PREM 19/303

Electricity and Gas Pricing Policy.
Capital Investment and Financial Target

NATIONALISED INDUSTRIES

Part 1.

September 1979

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~31.10.79~~		~~26.2.80~~					
~~1.11.79~~		~~29.2.80~~					
~~6.11.79~~		~~6.3.80~~					
~~7.11.79~~		~~11.3.80.~~					
~~9.11.79.~~		~~14.3.80~~					
~~12.11.79~~		21.3.80.					
~~16.11.79~~		-ENDS-					
~~23.11.79~~							
26.11.79							
3-12-79							
~~4.12.79~~							
~~7.12.79~~							
~~14.1.80.~~							
~~15-1-80~~							
~~16.1.80~~							
~~17.1.80~~							
~~23.1.80~~							
~~31-1-80~~							
~~6.2.80~~							
~~8-2-80~~							
~~11.2.80~~							
~~14.2.80~~							
21.2.80.							
~~25.2.80~~							

PREM 19/303

PART 1 ends:-

CST's ltr to Energy 21/3

PART 2 begins:-

S/S Energy to PMG 26/3

TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
E (EA) (79) 47	28.9.79
E (EA) (79) 15th Meeting, Minute 2	2.10.79
E (79) 51	12.10.79
E (79) 52	15.10.79
E (79) 12th Meeting, Minutes 2 and 3	17.10.79
E (79) 61	26.10.79
E (79) 14th Meeting, Minute 1	30.10.79
E (79) 64	9.11.79
E (79) 65	16.11.79
E (79) 15th Meeting, Minutes 1 and 2	26.11.79
CC (80) 2nd Conclusions, Minute 4	17.1.80
E (80) 19	22.2.80
E (80) 20	22.2.80
E (80) 8th Meeting, Minutes 2 and 3	26.2.80

The documents listed above, which were enclosed on this file, have been removed and destroyed. Such documents are the responsibility of the Cabinet Office. When released they are available in the appropriate **CAB** (CABINET OFFICE) CLASSES

Signed OSWayland Date 22 July 2010

PREM Records Team

Published Papers

The following published paper(s) enclosed on this file have been removed and destroyed. Copies may be found elsewhere in The National Archives.

House of Commons Hansard Nuclear Power	18/12/79 Columns 287-304
House of Commons Hansard Gas and Electricity Industries	16/01/80 Columns 1644-1661

Signed CAWayland Date 22 July 2010

PREM Records Team

Not I'vd

Treasury Chambers, Parliament Street, SW1P 3AG

Dennis Walker Esq
Private Secretary to
Rt Hon David Howell MP
Secretary of State
Department of Energy
Thames House South
Millbank
London SW1

R 21/3

21 March 1980

Dear Dennis

ELECTRICITY INDUSTRY ENGLAND AND WALES: EXTERNAL FINANCING LIMIT 1979-80

The Chief Secretary has seen your letter of 20 March to me proposing a draft question and answer announcing the £300 million increase in the electricity industry's EFL. The answer would be given on Budget day.

The Chief Secretary is content with the draft, subject to the insertion of the words "in the public expenditure plans" after "Contingency Reserve" in the final sentence. This would make the answer a little clearer.

The Chief Secretary understands that following the discussion in E Committee on 26 February, officials from your Department and the Treasury have considered whether the increase could be presented separately from the industry's EFL by making clear that the extra expenditure was required for contingency fuel stocks. The Chief Secretary agrees with their conclusion that this would be counter-productive. Attempts to make a contingency fuel scheme retrospective would be seen through as a purely cosmetic move. Furthermore, any hint that the Government had built up stocks in case there had been a miners' strike would be regarded as provocative both to the mineworkers and the power station workers and would make it harder to maintain good stock levels for the future.

The Chief Secretary will shortly be writing to your Secretary of State about the possibility, also referred to at E Committee on 26 February, of financing the industry's fuel stocks held for contingency purposes separately from the industry's EFL.

I am sending a copy of this letter to the Private Secretaries to Members of E Committee, the Secretary of State for Scotland and to Sir Robert Armstrong.

Yours sincerely
Roger Watts
R J T WATTS

CONFIDENTIAL

Prime Minister 2

For Written Answer on Budget Day.

R Lankester 20/3

Nationalised Industries

01 211 6402

R J T Watts Esq
Private Secretary to the
Chief Secretary
HM Treasury
Parliament Street
LONDON SW1P 3HE

20 March 1980

Dear Roger,

ELECTRICITY INDUSTRY ENGLAND AND WALES: EFL 1979/80

The Chief Secretary's letter of 14 March to my Secretary of State agreed that it would be appropriate to announce the revised EFL for the electricity industry by means of an arranged question to be answered on Budget Day. The Chief Secretary asked for the opportunity to comment on the draft of the answer.

We now propose the following draft question and answer, which has been discussed informally with Treasury officials.

> "Q To ask the Secretary of State for Energy whether he has any plans to revise the external financing limit of the electricity industry in England and Wales for the current year.
>
> A The Electricity Council has sought an increase in its external financing limit to cover variations in the electricity industry's cash flow and its trading circumstances compared with the assumptions on which the limit was based. This is mainly due to the successful build up of fuel stocks which, in the increasingly uncertain world energy supply situation, the Government welcomes.
>
> In these exceptional circumstances, and having satisfied myself that the industry has taken all reasonable steps to absorb these unforeseen increases in its financing requirement, I have agreed to an increase in its external financing limit in the current year from (-)£68m to (+)£232m. This increase is partly met by prospective shortfalls in the financing requirements of other nationalised industries, and partly from the contingency reserve; consequently it does not add to the public expenditure planning total".

I should be grateful to have your comments on this draft as soon as possible.

(2)

I am sending copies of this letter to the Private Secretaries to members of E Committee, the Secretary of State for Scotland and Sir Robert Armstrong.

Yours ever,

Denis

Denis Walker
Private Secretary

Nat Inds.

TL O10

PMG NOTE 16/80

14/3/80

PRIVY COUNCIL OFFICE

WHITEHALL. LONDON SW1A 2AT

ELECTRICITY PRICES

The Central Electricity Generating Board (CEGB) will today (14 March) announce its revised Bulk Supply Tariff (BST) for the whole of 1980/81 (the wholesale electricity price to Area Boards on which they base their tariffs to consumers). Also Area Boards are now formally publishing revised tariffs to take effect from 1 April showing increases averaging 17% (the first of the two stage phasing of the industry's 1980/81 increase requested by Ministers last November). Most of the Area Board announcements are expected next week.

The BST structure is complex and is designed to relate prices as closely as possible to the cost of production at different times of the day (ie when cheaper base load or more costly peak load plant may be in use). The Generating Board will explain that it is a tariff for Area Boards and not for the consumer. Publication may revive recent press speculation that the level of the second Area Board tariff increase later in the year would need to be higher than earlier anticipated. Arguments quoted - although in no way accepted by Ministers - were increases in the industry's costs and a fall in demand due to the mild winter and the steel strike. Reference was also made to the industry's revised lower load forecasts for seven years ahead and possible cuts or deferments of capital projects. It was also suggested that the Government's energy conservation campaign had contributed to the reduced demand and so to higher prices.

Demand is only one of a number of factors affecting the industry's costs and the Government's conservation programme is only one of the factors acting on demand in the long-term. The key cost element is fuel costs over which the industry has little control and which now accounts for half the final price of electricity. The Government would not accept that the effect of fall in demand should automatically be passed on to consumers in increased costs. There would be a danger in this of a vicious circle with increasing prices further reducing demand. This danger is fully recognised by the industry and it is vigorously seeking to identify further economies.

LINE TO TAKE

(i) the changing financial position of the electricity supply industry as a whole for the next year is being reviewed with them in the light of their already announced three year financial target;

(ii) the industry faces steep increases in fuel prices and reduction in demand, and they are vigorously seeking to identify further economies. The Government do not accept that costs arising from reduced demand should be automatically passed on to the consumer;

(iii) precise tariff increases are the industry's responsibility. But the three year financial target requires it not only to cover costs but also to earn an adequate return on the substantial sums of public money invested in it;

(iv) the Government has asked the industry to phase this year's price increase in two stages. Area Electricity Boards are proposing price increases averaging 17% from 1 April. The size and timing of the later increase will depend on movement in the industry's costs;

(v) the Government has undertaken to make extra provision for the elderly and others on low income who may need help with fuel bills. We shall announce our proposals in good time for next winter.

Boards	Tariff Increases (%)	
	Domestic Class	Industrial Class*
London	18.0	8.7
South Eastern	17.3	6.2
Southern	18.4	7.7
South Western	16.9	8.6
Eastern	17.8	6.0
East Midlands	16.7	4.1
Midlands	17.9	4.1
South Wales	18.1	6.2
MANWEB	17.8	4.4
Yorkshire	18.2	5.3
North Eastern	17.4	8.1
North Western	16.2	4.8
Overall	17.6	5.7

* Excluding fuel cost adjustment increases to monthly billed consumers which are expected to add a further 10.7% to these figures

ANNEX B

STATEMENT BY THE SECRETARY OF STATE FOR SOCIAL SERVICES

14 MARCH 1980

GOVERNMENT TO PROVIDE EXTRA HELP TOWARDS FUEL BILLS

Mr Patrick Jenkin, Secretary of State for Social Services, today repeated earlier pledges that the Government will give extra help to those on low incomes - including the elderly - so that effects of higher gas and electricity bills will be cushioned next winter.

In a statement today he said: "The Government is agreed on the necessity of an energy pricing policy which is realistic. But at the same time, from the beginning of our discussions on increased gas and electricity prices, we have always had in mind the need to help the elderly and those on low incomes. We recognise that without Government help they would be particularly hard hit by the increased bills which will be necessary in the overall national interest next winter.

"The Government is reviewing the whole range of assistance available to help the most vulnerable consumers with their fuel bills. As the Prime Minister and the Secretary of State for Energy told the House of Commons in January, we intend to make extra provision for those on low incomes who need special help.

"Detailed proposals for new measures are in the final stage of discussion and I hope to make an announcement before the Easter recess of Parliament. I want those who will have most difficulty in meeting the increased bills to have the necessary assurance of our intention to deal with the social implications of the Government's energy pricing policy."

Note to Editors

Heating additions are paid to approximately 70% of all supplementary pensioners and to many other supplementary benefit recipients at a cost in 1979 of £93 million.

From November 1979, a number of changes were introduced which provided an additional £16.5 million a year to approximately 345,000 families and pensioners.

Paymaster General's Office
Privy Council Office
68 Whitehall
London SW1A 2AT

Nat Inds.

CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon David Howell MP
Secretary of State
Department of Energy
Thames House South
Millbank
London SW1

R 14/3

14 March 1980

Dear David,

ELECTRICITY INDUSTRY EFLS FOR 1979-80 AND 1980-81

Thank you for your letter of 11 March.

I am glad to see that Sir Francis Tombs seems to be ready to recommend to his Council acceptance of proposals to keep his industry within its 1980-81 EFL of £187 million. I therefore agree that the industry should be instructed that the £20 million deferment should, as we agreed last week, be in the respect of payments to the NCB.

I should much prefer it if you were able to avoid a discussion with Tombs about the nature of the EFLs. But if you think this unavoidable in order to secure his cooperation in any decisions to keep the industry to its 1980-81 EFL, I would be prepared for you to write to him using the following slightly amended version of the form of words set out in the second paragraph of your letter.

> "On the EFL, this year has clearly demonstrated that, while it is a limit, it is not one which is applied without regard to the circumstances. In applying the limit we do, of course, take into account significant variations from declared estimates of sales, fuel prices, wage increases and inflation - together with their implications - and wish to discuss these with you as soon as they are identified so that steps can be taken to avoid a breach."

(The amendments are underlined.)

Finally, I agree now it has been decided that the £300 million increase in the industry's EFL for 1979-80 should be published in the White Paper, we ought to decide how to give publicity to the revised EFL. I also agree with you that this should be done through an arranged question, which I think ought to be answered with minimum publicity on Budget Day when the White Paper is published. I should be glad of the opportunity to comment on the draft of your answer.

I am copying this letter to the Members of E Committee, George Younger and Sir Robert Armstrong.

Yours

John Biffen

JOHN BIFFEN

14 MAR 1980

cc Mr Duguid

2pps

Prime Minister

To note.

12/3

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ
01 211 6402

Rt Hon John Biffen MP
Chief Secretary to the Treasury
Treasury Chambers
Parliament Street
LONDON SW1

12 March 1980

Dear John

In my letter of 26 February I referred to a new forecast of electricity sales in England and Wales for 1980-81. This was part of a complete revision of their forecasts of sales and demand for the period to 1986-87 which the Electricity Council have now given me. I enclose tables comparing them with the forecast the Council made in October 1979.

The main reason for the downward shift in the forecasts of both Simultaneous Maximum Demand (SMD) and sales is recent forecasts of lower economic activity in the UK. The implications for power plant ordering will be discussed with the CEGB and the Electricity Council. The Prime Minister has as you know asked the CPRS to report on the AGRs at Heysham and Torness. I believe that the strategic arguments for having a more diversified electricity supply system through increasing the nuclear element remain strong, as do the economic arguments for nuclear power. It will be to our disadvantage in the longer term if all our competitors have access to nuclear electricity, while we remain dependent on higher cost fossil based power. My statement of 18 December 1979 made it clear that the precise level of ordering of nuclear stations would depend, amongst other things, on the evolution of electricity demand. The key factor in these forecasts is whether modest growth in demand is resumed, as forecast, in about 1982. Meanwhile I am sure it is right to continue with our present flexible plans, and in particular work on the PWR, so that it is available when needed.

I am sending a copy of this letter to E Committee colleagues and to Sir Robert Armstrong.

Yours ever

David

D A R HOWELL

Unit requirements on the CEGB - Twh

	October 1979	growth %	February 1980	growth %
1979/80	230		226	
1980/81	232	0.9	226	0
1981/82	236	1.7	226	0
1982/83	241	2.1	228	0.9
1983/84	246	2.1	231	1.3
1984/85	251	2.0	233.9	1.25
1985/86	256	2.0	236.6	1.2
1986/87	261	2.0	239.4	1.2

Average growth
1.9% per year

Average growth 0.84%
Average growth from
1981/82 - 1.2%

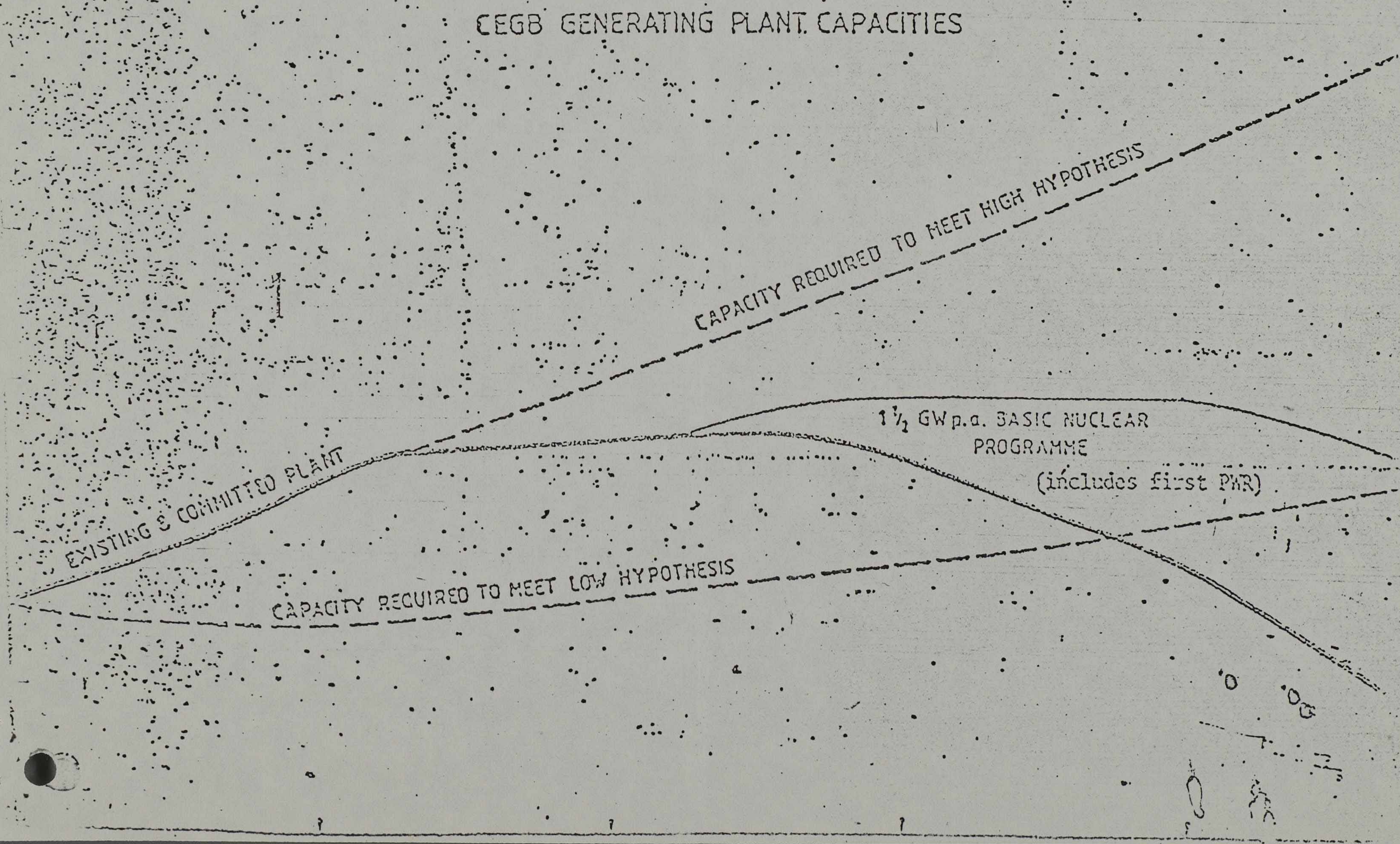
Unrestricted SMD on CEGB (GW)

	October 1979	growth %	February 1980	growth %
1979/80	46.4		45.6	
1980/81	47.07	1.4	45.7	0.2
1981/82	47.77	1.5	45.8	0.2
1982/83	48.50	1.6	46.2	0.8
1983/84	49.40	1.8	46.8	1.3
1984/85	50.30	1.8	47.3	1.1
1985/86	51.10	1.7	47.9	1.3
1986/87	52.00	1.7	48.5	1.25

Average growth
1.5%

Average growth
0.9%

Average growth for
1981/82 1.2%


CEGB GENERATING PLANT CAPACITIES
CAPACITY REQUIRED TO MEET HIGH HYPOTHESIS
1½ GW p.a. BASIC NUCLEAR
PROGRAMME
(includes first PWR)
EXISTING & COMMITTED PLANT
CAPACITY REQUIRED TO MEET LOW HYPOTHESIS

CONFIDENTIAL

Nat. Ind.

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SWIP 4QJ
01 211 6402

~~Duty~~

see x below

Rt Hon John Biffen MP
Chief Secretary to the Treasury
Treasury Chambers
Parliament Street
LONDON SW1

11 March 1980

Dear John

ELECTRICITY INDUSTRY EFL's 1979/80, 1980/81

In your minute of 4 March to the Prime Minister you proposed that, provided the electricity industry agreed to take steps to live within the EFL for 1980/81 you would be ready to drop all but £ 20 m of the proposed deferment of payments from 1979/80 to 1980/81. I have seen the Prime Minister's Private Secretary's letter of 6 March to yours, and have spoken to Tombs who has indicated that he will recommend acceptance of these proposals to the Council. I shall be discussing the options with him further, and in view of his reaction now propose to instruct the industry that the £ 20 m deferment should, as we agreed last week, be in respect of payments due to the NCB.

Tombs has predictably come back to the nature of the EFL. In writing to him I propose to use the following form of words, which follows the lines we discussed:

"On the EFL, this year has clearly demonstrated that, while it is a limit, it is not one which is applied without regard to the circumstances. In applying the limit we do of course take into account variations from declared estimates of sales, fuel prices, wage increases and inflation - together with their implications - and wish to discuss these with you as soon as they are identified."

We have still to decide how to give publicity to the revised electricity EFL for 1979/80. Subject to your views, I would propose to do this in an arranged Question on or shortly before 26 March.

I am copying this letter to Member of E Committee, George Younger and Sir Robert Armstrong.

Yours ever

David

D A R HOWELL

CONFIDENTIAL

Copied to
NAT IND : Steel
a NAT IND : Policy

10 DOWNING STREET

From the Private Secretary

6 March 1980

Nationalised Industries' EFLs for 1979-80 and 1980-81

The Prime Minister has now considered the Chief Secretary's minute of 4 March on the above subject; she has also read the letter of 29 February from the Secretary of State for Energy, and the letter of 4 March from the Secretary of State for Industry.

The Prime Minister agrees with the Secretary of State for Industry's proposal for transferring £150 million of BSC's EFL for 1979-80 to 1980-81, which the Chief Secretary has endorsed. She also agrees with the arrangement proposed by the Chief Secretary for the electricity industry's EFL for 1979-80, and she agrees that the present EFL for 1980-81 of £187 million should now be accepted and confirmed in the Public Expenditure White Paper. However, she does not think it would be right at this stage necessarily to accept that the only way of living within the 1980-81 EFL is to put up electricity prices by 10% in July. Instead, she would like the Secretary of State for Energy to bring a full paper to E Committee with recommendations on the ways in which the industry might stick to its EFL. This paper should look at all the options, including the possibility that working capital requirements might be lower next year on the assumption that it may not be necessary to spend so much on building up fuel stocks as in 1979-80 and it should be ready for discussion in E Committee immediately after the Easter Recess.

I am sending copies of this letter to the Private Secretaries to the members of E Committee, Godfrey Robson (Scottish Office) and David Wright (Cabinet Office).

T. P. LANKESTER

A.C. Pirie, Esq.,
Chief Secretary's Office.

CONFIDENTIAL

Copied to NAT IND: Steel

Prime Minister
I'm afraid the Treasury need an immediate decision on this. This advice seems the best way forward. Are you content?
TL 6/3

Ref. A01614

MR. LANKESTER

Nationalised Industries' EFLs for 1979-80 and 1980-81

With PM or TL?

You asked for advice on the minute from the Chief Secretary dated 4th March in which he asks for very urgent decisions about the EFLs for the BSC and the electricity supply industry in England and Wales both for 1979-80 and 1980-81. He needs certainty about the figures because they will be published on Budget Day.

2. The recommendations about EFLs for the BSC are probably inescapable. They represent a simple transfer of expenditure from one year to the next brought about by the steel strike. The problem is presentational rather than real - with a danger of misrepresentation on the 1980-81 figures against the background of the Government's firm adherence to £450 million for that year. But the presentational difficulties are not insuperable.

3. The EFL for the electricity supply industry in England and Wales presents a different problem. Here we are talking about real overruns and corrective action. You will recall that when E Committee discussed this subject on 26th February (E(80) 8th Meeting, Item 3) they agreed that the increase in the electricity industry's EFL for 1979-80 should be held at £200 million with a deferment of about £100 million of expenditure from 1979-80 into 1980-81. The Chief Secretary is now offering to absorb the greater part of the overrun into the 1979-80 figure (no doubt making use of the underspend on BSC as an offsetting factor). In the circumstances there is no need to object to this action - which indeed is helpful. But even without a carry-forward the electricity industry is heading for a substantial overspend in 1980-81, the full details of which are set out in Mr. Howell's letter to the Chief Secretary of 29th February.

