secretary of State for Energy was invited to prepare further papers setting out the shape and content of the legislation (including provisions on safety and arrangements for Consumer Councils) and the nature and coverage of the system of price regulation and its impact on the future of BGC's business.

..... The Secretary of State for Energy's memorandum (E(A)(85)52) is the result.

Proposals

2. Mr Walker proposes that the Gas Privatisation Bill should:

(a) establish a new regulatory agency (along the lines of OFT (Office of Fair Trading) or OFTEL) under a Director;

(b) set up a licensing system for gas utilities who will obtain certain rights in return for submitting to the control regime specified in the Bill;

(c) continue the regime established by the Oil and Gas (Enterprise) Act for private suppliers of gas to industry.



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(d) specify the Director's functions in relation to licence conditions;

(e) provide for the Secretary of State for Trade and Industry to appoint an Advisory Council to the Director to represent consumers' views;

(f) set out the safety provisions;

(g) provide for the transfer of the existing Corporation to a Companies Act company.

3. Mr Walker also proposes:

(a) for the tariff market, a price formula of RPI (rate of inflation) - X (target reduction in onshore costs) + Y (increase in gas costs);

(b) for contract sales, the following price formula:

(i) a temporary assurance limiting rates of price increase for an initial three year period;

(ii) after that, no price control but publication of scheduled (maximum) prices against which rebates could be given;

(iii) a broadly drawn undertaking on even-handedness between consumers.

MAIN ISSUES

4. The main issues are:

(a) the content of the legislation; and

(b) the price regulatory regime.



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Legislation


5. The legislative provisions Mr Walker proposes are discussed in Annex 1 of his memorandum. He proposes the legislation should cover:

(a) a new regulatory agency (like OFTEL) under a Director to be appointed by the Secretary of State. The Director will be responsible for day-to-day regulation of the industry and the price control system. At E(A)'s last discussion of gas privatisation, Mr Tebbit was concerned that a proliferation of regulatory bodies such as OFGAS and OFTEL could be untidy. However, a single regulatory body would be unwieldy;

Mr Walker proposes the Director exercise his functions so that public gas suppliers can earn a reasonable return and are not forced into bankruptcy (Annex 1, paragraph 4). There is a similar provision in the case of BT, where the OFTEL Director have regard to BT's need to finance the services BT has to provide. But Treasury fear the gas formula will enable BGC to thwart the Director's wishes, by pointing to a reasonable rate of return criterion.

(b) a licensing system for gas utilities (public gas suppliers).

A licensed public gas supplier will have a general duty to satisfy, subject to an economical and reasonable caveat, all demand for gas in its authorised area and will have a specific duty to supply any customer within 25 yards of a main and requiring less than 25,000 therms (ie including all domestic consumers). Public gas suppliers



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will have BGC's existing powers to acquire compulsorily land and rights necessary to supply gas in their authorised areas. Firms which are not public gas suppliers* will have to apply for pipelines under the 1962 Pipelines Act and use the powers under that Act to break up streets etc. The legislation will permit companies other than BGC to become licensed public gas suppliers in areas where BGC has not laid supply pipes.

(c) Continuation of Oil and Gas (Enterprises) Act regime for private supplies of gas to industrialists. Provisions for the common carriage of gas introduced under the Oil and Gas Enterprise Act 1982 will continue. E(A)(85)11th Meeting invited the Secretary of State for Energy to consider the possibility of strengthening the scope for competition in gas supply by improving these common carrier provisions. Mr Walker is likely to be able to submit a paper on this in September.

(d) Specified Functions for the Director as regards licence conditions

In particular, Mr Walker proposes to replace the present Regional Gas Consumers' Councils by a single Council, appointed by the Secretary of State for Trade and Industry, representing consumers with a small staff in the Regions to handle complaints. Consumer lobbies will be critical if provision for consumer representation is inadequate; on the other hand, potential investors may be reluctant to invest, if consumer interests appear to wield excessive influence. The provisions here are similar to those in the case of British Telecom, and the Department of Energy export consumer interests to accept them, although without enthusiasm.

(e) Safety. Essentially, the existing safety provisions of the 1972 Gas Act will be re-enacted. Mr Walker intends to bring existing arrangements more closely into line with the Health and Safety Executives (HSE)'s general safety legislation.

