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Policy Unit

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PRIME MINISTER

NBPM AT 27/2

GAS PRIVATISATION

I met Mr Davis from the Department of Energy today.

I suggested to him that the paper be strengthened in three respects:

1. Competition. The paper should ask the question why no-one is using the common carrier provisions for the grid; should assess the chances of bringing competitors into the gas supply market; and should discuss the role of the oil companies and heavy industrial users. It should also ask the question: in what conditions would a new supply company set up, perhaps for a new industrial estate or a new town or an expanding village?

2. Rejection of Price-Linked Regulation, I suggested that the rejection of this scheme had been too hasty.

Customers need to be reassured. They understand prices and are worried by complex profits formulae.

Price control could be related to market prices for oil substitutes. The price of interruptible gas for industry is related to residual fuel oil. Commercial gas also has its oil equivalents.

Price regulation could be arranged on a RPI-X formula for onshore costs, and a market price for gas bought from the North Sea if a market has been established.

Price control could be based on a total RPI+X formula so that the customer had a guaranteed maximum real price on which to plan.

Mr Davis agreed that the case for regulation by price should be strengthened, so that it was a serious option for E(A) debate.

3. Profit base regulation. This is a scheme favoured by the Department of Energy. Under this scheme, there is a grave danger that:

i. The new gas company would be able to gold-plate its investment, as part of the scheme depends on regulation by a profit control expressed as a percentage of net assets.

ii. DEn argue that it would be less complicated than price regulation: however, they would need to regulate not only profits, but also relative prices between types of customer,

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otherwise any individual group of customers could be made to pay at the expense of the rest.

iii. They wish to include some kind of performance incentive in their formula. I suggested this should be a large element of the allowed profit, in order to have the desired effect of controlling costs.

iv. I suggested that they should deal with the question of transfer prices. It would be possible for the new corporation to avoid the impact of the regulation by transferring the real profits they were earning outside that element of their business that was subject to profit control.

In conclusion, Mr Davis said he found these comments helpful, and would endeavour to sharpen up the choices in the report in the light of these criticisms.

JOHN REDWOOD