4. The essential problem is this: a figure for electricity in 1980-81 must be published in the White Paper (Table 3.4 of the present draft) - and the White Paper goes to Press this week. Quite apart from publication problems, however, the Chancellor needs to know the number as part of his Budget arithmetic. The Chief Secretary suggests sticking to £187 million and accepting the consequences (which

CONFIDENTIAL

could include a 10 per cent price increase from July rather than the 5 per cent increase in October which Ministers have already agreed). The alternative would be to decide now on a different number. But this is neither practicable in the timescale nor sensible, given that the actual means by which the electricity industry would comply with the EFL have still to be argued through. In the circumstances the best course might be to agree to the maintenance of the present limit but expressly to reserve decisions on how to achieve it for the time being. Even a price increase as early as July does not need feeding into the consultative machinery before April or May and the Prime Minister would, I am sure, prefer to be able to take into account as well the work she has commissioned from the CPRS on electricity investment. It is of course also possible that at the end of the day Ministers might find that the most convenient package of measures also involved some adjustment of the industry's EFL (if necessary at the expense of the Contingency Reserve) - but this too is for the future.

5. If the Prime Minister agrees, the best course might be:-

(a) To endorse Mr. Biffen's and Sir Keith Joseph's suggestions on the BSC's EFLs.

(b) To endorse the proposed arrangement for the 1979-80 EFL for the electricity supply industry in England and Wales as proposed by Mr. Biffen.

(c) To endorse the electricity industry's present EFL for 1980-81 for publication in the expenditure White Paper and to commission Mr. Howell to bring a full paper and recommendations on the ways in which the electricity industry might live within this EFL to E Committee immediately after the Easter Recess.

Agree s.a.h.c.

RTA

ROBERT ARMSTRONG

6th March, 1980

CONFIDENTIAL

Prime Minister

Warning from the Treasury that the NCB may be heading for an over-spend next year. They are right to ask for an assessment of the options for bringing the NCB back within its cash limit.

2

CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon David Howell MP
Secretary of State
Department of Energy
Thames House South
Millbank
London SW1

5 March 1980

Dear David,

NATIONAL COAL BOARD EFL FOR 1980-81

Flag A

I have seen a copy of your letter of 15 February to the Chancellor of the Exchequer reporting the NCB's views that the coal price increases due to take effect from 1 March are designed to enable them to remain within their EFL for 1980-81.

As you say in your letter, if the Board are affected by unforeseen factors, they must take all practical steps to ensure that they still remain within the EFL. There are of course many uncertainties affecting the NCB's business in 1980-81, but some rough calculations by my officials suggest that the Board could well be in considerable difficulty in keeping within the limit. Coal production is rising, but sales are likely to be lower in 1980-81 because of reduced off take by the Generating Board and BSC. This will lead to increases in coal stocks above the levels planned with the result that the NCB could have an additional financing requirement of perhaps £100m-£150m.

I accept that it would be wrong to take precipitate action in view of the uncertainties, but all the signs seem to be pointing to the need for some action by the NCB if they are to contain their EFL within the published limit. No doubt you are considering with the NCB what needs to be done, and will let us have an early report since the earlier action is taken in the financial year, the better. I also hope that if it appears that excess stocks are indeed the cause of the pressure on the EFL, one of the steps to be considered will include reducing production.

I think we ought also to consider the postponement of the delivery of (or the payment for) some at least of the 5m tonnes of coal imports which the CEGB have arranged for 1980-81 with the NCB meeting the deficit from their excess production. If it is too late for the CEGB to alter its contracts, it might be possible for them to sell the coal abroad. I should be reluctant to see pressure brought to bear on the CEGB to restrain coal imports decided on commercial grounds, particularly as threat of coal imports might serve to inhibit the NCB and the miners from inflationary pay increases. Nevertheless, this option ought to be considered since it might produce public expenditure savings overall. I therefore suggest that your officials should prepare an assessment of the financial consequences of this option for the Exchequer, the NCB and the CEGB.

I am sending a copy of this letter to Members of E Committee and to Sir Robert Armstrong.

Yours

John Biffen

JOHN BIFFEN

Copied to NAT IND (Steel)

CHIEF SECRETARY TO THE TREASURY

PRIME MINISTER

NATIONALISED INDUSTRIES' EFL FOR 1979-80 AND 1980-81

Flag A

You will have seen Keith Joseph's letter to Geoffrey Howe of 4 March about BSC's inability to pay 1979-80 bills worth about £150 million until 1980-81. You will also have seen David Howell's letter of 29 February about the electricity industry's EFL for 1980-81.

Flag B. See Nat Ind: Elec + Gas Pricing attached.

There seems no defensible alternative to allowing BSC in these exceptional circumstances to transfer £150 million of its EFL for 1979-80 to 1980-81, though I agree with Keith that we should present this separately from the existing 1980-81 EFL of £450 million. The consequent increase in public expenditure (a little over £100 million in Survey prices) makes it even more important to avoid any other increases in EFLs for 1980-81.

I also think we need to reconsider the decisions we took on electricity at E Committee last week in view of the new information. As I understand it, David Howell is in effect saying that if we force the electricity industry to defer £100 million of its payments from this year to 1980-81, which is the effect of limiting the increase in this year's EFL to £200 million, he can see no acceptable way of ensuring that the EFL of £187 million for 1980-81 is made to stick. In all the circumstances I would now be ready to drop all but £20 million of the proposed deferment, provided that the electricity industry agrees on the basis set out below to take steps to live with the EFL for 1980-81. The electricity increase this year would then be £280 million (before allowing for the further losses from the steel strike mentioned at the end of Davids's letter which might bring the total to around £300 million). I think we must accept that the industry would on current assumptions need to raise prices in July by about 10 per cent as a minimum in order to achieve the first stage of its financial target and to reduce its capital expenditure by the means David mentions which add up about £40 million. The industry would still be left with about £40 million to absorb next year to remain within the agreed EFL of £187 million for 1980-81.

Now that the electricity story is in the public domain I think we should be ready to publish the electricity figure for 1979-80 in the White Paper at the same time as we publish BSC's transfer of £150 million from 1979-80 to 1980-81. Given the publicity on electricity it would be difficult to defend leaving the present unrealistic figure in the White Paper. We can leave the question whether there should be a separate announcement on electricity before the Budget until we see when the steel strike comes to an end, unless of course, the weekend Press reports mean that we can make an announcement now.

The timetable for the White Paper is now very tight and I propose to make the changes proposed above unless I hear to the contrary by Thursday lunch-time.

I am sending copies of this minute to Members of E Committee, George Younger and to Sir Robert Armstrong.

A C Pirie

P.P. JOHN BIFFEN
4 March 1980

[Approved by the Chief Secretary
and signed in his absence]

Not Fwd

NBam

TL 29/2

01 211 6402

The Rt Hon John Biffen MP
Chief Secretary to the Treasury
HM Treasury
Parliament Street
LONDON SW1P 3HE

29 February 1980

Dear John

ELECTRICITY INDUSTRY EFL 1980/81

22.2.80 In his minute to the Prime Minister, Geoffrey Howe proposed that Ministers collectively should decide as early as possible in March on actions to be taken to keep the electricity industry to its financial target and within its 1980-81 EFL. Before that happens, I would like to discuss things with you: this letter is intended to provide a framework for the discussion, though of necessity it is only an interim account of the situation.

The main factors in our consideration of next year's EFL are these:

a) the national average fuel price is now estimated at 4250 p/te, compared with 4000 p/te when the EFL was set in November. The industry's assumptions here are a coal price increase of 20% in January 1981 and an oil price increase of around 20% between March 1980 and March 1981. Neither of these is improbable.

b) there is a good deal of uncertainty about fuel stocks - the CEGB's best estimate is of a total coal burn of 82 mt, which implies a take and burn of 75 mt of NCB coal (the balance being imports and licensed mine coal). But it is notoriously hard to forecast these things at this time of year - the vagaries of the weather and of sales (not to mention the effects of any industrial action) could vary this assumption by 3 mt or more;

c) the current EFL assumed that 12% of "new money" would be sufficient to settle this year's pay round. I am advised that in current circumstances 15% is not likely to achieve settlement and that even 18% may not be enough (each percentage point represents about £10m on costs). In addition, the recently announced arbitration award for power engineers has raised the effect of last year's wage round on 1980/81 wage costs from 6% to 8%.

d) the industry have revised their sales forecast for 1980-81 downwards in the light of reduced economic activity. It now stands at 226 Twh - a considerable decline compared with the earlier forecast of 232 Twh. The industry believes that the new figure could still be on the top side, and will be looking at it again in the Spring when they have fully analysed this year's sales figures.

All these factors pose threats to the achievement of the EFL of £187m; a deferment of £100m payments from this year increases this pressure.

I have discussed the implications with the industry. They advise that if we stayed with our present intention to follow the April 17% tariff increase (which cannot now be altered) with a 5% increase in October, the industry's borrowing requirement would rise to £510m, assuming the deferment of £100m from 1979/80, and no further action to reduce costs beyond what the industry have already done. This would also have serious implications for the industry's financial target. (Though the latter is expressed as an average of 1.8% pa over 3 years, we have accepted that industry will follow a path starting with 0.9% in 1980/81). Other options are set out in the following table, which shows that, on the same assumptions, a tariff increase of 21% in October or 15% in July would be required to stay within the EFL - substantially above the 10% gas price increase envisaged for October:

Tariff Increases	CCA Return %	EFL £m
5% in October	-0.3	510
10% in October	+0.5	440
10% in August	+0.7	360
11% in July	+0.9	330
15% in July	+2.2	187

The industry are extremely reluctant to contemplate any tariff increase in excess of the 10% envisaged for gas, and are concerned about the further effect on electricity demand which could result from two large increases within a matter of months.

The industry have also let me have their proposals for further reductions in capital spending (ie beyond those assumed when the cash limit was set). There is no further reduction available from the Area Boards, whose capital programmes have already been put under considerable pressure. Further savings on the CEGB's 1980/81 programme of about £40m have however been identified. These comprise

a) delaying the start on site at Heysham II from April 1980 to August 1980 (£26m)

(3)

b) deferment of CEGB expenditure on a specific coal import facility (£11m)

c) discontinuing work on Grain units 4 and 5 and transferring the turbines to Heysham II (£10m): I understand that £8m of this saving is independent of the transfer of the turbines, though the effects in subsequent years will depend on whether the transfer is undertaken. I discuss this further below.

d) deletion of a number of smaller schemes

e) likelihood that the start on site of the PWR will be delayed (£1m); this is a recognition of the extreme tightness of the programme in aiming for a 1982 start; it would not be announced and would not represent any slackening of effort

I am continuing discussions with the industry to establish whether further reductions are possible and have asked for their latest economic assessment of Heysham II. However, it is clear that further significant cuts would have severe implications for the plant industry. Already the transfer of the turbo-generators from units 4 and 5 at Grain to Heysham II would be very damaging to NEI/Parsons, who have the design contract for turbo-generators for Heysham II, and would normally expect to get the hardware order. The implication of this, and of any deferment of Heysham II beyond August 1980, would need very careful consideration. Geoffrey Howe has rightly mentioned the effect on the nuclear industry and on Torness. Any further deferment of Heysham II, let alone its cancellation, could well call in question the Government's commitment to the nuclear power policy I put forward in my statement to the House on 18 December 1979. These major issues need careful consideration, which could not I think be completed by early March, when it will be necessary for us to take decisions on the EFL.

Economies in other directions will I think be very difficult to achieve. As Geoffrey Howe points out, the industry has been squeezed hard over the past 19 months, and any further savings through improved efficiency are unlikely to be significant. (The industry has been striving for some time for instance to accelerate payment of bills and to reduce bad debts). Provision for salaries is, as I have pointed out, very tight.

A reduction in working capital requirements could be achieved by reducing fuel stocks. To ask the industry to reduce their coal take from the NCB would cause difficulty for the NCB's external financing limit and would be imprudent for strategic reasons, as would a reduction in imports. The present assumptions include a year-on-year reduction in oil stocks of some 300,000 tonnes: it would be imprudent to do more. The assumptions also include an increase in the value of nuclear stocks, arising from contractual obligations to take both uranium concentrate and enriched uranium; the industry have been asked to examine the possibility of deferring receipt of some of this material. But fuel stock reductions carry with them the risk of reduced endurance in the event of industrial action; minor savings may be possible, but even here there are dangers.

(4)

The position as I see it therefore is that a 10% August tariff increase and the £40m reduction in capital which I have so far obtained would result in a borrowing requirement of £320m. This exceeds the November EFL by £133m (of which £100m is payments deferred from 1979-80). There are large uncertainties about load growth, stocks and fuel prices. I am exploring all possibilities, but I must warn you that I think it most unlikely that further savings of anything like this amount can be found on capital account; as I have pointed out, painful consequences for other industries are likely from the savings already identified. The other main possibility is a tariff increase in excess of 10%, which I regard as most undesirable.

On 1979/80, I now propose, if you agree, to ask the industry to activate arrangements they have made for deferment of payments of broadly the following amounts:

	£m
NCB	50
Oil companies	30
Other	20
	100

Although the conclusion at E Committee was that the increase in the industry's EFL should not exceed £200m, I must warn you that, as I pointed out at the meeting, the steel strike is adding to the prospective breach at the rate of £4m per week, so that an increase of £200m may not in fact suffice.

I am sending copies of this letter to members of E Committee and to Sir Robert Armstrong.

Yours ever

David

D A R Howell

Nat Ind

CONFIDENTIAL

Ref. A01526

PRIME MINISTER

A Gas Tax or Levy

(E(80) 19)

BACKGROUND

This paper deals with a loose end left over from the E discussion on gas prices before Christmas.

2. The issue is straightforward: given that prices are going up, and that targets have been set accordingly, how can the high profits of BGC be creamed off, to the benefit of the Exchequer? The real effect on the PSBR is stated to be nil, because BGC's profits are lent to the Exchequer at present - the so-called 'negative NLF' arrangement - though in fact there may be a net gain because the Exchequer will not have to pay interest on BGC's lending.

3. The paper by officials examines four options, and comes down in favour of a levy on gas purchased. The two Ministers agree. They want to make an early announcement, and perhaps to legislate if possible in the Finance Bill (though this point is in dispute). They also want to consult with BGC, and to reserve a final position on the amount of levy until this has been done.

4. The paper does not discuss the important issue of public presentation of the decisions taken. As things stand, the chosen options will appear as an arbitrary import by Government. You may care to inquire about this. For example, could the levy be justified as a <u>substitute</u> for PRT? How do the levy proposals rate in income terms against the PRT which would have been payable if 'old gas' were not exempt? Would not a justification on these lines make it easier to defend future price increases?

HANDLING

5. It should be possible to dispose of this paper fairly quickly. You might call on the two joint authors to speak in turn - the Chancellor first, the Secretary of State for Energy second and then perhaps Sir Kenneth Berrill. After that, one or two other Ministers might wish to intervene. But you may wish to emphasise that you are not re-opening the decision on gas prices; this is an argument about presentation and about accounting arrangements, not about substance.

6. If, however, Ministers wish to get into detail, there are three points which are worth pursuing:

(i) Should legislation be in the Finance Bill, or separately? The Chancellor will report on the enquiries officials have been making: there is a serious risk that this legislation would make the Finance Bill hybrid, and they will advise that it should go into a separate Bill. There is no place for this as yet in next year's programme. Mr. Howell may however propose that a very short Bill be added to this year's programme, to take the place of his BNOC Bill which he and the Chancellor agree should now be postponed to next year. The Chancellor of the Duchy will not be at this meeting; but I understand he would say that there is no hope of finding time for a new Bill. The spare time has already been used up with the new Social Security Bill.

(ii) The exact nature of the levy. Paragraph 5 of the cover note sets the upper limit as the amount of economic rent accruing to BGC, but notes that BGC will wish to retain some part of their profit as a 'cushion'. The paper is drafted in terms of a fixed price per therm of gas purchased. An alternative, and more sensitive, version (put to me by the CPRS) would be to charge levy on the difference between the various beach prices of BGC gas and either the gross selling price of the gas or its oil-related value. The amount of the levy, as a percentage of this difference, would be so determined as to recover a proportion, possibly rising over time, of this difference, leaving the balance with the Corporation. This links with the 'substitute for PRT' point I have referred to above.

(iii) Public expenditure effects. Paragraph 6 points out that, although the PSBR effect of the levy is neutral (in practice even beneficial, given that BGC will not receive interest on the loans they would otherwise make to the Exchequer), its effect on public expenditure is, perversely, to increase it. This is, of course, an optical illusion; but it has its presentational difficulties. One way of postponing the impact, again proposed by the CPRS, would be to make the levy payable a year in arrears.

CONCLUSIONS

7. You should be able to guide the Committee to endorse the five conclusions listed in paragraph 9 of the joint paper, modified as above. The conclusions would then be:

(a) that BGC's excessive profits for 1980-81 onwards should be reduced by a levy on their purchases of PRT-exempt gas [collected a year in arrears].

(b) That the Government should announce its intentions soon with a view to taking the necessary powers as soon as practicable [either in the Finance Bill; or in separate legislation in the present or next Session of Parliament].

(c) The levy should be set at the level which will secure for Government the desired proportions of the economic rent going to BGC [on the lines of the formula proposed by the CPRS or by a direct analogy to PRT foregone].

(d) BGC's financial targets should be adjusted accordingly.

(e) Treasury and the Department of Energy officials should consult BGC, consider the appropriate form and level of the levy, and report back to Ministers accordingly. [It should be possible for the final step to be cleared between the Secretary of State, Chancellor of the Exchequer and yourself without troubling E Committee again].

RtA

(Robert Armstrong)

25th February, 1980

Ref. A01524

PRIME MINISTER

Electricity Industry in England and Wales: External Financing Limit 1979-80

(E(80) 20)

BACKGROUND

Sir Kenneth Berrill warned you, in a minute dated 6th February, that the overspend on the electricity external financing limit would present Ministers with very serious problems. Accordingly, you asked that a paper should be prepared for E Committee. Mr. Howell sent you a long minute about this on 19th February, but the information was not complete, and further facts are still being sought from the Electricity Council about next year's position. But a decision on the limit for the current year is now urgent. If it is to be exceeded - as seems almost inevitable - the Chancellor considers (in his minute to you of 22nd February) that an announcement must be made very quickly. Otherwise, any announcement will look like retrospective validation of an overspend, and weaken the discipline which the limits are designed to impose. This means taking two bites at the subject: this week, for the current year, and next week (or a little later) for 1980-81.

2. The immediate problem is therefore whether to sanction an increase in the cash limit for 1979-80 of about £200 million. Since the total excess is about £325 million, the balance will be found by savings of £25-£30 million (not all of them real: some of them will be acceleration of payments by debtors) and by rolling forward £100 million of bills for fuel supplies into next year. The second makes the position next year even worse.

3. Two subsidiary questions then arise:

(i) Should any disciplinary action be taken against the industry? It was precisely such a deterioration in the financial position of the steel industry which precipitated the decision to replace Sir Charles Villiers. The Chancellor's letter of 20th February and his minute to you of

22nd February suggest an independent investigation by outside accountants of the electricity industry's internal financial control system; the Secretary of State (25th February) turns this down.

(ii) How does the Government defend increasing the limit for electricity, while at the same time standing firm on the limit for steel, despite the strike? There is a difference. Electricity relates to 1979-80 whereas the BSC argument is about 1980-81; the electricity increase relates largely to financing stocks rather than to pay; there are other examples of overruns in 1979-80, including the Post Office. But it will not be easy to defend the apparent difference of treatment in public unless of course BSC is also overrunning in 1979-80.

4. A later meeting will have to consider the very much more serious questions next year: should prices go up further in the autumn? Should there be cuts in the capital programme to compensate? Should the high level of stocks be allowed to run down again, to reduce the financing burden? Should the whole system of cash limits for nationalised industries be reconsidered? These are the issues which arise on Sir Kenneth Berrill's latest minute, dated 22nd February.

HANDLING

5. I suggest you start the discussion by defining the limited topics for discussion at this week's meeting: should the electricity financing limit for 1979-80 be increased by £200 million? Should there be any penalties against the industry? Should the announcement be made immediately, despite the steel strike?

6. You should then ask the Secretary of State for Energy to introduce his paper, and call for comments from the Chancellor of the Exchequer (or perhaps the Chief Secretary). The Secretary of State for Scotland should also be given a chance to speak, although the Scottish Electricity Boards, who have also faced similar cost increases, have apparently been able to live within their financing limits. The Secretary of State for Industry may want to comment on the implications for the steel industry. You might also ask Sir Kenneth Berrill to comment.

7. Towards the end of the discussion, you might say that the Committee will have to consider very much wider questions in its next discussion. This will inevitably bring up the general question of the future of the cash limits for the nationalised industries. You have decided to set up a small Sub-Committee for this purpose (on which I submitted advice last week). But it will not be possible to redesign the cash limit system in a hurry: decisions on the electricity cash limit for 1980-81 will have to be taken very soon, because of the possible implications for prices later in the year.

CONCLUSIONS

8. At this stage, you might aim to record the conclusions on:

(a) The proposed increase in the electricity external financing limit for 1979-80: by £200 million, or some other figure?

(b) Whether or not to impose some sanctions on the industry for their failure to report, and tackle, their problems in good time?

(c) When to announce the increase: now, or after the end of the steel strike?

RA

(Robert Armstrong)

25th February, 1980

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ

Tel: 211 6402

CONFIDENTIAL

The Rt Hon Sir Geoffrey Howe QC MP
The Chancellor of the Exchequer
H M Treasury
Treasury Chambers
Parliament Street
London SW1

R 25/2

25 February 1980

Dear Geoffrey

ELECTRICITY INDUSTRY EFL

Thank you for your letter of 20 February.

I have of course made the Government's concern over the EFL position abundantly clear to the electricity industry and they are in no doubt whatever of our views. In their dealings with me, the industry have certainly not given the impression that they are treating this matter in a cavalier fashion; on the contrary they have shown very great concern about it.

The breach is very largely due to an increase in the volume of fuel stocks and to rising fuel prices - though it is now the case that sales are expected to be lower than when the EFL was agreed and the steel strike is having a continuing effect. It should be remembered that fuel stocks were built up at our request against the threat of a miners' strike, which was not removed until early December.

You point out that Frank Tombs has said that notice of the increase could have been given to us 3 weeks before it was - i.e late in December. Since the threat of industrial action by the miners was not lifted until early December, I think the timing suggested by Frank Tombs does not necessarily demonstrate grave defects in the industry's financial reporting system, but rather the extreme uncertainty until the miners' decision was known. It is however arguable that the electricity industry should have kept us better informed of what the consequences of stock building might be if there was no industrial action by the miners, and this is certainly a lesson they have learned.

I question whether a public demonstration of disquiet about the electricity industry's management would help us in our aim of getting

/their

their EFL right - and I simply cannot agree that it would make any sense to commission an independent report, as you propose, or in any other way. It would not in any event be an easy matter to present, since the industry was reponding to Ministerial pressure in building up stocks. Further it could be the one certain way of ensuring that we do not get the whole hearted cooperation we must have in dealing with the EFL position. The financial reporting arrangements within the industry have been tightened up still further, and I believe that we should give the new arrangements a chance to demonstrate their effectiveness before taking the sort of action that you propose. It is also relevant that I have in mind improvements in financial control at Board level at the Generating Board as part of my proposals on the organisation of the electricity industry which I shall be putting forward shortly.

I am sending copies of this letter to the recipients of yours.

Yours ever

David

D A R HOWELL

25 FEB [illegible]

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

ELECTRICITY EXTERNAL FINANCING LIMIT 1979-80 AND 1980-81

I have seen David Howell's minute to you of 19 February which I understand is to be discussed in E Committee next Tuesday.

2. You will have seen my letter of 20 February to David Howell registering my strong disquiet that the industry did not inform us earlier of the prospective over-run of £300m. There is no disguising that the episode is damaging to the EFL system. I do not regard this as mitigated by the fact that the building up of stocks was undertaken with our encouragement; if this was expected to put a strain on the EFLs, it should have been identified and the issue put to us in advance. As I said in my letter, the conclusion suggests itself that either the industry's financial forecasting leaves something to be desired, or they simply do not take their EFL seriously. I suspect that the industry's failure to inform us earlier of the prospective overrun has a lot to do with the fragmented structure of the industry: the CEGB incurs most of the industry's capital and current costs, the 12 Area Boards receive the revenue from the public with the Council co-ordinating finances. Financial control must clearly be difficult in such circumstances, particularly if relationships between the Council and the CEGB are not as close as they might be. I hope therefore that David Howell's present examination of

the future structure of the industry will bear these points in mind.