*i.e. which only supply gas to individual industrial consumers.



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Public gas suppliers will be obliged to provide a 24 hour emergency service and to deal with all escapes of gas on consumers' premises. Discussions with HSE and the British Gas Corporation (BGC) are proceeding, particularly over the role and status of the Confederation of Gas Installers (CORGI) and the question of improving standards of installation.

(f) Mr Walker proposes that the Secretary of State will have powers to invest in the successor company to enable him eg to acquire shares to adjust the successor authority's gearing ratio or maintain the Government's proportionate shareholding in the event of a new issue of shares.*

Regulatory Regime

6. Mr Walker proposes that OFGAS regulate the gas supply network - (ie transmission and distribution of gas), where BGC has a "natural" monopoly, with the rest of the business (production exploration, gas purchasing, gas appliance retailing, installation and servicing of appliances) subject to the normal rules of the Monopolies and Mergers Commission (MMC) and the Office of Fair Trading (OFT). He intends the ring-fence to be self-policing, based on clear rules laid down by the Director, with separate accounts for the gas supply business. A preliminary examination of the price regulatory formula RPI - X+Y is set out in Annex 2 of Mr Walker's memorandum. Modelling work so far suggests that a formula on this basis is feasible.

Gas Costs

7. Mr Walker believes the privatised BGC must be able to pass on to consumers the total costs of the gas it purchases (the Y component), for several reasons:

(a) potential investors will wish to know the company can recoup gas price costs which can change significantly

* Department of Energy officials see little need, after flotation, to adjust the gearing ratio; but a proportionate shareholding might facilitate distribution of shares to BGC employees; an incoming Government would be prevented from bringing the company back into the public sector, other than by primary legislation, because the Department propose to set a "target investment limit" setting a limit to the shareholding.



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as oil prices and exchange rates fluctuate;

(b) BGC has a well-established track record as a strong purchaser;

(c) US experience prior to deregulation shows that oil companies can be deterred from gas exploration if there is explicit price control at the well-head;

(d) BGC will be interested in buying gas cheaply to preserve its overall competitive position vis-a-vis other fuels such as electricity.

8. Treasury officials disagree. They fear this will make BGC relatively indifferent to the price at which it purchases gas because its monopoly position enables it to pass on high gas prices to consumers. They believe BGC should at least be required to satisfy the Regulator that it had acted prudently in its purchase of gas. (Department of Trade and Industry officials questions the approach Mr Walker is taking, but on balance they are inclined to accept his proposals in the light of Paragraphs (a)-(d) above).

Tariff Market

9. BGC has a statutory obligation to supply all customers within 25 yards of an existing main who consume less than 25,000 therms a year (all domestic and most commercial customers). Although there is some competition here from electricity, Mr Walker believes that in the tariff sector BGC should be required to use the RPI - X+Y formula when pricing their gas. (BGC have made clear to Department of Energy officials their view that there should be no price regulatory formula: in their view the new company should be free to act as it sees fit).

Contract Market

10. Mr Walker proposes a different pricing regime in the contract market. Here he proposes:



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(i) a temporary assurance limiting rates of price increase in the contract market for, say, an initial three year period;

(ii) thereafter no price control but publication of scheduled (maximum) prices against which rebates could be given, in effect following the same practice as oil companies; and

(iii) a broadly drawn undertaking on even-handedness between consumers.

11. Mr Walker justifies this on the grounds that:

(a) if the privatised BGC raised its selling prices significantly above the cost of new gas plus the likely toll for common carriage, competitors could use the common carrier provisions of the Oil and Gas (Enterprises) Act to undercut it. He acknowledges potential competitors face difficulties at the moment, but is considering how to eradicate these difficulties to encourage competition;

(b) there is already greater competition between fuels in the contract market.

12. The extent of competition in the contract market is discussed in Annex 3 of Mr Walker's memorandum. For interruptible gas customers, the main alternative fuels are fuel oil or coal. Present price relativities are:

	PENCE/THERM	
	PRESENT	TYPICAL RANGE
Interruptible gas (regions)	27.8-29.8	
Fuel Oil (low quality)	28	26-32
Fuel Oil (high quality)	35	30-35
Coal	19-22	



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In the coming months, contract prices for fuel oil charged by UK companies should fall to reflect the fall in spot prices since the CEGB withdrew from the market after the coal strike. In the immediate future, therefore, there is likely to be keen competition between fuel oil and interruptible gas. What the future holds beyond that is, of course, far less certain.

