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PRIME MINISTER

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Gas Industry Privatisation
(E(A)(85)52)

Mr Walker's paper responds to the remits from E(A) on 11 June. The full brief attached summarises the Department of Energy proposals and sets out the main issues for discussion. This note concentrates on a few issues where there may be significant disagreement, and which have particular importance for the terms of the flotation. These are:

(i) the desirability of a separate regulatory agency;

(ii) the extent of regulation over 'contract' gas supplies (it is common ground that 'tariff' gas supplies - i.e. supplies to domestic and small industrial/commercial consumers - should be fully regulated on the Telecom model);

(iii) whether there should be any regulation of the price BGC pays to producers of gas;

(iv) the common carrier arrangements.

A separate regulatory agency

2. At the last discussion Mr Tebbit suggested that it might be better to have one body to regulate public utilities, rather than a separate body for each industry as it was privatised. This may prove to be the sensible and efficient approach in due course; but the regulatory powers proposed for the gas regulatory agency (OFG) - which on any basis would not extend beyond the terms for the purchase and sale of gas - are appreciably narrower than those enjoyed by OFTEL, and it would be undesirable for bad relations between

SECRET

Telecom and OFTEL to sour the atmosphere in which OFG will be operating. It would be as well to establish that the successor company to BGC will be required to bear the costs of running OFG.

Contract gas supplies

3. The decision here is a matter of judgment rather than of a clear correct answer. The tighter the coverage of regulation, the less scope the privatised company will have for developing its business in the way which suits it best. If the RPI + X - Y formula covers all BGC's sales, the company will be a tightly regulated utility with little scope to develop a new independent marketing strategy designed to promote its growth. On the other hand, if there were no regulation over the contract market, BGC would have substantial scope to increase prices and profits in this area, and so could be expected to concentrate on it to the exclusion of development of the tariff business. As the brief below notes, the difference in the privatisation receipts, depending on the form and coverage of regulation, could be as much as £2 billion (i.e. between £5 and £7 billion).

4. Treasury officials have been inclined to argue for a wider coverage of regulation, despite the adverse impact on the receipts, in order to strengthen the protection of the (industrial) consumer. The Department of Energy emphasise the strength of the competition interruptible contract gas supplies will be facing from coal and fuel oil, and firm gas from gasoil and electricity. With oil product prices to consumers declining in Sterling terms because of both lower free market prices and Sterling appreciation against the dollar, there is likely to be somewhat less headroom for BGC to increase prices in these markets following privatisation. The Department of Energy further argue that measures to give gas producers readier access to BGC's main gas distribution network on a common carrier basis(on which they are still working) should also help to limit BGC's ability to exploit their position in relation to this class of customers.

5. The economic impact of price regulation will be different in the case of gas from that which arises in the case of Telecom. Unlike Telecom, gas will be facing rising marginal costs, at least of new supplies of gas, and possibly also in the distribution network given BGC's view that the market is almost saturated. Once prices to tariff consumers have been set, additional sales to such consumers could be at a loss. If contract supplies were unregulated, and tariff supplies tightly regulated, BGC would have an incentive to develop their contract market to the exclusion of their tariff market. But if the whole business were subject to the same degree of price regulation, then BGC's ability to develop its business in an entrepreneurial way would be reduced, arguably putting in question one of the main advantages of privatisation. Mr Walker's formula - a limit on price increases for three years, followed by a broadly-drawn requirement for even-handedness as between industrial consumers - represents an attempt to find a middle course which gives BGC some entreprepreneurial scope, while giving industrial customers some element of reassurance.

Treatment of BGC's purchase contracts

6. Mr Walker's proposal is to exclude BGC's gas purchase contracts from the scope of regulation. BGC have hitherto had effective commercial freedom in this area (except where imports are concerned), and it would be a new departure for the Government or a regulatory agency to seek to supervise the details of such contracts. The Treasury argue that allowing BGC to pass on all their gas purchase costs without question could lead the privatised company to become indifferent to the price it pays for gas, to the disadvantage of the consumer. This argument would be stronger to the extent that the prices of BGC's contract sales were subject to the same formula as the tariff sales. Underneath this question lies the issue of the treatment of gas imports and exports, and the interests of the oil companies. Hitherto the complaint of the companies has been that BGC has been too successful in exploiting its

power as monopsony purchaser; it is them, not the consumer, who needs protection. As long as BGC have some commercial freedom to develop their business, this will remain true after privatisation. Given that it is likely to be impossible for the Government to prevent gas imports after privatisation, sooner or later exports are likely to have to be allowed of UKCS gas. Once free trade in gas has been established, there would be no further scope for OFG to regulate the prices BGC pays for supplies. Mr Walker has undertaken to put a further paper on gas imports and exports to his colleagues in the autumn; meanwhile it would seem premature to decide to subject BGC's gas purchases to regulation in the same way as its sales.