3. Timing

The industry's EFLs for 1979-80 and 1980-81 are linked for the reasons explained in David Howell's minute. But I think that we ought to come to decisions at E Committee on the 1979-80 EFL even if we defer decisions, as I think we should, on what needs to be done to keep the industry within its published EFL of £187m for 1980-81. I say this because it is important to announce by the end of the first week in March the increase in this year's EFL, though there is a conflict between this general argument, which applied equally to the Post Office, and the need to avoid undermining the position of BSC management in their pay dispute. Any later announcement would discredit the EFL system since it would appear that the EFL was being adjusted upwards in the last days of the financial year simply in order to avoid a breach. It would be even more damaging to make no announcement, leaving the EFL at its present level. The nationalised industries would be bound to draw the conclusion that in the last resort the Government was willing to turn a blind eye to a breach, particularly if it was a big one. My conclusion therefore is that we ought to resolve at E Committee our response to the prospective breach in the industry's 1979-80 EFL.

4. 1979-80

David Howell points out in his minute that if the industry defers payments of about £100m from this year to next and makes savings of the order of £25m-£30m, this would leave a remaining excess of about £200m to be added to this year's EFL, making it £132m. I hope it will still prove possible to reduce the size of this excess.

5. I will shortly be reporting to Cabinet the consequences of the anticipated excesses of both the Electricity Council and the Post Office for this year's Contingency Reserve in accordance with the procedure in C(79)4. Briefly the position is that if the electricity industry's EFL was increased by £200m and that of the Post Office by £50m-£60m, in addition to the increase already announced as a result of the billing backlog (both figures in outturn prices), the remaining balance in the Contingency Reserve for this year would be reduced from £220m to £20m (both figures in Survey Prices).* At this stage of the year we can probably draw down the Contingency Reserve to this extent without undue risk, but it is uncomfortable to have come so close to exhausting the Reserve, and I shall have to report to Cabinet that there is virtually no room to accommodate further bids.

6. If colleagues agree, I suggest that there is an early announcement of the increase in the EFL of some £200m. David Howell and I would need to review the precise amount of the increase just before the announcement to take account of further effects of the steel strike on the industry; for every week the strike lasts, the cost to the industry is some £4m. The announcement will need to be presented with great care, particularly in view of possible repercussions on the steel strike. The announcement, which could be by way of a written answer, could emphasise the success of the industry in building up stocks in the face of the current uncertain energy supply situation. The answer might give some information on actual stock levels and end by pointing

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*This assumes that BSC will find a way of processing its bills, despite the strike among its clerks, and would use its EFL to the full.

out that this was the main reason why the industry's EFL had to be increased by £200m. (Not all the £200m increase can be ascribed to the higher fuel stocks; some £200m of the £300m excess is certainly due to that cause, but some £75m of the £100m payments to be deferred into next year are for fuel bills.)

1980-81

7. Our starting point for our consideration of the industry's 1980-81 EFL must surely be that it is essential to hold the published EFL of +£187m and if at all possible to see some reduction in it on account of the 1979-80 excess. We will need to consider the impact on other industries if the electricity industry was allowed to exceed this year's limit virtually with impunity. This could seriously reduce the effectiveness of the system.

8. David Howell's minute reports the deterioration in the industry's financial prospects in 1980-81 as a result of higher coal prices, lower sales and salary increases above the level assumed. As he points out, this will have consequences for the EFL. But just as important, it will make it harder for the industry to keep on path for meeting the three year financial target announced last month. Indeed, irrespective of any problem with the EFL, action would have been needed in any event to recover unforeseen cost increases so as to keep the industry to its target path. There ought therefore to be no criticism that the rigidity of the EFL is forcing the industry to take action against its will - action is necessary to keep on path for meeting the medium term financial target, which the industries want us to treat as the main constraint of financial discipline.

9. We are not yet in a position to take final decisions on the action needed to keep the industry within its 1980-81 EFL, but I agree with David Howell that action looks to be necessary on tariffs and cuts in the industry's capital programme. I note, however, that he makes no reference to the possibility of savings through improved efficiency, reductions in overheads etc. The industry has been squeezed hard over the last 19 months, but I should be surprised if there were not some savings, however modest, to be had from this source.

10. I understand that we will soon have a report on the industry's review of its capital programme, particularly of the three projects, new oil fired power stations, Drax and the new AGR station referred to on the fourth page of David Howell's minute; I would hope that the Area Boards', admittedly much smaller, programme is also put under the scrutiny. I would not rule out action on the new AGR programme at Heysham. I understand that some tenders received show costs some 40 per cent higher than assumed and this, together with the industry's lower load forecasts, must reduce the economic case for proceeding with the station at least as quickly as now planned. Delay or cancellation would certainly cause difficulties for the plant industry and would be difficult to reconcile with the statement in the House of Commons on 18 December. There also could be consequences for the Scottish station at Torness, though presumably it does not follow that action on Heysham II would have to be mirrored by action on the Torness station. These are all real difficulties, but at a time when public expenditure is under such restraint, we cannot afford to order in advance of need what could turn out to be a white elephant costing well over £1bn. I recognise that the savings in 1980-81 from postponing or cancelling Heysham II will not be large, but they would be considerable in later years.

11. I also recognise the difficulty of action to reduce fuel stocks in the face of uncertainty about oil supplies and the advance in the NUM settlement date. But some reduction in oil stocks and in coal stocks, even if not as much as the 3m tonnes referred to by David Howell, could help reduce any increase in tariffs. No doubt David will let us know whether he expects coal production to exceed consumption next year and how the NCB will accommodate this with their published EFL. It is also relevant here that one element in the prospective excess in the industry's EFL for 1980-81 is higher coal prices - they now assume an increase of some 45 per cent in coal prices in the year compared to their earlier forecasts of 24 per cent. As we have seen before, excessive increases in the coal industry's costs are being borne by the electricity consumer.

12. Conclusion

So, to sum up, I suggest that there should be an early announcement of the increase in the industry's EFL for 1979-80 of some £200m on the lines indicated in paragraph 7 above. We should then decide as early as possible in March on the action that needs to be taken to keep the industry on the path to its financial target and within its 1980-81 EFL. For that purpose, we ought to know the outcome of the industry's review of its capital programme in the light of its lower load forecasts, and have a report on the case for, and the consequences of postponing or cancelling either or both of the AGR stations and for other large reductions in capital spending.

13. I am sending a copy of this minute to the Secretaries of State for Industry, Energy and Scotland, the Chief Secretary to the Treasury, other members of E Committee in view of our forthcoming discussion, and to Sir Robert Armstrong.

G.H.

(G.H.)

22 February 1980

CONFIDENTIAL

Qa 04444

Prime Minister

To: MR LANKESTER

From: SIR KENNETH BERRILL

TL 22/2

Electricity Council's External Financing Limits
for 1979/80 and 1980/81

1. Mr Howell's minute to the Prime Minister -19.2.80 will be raised at next Tuesday's E Committee. The minute has exposed a situation that is very much worse than we in the CPRS anticipated when we recently raised the subject with the Prime Minister. For not only will there be a large breach this year of at least £300m. (less any deferrals of payments until 1980/81) but there is now a substantial breach in prospect for next year before any account is taken of possible carry forwards from 1979/80.

2. Mr Howell has given a graphic description of the difficult situation facing Ministers and a carefully designed package of measures is needed to handle this major test of the EFL system. Mr Howell's minute offers little guidance on this and he will have to come back with some firm proposals before decisions can be taken. Possible measures which the Prime Minister may wish him to consider are:

(i) Tariff in 1980/81. Clearly the previous concept of increasing electricity prices in April 1980 by the RPI rise and by another 5 per cent in October will not be adequate. At the same time the recent 30 per cent increase in gas prices in 1980/81 was justified by the need to begin to close the gap with electricity. This implies that the maximum for electricity might be 25 per cent and imposing it all in April would give the biggest yield. The industry's Consultative Councils will protest loudly against the sudden imposition of such a large increase, and they may ask for phasing (April and October). We doubt that the benefits of phasing would anywhere near approach the cost of lost revenue: as a rough rule of thumb, each one per cent of the rise deferred from April to October would cost the Electricity Council £25m.

(ii) Reducing the capital investment programme. The capital programme for 1980/81 is currently budgeted at over £1bn. Most of this is firmly committed to projects that are well advanced. The only two major projects at an early stage are a coal-fired station at Drax and the new AGR at Heysham.

At Drax, site construction has been under way for over a year and the major hardware contracts are placed. We agree with Mr Howell that the contractual commitments would probably make cancellation too expensive. It would also hit the plant industry hard.

The Heysham AGR is however a different story. Work has not started on site construction and the major hardware contracts have not yet been placed. With AGR costs escalating and electricity demand forecasts falling, it is virtually certain that if the AGR decision had been put forward today the answer would be 'No'. We believe that Mr Howell's minute exaggerates the effects of cancellation on the nuclear industry and on the plant manufacturers. It is true that Northern Engineering Industries (particularly the Reyrolle-Parsons arm) would be badly hit, but this might spur on the much needed rationalisation of the power plant industry. The nuclear design teams, NPC and GEC, on the other hand, would not be affected greatly provided that the Torness AGR for SSEB continued to go ahead.

(iii) Joint CEGB/NCB Financing of Coal Stocks. To the extent that the CEGB are carrying 'excess' coal stocks, i.e. above their normal operational requirements, this is clearly benefiting the NCB. Ministers will not wish to see stocks reduced in the face of the earlier NUM settlement date next year and it seems worth exploring the possibility that the NCB share the costs of the 'excess' stocks (valued at £100m. or so).

(iv) Deferrals of £100m. into 1980/81. The electricity industry believes that it could defer payments of about £100m. from this year to next (£50m. to the NCB; £25m. to the oil companies; and £25m. to CEGB plant and other suppliers). This would reduce their prospective 1979/80 breach to some £200m. On present prospects they may not be able to recapture this lost ground in 1980/81 and may have to continue this late payment into 1981/82.

(v) To write off the £200m. against this year's Contingency Reserve. It would probably be counter-productive to penalise the electricity industry further by forcing them to carry forward any of this £200m. over-run. The £200m. can all be attributed to circumstances outside the industry's control (higher fuel prices, low electricity sales, high arbitration award on pay, and high fuel stocks at Government encouragement). The Electricity Council can be faulted for not being aware of their likely 1979/80 over-run at an early date. But the main reason for the size of the over-run was that their EFL did not contain contingency margins for such a combination of unfortunate circumstances. But if they had insisted on such contingency margins the public expenditure problems facing Ministers would have looked that much worse.

4. This whole episode must call into question both the system for fixing nationalised industry cash limits and the quality of financial management in the electricity supply industry in England and Wales, i.e. the Electricity Council, the CEGB, and the twelve Area Boards. It would be interesting to ask why the SSEB, which has a unified structure, has not run into the same financial difficulties, and why it seems likely to live within the existing EFLs for this year and next.

5. I am sending a copy of this minute to Sir Robert Armstrong.

KB

22 February 1980

CONFIDENTIAL

Nationalised Industries

Ref. A01491

MR. WHITMORE

The Secretary of State for Energy's minute of 19th February to the Prime Minister about the electricity external financing limit 1979-80 and 1980-81.

2. I am clear that we shall need a Ministerial meeting on this subject. The Treasury are pressing for early Ministerial discussion of these issues, because they want to get any change in the external financing limit for 1979-80 agreed and announced before the end of the financial year. On the other hand the Department of Energy will not have full information about the prospects for 1980-81 until early next week. This is too late for the Treasury's timetable for 1979-80.

3. The proposals raise important issues, including electricity prices and decisions on electricity investment, and have implications for the cash limit on steel. These are issues which the Ministerial Committee on Economic Strategy should be asked to consider.

4. I am afraid that I see no alternative to taking two bites at the problem at E in successive weeks. I have already asked the Department of Energy to prepare a short paper about the 1979-80 position which can be added to the agenda for the meeting of the Ministerial Committee on Economic Strategy at 10.00 am on Tuesday, 26th February. We shall then need a further paper from Mr. Howell about 1980-81 for discussion at the next meeting of the Committee, the following week.

5. If you agree I will propose accordingly in the business minute to the Prime Minister tomorrow.

RA

ROBERT ARMSTRONG

21st February, 1980

CONFIDENTIAL

FILE Original in G/R DSG

CF to note

ccDE

10 DOWNING STREET

THE PRIME MINISTER

21 February 1980

Dear Mr. O'Neill,

Thank you for your letter of 22 January enclosing correspondence from your constituent, Mr. W. A. Turner of 4 Harviestown Road, Dollar, about the proposed gas price increases.

The Government recognise that adjusting to an era of higher energy prices brings serious problems for many consumers, especially the old and the poor. Our new scheme of assistance with heating costs announced last autumn is designed to provide worthwhile help for those most in need. The Government will take proper account of the cost of energy in its social policies and in determining the level of benefits. We are reviewing the whole range of help available to assist consumers with fuel bills so as to make extra provision for the elderly and others on low incomes who need help. I would however stress that the price increases resulting from the new financial target will not affect this winter's bills. The Secretary of State for Social Services intends to announce the Government's proposals in good time for people to plan how they can best manage next winter and these proposals will be fully publicised.

Turning to the question of the rise in the price of domestic gas it might be helpful if I explained some of the factors behind the Government's decision to set British Gas a financial target

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which would result in prices increasing by 10 per cent over and above the rate of inflation this year followed by comparable increases in the following two years.

First of all there is a problem over supplies. Domestic gas prices have risen by much less than the rate of inflation generally and by very much less than other fuels over the last few years. This has resulted in a massive surge in the demand for gas which has far outstripped British Gas's ability to supply. As a result there are 70,000 homes and 4,000 firms waiting for a supply who cannot get one. Those who do not have gas would be prepared to pay much more than the current price charged to the domestic consumer. Thus far from British Gas competing for customers, people and firms are competing for gas. In these circumstances were it not for British Gas's monopoly the price would move rapidly upwards towards the level of competing fuels whose price is largely determined by world market forces.

Secondly, British Gas's costs have been rising and if the price did not rise they would soon be making a loss on their domestic sales. Their profits are all coming from their industrial consumers who are charged a price related to oil which is significantly higher than that paid by their domestic consumers despite the fact that it costs much more to supply gas to the home.

Thirdly, our reserves of natural gas are limited and as world prices of energy rise represent an increasingly valuable national resource. If the price is too low we shall burn it up more quickly and bring forward the day when we have to turn to much more expensive sources of supply. At present two-thirds of our gas comes from low cost gas fields under contracts signed before the major increases in oil prices since 1973. But this proportion is now falling. The growing balance, largely from the deeper, more distant waters of the northern North Sea - and some of it imported - is already up to six times more expensive and it will become even more costly if oil prices continue to rise.

/ These

These considerations inevitably pointed to the need for a substantial rise in the price of domestic gas. Although, as I have said earlier, free competition would probably result in a rapid move to higher prices, the Government decided it would be far better to set British Gas a target which would cause them to phase in the inevitable domestic gas price increases carefully and gradually. The alternative would be to try to put off the day and then suddenly be faced with the need for very large increases all at once, as we have seen with oil.

I know that price increases are never welcome and it would have been easy to have announced only this year's increases but we believed that it was right that gas consumers should be told of likely future price trends rather than have the sort of increases that oil consumers have had sprung on them.

Yours sincerely,

Margaret Thatcher

Martin O'Neill, Esq., M.P.

CONFIDENTIAL

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

R 21/2

20 February, 1980

Dear David

ELECTRICITY INDUSTRY EFL

I have seen your letter of 8th February to John Biffen in which you reply to his letter of 28th January.

In his letter John Biffen asked you for your ideas on how we might publicly underline our dissatisfaction with the electricity supply industry's financial management. I note that you do not deal with this point in your reply. I am sure, however, that it is most important to make clear to those responsible in the electricity supply industry for financial management that the Government cannot permit EFLs to be treated in such a cavalier manner. The fact is that the prospective overrun of £300m. is not due to fall in industry's sales revenue - sales revenue is apparently slightly higher than that assumed when the EFL was agreed. The cause of the excess is the increase in the volume of fuel stocks and in prices and costs generally.

I recognise that Sir Francis Tombs accepted at your meeting with him on 21st January that earlier notice could have been given of the prospective breach. But is it not surprising that he maintains that notice could have been given only some three weeks earlier than was actually the case? The conclusion suggests itself either that the industry's financial forecasting leaves something to be desired; or they simply do not take their EFL seriously.

I am sure you share my distaste for sterile recrimination, but, equally, I have no doubt at all that we shall not let this pass without some vigorous demonstration of our disquiet at the situation the industry have reported so belatedly. I should, therefore, very much welcome your ideas on how we can get our views across to the management - and to the public.

The Rt. Hon. David Howell, M.P.

CONFIDENTIAL

One way forward might be to commission, at the industry's expense, an independent firm of accountants to produce a report for us, which would show precisely when the industry became aware of the prospective breach, when they might reasonably have been expected to know of it; and what steps should now be taken to tighten up the financial reporting arrangements within the industry.

I am sending a copy of this letter to the Prime Minister and to the Secretaries of State for Industry and for Scotland and to Sir Robert Armstrong.

GEOFFREY HOWE

COVERING CONFIDENTIAL

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ
01 211 6402

N Sanders Esq
Private Secretary to the
Prime Minister
No 10 Downing Street

19 February 1980

Dear Nick,

ELECTRICITY EXTERNAL FINANCING LIMIT 1979/80 AND 1980/81

I am attaching a minute from my Secretary of State to the Prime Minister about the external financing limit of the electricity industry.

My Secretary of State has asked me to apologise for the length of this minute. He felt however it was important to set out the whole picture of this complex issue before any discussion.

Yours ever,

Denis

~~Denis Walker~~
Private Secretary

PRIME MINISTER

ELECTRICITY EXTERNAL FINANCING LIMIT 1979/80 AND 1980/81

I refer to your Private Secretary's letter of 11 February, asking for a report with a view to a meeting. Before dealing with the specific points you raise, it may be helpful if I explain the background.

In late November and early December the industry notified me that their then best estimates showed a possible breach of their EFL by £62m. I wrote to John Biffen about this on 3 December. The main reason for the breach at that time was that fuel prices had risen faster than the industry anticipated when, in July 1979, they decided on their tariff increase for September 1979. Fuel stocks had been building up during the autumn, with our encouragement, against the possibility of industrial action in the mines. In response to my expression of concern about the £62m, the Electricity Council demanded their latest and best estimates from all the Boards. They told me on 11 January of the outcome, which was an estimate of a possible breach of £254m. They accepted that we should have been notified of this earlier and I have been assured that arrangements for better reporting to the Council are in hand. Fuel stock increases (both coal and oil) were the main reason for the possible breach, accounting for £161m, and the effect of the higher fuel prices mentioned above accounted for a further £73m. At that time the industry were still expecting sales to be higher than those forecast when the EFL for 1979/80 was fixed in June 1979. They have now revised their sales forecast down in line with revised assumptions of economic growth. The latest estimate of the breach, which takes account of the effects of the steel strike so far, is £325m. The main factors underlying the breach are thus;

a) fuel prices, both coal and oil, have risen more rapidly than was expected when the September 1979 tariff increases were decided on in July 1979. Oil prices have risen particularly rapidly.

b) the industry have recently revised downwards their forecast of electricity sales for this year by 3 twh from 230 twh to 227 twh. This is because of the combined effects of 3 factors - the BSC strike, milder than average weather, and a lower general level of industrial activity.

c) wage and salary settlements were higher than expected when the EFL was set in July. Settlements accepted by union negotiators were twice rejected by ballots of the workforce. An arbitration award a few weeks ago was the final part of last year's settlement.

d) at the start of last summer the CEGB's coal stocks stood at 11.4m tonnes, lower than they had been for some years, and the Board were forecasting an end winter stock position of some 10m tonnes. Colder weather in the early part of the summer and the CEGB's response to the oil supply situation kept stocks low. The action taken by the Board, British Rail and the National Coal Board (encouraged by us) succeeded in building up coal stocks of 16m tonnes before Christmas, equivalent to 5 weeks' endurance at peak winter demand. Under the threat of a miners' strike we were grateful for these efforts. End year stocks are now forecast at 13½ mt - 3½ mt more than the original forecast.

e) oil stocks were built up in the autumn with a view to providing flexibility and increased endurance. The CEGB was able to obtain additional oil from BNOC sources (I wrote to you at the time about this) and filled its storage capacity of 1.8m tonnes by November. Thus the Board emerged from the Christmas holiday period with good stocks of coal and of oil.

My discussions with the industry have also looked ahead to 1980-81. In November 1979 we agreed an EFL for that year of £187m, based <u>inter alia</u> on assumed tariff increases of about 17% in April (corresponding to the expected general increase in the RPI) and 5% in October, consistent with the achievement of a financial target of an average of 1.8% return on assets on a CCA basis over a period of 3 years. Since that EFL was set, there have been adverse movements in several major underlying assumptions:

a) The EFL took into account expected coal price increases of 17% in March this year and 7% later in the year. The CEGB and NCB have just agreed on an increase of 19.25% for March, and the CEGB now assume a further increase of 20% in January 1981, the miners' new settlement date.

b) Electricity sales forecasts have been revised downwards in line with new GDP assumptions.

c) The industry no longer believe they can achieve a salary settlement of 12%.

It is against this background that I consider the points you have raised. I await confirmation, but it looks as if it will be possible for the industry to defer payments of about £100m from this year to next, and that they could make savings of the order of £25-£30m. This would leave a remaining excess of about £200m to be added to this year's EFL, making it £132m (- 68m + £200m). As regards next year, after taking into account the need to cope with £100m of deferred payments, the industry estimate that to hold the EFL back to the original £187m, taking account of all the adverse factors mentioned above, could necessitate tariff increases of around 21% in October, or around 15% if the increases were brought forward to July. Much depends on the timing and extent of any coal price increase in connection with the new NUM settlement date of 1 January 1981. A larger than expected increase could still leave the electricity industry in trouble with its EFL.

However, the Chief Secretary's proposal, about which you have asked, would involve reducing next year's EFL by the net amount of the breach in this year's (ie by £200m). The October tariff increase could then reach even worse levels - around 30%, or around 18% if the increase were brought forward to July.

Clearly all this is unacceptable - we are reviewing urgently the possibilities for remedial action with the industry. You have asked what scope there is for a cutback in the industry's capital investment programme, with particular reference to new power stations. The industry is reviewing at top speed its capital programmes in the light of the new, lower, load forecasts. However, particularly in respect of power stations, a very high proportion of expenditure in any year is determined by commitments entered into in previous years.

Possible fields for action include;

a) oil-fired power stations under construction (Ince, Grain and Littlebrook). Grain and Littlebrook were slowed down to make savings required by the Government for EFL purposes in the summer of 1979. The Board have been taking a tough line with the workforce on these sites; that at Ince has been substantially reduced, and the laggers' strike at Grain has brought the possibility of the closure of the site.

b) curtailment of work on the completion of Drax, where construction began on site in the autumn of 1978. Contractual commitments would probably make the cancellation of the work too expensive. The project was brought forward with Government financial aid to help the plant industry. To stop it would hit them hard.

c) the new AGR station at Heysham II. This is a course which could have great dangers for the whole of our nuclear programme. Work has not started on construction of the station, and no major hardware contracts (boilers, turbine generators) have yet been placed. The effect of serious delay or cancellation on the plant industry would be severe, and there would be repercussions for the Scottish station at Torness. As I say a setback to this project would certainly call in question our commitment to the nuclear programme I announced in the House on 18 December. I do not believe this is a price worth paying.