13. Main alternative fuels for firm gas customers (smaller and medium-sized commercial and industrial companies) are gas oil and electricity. Present price relativities are:

PENCE/THERM

	PRESENT	TYPICAL RANGE
Firm gas (regions)	<u>33.3-33.6*</u>	
Gas oil	<u>52</u>	<u>45-52</u>
Electricity (effective price taking account of point of use efficiency)		
"interruptible"	<u>50-61</u>	
"firm"	<u>78</u>	

* the first 25,000 therms a year are supplied at the tariff price of 37p.

These figures do not support the view that the forces of competition are particularly vigorous as regards firm gas. Indeed, they suggest that a privatised BGC would have the headroom to raise firm gas prices to industrial customers substantially, if it so wished, and was able to do so.

14. Under Mr Walker's proposals, predatory pricing by the privatised BGC would fall to the MMC and the OFT. The Treasury



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would prefer the RPI - X+Y regime to extend into the contract market, even though this would reduce the likely receipts from privatisation. The Treasury fear that BGC, constrained by a fairly tough price regulatory regime on tariff sales, may seek to edge prices upwards in the contract sector by way of recompense. Department of Trade and Industry officials are also anxious lest this price regime produces real price increases for contract gas prices. Very rough estimates are that a privatised BGC without any price regulatory regime (BGC's preference) would fetch £7 billion; a privatised BGC with RPI - X+Y throughout would fetch £5 billion; and the course recommended by Mr Walker £6 billion. Treasury acknowledge this, but feel that BGC could raise contract gas prices in a way which might give future privatisation a bad name (looking forward, possibly to privatisation of the electricity supply industry). Certainly, real increases in gas prices could provoke an adverse political reaction from the commercial and industrial companies affected. On the other hand, to negotiate with BGC on an RPI - X+Y arrangement for the contract market will not be easy.

OTHER ISSUES

15. Nearer the time of flotation decisions will need to be taken on the following issues (not addressed in Mr Walker's latest memorandum, but covered in earlier papers):

(a) Employee Participation

Mr Walker is keen to get the support of employees for the new company and to provide protection against unwelcome takeover.

(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;



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

(f) 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.

(g) Import/Export of Gas

Mr Walker is consulting the Treasury and the Foreign and Commonwealth Office about this. He should be ready to submit a paper in November. 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. The existing power to control the installation of submarine pipelines will remain, which 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



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European Court if the Government sought in this way to block gas imports.

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 ensuring the success (or otherwise) of the privatised company, and in influencing future UKCS activity and tax revenues therefrom. 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. If imports were prevented, UKCS licensees would be in a much stronger position in negotiation with BGC, to the disadvantage of the consumer but partially offset by additional receipts to the Exchequer. No early statement is likely to be needed from the Government about this question, but considered views will be needed in time for the second reading of the Bill.

HANDLING

16. You may wish to divide the discussion into two parts - the first part dealing with the legislative provisions Mr Walker proposes, and the second part with the price regulatory framework.

17. On legislative provisions, you will wish to invite the Secretary of State for Energy to introduce his proposals. Thereafter, you may wish to invite the Chancellor of the Exchequer to respond. The Secretary of State for Trade and Industry may wish to comment on the treatment of Consumer Councils. The Secretary of State for Employment might have views on the safety regime. The Attorney General may have points on legal implications.



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18. On the price regulatory framework, you will wish to invite the Secretary of State for Energy to introduce his proposals. After that, you may wish to invite the Chancellor of the Exchequer to comment. The Secretary of State for Trade and Industry may wish to comment on any implications for industrial gas prices, as well as on the regulatory framework more generally.

CONCLUSIONS

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

(a) whether or not to approve the legislative provisions Mr Walker recommends;

(b) whether or not to endorse the approach Mr Walker recommends on price regulation, as regards:

(i) the tariff market;

(ii) the contract market.

J B UNWIN

Cabinet Office
30 July 1985