

PRIME MINISTER

GAS INDUSTRY PRIVATISATION

Peter Walker's paper argues that British Gas provides a unique opportunity "to engage capital market disciplines and real individual ownership in place of political and bureaucratic control". He portrays a business which is now mature: there will be problems in the medium term in finding replacement sources of gas for the North Sea gas it is currently using, coupled with the possible need for major new investment in coal conversion.

The paper examines the possibility of splitting the Gas Corporation into different operating regions. It concludes that this would result in diseconomies and higher prices for customers, whilst offering little genuine competition, as there would still be local monopolies.

It examines the case of gas retailing, setting out three options:

- i. ending retailing by the gas supply industry and selling it off;
  - ii. allowing a privatised British Gas Corporation to continue to operate retailing and servicing, subject to tight OFT controls; and
  - iii. selling a majority shareholding in a separate retail business to the private sector, but leaving BGC with a minority stake.
- The paper recommends this latter course.

The paper examines BGC's interest in gas exploration and production, and concludes that the privatised Corporation should maintain its presence. They currently control 7 per cent of United Kingdom Continental Shelf production, and one-sixth of proven UKCS gas reserves.

The paper favours a substantial management-employee involvement to the extent of around 10-15 per cent of the equity in a denationalised Corporation.

Selling segregated regional companies would delay the sale until the next Parliament. For this and other reasons, the paper concludes in favour of selling the main core of the existing business during the

life of the present Parliament. This would require substantial regulation and greater transparency of accounting and information, so that different classes of customer could be assured of non-discrimination. There would be regulation of profits through a complex formula, and a gas tax. Proceeds might be around £6 billion, possibly split 50:50 between debt and equity.

Comment

Peter Walker is right to stress the need for more competition, for employee involvement in shareholdings, and for the urgency of some action in tackling a large public sector monopoly business.

He is right to reject the route of forming separate regional companies. The way proposed in his paper would delay privatisation, and would produce few competitive benefits, as local monopolies are every bit as unpleasant as national monopolies to their customers. You could congratulate him on the range and depth of his draft paper, which covers the regulatory experience in 7 overseas countries, and the history of the UK industry.

The draft paper has its less good points:

1. British Gas is not as unattractive an investment as he makes out. Yes, the gas reserves of the North Sea are finite, and yes, there will need to be investment or new purchasing to replace them. This is exactly the same for any North Sea oil company. In the case of BP, the main profits are earned by two large capital projects - the Forties Field in the North Sea, and the North Slope in Alaska. Forties is already past peak production, and within 15 years both these major investments will have to be replaced at enormous cost. However, investors are still keen to own BP shares.
2. Greater customer benefits could come from pursuing the retail question further. Full denationalisation would provide a much greater spur to improving the service and the range and price competitiveness of products. It would also free BGC to contemplate using other retailers for their gas billing and service activities. Gas servicing and installation should also be sold with the shops.
3. Exploration and development of North Sea Gas is a competitive activity, and the same logic that led to divestment of the oil

interests could sustain a case for separate divestment of the gas interests. British Gas should be a company involved in distributing gas, buying it from the best source but not owning it.

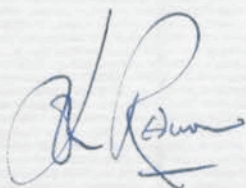
4. It is difficult to see that the regulatory system designed for the main core business presents a material improvement over the BT one; in many respects it is worse.
5. A more important issue in encouraging gas privatisation is how a good gas market can be established both at the well head end of the business and at the customer supply point. The Oil and Gas Enterprise Act took the necessary powers to make BGC's pipeline into a common carrier. Nothing so far has happened to give any meaning to this relaxation. BGC should only be sold if other companies are routing gas through the common carrier pipeline system. In that way, there would then be a market price for gas and BGC would be on risk if they set their prices at the wrong levels. Under the scheme in Peter Walker's paper, the pressures on the regulators to set the price of gas will be just as unpleasant as the pressures at the moment on the Cabinet. Markets work best. It was only the deregulation moves of the last Parliament which forced BGC to offer a better price for new North Sea gas and led to a sharp acceleration of exploration and discovery.
6. The paper does not refer to the chronic shortages of gas which have occurred owing to the managed BGC price regime of recent years. Many potential customers have been prevented using gas as there has been a shortfall in supply. BGC's reluctance to pay a realistic price to producers (until recently) has caused this hardship. There is a growing international market in gas which could help in establishing a fair price.

#### Conclusion

Peter Walker's preferred route for the core business pays too much attention to reassuring the employees and too little to the questions of competition and customer service. I fear his view of the politics has prejudiced the judgement of the draft paper. People keenest to denationalise could turn out to be the most hostile critics of his scheme! The regulatory system proposed is as complex as it is worrying.

It would be better to be a BGC manager than a customer of the new business proposed.

I have been invited round to talk to him at length concerning the detail of his paper. I would like to concentrate at that meeting on the questions of whether and how an active market in gas supply can be developed, and whether splitting BGC by functions could be carried further to make it a serious option to be studied by E(A) when his paper comes through in final form.



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*G. Gray 18/7/2013*