We could consider easing the pressure on the EFL by asking the CEGB to reduce fuel stocks. Their current forecast is that coal stocks will reach 13m tonnes by the end of 1980/81, ½m tonnes below this year's expected spring stock. Taking action to reduce coal stocks by 3m tonnes to 10m tonnes next spring would reduce working capital needs by £100m. But of course there are considerable risks in planning to reduce coal stocks. The CEGB normally build up their stocks steadily from spring to November when the peak usually occurs. However, this year the NUM settlement date has been advanced (a point the Secretary of State for Scotland has made). In the new circumstances I would hope stock levels could reach their peak earlier compared with last winter. The effect of running down coal stocks on the NCB and on the course of NUM negotiations must also be considered.

Summing up, the main features of the situation we face are;

a) rising fuel (particularly coal) costs and other factors have, in the industry's view, made it impossible for them to achieve the EFL next year on the basis of the previously contemplated tariff in crease of 17% in April and 5% in October. We shall almost certainly need a higher tariff increase in the autumn;

b) the suggestion that any excess borrowing over this year's EFL should be absorbed next year would lead to very grave difficulties and should not in my view be further pursued;

c) some reduction of financing requirements could be achieved by reducing fuel stocks, but this would be very risky in the face of the earlier NUM settlement date next year and world energy supply uncertainties.

d) the industry is reappraising its capital programmes in the light of the reduced load forecast, but there is little room for manoeuvre, and the implications for the plant industry and the nuclear programme will need extremely careful consideration and could be very dangerous.

I am sending copies of this minute to the Chancellor of the Exchequer, the Chief Secretary to the Treasury, the Secretary of State for Industry, the Secretary of State for Scotland, and to Sir Robert Armstrong.

DA

Secretary of State for Energy
19 February 1980

A

CC PUS
MR TUCKER
MR MONGER

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ
01 211 6402

The Right Honourable
Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON SW1

15 February 1980

Dear Geoffrey

As you know, the National Coal Board are to increase their prices from 1 March. These increases are a commercial matter for the Board, so long as they remain within their external finance limit. But it is of course of paramount importance that they should remain within this limit. The Board have said that the increases are designed to enable them to remain within the limit for 1980-81. I am however writing to Ezra to impress on him that the Board must remain within their EFL and that if they are affected by unforeseen factors they must take all practical steps to ensure that they still do so. They are of course in any event likely to have to make a second price increase during the year to offset the wage increase due on 1 January 1981.

Yours ever

David

D A R Howell

FILE

Original in G/R.

OCD/N

Nat. Ind.

C.F. to note

10 DOWNING STREET

THE PRIME MINISTER

14 February 1980

Dear Greville,

Thank you for your letter of 24 January enclosing correspondence from your constituent, Mr. Ward, about heating costs.

The position is that David Howell announced on 16 January financial targets for the gas and electricity industries. For electricity this means that prices are likely to increase over the three year period of the target by about 5 per cent over and above the increases in the industries own costs, of which fuel costs are the biggest element.

Turning to the question of the rise in the price of domestic gas it might be helpful if I explained some of the factors behind the Government's decision to set British Gas a financial target which would result in prices increasing by 10 per cent over and above the rate of inflation this year followed by comparable increases in the following two years.

First of all there is a problem over supplies. Domestic gas prices have risen by much less than the rate of inflation generally and by very much less than other fuels over the last few years. This has resulted in a massive surge in the demand for gas which has far outstripped British Gas's ability to supply. As a result there are 70,000 homes and 4,000 firms waiting for a supply who cannot get one. Those who do not have gas would be prepared to pay much more than the current price charged to the domestic consumer. Thus, far

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RH

from British Gas competing for customers, people and firms are competing for gas. In these circumstances were it not for British Gas's monopoly the price would move rapidly upwards towards the level of competing fuels whose price is largely determined by world market forces.

Secondly, British Gas's costs have been rising and if the price did not rise they would soon be making a loss on domestic sales. Their profits are all coming from their industrial consumers who are charged a price related to oil which is significantly higher than that paid by their domestic consumers despite the fact that it costs much more to supply gas to the home.

Thirdly, our reserves of natural gas are limited and, as world prices of energy rise, represent an increasingly valuable national resource. If the price is too low we shall burn it up more quickly and bring forward the day when we have to turn to much more expensive sources of supply.

Fourthly, at present two-thirds of our gas comes from low cost gas fields under contracts signed before the major increases in oil prices since 1973. But this proportion is now falling. The growing balance, largely from the deeper, more distant waters of the Northern North Sea - and some of it imported - is already up to six times more expensive and it will become even more costly if oil prices continue to rise.

These considerations inevitably pointed to the need for a substantial rise in the price of domestic gas. Although, as I have said earlier, free competition would probably result in a rapid move to higher prices, the Government decided it would be far better to set British Gas a target which would cause them to phase in the inevitable domestic gas price increases carefully and gradually. The alternative would be to try to put off the day and then suddenly be faced with the need for very large increases all at once, as we have seen with oil.

/I know

I know that price increases are never welcome and it would have been easy to have announced only this year's increases; but we believed that it was right that gas consumers should be told of likely future price trends rather than have the sort of increases that oil consumers have had sprung on them.

The Government recognise that adjusting to an era of higher energy prices brings serious problems for many customers, especially the old and the poor. Our new scheme of assistance with heating costs announced last autumn is designed to provide worthwhile help for those most in need. The Government will take proper account of the cost of energy in its social policies and in determining the level of benefits. We are reviewing the whole range of help available to assist consumers with fuel bills so as to make extra provision for the elderly and others on low incomes who need help. I would however stress that the price increases resulting from the new financial target will not affect this winter's bills. The Secretary of State for Social Services intends to announce the Government's proposals in good time for people to plan how they can best manage next winter and these proposals will be fully publicised.

Yours sincerely

Margaret Thatcher

The Hon. Greville Janner, Q.C., M.P.

CONFIDENTIAL

cc HMT
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CO
SO
bc CPRS

Nat Inds

10 DOWNING STREET

From the Private Secretary

B/F 15.2.80

11 February 1980

The Prime Minister has read the recent correspondence between your Secretary of State and the Chief Secretary about the prospective breach of the Electricity Council's external financing limit for the current year 1979/80. She has noted that one of the proposals is that the industry should absorb any excess over this year's EFL by reducing next year's EFL by a corresponding amount. She would like to know, if this course were to be followed, what would be the implications for electricity prices; or alternatively, what scope there is for a cutback in the industry's capital expenditure programme with particular reference to new power stations.

I would be grateful if you could let me have an early note on this. The Prime Minister would then like to discuss the matter with your Secretary of State and other Ministers concerned.

I am sending copies of this letter to John Wiggins and Alistair Pirie (HM Treasury), Ian Ellison (Department of Industry), Godfrey Robson (Scottish Office) and David Wright (Cabinet Office).

T. P. LANKESTER

Bill Burroughs, Esq.,
Department of Energy.

CONFIDENTIAL

DSG

Nat Ind

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ 211 6402

The Rt Hon J Biffen MP
Chief Secretary to the Treasury
HM Treasury
Parliament Street
London SW1P 3HE

8 February 1980

Dear John

ELECTRICITY INDUSTRY EFL

You wrote to me on 28 January, following our meeting with Tombs and England and Tombs' subsequent letter, a copy of which I sent to you. I have also seen Keith Joseph's letter of 1 February.

attached

It now looks as though the industry may be able to defer payments of up to £100m to fuel and other suppliers from this year to next year. Some of these payments would of course be within the public sector. I have asked the industry for firm figures in the next few days.

I have also been discussing next year's position with Tombs and England. A number of factors have moved adversely since we set the EFL at £187m last November. Fuel prices are now expected to be higher, and load forecasts are being re-examined in the light of recent economic trends. I am pressing the industry to examine the scope for capital cuts, though the implications of these for the plant industry and the nuclear programme I announced before Christmas will have to be carefully considered. I have also asked the industry to advise me on the scope for reducing working capital requirements. Here again, the way we handle fuel stocks will need particularly careful thought.

I recognise the need to press ahead, and will write again as soon as possible.

I am copying this letter to the Prime Minister, Sir Keith Joseph, George Younger and Sir Robert Armstrong.

Yours ever

David

D A R Howell

SCOTTISH OFFICE
WHITEHALL, LONDON SW1A 2AU

The Rt Hon John Biffen MP
Chief Secretary
HM Treasury
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

P 11/2

8 February 1980

CONFIDENTIAL

ELECTRICITY COUNCIL'S EXTERNAL FINANCING LIMITS

I have seen copies of David Howell's letters to you of 24 January and 8 February and your letter of 28 January.

While I fully appreciate the need for the Electricity Council to take whatever action is practicable to reduce the forecast excess over its external financing limit for the current year, I am concerned to ensure that we do not lose sight of the importance of maintaining power station fuel stocks at a high level. It was quite clear from the contingency preparations for possible industrial action in the mining industry last November that the level of coal stocks carried by the Generating Boards largely dictates how long we can withstand a strike in that industry. At that time it was estimated that the Boards would have sufficient stocks in January for about 5 weeks' endurance at full output. With the NUM reverting to an earlier settlement date, I think we should encourage the Boards to aim for a higher level of coal stocks for next winter. The value of these stocks to our economic strategy could well prove to be much greater than the cost of the borrowing necessary to finance them.

I am copying this letter to the recipients of yours.

Approved by the Secretary of State
and signed in his absence

11 FEB 1980

Prime Minister

This is indeed worrying. Shall I write as suggested in para 10?

T. 6/2

We must

(1) discuss the immediate problem

(2) discuss the whole EFL system and related industries (ask CPRS help)

(3) consider breaking up these industries' monopoly i.e. denationalising more rapidly.

M.T.

An ad hoc group please

CONFIDENTIAL

Qa 04424

To: MR LANKESTER

From: SIR KENNETH BERRILL

The Electricity Council's External Financing Limits and the Increase in Electricity Prices

1. The Prime Minister has been sent copies of recent correspondence between the Secretary of State for Energy and the Chief Secretary on the expected breach in the Electricity Council's external financing limit (EFL) for 1979/80. In this minute we in the CPRS outline the possible serious implications for electricity prices in April 1980 and November 1980.

2. The Electricity Council have warned the Government of the prospective £300m. breach in their EFL for the current year 1979/80. This £300m. over-run is almost entirely due to a combination of the unexpectedly high price of fuels (oil and coal) and the rebuilding of fuel stocks at power stations largely at Government request. The £300m. figure takes no account of the steel strike which is estimated to be costing the Council some £4m. a week.

3. The proposal is that any over-run on the 1979/80 EFL should be carried over into 1980/81 and coped with inside an unchanged EFL for that year. The 'hard line' approach is that the Electricity Council should have to meet the whole of their 1979/80 over-run. The 'soft line' approach is that they should be compensated for their 'successful' efforts to rebuild stocks (a figure of up to £135m. was mentioned in the Chief Secretary's letter - an amount which we believe could just be accommodated within the contingency reserve for 1979/80).

4. As always in the electricity industry much will depend on whether the winter of 1980/81 is abnormally cold or warm and on what happens to the price of oil and coal inputs to power stations over the year. But the 1980/81 EFL was set very tight, i.e. based on mid-range assumptions which are now proving optimistic and contained no reserve for contingencies.

5. There will, of course, be limited opportunities in 1980/81 for improved efficiency and for deferment of payments into 1981/82 but generally speaking the Electricity Council would have to plan to meet its 1980 EFL by a mixture

of (i) price rises over and above the 'inflation plus 5 per cent' already assumed for April and October 1980; (ii) cut backs in capital spending, (the capital expenditure programme for 1980/81 is currently costed at over £1 bn.); and (iii) reduction in stocks of coal and oil at power stations (a move which the Government would presumably not wish to encourage given the annual pay negotiations with the miners).

6. Each one percentage point rise in electricity prices on top of 'inflation plus 5 per cent' is worth around £50m. in a full year. A one percentage additional rise left until October would raise only £25m. in 1980/81. We in the CPRS believe that under the 'hard line' approach the Electricity Council could be forced into raising tariffs in April by the rate of inflation and in October by over another 10 per cent. Indeed, they might feel it necessary to propose this even if the 'soft line' of allowing them £135m. for stocking costs were agreed. For if the EFLs are to be rigidly applied they may feel it necessary to provide some contingency margin in October 1980 against, for example, a warm winter or unexpected rises in oil prices.

7. The problem this presents for the Government is obvious. Further public sector price adjustments in the 30 per cent region in 1980/81 have obvious implications for the Government hopes of achieving a drop in the rate of inflation that year, and on energy pricing policy the Government has recently said that gas rises should rise at inflation plus 10 per cent in order to close the gap with other fuels. A subsequent decision to raise electricity prices at, at least, this rate would look peculiar.

8. All this suggests a careful look both at the case for giving the Electricity Council some relief on its successful stocking operation and at the Council's proposed capital spending programme - including, of course, the AGR at Heysham.

9. It also suggests that the cash limits system for nationalised industries needs discussion (as the Chairmen have suggested). The turnover of some of these industries is so large (£3bn./£4bn.) that small percentage changes in sales (perhaps due to the weather) can cause variations costing not just tens but hundreds of £m. They are only allowed to change their prices once or twice a year and at fixed times. Against this how should the EFL system be operated: (a) do they put in generous contingency margins -

which could mean public expenditure cuts elsewhere; (b) are they allowed to 'take one year with another' - if so, how many years; (c) are they given retrospective adjustments for certain events outside their control (steel strike, faster rate of inflation of their raw materials, a warm winter, etc.)? There are obvious difficulties in any of these courses but in the view of the CPRS the EFL system has not yet been adequately fitted into the Nationalised Industry Sector. This year we have prospective over-runs in the post office, steel, electricity, shipbuilding, and don't quite know what to do with them.

10. Against this background the Prime Minister may wish to ask Mr Howell -

(i) what effect the prospective breach of the Electricity Council's EFLs will have on electricity prices;

(ii) if the prospective increase in electricity prices is unacceptable, what scope there is for a cut back in the Council's capital expenditure programme with particular reference to new power stations?

11. She might also, at some time, like to ask the Chancellor if he is satisfied with the system of EFL as presently applied to the nationalied industries.

12. I am sending a copy of this minute to Sir Robert Armstrong.

KB

6 February 1980

Nat. Ind 2

Prime Minister

This looks encouraging.

TL
8/2

Sir Ian Bancroft

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ 211 6229

MT.

T P Lankester Esq
Private Secretary to the
Prime Minister
10 Downing Street
London SW1

6 February 1980

Dear Tim,

When John Wiggins replied to your letter of 23 January on the question of means of reducing BGC's surplus profits he said that I would be writing separately about the gas workers' pay negotiations.

X British Gas have now concluded negotiations with their Manuals. If the Delegates' Conferences accept their unions' recommendation to accept the offer it will mean that the wage costs for their Manuals will rise by about 14.2% this year. This is the same as they had assumed in their profit forecasts for this year. For 1981/82 and 1982/83 they are assuming that gas industry earnings will increase by 12% in each year. It was on the basis of the profit forecasts which included these assumptions that their 3 year target was set. British Gas still have to conclude negotiations with their White Collar staff (these have not started yet) but as yet there are no indications that their workforce intends to take advantage of their high profits. The Management have also agreed to a target which would not allow them to concede inflationary increases. Furthermore, in our analysis of the forecasts of British Gas's profits we and the Treasury satisfied ourselves that they would result in a reduction in their real unit trading costs (excluding gas) over the three years of the target.

The target is therefore aimed at providing a real spur to increase efficiency and a moderate level of wage settlements as well as the means of increasing the price of domestic gas. We will, of course, keep it under review.

On the question of methods for reducing BGC's surplus profit we are pressing ahead with our analysis of the options mentioned in John Wiggins' letter and we hope to be able to make recommendations to the

Treasury very shortly.

I am sending a copy of this letter to John Wiggins (Treasury), David Wright (Cabinet Office) and Ian Fair (Department of Employment).

Yours sincerely

Bill

W J Burroughs
Private Secretary

EB 1980

CONFIDENTIAL

NAT/MS

10 DOWNING STREET

From the Private Secretary 31 January, 1980.

Gas Prices

I have shown the Prime Minister your letter of 28 January. She has asked me to say that she hopes that the proposed charge on the BGC will be "above the line" so that BGC's profits are reduced: for only if it is done in this way will it meet the wages point mentioned in my earlier letter.

I am sending copies of this letter to Bill Burroughs (Department of Energy) and David Wright (Cabinet Office).

T. P. LANKESTER

A.J. Wiggins, Esq.,
HM Treasury.

CONFIDENTIAL

TCR

Treasury Chambers, Parliament Street, SW1P 3AG

MBPM

R
22/1

Rt Hon David Howell MP
Secretary of State
Department of Energy
Thames House South
Millbank
London SW1

28 January 1980

Dear David,

ELECTRICITY COUNCIL'S EXTERNAL FINANCING LIMITS

Thank you for your letter of 24 January about the Electricity Council's response to our meeting with them on 21 January about the prospective breach of £300m in their external financing limit for this financial year.

Like you I find the remedial action discussed in Tombs' letter of 22 January inadequate and I am glad that you are pressing the industry for further measures including whether more can be found by deferring payments to the oil companies or deferring until next year some deliveries of oil due this year. Certainly the industry ought to try to prevent such discussions becoming public knowledge, but I agree with you that little, if any, harm would be done if the matter did leak. There have already been references in the newspapers to the industry's difficulties of keeping within its EFL. I also welcome your decision to seek further information from the industry on the scope for economies in next year's capital programme. If an excess like this occurs, the capital programme must be reviewed.

My reaction to the prospective breach in EFL is still to ask the industry to absorb the £300m excess within this year's EFL, either by genuine savings or deferment, and if they cannot manage this, to reduce next year's EFL by the amount of any increase necessary in this year's. I have noted your view that it would be imprudent to take any action which would result in approaching next winter, with its early NUM settlement date, with reduced fuel stocks. But I assume that you are not suggesting that we should therefore be prepared to increase this year's EFL by the amount of the increase in fuel stocks, some £210m. The industry themselves have put forward the possibility of deferring £75m of the cost of the increased stocks (£50m from the NCB and £25m from the oil companies) into next year and you have suggested that the industry should try to defer more payments in this way. Thus, on the basis of the proposals already made the cost this year of the higher stocks will be no more than £135m, and possibly a good deal less if your requests to the industry for further deferrals produces results.

I have also noted Tombs' comments about the industry's financial prospects for 1980-81. As you say, virtually all of the action suggested by the industry will have consequences for 1980-81, but I think that the industry should be under no illusion that there will be any increase in their EFL for that year to take account of expenditure deferred from this. Tombs hints in his letter that the industry will in any event need a higher and earlier second increase in tariffs than the 5 per cent proposed for October if it is to keep within its existing EFL. I should be grateful for your views on this.

So to sum up my views on the general question, the choice seems to be between asking the industry to absorb the £300m excess within this year's EFL and if they cannot do this, to reduce next year's EFL by the amount of the increase necessary in this year's EFL to cover part of the cost of increased stocks (ie by something less than £135m) <u>and</u> to maintain next year's EFL at its existing level. I should like to get this matter settled quickly so that we can make any announcement necessary well before the end of the financial year (though we shall need to consider the date carefully in relation to the steel strike). Could I therefore suggest that you press the industry further and let me have your proposals for dealing with the matter very shortly.

Turning to some other points raised by your letter:

i) You ask about the possibility of adjusting the EFLs of the NCB and electricity supply industry in equal and opposite directions. I should be opposed to this. Our position must be that each industry must observe its own EFL.

ii) I agree that there is little to add to what we said at the meeting with Tombs about the nature of the EFL. I agree with you that if there is a risk of a breach, Ministers must be informed immediately, and options for remedial action discussed. I am therefore glad that the Boards have now agreed to provide the Council with better and more frequent returns.

iii) The prospective excess of £300m does not take account of the steel strike, the direct effects of which are worsening the industry's cash flow by about £4m a week. Although I well recognise the difficulties, I think that the Council ought to be asked to see what can be done to offset the financial effects of this.

iv) Tombs dismisses the suggestion that we should consider re-introducing the fuel cost adjustments in quarterly tariffs. I recognise that there would be some opposition to this, but in a time of so much uncertainty about oil prices, it ought to be a means of going some way to protect the EFL in future years from unexpected increases in oil prices. I hope therefore that you will press the industry to give some further thought to this possibility and to let you have a more considered reaction.

Finally we should consider what further step we should take to demonstrate publicly the seriousness with which we regard this situation. I suggested in my letter of 15 January the possibility of having separate EFLs for the CEGB and the rest of the industry. I should welcome your views on this and any other ideas you may have for publicly underlining our dissatisfaction with the industry's financial management.

I am sending a copy of this letter to the Prime Minister, the Secretaries of State for Industry and Scotland and to Sir Robert Armstrong.

Yours

John Biffen

JOHN BIFFEN

29 JAN 1980

CONFIDENTIAL

2

Prime Minister

TL
29/1

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

28 January 1980

Dear Tim,

GAS PRICES

Flag A

Thank you for your letter of 23 January. The remit from E Committee on 26 November was that the Chancellor and the Secretary of State should consider the choice between the alternative options of applying PRT to exempt North Sea gas fields and a charge on the BGC. I understand that the group under Mr Lamont's chairmanship has now accepted Treasury Ministers' views that the latter option is preferable. The Department of Energy are working on the question of the best form of such a charge. Once a conclusion is reached on that, the Chancellor hopes to bring forward firm proposals quickly.

Bill Burroughs will be writing separately about the gas workers' pay negotiations.

I am sending a copy of this letter to Bill Burroughs (Department of Energy) and David Wright (Cabinet Office).

yours

John

J. WIGGINS
Private Secretary

It seems to me that this does not meet the wider point. Is the 'charge' before or after the profits?

PR

T. Lankester Esq.
No. 10 Downing Street
SW1

28 JAN 1980

010

2

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ
01 211 6402

Prime Minister

To note: the electricity industry are likely to over-spend their cash limit for 1979/80 because of fuel stock-building and higher fuel prices.

T 24/1

cc Mr Ingham

The Rt Hon John Biffen MP
Chief Secretary
HM Treasury
Parliament Street
London
SW1P 3HE

24 January 1980

Dear John

At our meeting on Monday with Sir Francis Tombs and Mr England the industry explained that the prospective breach of their cash limit could now - almost entirely as a result of fuel stock build and fuel price increases - amount to £300m. The effect of the steel strike could lead to a further deterioration which the industry are not yet in a position to quantify, but their direct losses in sales to BSC are running at £4m per week. Tombs has now written, as he promised, summarising actions which the industry could take to reduce the size of the breach. I attach a copy of his letter.

As Tombs points out, fuel stocks have increased considerably. Under pressure from the Department, the Generating Board were of course throughout much of last year taking every possible measure to build up stocks in anticipation of possible industrial action by the miners. This exercise has been more successful than the industry itself anticipated, not least because of the successful effort of the NCB and British Rail to shift coal to the power stations (including some coking coal which became available as a result of reduced demand by the steel industry). When the CEGB took stock of the position in late December they estimated that they would end the financial year with 2.7 mt more coal than was anticipated. Their latest forecast is that a further $1\frac{1}{2}$ mt of coal will be added to stock by end-March, given that coal deliveries are still running at a high level.

Oil stocks have also risen, and this - together with the considerable increase in oil prices, has been a further important contributory factor.

Because it takes three months before a revised tariff begins to yield extra revenue from domestic consumers, there will be an under-recovery of fuel costs from these customers in this financial year. Tombs has told us that £73m of the deterioration is largely due to this factor.

My views on the possibilities of remedial action which have been put forward by the industry are as follows:

(i) Defer payments to the NCB

Because of improvement in the NCB's external financing position it seems likely that deferment of payments of £50m - and possibly a little more - could be accommodated without breach of the NCB limit. There would of course be no net benefit to the PSBR if this action were taken, but it would demonstrate that we attach importance to individual industries taking action to live within their limit. As you know, I have already invited the CEGB to discuss the possibility with the NCB. A further possibility would be to adjust the EFLs' of the NCB and the electricity supply industry in equal and opposite directions. I would welcome your views on this.

