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- 4 OCT 1979

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Chief Secretary
HM Treasury
Treasury Chambers
Parliament Street
London SW1

4 October 1979

Mr B. Pollard (IR)
Mrs V. Strachan (C+E)

Dear John

BRITISH GAS: PROPOSALS FOR ADDITIONAL CAPITAL INVESTMENT

Thank you for your letter of 27 September in which you offered support for the proposals in my Gas Pricing Policy paper.

The decision taken at E(EA) on Tuesday to endorse these proposals is an important step forward. But of course we still need to gain the agreement of our colleagues in Cabinet and to decide how to handle the presentation of the price rise, both to the House and to the country generally. I can certainly accept your proposal that we should settle the question of gas prices before the White Paper on public expenditure in 1980/81 is finalised and before Cabinet takes decisions on public expenditure for 1981/82 and later. As I made clear at our meeting on 25 September, my acceptance of your public expenditure figures for BGC is dependent on our colleagues accepting my pricing recommendations (and subject to the uncertainty about Corporation Tax). Once decisions are reached on prices, and on capital expenditure, I shall ask British Gas to compile up to date financial forecasts as a matter of the utmost urgency. There can be little doubt, however, that it would be counter-productive to seek further forecasts from the Corporation before a firm decision on prices had been reached.

My recommendation that domestic prices should rise by 10% a year in real terms was made in part with the need to finance additional capital investment in transmission and storage in mind, as I explain below.

You will probably be aware that BGC have recently experienced a marked upsurge in demand for gas, following the oil price rises and supply difficulties earlier this year. In the light of this the Corporation have revised their forecasts of demand growth over the

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next five years and beyond. They now foresee, on present plans, a serious shortage of capacity to meet demand on the coldest winter days; in 1981/82, for instance, this would amount to some 7m therms a day out of a total peak day supply of some 100m therms. This deficit grows to 21m therms by 1984/85. The Corporation have therefore proposed measure for restraining the further growth of demand, essentially by limiting existing and potential customers to their statutory entitlement; and they have come forward with plans for advancing capital investment. The proposed additional capital investment includes bringing forward the development of BGC's Morecambe field; the fourth feeder from St Fergus; and the availability of two partially depleted Southern Basin gas fields for seasonal storage. Peak-shaving LPG/air plant is also to be built.

The cost of BGC's proposals, over the five years 1980/81 to 1984/85 amounts to £407m at 1979 Survey prices. This includes lump sum payments amounting to £190m to the producers for the acquisition of the two S. Basin fields, Rough and Hewitt, for storage. Given the very tight position on public expenditure generally, I intend to ask British Gas to look again at the financing of the purchase of these two fields, to see whether it cannot be done out of revenue (though this will of course have consequential effects on their cash flow.) I should stress that the use of depleted gas fields for storage is particularly desirable in terms of matching supply to peak demand. If, therefore, it does not prove possible to avoid lump sum payments, I should need to raise the matter with you again.

The total proposed additional expenditure, less Rough and Hewitt, amounts to £217m; your officials are aware of the incidence of this expenditure. You will, no doubt, wish for this additional expenditure to be met out of the proceeds of price rises, rather than from elsewhere. We shall need to consult with British Gas, once decisions are reached on pricing policy, to see just how matters stand. But on the basis of the information at present available it looks as though the extra expenditure could be accommodated (with the possible exception of 1980/81) within the revenue from a 5% p.a. average real price rise while still meeting the requirements for BGC set out in your Investment and Financing Review paper (C(79)37), provided credit can be taken for BGC's Corporation Tax payments. To meet both the net of tax requirement you proposed when we met on 25 September, as well as the extra expenditure, it looks as though average price increases of 10% p.a. in real terms would be necessary, though as I then made clear there is considerable uncertainty because of the difficulties of estimating Corporation Tax payments. These depend of course both on profits and on the timing and volume of capital expenditure.

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British Gas are at present making a good return on their current investment programme, as you might expect; and the future programme including the proposed additional investment will, I understand, also achieve at least the required rate of return. The Corporation will remain 100% self-financing.

My officials have discussed with the senior management of British Gas the capital expenditure proposals in detail, together with the possible scope for obtaining additional peak supplies from other sources, for instance from existing or as yet uncontracted Southern Basin fields. We have satisfied ourselves that although these may have a role to play in the longer term, they could not be relied upon to substitute for any of the existing BGC proposals.

We have also discussed with British Gas the question of security of supply. They advise that delaying investment in additional capacity by only a year would mean, for instance, that the risk of failing to meet demand in cold weather in the winters of 1981/82 and later years would be increased by over three-fold, compared with the present criteria. The consequence of failing to meet peak demand would be that large firm industrial customers would have to be cut off for periods that would depend on the severity of the weather; and British Gas would of course insist that the Government publicly accept responsibility for this. I do not believe this would be politically acceptable, particularly since gas prices to industry have increased very sharply over the past year. We could not, moreover, easily defend raising domestic prices if we were not prepared to allow the industry to finance necessary investment out of the proceeds.

More generally, I am doubtful whether the severe measures that British Gas have taken to restrain demand growth can in practice be sustained for as long as six years, the period they have mentioned. These measures include refusing new gas supplies to industry unless the premises are within 25 yards of an existing main; even then, the quantity supplied would be limited to 25,000 therms a year.

The fact that the existing transmission and storage facilities will prove inadequate to meet the unanticipated growth in demand provides a good indication that the Corporation have not made it a practice to build appreciable spare capacity into their system. I regard their new proposals as making sensible, economical provision for meeting a growth in peak demand, which is not likely to be inconsistent with whatever views we may reach on a proper rate of depletion of our gas reserves.

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For all these reasons I would endorse BGC's proposals (with the qualification about financing offshore storage) and would be grateful for your early agreement that they be included in the Corporation's capital investment programme. Furthermore public resistance to my pricing proposals will be ameliorated to some extent if we can state that BGC are also taking steps to increase the availability of gas. Your officials have been involved with mine in discussions with British Gas on these matters and if there is any further information you require we should of course do our best to provide it.

I am copying this letter to Keith Joseph, given his interest in gas supplies to industry.

Yours ever

David

D A R Howell