Common carrier

7. So far no use has been made of the Oil and Gas (Enterprise) Act provisions enabling gas producers to sell gas directly to UK industrial consumers, transporting it through BGC's trunk lines. No doubt BGC will do their best to ensure that no such sales are actually made. But the position of gas producers in negotiating sales to BGC would be considerably strengthened if appropriate transparent terms could be specified on the basis of which they would have access to BGC's distribution network; this would then limit the extent to which BGC could seek to force down the price it pays to its suppliers, since if the privatised company were too greedy, direct sales to industry would become an attractive option to them. Strengthening competition by facilitating access to BGC's distribution network on 'fair' terms should thus help to reduce the need to regulate both the prices BGC charges to its large industrial consumers and those it pays to its offshore suppliers. It would clearly be helpful if Mr Walker could put a further paper on this issue to his colleagues as soon as possible after the Summer holiday.

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Cabinet Office.
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ELECTRICITY PRICES AND LARGE INDUSTRIAL CUSTOMERS

Note by H.M. Treasury

A. The Scheme

It is proposed that the NCB sell cheap coal to the CEGB. The CEGB would turn this coal into electricity and sell it at a low price reflecting the cheapness of the coal.

2. The objective of the scheme is to reduce electricity prices to large industrial users.

3. The scheme would initially cost some £50 million a year. It proponents claim the cost would fall in the "longer term" to £30-41 million a year.

B. Assessment

4. This scheme is a selective industrial subsidy. It is not designed to serve energy policy objectives.

5. The Treasury has not yet seen the evidence on relative electricity prices referred to in the note. In general UK electricity prices compare favourably with those overseas. That said, our largest industrial users do complain of a disadvantage with France and, sometimes, with Italy and Germany.

6. Any such disadvantage does not derive from the price charged for NCB coal. There is an open international market for coal and the NCB's prices are based on that market. This was the basis of the coal agreement signed by the NCB and CEGB in 1983.

7. Any disadvantage derives

either (i) the lower non-coal costs of the electricity industry in the country in question (eg France with its high nuclear

capacity)

or (ii) the sale of electricity below cost (possibly happening with large consumers in Germany and Italy).

8. The paper says the NCB long run marginal costs (LRMC) of production are £32 a tonne and below its present selling prices. The Treasury knows of no evidence that the NCB's LCRM is £32. The costs of one of the most profitable mines of the future, Asfordby, are £39 and this is not the marginal capacity. The marginal capacity currently has costs around £60 a tonne and, even the NCB is breaking even, the marginal costs are likely to be over £50 a tonne.

9. In any case the NCB's costs (including its LRMC) do not determine its prices (which are set by the international market). The NCB costs determine which pits can make a profit at the market prices and which pits can not - and so should be shut.

10. This is a key point. The recent coal strike was fought and won to establish that the coal industry should be run as a commercial, market orientated business with the size of the industry (e.g. in terms of numbers of pits) determined by its costs.

11. The thrust of the present proposal run quite counter to this philosophy. It returns to the Labour/NUM philosophy

that the size of the NCB should be determined by physical production capacity. This comes out quite clearly in paragraph 28(ii) of the paper which makes clear the scheme only makes sense for the NCB "if there is difficulty in bringing capacity into line with profitable demand" i.e. if the Government abandons the philosophy of a market driven NCB and runs the NCB at excess capacity in the medium and long term. This is exactly what Mr Scargill wants the Government to do.

12. The cost of the scheme does indeed look like £50 million a year. It is unconvincing to suggest additional electricity demand would reduce this much over the years and so cut this figure.

13. 80% of the benefit of this scheme look like going to ICI, BOC and BSC - i.e. two highly profitable companies and one state pensioner. BSC would not in fact benefit as the paper says its EFL would be reduced to offset the gain from chaper electricity.

14. Sir Walter Marshall's interest in the scheme is no doubt driven by pressures on him from industrialists (Giordano of BOC is on the CEGB Board). His best strategy would be to seek to translate this pressure into public pressure for CEGB investment in lower cost capacity (i.e. Sizewell and further PWRs). Reducing electricity prices by means of the proposed scheme would mean industrialists would see less need to support the case for Sizewell and PWRs.

C. Points to make

(a) the scheme looks a poor energy policy - the NCB sells coal at prices based on the international market. The NCB's own costs determine how much of its capacity is

economic. Its costs do not determine the price of coal;

(b) coal strike implications - the coal strike was fought and won to establish that the NCB's capacity should be determined by its costs. As the paper says, a scheme of this sort would only make sense for the NCB if its capacity is not brought into line with profitable demand. In short the scheme assumes we run the NCB at excess capacity - this is pure Scargillism;

(c) cost figures - the Treasury do not think it likely the scheme's long term costs would be significantly below the initial £50 million a year;

(d) industrial subsidy - the scheme is a selective subsidy to industry. Most of the benefit goes to ICI and BOC i.e. to two large companies with good profits. BSC would not benefit as its EFL would be cut.

(e) international electricity prices - our electricity prices are indeed higher than those in France. This has nothing to do with the price of coal. It reflects the lower non-coal costs of the French electricity industry. Surely this comparison should be used by the CEGB to build support for Sizewell and PWRs. If the present scheme were approved industrialists would be less inclined to press the Sizewell case.