(ii) Defer payments to oil companies (industry estimate of £25m)

I invited the industry to take no action with the oil companies until I had given this further thought. I agree with Tombs that it is important not to damage the CEGB's good relations with the oil companies, whose co-operation may be essential in any future emergency. But on reflection I am sure that the CEGB ought to press the oil companies on this and report back on their reactions. Another possibility, on which I am seeking further advice from the industry, would be to defer until next year some deliveries of oil due this year, though there would be the risk that later deliveries would come in at higher prices. These discussions could of course become public knowledge, but since they would be without prejudice to our final decisions, I doubt, subject to your views, if any harm would be done. On the contrary it would demonstrate the seriousness of our endeavour to control the industry's borrowing.

(iii) Defer payments to CEGB plant and other suppliers (industry estimate of £25m)

Similar considerations arise here, and I propose to invite the industry to consider further, where necessary in consultation with its suppliers, what can be achieved.

(iv) Area Board action to defer payments and increase income (£20m)

I propose to endorse action along the lines indicated, subject to further advice from the Council on the potential effect on equipment and appliance manufacturers.

(v) Reduce 'cash in transit' (£30m)

This is eminently desirable.

I have given careful thought to whether additionally we might invite the industry to reduce fuel deliveries during the rest of the year. The industry's projected end-year stocks, though much higher than originally predicted, are by no means excessive in historical terms, and it would be contrary to all our earlier efforts to improve the stock-holding position to take such action. Moreover, in respect of coal, there would be no net advantage to the PSBR. In respect of oil, Tombs has indicated that this could give rise to problems through upsetting refinery balances and schedules, and prejudice relations with the oil companies. I am pursuing this further with him but in any event I am sure that it would be imprudent to take any action which would result in approaching next winter, with its early NUM settlement date, with reduced fuel stocks.

Action under (i)-(iv) above will of course have consequences for 1980/81. Whether the industry can accommodate this extra expenditure within their existing EFL without increasing tariffs is not clear, and I have sought further information from them on the scope for economies in next year's capital programme. As Tombs has mentioned however there are growing uncertainties eg on fuel prices and electricity demand in 1980/81 which will also need to be considered.

On Tombs' question about the nature of the EFL, there is I think little to add to what we said at the meeting. This is no doubt a question which will arise again in NICG. The point which I have been at pains to emphasise is that if there is risk of a breach Ministers must be informed immediately, and options for remedial action discussed. Boards have now agreed to provide the Council with better and more frequent returns.

I am copying this letter to the Prime Minister and to the Secretaries of State for Industry and Scotland.

Yours ever

David

D A R HOWELL

THE ELECTRICITY COUNCIL

SIR FRANCIS TOMBS
Chairman

30 MILLBANK
LONDON, SW1P 4RD
TELEPHONE: 01-834 2333

CONFIDENTIAL

22nd January 1980.

The Rt. Hon. David Howell MP,
Secretary of State for Energy,
Thames House South,
Millbank,
LONDON SW1P 4QJ.

Dear David,

This is to confirm the information we gave you and the Chief Secretary at our meeting yesterday.

We accept that we should have given you an indication of the deteriorating EFL position in 1979/80 a few weeks earlier than my letter of 11th January. Until the NUM accepted the NCB's wage offer in early December, however, it was not sensible to depart materially from earlier assumptions about the fuel stocks position. The absence of industrial action in the coal industry coupled with deliveries of coal in excess of those programmed (arising in part from coking coal made available as a result of reduced demand by the steel industry), and a fall back in the rate of growth in electricity demand have led to a marked improvement in coal stocks as compared with those previously envisaged. Equally the measures taken by CEGB to improve oil stocks proved successful. As you know, higher than expected fuel stocks are the biggest single reason for the EFL deterioration as compared with the figures we notified your Department in November.

We are taking steps to ensure that in future we give you progress reports on the EFL position as early as possible.

It is implicit in the figures that the industry's profitability will be well down this year. Consistent with the EFL, we expected that profit after interest would be £191M. The latest estimate, before allowing for the effects of the BSC strike, is that profit will be about £50M on present accounting practices. This has been allowed for in the deterioration in the EFL position.

Even at this time of the year there remains considerable uncertainty regarding the EFL outturn. Coal deliveries are still running at a high level and estimates made since my letter of 11th January suggest that power station coal stocks at the end of the year could be 1.5M tonnes or more higher than I then indicated. This would add about £50M to our external financing requirements and in addition the direct effects of the BSC strike are worsening our cash flow by about £4M a week. It would be prudent, therefore, to assume that, before allowing for the remedial action I outline below, our external financing requirements by the end of the year could be about £300M worse than the EFL, plus the effects of the steel strike.

/Continued ....

The possibilities of remedial action we outlined to you are as follows:-

	Approximate benefit
Defer payments to the NCB	£50M
Defer payments to oil companies	£25M
Defer payments to CEGB plant and other suppliers	£25M
Area Board action to defer payments and increase income	£20M
Reduction in "cash in transit" through the banks	£30M
	£150M

I have to emphasise that the first three items and part of the fourth will defer payments from 1979/80 to 1980/81 and will thus worsen the EFL position next year. In addition, all the figures are at this stage broad indications of the possible benefits and may need to be varied when we have completed the detailed examination of what is involved.

Although the question of running down oil stocks was raised, this would give rise to problems especially as some stations are fuelled directly by pipeline and one could not precipitately upset refinery balances.

You emphasised that you did not wish us to take any action on these possibilities, except as regards cash in transit, until you and your colleagues have had an opportunity to consider the implications. I hope that the following comments will help you in this.

CEGB Actions

We consider that it is essential that we discuss the possibility of deferring payments with the suppliers concerned. This will be almost entirely a task for the CEGB, who will have the following points very much in mind:

(i) The scope for deferring payments to the NCB demands very much on their EFL position. We know that they understand our problem and will do their best to help.

(ii) Any actions with the oil companies must not disturb the good relations the CEGB has with them. In the EFL context, we are talking about payments for supplies up to the end of February as the March supplies will not be paid for until April. The oil companies may be prepared to have payments for February supplies deferred until next year, but there will no doubt be a price to be paid. This may be in terms of an interest charge or they may require February supplies to be paid for at the oil prices ruling when the payments are made. There are a number of oil companies involved but the most important one is ESSO. It is therefore particularly important in an international context that any arrangements made are with their full agreement.

/Continued .....

(iii) Plant and other suppliers. Steps would need to be taken to discuss the position with certain contractors and other suppliers with a view to deferring payments until 1980/81, having regard to contractual terms and conditions. Again some cost could be involved.

Area Board Actions

The Area Boards could take actions on the following lines:-

(i) Defer payments to their suppliers of distribution plant and equipment. It will be important that these deferrals are also negotiated with their suppliers.

(ii) Attempt to negotiate with large electricity consumers earlier than normal payment of February and, possibly, March bills. This might be done on the basis that in return the consumers will be able to pay late some bills arising early next financial year, in which case this would only affect the timing of the cash flow, but it is possible that these consumers might require a financial incentive to pay earlier their bills for the remaining months of this financial year.

(iii) Try to speed up payment of bills by consumers in general. This is a particular problem in the London Board where for some years the ratio of outstanding debt has been very much higher than for other Area Boards. The London Board has been trying hard this year to improve the position by generally tightening up on debt collection procedures. These efforts have not so far been particularly successful, partly no doubt because of the difficult economic climate. The Board intend to press this issue hard in the coming months. The reason for mentioning this particular problem is that the Board's actions will be directed, inter alia, at central and local government debtors and could also result in more complaints by MP's who find that their constituents are being pressed harder to pay.

(iv) Look again at Boards' charges for miscellaneous services although the cash benefits this year would be small.

(v) Run down stocks of distribution equipment and domestic appliances and, where appropriate, to arrange "cash only" sales of appliances during March. These actions may lead to short time working by manufacturers.

The possibility of a reduction in "cash in transit" through the banking system arises because at the end of last year there was a total of £63M in cheques passing through the system which could not be included in our cash balances at 31st March. We are investigating the special arrangements that could be made to get earlier clearance of a proportion of these cheques and the figure of a £30M reduction in the EFL in this respect is very much a first estimate of what we might be able to achieve.

/Continued ...

Other Matters

Mr. Biffen raised the question of the desirability of reintroducing fuel cost adjustment in quarterly tariffs as a way of covering the uncertainties of fuel cost estimates. We have considered this, but it should be appreciated that while this helps the profit and loss account it does not overcome the EFL position in this respect because of unbilled revenue at the end of the year. Nor would it cover departures from assumptions in other key respects and we feel that it is preferable to review the whole financial situation and increase tariffs as necessary in the light of the EFL position. There is a further public relations aspect. As you know, we withdrew quarterly f.c.a. at the urging of consumer bodies, the Price Commission, the Select Committee, etc., and we feel that it would be difficult to reintroduce it.

Arising from our meeting, there are three further topics which we will arrange to discuss with you as soon as possible:

(i) What is meant by an external financing limit. We have hitherto provided you with best mid-point estimates of the outturn, emphasising that there are substantial uncertainties for a large trading organisation. If you consider that "limit" means a figure which we must keep within unless really exceptional circumstances arise, then clearly we will need to build in contingencies in our planning and this will require that electricity tariffs be higher to reflect these contingencies.

(ii) Fuel stocking policy for 1980/81. Glyn England mentioned that he is urgently reviewing this and you emphasised that you wished to be fully consulted.

(iii) Financial prospects for 1980/81. We indicated that our latest estimates of fuel and other costs for next year suggested that it would be desirable to keep open in our minds the level and timing of the Autumn tariff increases; increases of only 5 per cent in October might not generate sufficient cash to enable us to keep within the EFL.

Yours sincerely,

Frank.

SECRETARY OF STATE'S OFFICE

TO MR WILCOCK

FOR ADVICE (AND DRAFT REPLY IF APPROPRIATE)

PLEASE BY: ASAP

Copies to
MOS
PUSS
PUSS
PUS
MR TUCKER
MR T.P. JONES
MR CAMPBELL
MR MORPHET
MR SPAIN
MR D'ANCONA
MR HADLEY
MR MACINTYRE
MR PASH
MISS COHEN
DR. HAUSER

24 JAN 1980

CONFIDENTIAL

Nat Inds

A

10 DOWNING STREET

From the Private Secretary

23 January 1980

When the Chancellor called on the Prime Minister this morning, she mentioned to him that she was concerned about the effect which the high level of the British Gas Corporation's profits might have on the gas workers' pay negotiations. Mr. Eric Varley raised this point at Question Time yesterday (column 199 of yesterday's Hansard).

Following the remit from E Committee on 26 November, the Prime Minister understands that the options for reducing BGC's surplus profits for the benefit of the Exchequer are being further reviewed by the group under Mr. Lamont's Chairmanship. In view of the problem mentioned above she hopes that firm proposals can be brought forward as soon as possible.

I am sending a copy of this letter to Bill Burroughs (Department of Energy) and Martin Vile (Cabinet Office).

KRB

John Wiggins, Esq.,
HM Treasury.

CONFIDENTIAL

NAT. IND

Conservative Research Department,
32, Smith Square,
London SW1.

LMR/STR
17.1.80

Gas and Electricity Prices.

R.

It is hoped that members will find these notes useful in discussions prompted by the recently announced financial targets for the gas and electricity industries in 1980-83. (Hansard 16.1.80, column 1644).

Gas Prices.

The target average annual rate of return (AARR) on net assets valued at current costs over the period April 1980 to March 1983 imposed by the Government on the British Gas Corporation is 9%. This is expected to imply price rises in each of the next three years of 10% over and above the rate of inflation. The two over-riding factors which have necessitated this are:

- the very real danger that the currently very low price of gas will give rise to levels of demand beyond BGC's ability to supply. Already supplies to our vital industries are subject to serious interruption as the Corporation struggles to meet high levels of demand from domestic users. If gas remains significantly cheaper than other fuels the situation might deteriorate to the stage where continuity of domestic supply is threatened and as the Energy Secretary, Mr David Howell, told the House: "Then people really will freeze". Almost one million new domestic consumers have been connected to the gas grid in the last three years, and the number applying for connection is growing rapidly. Sensible pricing is essential in order to bring demand down to the levels BGC is physically able to supply.

- the cost of obtaining gas from the North Sea is rising dramatically, and long run marginal costs must be covered. This means that today's prices must reflect tomorrow's costs, when gas will come increasingly from the hostile Northern North Sea. As a monopoly buyer of gas for the UK market, BGC was able to negotiate prices below 2p per therm in the early days of exploitation in the Southern North Sea fields. But gas from the Frigg field is currently costing 14p per therm and costs will go on rising.

PA

MJS

MT.

NAT. IND

Mr Howell's supplementaries are attached at B. 31

I have sidelined a few passages

MJS

PRIME MINISTER

[A]

Mr. Howell's Statement on gas and electricity prices

Mr. Howell scored an honourable draw this afternoon. The atmosphere was calm and pretty well-mannered; there was a great deal of emphasis from the Opposition side on the plight of the poorest consumers, and there was some criticism from Government backbenchers of the decisions which were being announced, but Mr. Howell steered a skilful way through the cross-examination and made a number of telling points. I do not think that there was ever much chance of coming out clear winners, so I count it a reasonably successful afternoon.

Dr. Owen said that the Opposition could not possibly accept price increases on the scale proposed without generous help for poor consumers and described the abolition of the Electricity Discount Scheme as "appalling economic meanness". Mr. Howell said that it was important to concentrate help on those who needed it most, and that it was silly to seek to help the poor by holding down prices. All that did was to help rich and poor alike. He said several times that the needs of the poor and old would be recognised in Government social policies.

Enoch Powell asked why we should conserve resources for future generations. Mr. Howell said that there were strategic and patriotic considerations in postponing as long as possible the day when we should again be dependent on politically unstable sources of supply for our energy.

Peter Emery said that a 9% rate of return was higher than that justified by long run marginal cost pricing. He suggested that the 27% increase should be spread over a longer period. Mr. Howell said that it was not the Government's policy to move away from long run marginal cost pricing. The BGC could not rely on gas from the Southern basin at 2p per therm. It was already having to pay 14p per therm for Frigg gas. To replace cheap sources of gas would require vast investment.

/Arthur Lewis

Arthur Lewis said that the aged, sick, infirm, blind and bedridden were being cut off enthusiastically by the Boards. Mr. Howell said that there was an independent review of the code of conduct and he accepted that this was a very important subject.

Mr. Howell said that the average domestic quarterly gas bill was now £29.00. In a year's time it would be £7.00 greater.

Sir Bernard Braine said that many people would be mystified by the size of the increases in gas prices. Mr. Howell said that it was not true that the gas industry was competing for customers. In fact, customers were competing for gas. A failure to go to economic pricing would lead to arbitrary rationing and shortages.

Mr. Benn accused Mr. Howell of imposing a savage attack on the poorest consumers. He said that the increase in industrial costs would further weaken British manufacturing industry. Mr. Howell said that industry was clamouring for more gas at present prices.

Sam Silkin asked whether the Secretary of State had legislative authority for his proposals. Mr. Howell dodged this, but we will find out the answer before tomorrow's Questions.

Mr. McCrindle urged an early announcement on an improved fuel discount scheme. Mr. Howell said that these new prices would have their impact next winter but that he would draw the point to Mr. Jenkin's attention. Jock Bruce-Gardyne suggested that there should be private enterprise competition with the BGC. Mr. Howell said that was an interesting suggestion. Freddie Burden asked whether the British Gas Corporation had themselves asked for price increases as large as the Government was now proposing. Mr. Howell said that he would be candid, and that the Government's targets were higher than the BGC had wanted. The Government had to take into account the needs of national energy policy and to ensure that our gas reserves were not burned up too quickly. Mr. Harvey Proctor said that the BGC had indicated to the

/National

National Consumers' Council that price increases on this scale could not be justified on commercial grounds. He hoped that the surplus generated would not be used to subsidise inefficient nationalised industries. Mr. Howell said that the Government were committed to market pricing and were moving in that direction. It was rubbish to say that the surpluses would be used as a subsidy to loss-making industries. They would be used for various purposes, including the reduction of the PSBR. This is a somewhat fine distinction.

Various Members on the Government side suggested that there should be a gas tax. Mr. Howell said that this was an interesting idea which he had noted.

Finally, Dr. Owen asked what price the Chairman of BGC had said was justified, and how much extra profit would be generated by the difference between that price and the price that was now going to be charged. Mr. Howell said that something like £200-300 million would be generated. The BGC had agreed with the Government's aim and objective, but had wished to see a somewhat lower price increase.

MS

16 January 1980

B

Reference..

As Hon Members are aware, the Price Commission estimated that the cost of Norwegian Frigg gas last year was nearly 14p/therm. BGC are paying between 2p and 7p/therm for Southern Basin gas fields. They would expect to pay substantially more for further supplies from Southern Basin gas. Future Northern basin supplies could well cost more than the present Frigg level.

CODE 18-78

FINANCIAL TARGET

SUPPLEMENTARY BRIEFING

Q1 HOW DO UK DOMESTIC GAS PRICES COMPARE WITH THOSE IN OTHER EEC COUNTRIES?

A1 The available data indicate that our domestic tariffs are at present amongst the lowest in Europe. I would expect this to remain the case in the coming years, despite the proposed increases.

this was used

Q2 HOW WILL GAS BILLS INCREASE?

A2 An average quarterly domestic gas bill is about £29 this year. Next year it will be about £7 more. About £4 of this rise is due to the effects of inflation, and the remaining £3 to a real increase in the price of gas. So average bills will be about 50p a week higher next year, of which less than half will be due to a real increase in gas prices.

this was used

Q3 WHY NOT USE SOME OF BGC'S PROFITS TO FINANCE A PIPELINE TO CONVEY NATURAL GAS TO NORTHERN IRELAND?

A3 /That is a matter for my Rt Hon Friend, the Secretary of State for Northern Ireland./
Careful studies have shown that a gas pipeline to Northern Ireland would require a very substantial subsidy, and for that reason it has been decided not to undertake the project. The effects on public expenditure and the PSBR are exactly the same whether this subsidy comes out of British Gas's profits or direct from Government.

Q4 WHAT IS THE PRICE BGC PAY FOR FRIGG GAS?

A4 The Corporation regard the prices paid for particular gas supplies as commercially confidential. But Members may recall that the Price Commission estimated that the cost of Norwegian Frigg gas last year was nearly 14p/therm. This figure, which will increase in line with oil prices, is more than twice the current average cost of gas to BGC.

BGC. was 17p or [illegible] X for Southern Basin contracts. It [illegible] we have to ~~the~~ pay [illegible] in the higher range for new gas.

SUPPLEMENTARY BRIEFING

Q THE GOVERNMENT IS NOT PROVIDING ENOUGH HELP FOR POOR CONSUMERS

A The most vulnerable groups are already given valuable protection through the new scheme of assistance announced by the Secretary of State for Social Services on 22 October last year. The increases which take place this year will not of course affect the heaviest bills until next winter, and they will be taken into account in the November uprating of pensions and social security benefits, including supplementary benefit heating additions and family income supplement. In addition, as I have announced, we are reviewing the whole range of help available.

Q PREVIOUS GOVERNMENT GAVE MORE HELP UNDER THE ELECTRICITY DISCOUNT SCHEME

A. I would remind the hon member that the discount offered under the previous Administration's scheme applied to electricity only, and that help given under the scheme averagedonly £7.50 per recipient. By contrast, our scheme, which is designed to concentrate a worthwhile degree of help where it is most needed, applies to all fuels and gives about £50 per beneficiary.

Q FURTHER HELP NEEDED WITH INSULATION

A. The Government already has an extensive programme to encourage domestic insulation in both public and private sectors. We have recently announced new guidelines for local authorities, which should enable more pensioners and other elderly people to benefit from the scheme for Homes Insulation. (The requirement to provide receipts has been abolished, and payment no longer has to be made in advance. This should help those who do not have the capital to make the initial outlay themselves. Local authorities have been asked to give priority to pensioner applicants.)

this was used

Q GAS INDUSTRY PROFITS

A - The present profits of BGC stem in large part from their cheap Southern Basin gas contracts - they already benefit the PSBR. Prices must rise to bring supply and demand into balance, and this is bound to produce a surplus, but it will be needed to pay for future much more expensive gas supplies, and benefit the community more generally from further contributions to the reduction of the PSBR, which will of course be of enormous help in a situation of extreme pressure to cut public expenditure.

DISCONNECTIONS

WILL THIS NOT INCREASE DISCONNECTIONS?

The industries exercise their disconnection powers with care and responsibility. They operate to a Code of Practice which lays down safeguards to avoid disconnection in cases of genuine hardship.

THE CODE IS INEFFECTIVE WILL THE GOVERNMENT NOW ABOLISH THE INDUSTRIES' POWER TO DISCONNECT?

I know the Code has been criticised but I am sure it has helped many consumers avoid difficulty and hardship. I also understand that an independent study is being made of the Code's operation on behalf of the industries and their Consumer Councils. To abolish the industries' powers to disconnect would add substantially to their costs. These additional costs would have to be borne by consumers generally. This is not a policy the Government considers appropriate.

WHAT ABOUT PEOPLE DISCONNECTED FOR LONG PERIODS (OVER A MONTH)?

I understand this problem is receiving particular attention in the independent study of the Code.

COULD THE INDUSTRY NOT DO MORE TO HELP CONSUMERS?

The industries already operate a wide range of schemes to help people spread the burden of high winter bills over the year. I am encouraging the industries to publicise these schemes widely and to consider ways of extending them. [If pressed In particular the industries are cooperating in looking at ways of extending their fuel savings stamp schemes.]

WHY DO THE INDUSTRIES NOT MAKE PREPAYMENT METERS MORE FREELY AVAILABLE?

I understand the industries policy is to install prepayment meters where it is safe and practical to do so. They must be the judge of these criteria.

Background Note

Questions on disconnections are likely to focus on electricity. Gas disconnections are fewer (they are technically more difficult) and being without gas is not considered to give rise to the same degree of hardship.

2 Electricity disconnections fell from about 130,000/year in 1976/77 to around 88,000 in 1977/78 and have remained relatively constant at this lower level ever since. The drop was attributed partly to introduction in February 1976 of the DHSS/industries' agreement for direct payment of bills by deduction from supplementary benefit and partly to introduction of the Code of Practice in December 1976.

3 Attacks on the Code allege that many people referred under its safeguard procedures to DHSS or local authorities for help get none. Lately there has also been much concern about those disconnected for long periods of a month or more. The Code was reviewed in 1978 and re-published in an easier to read version in January 1979.

4 Because of these criticisms it was also agreed last year to set up an independent study of the Code. This is being carried out by the Policy Studies Institute (PSI) and sponsored by the industries and their Consumer Councils. The study has however run into difficulties because of disagreement over the questionnaires to be used by PSI. This has delayed the start and it is unlikely now to be completed before the end of this year.

Stamps

5 A common stamp sold through Post Offices was considered by the industries to be too costly (at least £5m a year). At Mr Lamont's request the industries agreed last summer to consider extending their own stamp schemes. They have agreed to accept each others stamps and the necessary preparatory note is under way but not yet complete. They are also negotiating extending outlets through sub-Post Masters. Progress here is stalled by the fee being demanded but discussions are continuing.

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HOW DO UK ELECTRICITY PRICES COMPARE INTERNATIONALLY?

UK Domestic prices at typical levels of consumption are amongst the lowest in the EEC.

[Based on Electricity Council's "Comparison of Electricity Prices in the Countries of the European Community - comparison as at August 1979 and published in December 1979]

Gas prices.

QUESTION AND ANSWER BRIEFING

PRICES

Q. WHY HAVE THE GOVERNMENT ASKED THE INDUSTRIES TO PHASE NEXT YEAR'S PRICE INCREASES?

A. In order to ease the burden on consumers as far as practicable within the price rises required.

Q. WILL THE GOVERNMENT ALSO ASK FOR THE INCREASES TO BE PHASED IN 1981/82 AND 1982/83?

A. I cannot say at this stage.

Q. WHAT WILL BE THE EXACT SIZE OF THE INCREASES?

A. Detailed tariff proposals are a matter for the industries, but in general this April's increases should be roughly in line with the rate of inflation ~~[at about 17%]~~. Domestic gas prices will go up by a further 10% in October. The precise size of the October electricity price increase will depend on movements in the industry's costs.

Q. WHEN WERE TARIFFS LAST INCREASED?

A. Domestic gas and electricity tariffs were increased by about 8½% in June (following a 2 month delay due to Price Commission intervention); domestic electricity tariffs went up by a further 8½% in September. [Gas tariffs, in real terms, have fallen by well over 30% since ~~in the 1970s.~~]

?

Q. WILL NOT THE INCREASES ADD TO THE RATE OF INFLATION, ESPECIALLY ON TOP OF THE OIL PRICE RISES WHICH HAVE ALREADY TAKEN PLACE?

A. We are living in an era of rising energy costs and we cannot insulate ourselves from this fact. If we try to hold down the price of fuel artificially, this would only encourage wasteful consumption and could cause supply difficulties.

Q. DOES NOT THIS DEMONSTRATE THE FAILURE OF CONSERVATIVE ANTI-INFLATION POLICY, AND THE EFFECT OF ABOLITION OF THE PRICE COMMISSION?

A. I would remind the Hon Member that the Price Commission itself concluded in the middle of last year that domestic gas tariffs should be 30-35% higher over and above the inflation rate and that electricity too was underpriced though to a lesser extent than domestic gas.

By 6p-7p per therm.

Q. WHAT STEPS WILL THE GOVERNMENT TAKE TO PROTECT POOR CONSUMERS FROM THE EFFECT OF THESE INCREASES?

A. The Government has already announced a scheme of assistance with heating costs this winter. As my Rt Hon Friend the Secretary of State for Social Services explained when announcing this scheme, we cannot shield the entire population from rising energy costs even if we wanted to. However we are well aware of the need to take the cost of energy into account in our social policies, and we ~~shall~~ are ~~be keeping the matter under~~ reviewing these matters

Disconnections

Stamps

Q. WHY WERE CONSUMER COUNCILS TOLD AHEAD OF PARLIAMENT?

A. The industries are obliged by statute to inform the Consumer Councils about tariff proposals so that they may in turn make representations about them, if necessary to the Secretary of State.

N.I. [illegible]
[illegible] proposals.
Sec of [illegible] [illegible]

Q. WHAT ABOUT PRICES IN NORTHERN IRELAND/SCOTLAND?

A. The electricity industry in Scotland and the electricity and gas industries in Northern Ireland are the responsibility of the respective Secretaries of State. However I understand that a separate announcement on Scottish electricity will be made within a few weeks.

Q. WILL THE PRICE RISES BE THE SAME IN ALL PARTS OF ENGLAND AND WALES?

A. This is a matter for the industries.

Q. WHY DOES THE SECRETARY OF STATE NOT BRING DOWN THE PRICE OF GAS TO INDUSTRY INSTEAD OF PUTTING UP THE PRICE OF GAS TO DOMESTIC CONSUMERS?

A. Any attempt to reduce prices in this way would only exacerbate the present position in which demand exceeds supply.

Q. WILL THE SECRETARY OF STATE PUBLISH HIS CALCULATIONS OF THE ECONOMIC PRICE OF GAS AND ELECTRICITY?

A. The figures are indicated in the statement. The Price Commission's reports last year explained the considerations involved.

Q. HOW MUCH WILL THE INCREASES ADD TO THE RPI?

A. The April increases will add about ½% (electricity) and ¼% (gas) (spread over the subsequent three months); the October domestic gas increase will add a further 0.16%. The size of the October electricity increase is still uncertain.

Q. IS THIS MOVE INTENDED TO BRING GAS PRICES INTO LINE WITH ELECTRICITY? AND IF SO WHY HAVE ELECTRICITY PRICES GONE UP TOO?

Over the period the intended changes to improve the balance

A. ~~I believe that a consistent overall approach to energy pricing is essential to maintain a proper balance in the supply and demand of different fuels, but I do not favour the alignment of all energy prices, regardless of the costs of production. Electricity prices must continue to reflect the costs involved in generating and distributing electricity.~~

Q. ARE ELECTRICITY PRICE INCREASES NECESSARY TO FINANCE THE NUCLEAR PROGRAMME?

A. No. The increases are necessary to cover the industry's current costs and to produce an appropriate return on its assets.

PROFITS AND RATES OF RETURN

Q. WHAT RATE OF RETURN ARE THE INDUSTRIES EXPECTED TO MAKE FOR THE CURRENT YEAR? AND WHAT PROFITS DOES THIS MEAN?

This year, rate of return lower than target.

A. ~~It is too early to say precisely, but present indications are that outturn for the current financial year will be considerably lower than that expected over the target period.~~

Q. WHAT PROFITS WILL THE INDUSTRIES MAKE OVER THE TARGET PERIOD?

£200 - 300m

A. As I have explained, the actual rates of return achieved are expected to rise progressively over the target period (British Gas, for instance, from 6½% to 11%); and I would expect the industries' profits also to rise progressively above their present levels.

Q. HOW CAN YOU JUSTIFY PROFITS OF THIS SIZE? / WHY ARE THE GAS CORPORATION'S PROFITS SO HIGH?

A. The Hon Member should welcome the fact that some of our nationalised industries are profitable. [If pressed] I would certainly not regard the electricity industry's profits as excessive. The Gas Corporation is of course in a very favourable position at the moment because of its access to very valuable North Sea gas resources. The Corporation needs a firm financial foundation for the investment required to ensure the availability of gas for the future.

Q. WHY SHOULD THE NATIONALISED INDUSTRIES MAKE PROFITS AT ALL?

A. In order to help provide for their formidable investment requirements without undue recourse to the taxpayer.

Q. WHAT ABOUT A GAS TAX? / SPECIAL FUND FOR THE POOR, ENERGY CONSERVATION ETC?

this was used

A. This is an interesting suggestion, but the Hon Member may know that the industry's surplus cash is already deposited with the Government. This helps reduce the public sector borrowing requirement, and thus benefits the community as a whole, not just those who have gas.

Q. ARE NOT THE GAS INDUSTRY'S PROFITS WELL ABOVE THOSE EXPECTED IN THE PRIVATE SECTOR?

A. As the previous administration pointed out in Cmnd 7131, targets for nationalised industries need to take account

How to get rate of return up.

of a wide range of factors, not just returns in private industry. In any event I do not think the target rate of return is out of line with the return achieved or aimed at by comparable private sector concerns, bearing in mind the special circumstances of the gas industry.

Q. DO NOT THE NATIONALISED INDUSTRIES CONCEAL THE SIZE OF THEIR PROFITS IN THEIR ACCOUNTS IN ANY CASE?

No.

A. There has certainly been some diversity in recent years in the presentation of accounts in both public and private sector, due to the difficulty of producing a true profit figure on historic cost conventions in present inflationary times. I am therefore glad to note that a new Standard of current cost accounting is likely to be introduced in the near future; this will facilitate comparisons between different industries' profit figures. /The Government has announced that nationalised industries should in general apply the proposals set out in the final standard based on ED 24 (though it considers the gearing adjustment is not appropriate in view of their special financial arrangements)./

Q. WHAT TARGETS HAVE BEEN SET FOR OTHER NATIONALISED INDUSTRIES?

A. Targets for other nationalised industries are set out in the previous Government's White Paper Cmnd 7131. Since then a breakeven objective for BSC has also been announced.

Q. IS THE TARGET CONSISTENT WITH THE INDUSTRIES' CASH LIMITS FOR 1980/81 AND THE GOVERNMENT'S PUBLIC EXPENDITURE PLANS?

A. Yes. The external financing limits for 1980/81 announced recently were set in the light of discussions leading to the financial target.

Q. WHY IS THE TARGET FOR GAS SO MUCH HIGHER?

A. The target for the British Gas Corporation reflects the very considerable benefits stemming from its preferential access to North Sea Gas supplies, benefits which should not be passed on, through underpricing, to gas consumers alone, but should be made available for the nation as a whole.

EFFICIENCY AND MONITORING

Q. WHAT ARE YOU DOING TO ENSURE THAT THE INDUSTRIES OPERATE EFFICIENTLY AND DO NOT JUST PUT UP THEIR PRICES TO MEET THE TARGET?

A. In addition to the tight financial framework imposed by the industries' targets and financing limits, the Government has made special provision in its Competition Bill for the Monopolies and Mergers Commission to investigate the efficiency of nationalised industries, and possible abuse of monopoly.

Q. WHAT HAPPENS IF THE INDUSTRY DOES NOT MEET ITS TARGET?

A. We shall of course monitor closely progress towards the target through the financial returns the Government receives from the industry. If at any stage it appears that the industry is not on course to achieve its target, perhaps due to extraneous factors we should of course wish to discuss the situation with it in case any corrective action was needed.

COAL

Q. WHEN WILL YOU BE SETTING A FINANCIAL TARGET FOR THE COAL INDUSTRY?

A. I expect to make an announcement ~~at the earliest opportunity.~~ in the near future.

Q. WHAT COAL PRICES ARE ASSUMED IN ELECTRICITY TARGETS?

A. As I have explained, electricity prices must reflect changes in the cost of supply, including those of primary fuels such as coal. It is too early to say exactly what coal price rises will take place next year. ~~but Hon Members will be aware of the agreement between the CEGB and the NCB.~~

Background Note

Energy Fund. It has recently been suggested by the Energy Industry Consumers Councils (in a Press Release on Monday - copy attached) that a special fund should be set up with the profits of the gas and electricity industries for such purposes as energy conservation, assistance for the poor etc. This suggestion was also put forward by the National Consumer Council in a letter to the Secretary of State (copy of correspondence attached), and is likely to be brought up in questions. Although some forms of gas tax are currently under consideration at official level, it is not possible to give a clear indication of the Government's intentions since Ministers have not considered detailed proposals.

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Fuel and the Poor. This is likely to attract considerable attention. A paper for submission to DHSS Ministers is under discussion at official level, but Ministers have not yet given collective consideration to the options for next winter. So far as possible, questions should be deflected by reference to the responsibility of the Secretary of State for Social Services and the fact that the Government will keep the situation under review.

Current Cost Accounting. There has been considerable criticism recently of the diversity of approach in the nationalised industries' accounts, especially with regard to their depreciation policies and methods of accounting for inflation (the Consumers' Association, for instance, recently published a report on this question). The final standard on Current Cost Accounting is due to be published at the end of March, and the Government has announced its view that the standard should in general be applied by the industries (except that they should not make the gearing adjustment in their main accounts), and that financial targets will generally be set on the basis of current operating profit. As made clear in the statement, the targets for the gas and electricity industries are consistent with this approach, (though they may need to be reexpressed once the exact terms of the eventual standard are known).

Industry Returns and Prices. The table below gives details of the progress expected through the target periods.

	Gas			Electricity		
	80/81	81/82	82/83	80/81	81/82	82/83
Net % return	6.6	8.9	11.5	0.9	2.0	2.5
Average net assets £m at current cost	9,900	11,500	13,100	23,600	26,400	30,500
Current cost operating profit £m	650	1030	1510	210	530	760
Profit after interest ("bottom line profit") £m	660(1)	1080(1)	1610(1)	-310	-10	200
Price increases %	10(2)	10(2)	10(2)	2½(3)	1½(3)	1½(3)

(1) Assumes continuation of present "reverse NLF lending" arrangement.

(2) Domestic prices only: increases additional to the rate of inflation.

(3) Increases over and above those in the industries' own costs.

Since the targets themselves are expressed as averages over the three year period, only a general indication of this trend in the industries' returns is suggested in the Question and Answer brief if both industries are covered. If only gas the Secretary of State could give a more precise indication of the trend.

A

ORAL STATEMENT - FINANCIAL TARGETS FOR GAS AND ELECTRICITY

With permission Mr Speaker I should like to make a statement about financial targets for the British Gas Corporation and the electricity supply industry in England and Wales.

It is a fundamental objective of this Government's policy towards the nationalised industries that they should be set a clear financial discipline. We therefore opened discussions with the gas and electricity industries on medium-term financial targets for the period 1980/81 to 1982/83. The external financial limits for 1980/81 announced last November were set in the light of those discussions, which have now been satisfactorily concluded.

In a period of international uncertainty over fuel supplies and rapidly rising fuel costs, it is important that consumers should be aware of the true value of the fuel they are using. The prices which consumers pay for different fuels must reflect that value - taking into account in particular the fact that oil and gas supplies are limited. We must conserve our scarce energy supplies for future generations. After a year in which crude oil prices have risen by 100 per cent or more, this is bound to mean heavy increases in other fuel prices. The need to move to economic pricing has been our main consideration in setting the financial targets for the two industries.

I recognise that adjusting to an era of higher energy prices brings serious problems for many consumers, especially the old and the poor. The new scheme of assistance with heating costs announced by my Rt Hon Friend the Secretary of State for Social Services on 22 October last was designed to provide worthwhile help for those in most need. We shall take proper account of the cost of energy in our social policies and in determining benefit levels, particularly the levels of extra heating additions. We are reviewing in this context, the whole range of help available to assist consumers with fuel bills.

Turning specifically to gas first: there are five reasons why domestic gas prices will have to rise. First our reserves of natural gas represent a finite and increasingly valuable national resource. If the price is too low, we shall burn it up too fast and bring forward the day when we have to turn to more expensive sources of supply.

Second, in the short term too, low prices cause peak demand to surge above what it would otherwise be, bringing the risk of shortages and supply cuts on cold winter days.

Third, gas from new North Sea fields will cost several times more than earlier gas supplies and prices must reflect these much higher costs.

Fourth, a sensible approach to pricing is vital if we are to achieve a proper balance of supply and demand, as between all consumers of gas. For industrial and commercial customers it has been the long standing policy of the British Gas Corporation to sell gas at a price broadly related to that of the competing oil product. The Government endorses this policy. The only alternative would be some form of arbitrary rationing and the risk of ever increasing supply shortages.

Fifth, artificially low prices concentrate the benefits on those who have access to gas supplies at the expense of the rest of the population. Correct pricing is essential if some of the financial proceeds from our natural gas resources are to be secured for the benefit of the nation as a whole. Hon. Members will recall that even the Price Commission in their report last July, before recent oil price increases, concluded that domestic tariffs should be 30-35% higher in real terms.

Against this background, and the background of soaring world oil prices, we have set the British Gas Corporation a target, expressed as an average annual rate of return to be achieved over the period April 1980 to March 1983, of 9% on net assets valued at current cost. The target is related to current cost operating profit after taking account of depreciation but before interest and tax. It will be adjusted if necessary after introduction of the proposed new current cost accounting standard. The target rate of return is expressed as an average over three years: the actual rate of return is likely to be lower than 9% at first, but will increase progressively over the period.

Details of the tariff changes necessary to achieve the target are a matter for British Gas. However, in broad terms the Government expects domestic gas prices to increase this year by 10% over and above the rate of inflation, followed by comparable real increases in the following two years.

Against the same criteria of economic pricing, electricity prices will also rise, though the expectation is that this will be less than in the case of domestic gas.

The target for the electricity supply industry in England and Wales has been set at an average annual rate of return of 1.8 per cent on net assets valued at current cost - again over the three years 1980 to 1983. As in the case of gas, details of tariff changes are a matter for the industry. Prices are likely to increase over the three-year period of the target by about 5 per cent over and above increases in the industry's own costs, of which fuel costs are the biggest element.

The Government has asked both BGC and the Electricity Council to phase this year's increases in two stages, one in April and another in October.

British Gas Corporation Press Notice - January 16,1980

GOVERNMENT STATEMENT ON FINANCIAL TARGETS AND GAS PRICES

The Secretary of State for Energy made a statement in the House of Commons today (Wednesday, January 16) about the Government's financial targets for the gas and electricity industries and about gas and electricity prices in a period of rapidly rising fuel costs.

In reaching its decision, the Government has told the Corporation, it had in mind the importance of correcting the under-pricing of domestic gas and of narrowing the gap between the price to the domestic consumer and that to industry.

The Government has also told the Corporation that it considers that it would be right to raise domestic prices by 10 per cent per annum over and above the rate of inflation in each of the three years covered by the target.

The financial target for gas is to be an average rate of return of 9 per cent on net assets at current cost over the three years, 1980-81, 1981-82, and 1982-83. The Government's statement points out that the actual rate of return will increase progressively over the target period.

The Corporation has been discussing with the National and the 12 Regional Gas Consumers Councils detailed changes in the tarriffs so as to increase domestic prices by an average of 17 per cent from April 1, 1980, and an average of 10 per cent from October 1,1980. These discussions are confined to the increases this year. The size of the increases needed to implement the Government's pricing policy for the following two years will depend on the future rate of inflation.

Domestic gas prices were increased by 10 per cent in April 1977 and no further increase was made until the 8 per cent increase from June 1 last year. During that interval gas prices fell in real terms by more than 15 per cent. No increase in domestic tariffs was made following the budget last summer when the Corporation's cash limit was increased by £190 million to minus £449 million.

The Price Commission, in its report on gas prices (July 18, 1979) said that in the current year the domestic market was expected only to break even. Clearly, increases this year are necessary if this sector of the market is not to move into a loss. The Commission also said that the price of gas to domestic customers was 6p or 7p a therm below the long-run marginal cost. In view of previous restraint, the Corporation believes that sharp increases in domestic tariffs were inevitable this year.

Non-domestic tariffs, which under the new proposals will rise by 10 per cent from April 1, 1980, were increased from September 1 last year by 21 per cent, to help meet the tighter cash limit. They had previously been raised 11 per cent from March 31, 1979, and by 10 per cent from April 1, 1977.

NOTE TO EDITORS

The new tariffs are expected to apply from after the first meter reading on or after April 1, 1980, and from after the first meter reading on or after October 1, 1980. This means that gas consumed up to the date of the meter reading will be charged at the old rate.

Full details of the new tariffs will be published after the current discussions have been concluded and the new charges agreed.

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From the Private Secretary

16 January 1980

Dear Bill.

Financial Targets for the Gas and Electricity Industries

The Prime Minister has now considered the draft statement which you enclosed with your letter of 15 January, and has suggested a number of amendments. I enclose pages 1, 3 and 4 of the statement as redrafted. The Prime Minister has not made any changes to page 2.

The Prime Minister asked why the statement does not make clear what will be the approximate size of the April and October increases - ie it does not indicate that the April increase will be the larger one, reflecting inflation over the past 12 months, and the October increase will be the "smaller "real terms" increase. You said that your Secretary of State would prefer to bring this out in supplementaries.

The Prime Minister also asked why in the second paragraph of page 3, and again on page 4, you need to refer to average net assets. Unless this is absolutely essential, it would seem better to leave "average" out: you already have "average annual rate of return" in these two sentences.

I am copying this letter to the Private Secretaries to members of E Committee, Don Brereton (DHSS), John Stevens (Office of the Chancellor of the Duchy of Lancaster), Richard Prescott (Paymaster General's Office) and Martin Vile (Cabinet Office).

Yours ever.

Tim Lankester.

Bill Burroughs, Esq.,
Department of Energy.

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DRAFT ORAL STATEMENT - FINANCIAL TARGETS FOR GAS AND ELECTRICITY

With permission Mr. Speaker I should like to make a statement about financial targets for the British Gas Corporation and the electricity supply industry in England and Wales.

It is a fundamental objective of this Government's policy towards the nationalised industries that they should be set a clear financial discipline. We therefore opened discussions with the gas and electricity industries on medium-term financial targets for the period 1980/81 to 1982/83. The external financial limits for 1980/81 announced last November were set in the light of those discussions, which have now been satisfactorily concluded.

In a period of international uncertainty over fuel supplies and rapidly rising fuel costs, it is important that consumers should be aware of the true value of the fuel they are using. The prices which consumers pay for different fuels must reflect that value - taking into account in particular the fact that oil and gas supplies are limited. We must conserve our scarce energy supplies for future generations. After a year in which crude oil prices have risen by 100 per cent or more, this is bound to mean heavy increases in other fuel prices. The need to move to economic pricing has been our main consideration in setting the financial targets for the two industries.

I recognise that adjusting to an era of higher energy prices brings serious problems for many consumers, especially the old and the poor. The new scheme of assistance with heating costs announced by my Rt. Hon. Friend the Secretary of State for Social Services on 22 October last was designed to provide worthwhile help for those in most need. We shall take proper account of the cost of energy in our social policies and in determining benefit levels, particularly the levels of extra heating additions. We will keep under review, in this context, the whole range of help available to assist consumers with fuel bills.

Turning specifically to gas first: there are five reasons why domestic gas prices will have to rise. First our reserves of natural gas represent a finite and increasingly valuable national resource. If the price is too low, we shall burn it up too fast and bring forward the day when we have to turn to more expensive sources of supply.

Second, in the short term too, low prices cause peak demand to surge far above what it would otherwise be, bringing the risk of shortages and supply cuts on cold winter days.

Third, gas from new North Sea fields will cost several times more than earlier gas supplies and prices must reflect these much higher costs.

Fourth, a sensible approach to pricing is vital if we are to achieve a proper balance of supply and demand, as between all consumers of gas. For industrial and commercial customers it has been the long standing policy of the British Gas Corporation to sell gas at a price broadly related to that of the competing oil product. The Government endorses this policy. The only alternative would be some form of arbitrary rationing and the risk of ever increasing supply shortages.

Fifth, artificially low prices concentrate the benefits on those who have access to gas supplies at the expense of the rest of the population. Correct pricing is essential if some of the financial proceeds from our natural gas resources are to be secured for the benefit of the nation as a whole. Hon. Members will recall that even the Price Commission in their report last July, before recent oil price increases, concluded that domestic tariffs should be 30-35% higher in real terms.

Against this background, and the background of soaring world oil prices, we have set the British Gas Corporation a target, expressed as an average annual rate of return to be achieved over the period April 1980 to March 1983, of 9% on (average) net assets valued at current cost. The target is related to current cost operating profit after taking account of depreciation but before interest and tax. It will be adjusted if necessary after introduction of the proposed new current cost accounting standard. The target rate of return is expressed as an average over three years: the actual rate of return is likely to be lower than 9% at first, but will increase progressively over the period.

Details of the tariff changes necessary to achieve the target will be decided by British Gas. However, in broad terms the Government expects domestic gas prices to increase this year by 10% over and above the rate of inflation, followed by comparable real increases in the following two years.

[Against the same criteria of economic pricing,] electricity prices will also rise, though less so than in the case of domestic gas.

The target for the electricity supply industry in England and Wales has been set at an average annual rate of return of 1.8 per cent on average net assets valued at current cost - again over the three years 1980 to 1983. As in the case of gas, details of tariff changes will be decided by the industry. Prices are likely to increase over the three-year period of the target by about 5 per cent over and above increases in the industry's own costs, of which fuel costs are the biggest element.

The Government has asked both BGC and the Electricity Council to phase this year's increases in two stages, one in April and another in October.

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Nat Inds.

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

16? January, 1980

Dear David, R 17/1

FINANCIAL TARGETS FOR THE GAS AND ELECTRICITY INDUSTRIES

Thank you for your letter of 14th January. I understand that you now propose to make this statement today (16th January).

Our officials met with the British Gas Corporation yesterday morning and I understand that it is now agreed that the correct target for BGC is 9 per cent not 10 per cent. I understand that this adjustment does not reflect a change in the profitability expected of BGC, but certain refinements to the definition of their net assets at current prices. Subject to this adjustment, I am content with the statement as it stands.

It does, however, occur to me that one point you may wish to consider for your statement is the importance of realistic energy pricing in any approach to an "energy policy" - a concept which attracts some attention these days.

I recognise your concern to say something about the effects of the price rises on the poor. I also note what you say in your letter about your wish for further consideration of our policy in this area. You are, of course, aware that our plans at present contain no provision for additional expenditure in this area. Any additional resources would become a claim on the Contingency Reserve, and the difficulties of such a proposal in the present public expenditure climate are all too obvious.

Given the present consideration of Government policy on uprating benefits, I therefore think that the formulation in the last paragraph of your draft statement is about as far as you can safely go, and I should be grateful if you could stick closely with it.

The Rt. Hon. D. Howell, M.P.

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My officials have been associated with your Department's discussions with the electricity and gas industries about the appropriate target levels consistent with our pricing and public expenditure decisions. I am content that the appropriate levels, on the information we have available and on current accounting policies, are 9 per cent for gas and 1.8 per cent for electricity. As I know you are aware, these targets will, however, need to be reassessed in the light of the adoption later this year of the expected new Accounting Standard on current cost accounting, based on ED24. We shall need to reconsider the targets in some detail at that stage, to ensure that this re-definition does not relax the target discipline.

I note that in your letter you propose early discussion on the possibility of a gas tax. The present phase of consideration of this proposal is, as you say, proceeding within your Department, under Norman Lamont. When that is concluded, I suggest we consider together the fiscal implications of whatever emerges before proposals are put to Ministers collectively.

I am copying this letter to the Prime Minister, other members of E Committee, Patrick Jenkin, Norman St John Stevas, Angus Maude and Sir Robert Armstrong.

GEOFFREY HOWE

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ

01 211 6402

PR
discussed
with PM

Tim Lankester Esq
Private Secretary to the
Prime Minister
10 Downing Street
LONDON SW1

15 January 1980

Dear Tim,

FINANCIAL TARGETS FOR THE GAS AND ELECTRICITY INDUSTRIES

In the light of the Prime Minister's discussion with the Secretary of State on the draft of the announcement circulated yesterday evening I now attach a revised draft, approved by the Secretary of State, which takes into account the Prime Minister's comments. The announcement has now also been agreed with Sir Denis Rooke and Sir Francis Tombs. The Secretary of State would like to make the announcement after Questions tomorrow.

Copies of this letter and the enclosure go to the Private Secretaries to the recipients of my Secretary of State's letter of yesterday evening to the Chancellor of the Exchequer.

Yours sincerely,

Bill

W J Burroughs
Private Secretary

CONFIDENTIAL

DRAFT ORAL STATEMENT - FINANCIAL TARGETS FOR GAS AND ELECTRICITY

With permission Mr Speaker I should like to make a statement about [medium term] financial targets for the British Gas Corporation and the electricity supply industry in England and Wales.

It is a fundamental objective of this Government's policy towards the nationalised industries that they should be set a clear financial discipline (in which to work.) We therefore opened discussions with the gas and electricity industries on medium term financial targets for the period 1980/81 to 1982/83. The external financial limits for 1980/81 announced last November were set in the light of those discussions, which have now been satisfactorily concluded.

~~It is essential~~, In a period of ~~considerable~~ international uncertainty over fuel supplies and ~~very~~ rapidly rising fuel costs, it is important that consumers realise ~~should be aware~~ of the true value of the fuel they are ~~their energy~~ using. ~~consumption~~. [The main factor in setting these financial targets has accordingly been the overriding need to move towards consistent economic pricing for each fuel] so that our energy resources are properly used in the future. After a year in which crude oil prices have risen by 100% or more, this is bound to mean heavy increases in other fuel prices. The need to move to economic pricing has been our main consideration in setting the financial targets for the two industries.

The prices which consumers pay for different fuels must reflect their true value at a time when [illegible] oil & gas supplies are [illegible] limited. We must conserve our scarce energy supplies for future generations.

I recognise that adjusting to an era of higher energy prices brings serious problems for many consumers, especially the old and the poor. The new scheme of assistance with heating costs announced by my Rt Hon Friend the Secretary of State for Social Services on 22 October last was designed to provide worthwhile help for those in most need. We shall ~~continue to~~ take proper account of the cost of energy in our social policies and in determining benefit levels, particularly the levels of extra heating additions. We will keep under review, in this context, the whole range of help available to assist consumers with fuel bills.

Turning specifically to gas first: there are five reasons why domestic gas prices will have to rise. First our reserves of natural gas represent a finite and increasingly valuable national resource. If the price is too low, we shall burn it up too fast and bring forward the day when we have to turn to more expensive sources of supply.

Second, in the short term too, low prices cause peak demand to surge far above what it would otherwise be, bringing the risk of shortages and supply cuts on cold winter days.

Third, gas from new North Sea fields will cost several times more than earlier gas supplies and prices must reflect these much higher costs.

Fourth, a sensible approach to pricing is vital if we are to achieve a proper balance of supply and demand, as between all consumers of gas. For industrial and commercial customers it has been the long standing policy of the British Gas Corporation to sell gas at a price broadly related to that of the competing oil product. The Government endorses this policy. The only alternative would be some form of arbitrary rationing and the risk of ever increasing supply shortages.

Fifth, artificially low prices concentrate the benefits on those who have access to gas supplies at the expense of the rest of the population. Correct pricing is essential if some of the financial proceeds from our natural gas resources are to be secured for the benefit of the nation as a whole. Hon Members will recall that even the Price Commission in their report last July, before recent oil price increases, concluded that domestic tariffs should be 30-35% higher. in real terms.

Against this background, and the background of soaring world oil prices, we have set the British Gas Corporation a target, expressed as an average annual rate of return to be achieved over the period April 1980 to March 1983, of 9% on average net assets valued at current cost. The target is related to current cost operating profit after taking account of depreciation but before interest and tax. It will be adjusted if necessary after introduction of the proposed new current cost accounting standard. Although it is expressed as an average rate of return over three years, the actual rate of return ~~achieved is expected to increase~~ will be lower than that of profits and will [illegible], in real terms progressively over the ~~target~~ period.

?

Details of the tariff changes necessary to achieve the target ~~are~~ will be ~~set~~ decided by a ~~matter for~~ British Gas. However, in broad terms the Government expects domestic gas prices this year to increase by 10% over and above the rate of inflation, followed by comparable real increases in the following two years.

[illegible]

[Against the same criteria of economic pricing ~~for each fuel,~~] Electricity prices ~~must~~ will also rise, though [~~considerably~~] less ~~so~~ than ~~in the case of domestic gas.~~ those for domestic gas [~~On the same basis as for gas and over~~

[illegible]

~~the same period~~ the target for the electricity supply industry in England and Wales ~~is~~ has been set at ~~an average annual rate of~~ a return of 1.8% on ~~average~~ net assets valued at current cost again over the 3 years 1980 to 1983. As in the case of gas, details of tariff changes ~~are a matter for~~ will be decided by the industry. ~~but the~~ ~~Government expects~~ ~~prices~~ Prices are likely to increase ~~over the three year period of the target~~ by about 5% over and above increases in the industry's own costs, of which fuel costs are the biggest element.

The Government has asked both BGC and the Electricity Council to phase this year's increases in two stages, one in April and another in October.

The

MG

CONFIDENTIAL

Nat Inds.

DEPARTMENT OF HEALTH & SOCIAL SECURITY

Alexander Fleming House, Elephant & Castle, London SE1 6BY

Telephone 01-407 5522

From the Secretary of State for Social Services

P.

16/1

The Rt Hon David Howell MP
Secretary of State for Energy
Department of Energy
Thames House South
Millbank
London SW1

15 January 1980

Dear David,

FINANCIAL TARGETS FOR THE GAS AND ELECTRICITY INDUSTRIES

Thank you for sending me a copy of your letter of 14 January to Geoffrey Howe with the draft of the statement you are planning to make.

I am content with what you propose to say, in particular with the remarks at the end of your statement on the serious problems that substantially higher energy prices will bring for poorer consumers. As you say in your letter, we need to be seen to be taking further remedial action to give additional assistance to poorer consumers, for whom higher prices mean particular hardship.

I am especially concerned to see that further help goes to poor people in work equally with those on benefit, so as not to worsen the problems of incentives; and I agree that we should have early collective discussion of all possibilities, both for next year and for the longer term, when officials have presented the proposals on which they are urgently working.

I am copying this to the recipients of your letter.

Yours ever

Patrick

CONFIDENTIAL

CONFIDENTIAL

PA

Nationalised Industries

MJ5

Tim Lankester Esq
Private Secretary to the Prime Minister

14 January 1980

Dear Tim,

The Prime Minister may wish to see the attached draft statement on finazncial targets which my Secretary of State proposes to make later this week. If the pressure of events - and today's First Order Questions - mean that a written statement would be preferable my Secretary of State would favour a compressed version of the attached.

Yours ever,

Denis Walker

Denis Walker
Private Secretary

CONFIDENTIAL

(POSSIBLY ORAL)
DRAFT ~~ORAL~~ STATEMENT - FINANCIAL TARGETS FOR GAS AND ELECTRICITY

[With permission Mr Speaker I should like to make a statement about medium term financial targets for the British Gas Corporation and the electricity supply industry in England and Wales.]

It is a fundamental objective of this Government's policy towards the nationalised industries that they should be set a clear financial discipline in which to work. We therefore opened discussions with the gas and electricity industries on medium term financial targets for the period 1980/81 to 1982/83. The external financial limits for 1980/81 announced last November were set in the light of those discussions, which have now been satisfactorily concluded.

It is essential, in a period of considerable international uncertainty over fuel supplies and rapidly rising fuel costs; that consumers should be aware of the true value of their energy consumption. The main factor in setting these financial targets has accordingly been the overriding need to move towards consistent economic pricing for each fuel so that our energy resources are properly used in the future. After a year in which crude oil prices have risen by 100% or more, this is bound to mean heavy increases in other fuel prices.

To take gas first: there are five! four reasons why domestic gas prices will have to rise. First our reserves of natural gas represent a finite and increasingly valuable national resource. If it is underpriced, we shall burn it up too fast and bring forward the day when we have to turn to more expensive sources of supply. In fact, all analyses show that domestic gas is at present substantially underpriced. Hon Members will recall that even the Price Commission in their report last July, before recent oil price increases, concluded that domestic tariffs should be 30-35% higher.

Second, underpricing tends to divert scarce gas supplies from industry which would be willing to pay the proper price, as well as bringing the risk of shortages and supply cuts on cold winter days.

Third, underpricing concentrates the benefits on those who have access to gas supplies at the expense of the rest of the population. Economic pricing is essential if some of the financial proceeds from our natural gas resources are to be secured for the benefit of the nation as a whole.

Fourth, a sensible approach to pricing is also necessary to promote a proper balance of supply and demand. For industrial and commercial customers it has been the long standing policy of the British Gas Corporation to sell gas at a price broadly related to that of the competing oil product. The Government endorses this policy. The only alternative would be some form of arbitrary rationing and the risk of ever-increasing supply shortages.

Fifth, gas from new North Sea fields will cost up to several times more than earlier gas supplies and prices must reflect these much higher costs.

Against this background, and the background of soaring world oil prices, we have set the British Gas Corporation a target, expressed as an average annual rate of return to be achieved over the period April 1980 to March 1983, of [10%] on average net assets valued at current cost. The target is related to current cost operating profit after taking account of depreciation but before interest and tax. It will be adjusted if necessary after introduction of the proposed new current cost accounting standard. Although it is expressed as an average rate of return, the actual rate of return achieved is expected to increase progressively over the target period.

Details of the tariff changes necessary to achieve the target are a matter for British Gas. However, in broad terms the Government expects domestic gas prices this year to increase by 10% over and above the rate of inflation, followed by comparable real increases in the following two years.

In the case of electricity, there is also underpricing, but it is less than in the case of domestic gas. The target has however been designed to go a substantial way towards correcting this. On the same basis as for gas and over the same period, the target for the electricity supply industry in England and Wales is an average annual rate of return of 1.8% on average net assets valued at current cost. As in the case of gas, details of tariff changes are a matter for the industry but the Government expects prices to increase over the three year period of the target by about 5% over and above increases in the industry's own costs, of which fuel costs are the biggest element.

The Government has asked both BGC and the Electricity Council to phase this year's increases in two stages, one in April and another in October.

I recognise that adjusting to an era of higher energy prices brings serious problems for many consumers, especially the old and the poor. The new scheme of assistance with heating costs announced by my Rt Hon Friend the Secretary of State for Social Services on 22 October last was designed to provide worthwhile help for those in most need. We shall continue to take proper account of the cost of energy in our social policies and in determining benefit levels, particularly the levels of extra heating additions. We will keep under review, in this context, the whole range of help available to assist consumers with fuel bills.

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ
01 211 6402

Tim Lankester Esq
Private Secretary to the Prime Minister
10 Downing Street
LONDON SW1

TL 14/1

14 January 1980

Dear Tim,

Nick Saunders has asked me to let you have an indication of the reply my Secretary of State proposes to make if he is questioned on the level of gas prices at First Order Questions today.

The Question is from Mr David Winnick (Walsall North) and it asks the Secretary of State for Energy is he will make a further statement on the likely level of gas prices. My Secretary of State proposes to reply:

"I will be making a statement in the near future about the financial targets we will be setting the gas and electricity industries, which will include the implications for pricing".

In replying to supplementaries, my Secretary of State will draw on the draft provided by Nick Saunders. He will also be making the points that after a year in which world crude oil prices have risen by over 100% a significant increase in gas prices is essential if we are not to burn up our natural gas resources dangerously fast.

On the question of big BGC profits he will say that it is desirable to secure some of the proceeds of North Sea gas receipts for the people as a whole, and that it is not clear to him why for example electricity consumers (who are amongst the poorest) should subsidise gas consumers. He will also refer to the vital needs of industry for gas which are not at present being fully met, to the former Price Commission Report that domestic gas was 30-35% under-priced even before recent oil price increases and to the fact that the previous Government ducked this issue, which we have to tackle firmly.

Yours ever,

Denis Walker

D P ~~WALKER~~
PRIVATE SECRETARY

ΩA
MJ

01 211 6402

Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON SW1

14 January 1980

Dear Geoffrey

FINANCIAL TARGETS FOR THE GAS AND ELECTRICITY INDUSTRIES

My consultations with the gas and electricity industries on 3-year financial targets reflecting the pricing proposals agreed by E Committee are now virtually complete. I should like to announce these as soon as possible, and in view of the reports (originating, I understand, from one of the regional Gas Consumer Councils) appearing in the Press last weekend about domestic gas price increases, would aim to do so later this week, probably by means of an oral statement to the House. I enclose a draft of my statement, which has I understand already been discussed with your officials. I would hope this could be an oral statement; if pressure of events indicates a written answer I would expect it to be somewhat shorter.

The targets are to be expressed as average annual rates of return on assets, calculated on a current cost accounting basis. The figure for gas (subject to final confirmation with the industry) is 10% and for electricity 1.8% (the gas figure being larger because of its smaller asset base which does not fully reflect its real main asset, access to gas in the ground; and because its profits include an element of "economic rent" in respect of the Southern Basin gas fields). The targets are averages of the expected rates of return in each of the three years and are compatible with agreed public expenditure figures as well as with the pricing proposals agreed by E Committee.

Some of the main assumptions underlying the target will be set out in target-setting letters which I shall send to the Chairmen when the statement is made and which I should expect to become public; but the bulk of the underlying figure work, amounting to projected "target paths" will be, or has already been, contained in confidential letters to the industries. Our officials will continue to be in touch over this.

(2)

Recent news of further oil price increases will have emphasised to the public once more the fact that the days of cheap energy are over. The statement is nonetheless likely to attract a good deal of attention, and we must ensure that the case is presented as effectively as possible. I would therefore intend to give a fairly full explanation of the pricing strategy especially for domestic gas: indeed I welcome the chance to do so. But I do not in any case think there is any opportunity for the Government to duck this responsibility. The size of the domestic gas price increases stems directly from the Government's decision and was accepted with some reluctance by the Corporation themselves - and they will not be slow to point this out if they do not think the position has been made sufficiently clear.

You will see that I have also referred to two important areas of concern where the Government's intentions may be questioned: the special problems of the old and the poor, and the need to ensure that the nation as a whole derives appropriate benefit from our valuable North Sea gas reserves. I would like to have been more positive on both of these points, but recognise that this would require further collective consideration, which there would not be time to complete before the end of the month. Nonetheless, I am concerned that our ability to maintain our pricing strategy could be seriously weakened if we are unable to make any progress in these areas.

I realise that the two questions of high gas industry profits, and assistance to poorer consumers with fuel costs are separate, but it is inevitable that they will be linked in people's minds and I believe that we shall come under considerable pressure if we are unable to announce remedial measures, and indeed seem to be taking substantially less action than our predecessors did at a time of much lower real price increases.

On the question of high gas profits, and the possibility of an Exchequer charge, E Committee has of course already decided that Ministers should look in detail at two options identified in earlier discussions. I understand that Mr Lamont's Group on the Gas Industry will shortly be reporting on this - your officials have been kept in touch with the gas tax discussions. I also understand that a paper on the question of assistance with fuel costs is being prepared by DHSS officials for submission to their Ministers, in consultation with officials from other Departments. I believe that this matter also deserves collective discussion at an early stage, despite the very tight expenditure situation - even relatively modest developments could be of some importance in the presentation of our overall pricing strategy. I know you are very conscious of the public expenditure benefits of our gas and electricity pricing strategies: but I think we should not underestimate the difficulty of sustaining them over the period of the financial target and perhaps beyond. Additional assistance to those for whom

(3)

higher prices mean particular hardship could well be a worthwhile price to pay for the achievement of these larger savings.

I am copying this letter to the Prime Minister, our other E Committee colleagues, Patrick Jenkin, Norman St John-Stevas, Angus Maude and Sir Robert Armstrong. Press leaks over the weekend have given us rather less time than I would have wished, and I would be very grateful for your response, and any comments our colleagues may have, within the next day or two.

Yours ever

David

D A R Howell

DRAFT STATEMENT — FINANCIAL TARGETS FOR GAS AND ELECTRICITY

With permission Mr Speaker I should like to make a statement about medium term financial targets for the British Gas Corporation and the electricity supply industry in England and Wales.

It is a fundamental objective of this Government's policy towards the nationalised industries that they should be set a clear financial discipline in which to work. We therefore opened discussions with the gas and electricity industries on medium term financial targets for the period 1980/81 to 1982/83. The external financial limits for 1980/81 announced last November were set in the light of those discussions, which have now been satisfactorily concluded.

It is essential, in a period of considerable international uncertainty over fuel supplies and rapidly rising fuel costs; that consumers should be aware of the true value of their energy consumption. The main factor in setting these financial targets has accordingly been the overriding need to move towards consistent economic pricing for each fuel so that our energy resources are properly used in the future. After a year in which crude oil prices have risen by 100% or more, this is bound to mean heavy increases in other fuel prices.

To take gas first: there are four reasons why domestic gas prices will have to rise. First our reserves of natural gas represent a finite and increasingly valuable national resource. If it is underpriced, we shall burn it up too fast and bring forward the day when we have to turn to more expensive sources of supply. In fact, all analyses show that domestic gas is at present substantially underpriced. Hon Members will recall that even the Price Commission in their report last July, before recent oil price increases, concluded that domestic tariffs should be 30-35% higher.

Second, underpricing tends to divert scarce gas supplies from industry which would be willing to pay the proper price, as well as bringing the risk of shortages and supply cuts on cold winter days.

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Fourth, a sensible approach to pricing is also necessary to promote a proper balance of supply and demand. For industrial and commercial customers it has been the long standing policy of the British Gas Corporation to sell gas at a price broadly related to that of the competing oil product. The Government endorses this policy. The only alternative would be some form of arbitrary rationing and the risk of ever-increasing supply shortages.

Fifth, gas from new North Sea fields will cost up to several times more than earlier gas supplies and prices must reflect these much higher costs.

Against this background, and the background of soaring world oil prices, we have set the British Gas Corporation a target, expressed as an average annual rate of return to be achieved over the period April 1980 to March 1983, of [10%] on average net assets valued at current cost. The target is related to current cost operating profit after taking account of depreciation but before interest and tax. It will be adjusted if necessary after introduction of the proposed new current cost accounting standard. Although it is expressed as an average rate of return, the actual rate of return achieved is expected to increase progressively over the target period.

Details of the tariff changes necessary to achieve the target are a matter for British Gas. However, in broad terms the Government expects domestic gas prices this year to increase by 10% over and above the rate of inflation, followed by comparable real increases in the following two years.

In the case of electricity, there is also underpricing, but it is less than in the case of domestic gas. The target has however been designed to go a substantial way towards correcting this. On the same basis as for gas and over the same period, the target for the electricity supply industry in England and Wales is an average annual rate of return of 1.8% on average net assets valued at current cost. As in the case of gas, details of tariff changes are a matter for the industry but the Government expects prices to increase over the three year period of the target by about 5% over and above increases in the industry's own costs, of which fuel costs are the biggest element.

The Government has asked both BGC and the Electricity Council to phase this year's increases in two stages, one in April and another in October.

I recognise that adjusting to an era of higher energy prices brings serious problems for many consumers, especially the old and the poor. The new scheme of assistance with heating costs announced by my Rt Hon Friend the Secretary of State for Social Services on 22 October last was designed to provide worthwhile help for those in most need. We shall continue to take proper account of the cost of energy in our social policies and in determining benefit levels, particularly the levels of extra heating additions. We will keep under review, in this context, the whole range of help available to assist consumers with fuel bills.

cc 9/N

Original in G/R

Nat Inds

CF to ndde

10 DOWNING STREET

THE PRIME MINISTER

7 December, 1979.

Dear Hugh,

Thank you for your letter of 21 November enclosing correspondence from your constituent, Mr. Johnston, about gas prices.

I appreciate and share Mr. Johnston's concern about rising prices. The Government have been studying very carefully the whole question of gas pricing policy. Gas is however a finite resource and its price should properly reflect the long term cost to the nation of using it up, rather than the immediate profitability of the gas industry. You may be aware that the price of gas has fallen significantly in real terms in recent years; that is to say, it has risen much less than prices generally. Future supplies, which will come predominantly from the deeper and more distant waters of the northern North Sea, will be much more expensive than those currently taken from southern waters. In the longer term still, alternative sources of supply, such as the production of gas from coal, will need to be developed and this is certain to be a costly business. The role of pricing policy in encouraging conservation must also be taken into account. We need to ensure as far as we can that gas is not used wastefully, thereby preserving the availability of this valuable fuel for as long as possible.

Our policy must also have regard to the present position in the fuel market, as well as to the longer term. Following the oil price increases and supply uncertainties earlier this year, there has been an unprecedented upsurge in demand for gas which the British Gas Corporation are at present unable to meet in full.

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It will take time to strengthen the gas transmission and distribution system so that it can cope with the maximum demand that would be placed upon it - including all the potential new customers - on the coldest winter days. A realistic pricing policy is important in helping to match up demand to the available supplies. The alternative would be some form of arbitrary rationing.

You will, I am sure, know of the new measures, announced by the Secretary of State for Health and Social Services on 22 October, which the Government have introduced to help the less well off, especially the very old and those with young families, with fuel costs this winter. (For your convenience, I enclose a copy of the statement.) As Patrick Jenkin pointed out, we are living in an era of high cost energy and we cannct shield the whole population from that, even if we wanted to. We will however continue to take the cost of energy into account in developing our social policies, and meanwhile have tried to concentrate help where it is most needed.

I hope Mr. Johnston will find this of some help in understanding the Government's approach to these problems.

Yours ever,

(SGD) MT

Hugh Dykes, Esq., M.P.

Nat Ind

CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon David Howell MP
Secretary of State
Department of Energy
Thames House South
Millbank
LONDON SW1

4 December 1979

Dear David,

FINANCIAL TARGET FOR BRITISH GAS

Thank you for your letter of 3 December proposing the planning assumption to be used for the British Gas Corporation's financial target. As you recognise, the agreed assumption will also underlie the public expenditure figures for the later years of the Survey period, corresponding to those in paragraph 2 of annex B to your paper (E(79)64).

I fully agree with your proposal that we should use the assumption which British Gas would, left to themselves, make: that is, that the agreed real price increases would be achieved by a single increase at the start of each financial year. I accept that we can look again nearer the time at the question of phasing increases after 1980-81, should colleagues wish then to do so.

I am copying this letter to Members of E Committee and to Sir Robert Armstrong.

Yrs

John Biffen

JOHN BIFFEN

5 DEC 1979

CONFIDENTIAL

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SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ
01 211 6402

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3/12

Rt Hon John Biffen MP
Chief Secretary
Treasury
Parliament Street
LONDON
SW1P 3HE

3 December 1979

Dear John

FINANCIAL TARGET FOR BRITISH GAS

It was accepted at E Committee on Monday that domestic gas prices should rise on average by 10% a year in real terms in 1981/82 and subsequent years and we were invited to agree the precise planning assumptions to be used.

I am writing to the Corporation to say that we would wish to set them a 3-year financial target for the period 1980/81 to 1982/83 on the basis of domestic price increases of 10% a year in real terms and to ask for their co-operation in agreeing the form and value of the target. My understanding is that British Gas will be making their financial forecasts on the basis that a single annual price increase takes place on 1 April of each year. I suggest that we accept this for planning purposes, including the forthcoming Public Expenditure White Paper. Colleagues can of course consider the question of phasing price increases in 1981/82 nearer the time, should they so wish.

I am copying this letter to Members of E Committee and Sir Robert Armstrong.

Yours ever

David

D A R Howell

3 - DEC 1979

Nat Ind

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ
01 211 6402

12
26/11

Sir Kenneth Berrill KCB
Central Policy Review Staff
70 Whitehall
SW1

23 November 1979

Dear Kenneth

BRITISH GAS CORPORATION: EXTERNAL FINANCING LIMIT 1980/81

Thank you for your letters of 1 and 13 November.

As you say, oil price movements have an important effect on BGC's financial performance. However this is not only because revenue from non-domestic gas sales are linked directly or indirectly, to oil product prices, but also because the prices that the Corporation pays for gas are oil-related in part. The price of gas from the Frigg field, which comprises about a third of our total supplies at present, is escalated according to a formula which includes as an important element the average annual price of low sulphur heavy fuel oil at Rotterdam. While the price of Frigg gas is expected to increase in line with oil prices generally, the link with the Rotterdam market clearly makes forecasting more uncertain than would otherwise be the case. These difficulties are made worse by the fact that non-domestic prices are updated once a year as contracts are renewed whereas the Frigg price is escalated every six months. This leads to BGC's cost increases having a more immediate impact.

Thus, although the extra revenue from non-domestic gas sales would compensate for the additional gas purchase costs if oil prices rose faster than assumed, the net effect in the first year would in fact be a loss of revenue amounting to £1-2m for each 1% change in oil prices. In subsequent years the first year's unexpected oil price increases would generate a net benefit, provided there were no further unforecast price increases.

I share your concern about the effects oil price movements might have on the financial performance of British Gas since one would not, for instance, wish the pressures to increase efficiency and to raise domestic tariffs to be weakened, merely because oil price movements had proved beneficial.

But other external variables such as the rate of inflation, currency movements, and particularly the weather are also important. For example, if the mean annual temperature were to depart by $1^{o}C$ from the average, the effect on profits would be around £100 m. Thus if oil prices were to go up by more than is now forecast, and if the winter of 1980/81 were to be warmer than usual, British Gas could well miss the proposed external financing limit of £400 m by an appreciable margin. Conversely, if the changes go the other way the PSBR could benefit considerably though this obviously cannot be relied upon in advance. Last year British Gas undershot their cash limit by over £200 m, due mainly to a combination of lower costs of Frigg gas than forecast and buoyant gas sales, in part because of the cold winter.

All this suggests that any attempt to insulate British Gas' financial performance from significant external factors would have to cover more than oil price movements if it was to be effective. But I see great difficulty in doing this by a formula. Naturally we will need to look at this question in detail and my officials have already had preliminary discussion with the Corporation on the subject. However, at first sight I see attractions in adopting a consistent approach to both the three year financial target and the external financing limit, and setting both on a set of assumptions which are understood and accepted by BGC and Government. Then, if the Corporation's financial performance looks like being affected by external factors to such an extent that our basic policy objectives for BGC were in jeopardy, we would need to give careful consideration to adjusting the target and the external financing limit. The Chief Secretary in his letter of 7 November suggested something along these lines in respect of oil price movements for the external financing limit.

I am sending copies of this letter to the Prime Minister, other members of E, and to Sir Robert Armstrong.

Yours ever
David

D A R Howell

Nat Ind

CONFIDENTIAL

Ref. A0728

PRIME MINISTER

Gas Prices and Targets, and Taxes on Gas

(E(79) 64 and 65)

BACKGROUND

There has been a long series of Committee and Cabinet decisions on gas prices, the latest of which was an inconclusive discussion on 30th October, (E(79) 14th Meeting) which led to the two present papers.

2. The position so far reached is:

(i) Ministers have agreed on the price increases to be sought in 1980-81.

(ii) They have agreed in principle that gas prices should be returned to "economic levels" (roughly, to a price related to that of oil) by the end of the PESC period.

(iii) They have recognised that this may require very big annual increases, and have questioned whether it would be better to have two small increases a year, or one big one.

(iv) They have recognised that such increases would leave the British Gas Corporation with very large profits which owe nothing to good management. Under present arrangements these profits are lent back to the Government, against the day when the Gas Corporation needs to draw upon them to finance new investment. Ministers have considered that it might be better presentationally to cream off the profits by way of tax.

3. The two papers before the Committee therefore deal:

(i) with the phasing of price increases in 1981-82 and later years;

(ii) with the best way of creaming off the profits.

HANDLING

4. I suggest you take the two papers consecutively. The pricing one comes first. You should invite the Secretary of State for Energy to introduce this, and then seek comments from the Chief Secretary, Treasury, and from any other Ministers who wish to speak. Sir Kenneth Berrill may also wish to join in.

5. The key issue is straightforward: is it better to spread out the misery, or to concentrate it? The figures in the paper demonstrate that, for any given financial target, rather bigger increases will be needed on a twice-a-year basis than on a once-a-year basis. The total take from the consumer would of course be the same over the year as a whole. But presentationally, the pattern would look worse. The Secretary of State for Energy therefore proposes a single annual increase each April (with the alternative of an increase in July, which means losing £30 million revenue a year). He suggests that this should be a planning assumption, on the basis of which the industry would be set firm financial targets. The actual phasing of price increases would be settled each year as circumstances dictated. The Chief Secretary concurs. You may feel, on reconsideration, that the presentational advantages of a twice-a-year increase are outweighed by the disadvantages which he describes. But you will want to give the other arguments a run first.

6. You might then turn to the problem of excess revenues. Here the batting order is reversed: the Chief Secretary should introduce the paper, and the Secretary of State for Energy (who has agreed it in draft) should comment. It is common ground that the profits of the BGC should be syphoned off in some way, and not merely re-lent to the Exchequer as at present. (This leaves the initiative with the Corporation, and reduces the incentive to efficiency). You might take the Committee through the three options posed in the Chief Secretary's paper:

(i) PRT. Although you yourself favoured this route originally, it has the major disadvantage that a substantial part of the revenue would leak away to foreign-owned oil companies, thus reducing the contribution which BGC makes to reducing the PSBR. It would also require renegotiation of individual contracts with each company: the BGC would lose its statutory sole buying rights, and would be in a weak position in these negotiations. It does not seem a very attractive proposition.

(ii) A prior charge on BGC profits. Because it would be treated by BGC as a cost, it would be passed on automatically to consumers (i.e. it would justify the price increases which have been agreed for other reasons) and it could be presented as a way of spreading the benefits of cheap gas over the community as a whole, rather than over the minority who happen to use gas as their main fuel. It requires legislation, and could not be introduced until 1981-82 (unless imposed retrospectively) but it does not involve the oil companies at all. It could if necessary be adjusted to reflect the declining value to BGC of their present 'cheap gas' contracts, as these run out. On balance, this seems the preferable course, economically and politically.

(iii) A charge on the consumer. In logic there is a good case for taxing all consumption on energy - e.g. by removing its zero-rating for VAT purposes. But one thing at a time. The consumer has first to digest the considerable increases in prices which the Government has already agreed. Some part of those price increases could, in theory, be collected from the individual consumer as a surcharge on his bill, (which is what this course implies). But it is administratively untidy, would lead to lots of demands for individual exemptions, and would involve the Government much more directly.

7. There is one extraneous factor, not explained fully in the paper. Mr. Howell apparently believes that course (ii), while preferable on other grounds, would stand in the way of privatisation of the Gas Corporation. He considers that course (i), which would put the BGC much more into the position of a private sector gas distributor, is preferable on this ground. Since he has not yet put forward his proposals for privatisation of BGC, and was not ready to do so in this paper, it is difficult to judge this argument. But (as in the case of privatisation of BNOC, which you have already discussed with him) the PSBR cost of an ideal privatisation solution is very high: you may feel that it is not practical politics for the next few years. In that case, option (ii) is almost certainly the best one.

CONCLUSIONS

8. Subject to the course of discussion, I think the conclusions of this meeting will be:

(i) To confirm that gas prices should be raised over a period of four years to the oil-related level (as already agreed).

(ii) To agree that, in addition to the two increases already determined for 1980-81, gas prices should increase in April /or alternatively, in July/ 1982, 1983 and 1984, by 10 per cent in real terms (on top of any increase needed to keep pace with movements in the RPI).

(iii) To agree that the Secretary of State for Energy, in consultation with the Chief Secretary, Treasury, should now enter into discussions with the British Gas Corporation about financial targets which would require increases on this scale.

(iv) To agree that once these targets have been negotiated, they should be publicly announced and the implication for prices made clear, so that consumers have the right signals about the future course of gas prices and can plan their equipment and insulation accordingly.

(v) To agree that the consequent higher profits of the BGC should be reduced by the imposition of an Exchequer charge on gas, on the lines of option (ii) in E(79) 65.

(vi) To invite the Chief Secretary, Treasury, in consultation with the Secretary of State for Energy, to devise a detailed scheme for such charge, and to bring fresh proposals to the Committee in time for legislation in the 1980 Finance Bill.

RTA

(Robert Armstrong)

23rd November, 1979

Nat. Ind

bc MR INGHAM

JH

10 DOWNING STREET

From the Private Secretary

12 November 1979

Gas Prices

The Prime Minister was grateful for the Paymaster General's minute of 8 November and has noted Chief Information Officers have been instructed in future to send out written denials of false stories.

T. P. LANKESTER

Richard Prescott, Esq.,
Paymaster General's Office.

2

cc: Mr Ingham

PRIVY COUNCIL OFFICE

WHITEHALL, LONDON SW1A 2AT

PAYMASTER GENERAL

Prime Minister

8 November 1979

PRIME MINISTER

GAS PRICES

The moment the story by John Edmonds, a National Officer of the General and Municipal Workers Union, appeared on the Press Association news tape alleging that gas prices would rise by 40% next April I instructed my Office to telephone the Department of Energy and arrange for a denial to be issued.

I discovered today that whilst a written denial had not been issued, the Department had responded to enquiries from journalists by denying it verbally. This resulted in a number of today's newspapers carrying the 40% price rise story, with only one denying it.

As regards the 'Today' programme, a representative telephoned the Department of Energy Press Office yesterday and was given a flat denial of the story. In view of this my Private Secretary has today spoken to the Department's Head of Information and suggested that a complaint be made in writing to the BBC about the 'Today' programme this morning carrying the 40% price increase story.

Finally, in my view a written denial of such stories should be made in future, and I am informing C.I.O.s accordingly.

AM

ANGUS MAUDE

- Nat Ind

CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon David Howell MP
Secretary of State
Department of Energy
Thames House South
Millbank
London SW1

R 8/11

7 November 1979

Dear David,

BRITISH GAS CORPORATION: CASH LIMIT 1980-81

Sir Kenneth Berrill sent me a copy of his letter to you of 1 November suggesting that the BGC's cash limit for 1980-81 of £400 million might be linked in some way to the performance of the oil price.

I certainly sympathise with the thought behind Sir Kenneth's suggestion. Once the Energy Conservation Bill is enacted, the implicit link between contract gas prices and domestic tariff prices will have been removed. In these circumstances if oil prices rise faster than assumed for the calculation of BGC's cash limit, the Corporation could, if they so choose, reduce the increase in domestic tariffs and still keep within their cash limit. In these circumstances the industrial consumer would be subsidising the domestic consumer. This would be undesirable for both industrial and energy policies and, as Sir Kenneth says, the PSBR would be higher than it might otherwise be.

A link between the cash limit and the performance of the oil price might indeed be one way of dealing with this problem. But the disadvantage of this course is that it would introduce an explicit and automatic element of conditionality into the cash limit (or more properly the external financing limit as the nationalised industries' cash limits are now known). This might work in our favour in BGC's case but my judgement is that we have more to lose with conditionality than we have to gain so far as the other nationalised industries are concerned. I am reinforced in this view by some of the proposals in the paper which the Chairman of the Chairmen's Group sent to the Chancellor on "a framework of financial discipline for the public sector corporations".

I am therefore hesitant about Sir Kenneth's suggestion of linking the cash limit and the oil price in the way suggested and I would like to propose an alternative procedure which would go some way to meet his point. I suggest that when you write to the BGC informing them of their cash limit, you should make clear our understanding of the oil price asumptions implicit in their cash limit both for BGC's purchases and sales of gas. Your Department should then monitor movements of oil prices against those assumed in BGC's cash limit so that we can consider setting BGC a new limit if oil prices warrant it.

Sir Kenneth's suggestion is also relevant to the Corporation's financing target which we will shortly agree with them. This will require assumptions about oil prices over the next 3 years and will raise in even more acute form the difficulty to which Sir Kenneth has drawn attention. I see much less difficulty in making the financial targets conditional on oil prices and I suggest that our officials, in consultation with the Corporation, should try to devise a formula for the target which links it to rises in oil prices. Otherwise we could well find that the financial discipline implied in the target is eroded by unexpected increases in oil prices.

I am sending copies of this letter to the Prime Minister, other members of E Committee and Sir Robert Armstrong.

Yours

John Biffen

JOHN BIFFEN

JS

File

Nat. Grids

CF to note

cc: D/Energy

P/s in GR

10 DOWNING STREET

THE PRIME MINISTER

6 November 1979

Dear Mr. Faulkner,

Thank you for your letter of 15 October about gas prices.

I appreciate and share your concerns. You will know by now of the new measures announced by the Secretary of State for Social Services on 22 October. The Government has introduced these to help those who are most vulnerable to meet fuel costs this winter. I enclose a copy of the statement, for your convenience. As Patrick Jenkin pointed out, we are living in an era of high-cost energy, and it is not possible to shield the whole population from that. But we will continue to take the cost of energy into account in developing our social policies, and we will aim to concentrate help where it is most needed.

The price of gas has fortunately not risen as much as other fuels in recent years. Indeed, the proportion of a pension needed to pay for a given amount of gas has more than halved over the past ten years. The Government has yet to reach decisions on future gas prices. We have to consider the long-term effects of using up our limited gas resources so quickly. If the price of gas is a long way below other fuels, more and more people will change to gas heating and our North Sea supplies will run out that much more quickly. We must have some thought for future generations and their need for fuel.

/I hope

I hope this is of some help in explaining the Government's approach to these problems.

Yours sincerely,

Margaret Thatcher

Hugh Faulkner, Esq.

CONFIDENTIAL

CABINET OFFICE

Central Policy Review Staff

70 Whitehall, London SW1A 2AS Telephone 01-233 7765

From: Sir Kenneth Berrill KCB

Qa 04326

1 November 1979

Dear Secretary of State

British Gas Corporation: Cash Limit 1980/81

R. 1/11

I have read your minute of yesterday to the Chancellor of the Exchequer proposing a cash limit for the British Gas Corporation (BGC) for 1980/81 of -£400m. at outturn prices and setting out the basis underlying this proposal.

The first two items in the list of assumptions concern the non-domestic tariff increasing by 10 per cent on 1 April 1980, and the contract prices for gas to industry moving in line with the non-domestic tariff until 1 July. The passing of the Energy Conservation Bill is assumed to have removed the links between contract prices and the domestic tariff after that date.

Since non-domestic gas sales are of the order of half BGC's total revenue, the terms on which these are sold are clearly of great importance to the setting of cash limits.

One important determinant of the level of non-domestic gas prices is the price of the equivalent heating oil. The chances that the money price of oil on world markets will rise during 1980/81 are clearly considerable but hard to estimate now. This means that it is difficult to set the cash limits for BGC in a way which will both recognise the possible level of non-domestic gas prices and require them to put up the price for domestic gas on the terms agreed by E Committee last Tuesday.

Might one link the £400m. in some way to the performance of the oil price? I raise this because quite large sums are potentially at stake which, if the oil price does go up more than presently assumed in the calculations, could be used to help the Chancellor's PSBR.

I am sending copies of this letter to the Chancellor of the Exchequer and the other members of E, and to Sir Robert Armstrong.

Yours sincerely,

Kenneth Berrill

KENNETH BERRILL

The Rt Hon David Howell MP

CONFIDENTIAL

Nat Inds.

01 211 6402

Top copy on: Econ Pol, P+G, Pub Exp.

Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
LONDON
SW1P 3HE

31 October 1979

Dear Geoffrey

BRITISH GAS CORPORATION: CASH LIMIT 1980/81

Cabinet agreed on 25 October that domestic gas prices should rise next year by an amount equal to the increase on the Retail Price Index in April, and by a further 10% in October. On the basis of these increases I propose a cash limit for BGC for 1980/81 of minus £400m at outturn prices (£300m at survey prices). This is £100m higher than British Gas originally forecast and has been arrived at only after they have been pressed very hard. The key assumptions underlying the £400m proposed are now as follows:

a) the non-domestic tariff to be increased by 10% on 1 April 1980;

b) contract prices for gas to industry to move in line with the non-domestic tariff until 1 July 1980 by which time it is assumed that amendments to gas legislation which I am proposing for inclusion in the Energy Conservation etc Bill will have been enacted to remove the links between contract prices and the domestic tariff;

c) increased efficiency including a £25m reduction in their personnel budget which would be consistent with markedly lower pay assumptions than BGC were originally forecasting;

d) trading costs (other than gas purchase) per therm will fall in real terms by 10% between now and 1983/84;

e) wholesale prices (the relevant indicator for BGC) will increase by 13%.

3. I am satisfied that such cash limits will stretch BGC in terms of overall efficiency and, in particular, in skill at pay bargaining.

4. BGC have not yet been formally consulted on the cash limit and I invite you to agree that I should now do so with a view to agreeing

(2)

a cash limit of minus £400m.

5. I am sending a copy of this letter to our colleagues in Cabinet and to Sir Robert Armstrong.

Yours ever

David

D A R Howell

Ref. P.0130

Top copy on: Econ-Pol, Pt6, Pub Exp.

CONFIDENTIAL

PRIME MINISTER

NATIONALISED INDUSTRIES' CASH LIMITS - Revised brief

C(79) 48 and associated correspondence.

on Econ Pol, Pt5, Pub. Exp"

BACKGROUND

There was not time to discuss this paper at Cabinet on 25 October. Much of the brief you had then still stands but there have been a number of new moves. For convenience we have incorporated the fresh material in a single updated brief.

2. At its last discussion of cash limits, E Committee endorsed the general approach to the nationalised industries. The main components were:-

(i) to make allowances for the differing circumstances of each industry;

(ii) to note that their cash limits (which apply to external finance only) are the residuals of very much larger figures, and correspondingly volatile;

(iii) to agree, nevertheless, to use cash limits to put pressure on pay;

(iv) to start from the assumption that increases in wage costs (not necessarily increases for individuals) should be somewhat less than the predicted increase in the RPI - how much less, to be settled case by case.

3. At the same meeting, E decided on the general line on the Rate Support Grant cash limit; this was, of course, later remitted to MISC 21 and agreed by Cabinet last week. The fairly tight line endorsed by Cabinet for local authority cash limits is broadly consistent with the proposals in the Chancellor's paper.

4. There was one urgent issue left over from last week's Cabinet - the cash limit for the NCB, which it was essential to settle before the negotiating meeting on 30 October. As you know, that has now been agreed, and Mr Howell's

minute to you of 29 October reports a settlement with the Chief Secretary on a figure of £834 million. This represents a concession by the Chief Secretary, which he insists should not be taken as a precedent for other industries. But the real question is whether the likely pay deal for the miners can be accommodated within this figure. You may want to use the opportunity of this meeting to seek a progress report from Mr Howell.

5. The Chancellor hopes to get decisions on all the other cash limits at this meeting. Most of them are listed in the paper. Those for gas and electricity are set out in Mr Howell's letters of 30 October (electricity) and 31 October (gas) and in the Secretary of State for Scotland's minute of 31 October (Scottish electricity). These proposals follow the discussion on gas and electricity prices at Cabinet last week, and at E Committee on Tuesday. The Chancellor intends to announce the whole set of nationalised industry limits on 20 November, the day of the RSG 'Statutory Meeting', probably by way of a press notice or arranged PQ.

6. One final complication arises from the letter from the Nationalised Industries' Chairmen's Group, at Annex C. This raises a wide range of issues, beyond the scope of the present meeting. You will no doubt want them discussed, when Sir Keith Joseph reports on nationalised industry policy in general (probably now in December). Meanwhile, the immediate response to the chairmen is proposed in paragraphs 6 and 7 and need cause no problems.

7. But the immediate task for Cabinet is to agree specific figures for the cash limits of the nationalised industries listed in Annex A, plus gas and electricity. Our information is that only three of these are likely to be contested - rail, bus and airways - though coal, gas and electricity merit special confirmation because they result from agreements not reported in the paper. Detailed notes on all six are in paragraph 9 below. It should be possible to get agreement on the other cash limits "on the nod".

HANDLING

8. You will probably want to divide the discussion into two parts: a general discussion and then detailed consideration of the individual industries. As a general lead in you might invite the Chancellor to introduce his paper, and then seek comments from the Secretary of State for Industry (as de facto chairman of the unofficial group of Ministers on nationalised industry policy);

the Secretary of State for Employment (because of the implications for pay negotiations); the Secretary of State for Trade (consumers) and any others who wish to join in. But you will want to keep this part of the discussion short and avoid special pleading on particular cases. The issues which are likely to come up are:-

(i) the vulnerability of nationalised industry performance to extraneous factors: for example, the difference between a standard and a bad winter can mean £55 million to the electricity industry alone;

(ii) the inflexibility of their response. Because of constraints on redundancy agreements, closures, price increases and market response, the industries cannot react very quickly to any deterioration in their performance.

(iii) the special nature of their cash limits. Not all of your colleagues may fully appreciate that the nationalised industry 'cash limits' apply to their external financial needs only and are the net result of much larger gross numbers. The suggested change in nomenclature to "external financing limit" may help here. The consequence, of course, is that holding to these limits involves giving the industries freedom to adjust other factors, especially prices, if they are to stay within them; and that, even then, the task they face can be a good deal more demanding and uncertain of achievement than say that of a Government Department with a cash limit essentially related to gross expenditure.

(iv) Pay and other costs. Although there are considerable variations between industries, the Treasury have in most cases uprated the volume totals agreed in the summer by a standard figure of 17 per cent to cover both pay and prices. This is, of course, considerably above the 13 per cent agreed for the calculations of RSG. Indeed, it is even more generous, in one or two cases, than the industries themselves had assumed (but the industries were operating on much earlier information). You may want to probe a bit on the reasons for choosing these figures: but we know that the Chancellor has himself rounded them down from those discussed with Departments earlier. Whatever is decided, however, you will want to ensure that no figure as high as 17 per cent gains currency outside the Cabinet room, especially as the RSG is based on a lower percentage. This bears on the proposal in paragraph 7 of the Chancellor's paper that the industries might be told the assumption underlying the limits. Of course the fact that the 17 per cent - where this applies - covers other costs as well as pay makes it hard to disentangle any specific pay assumption. But considerable care will be needed if unfortunate public conclusions are to be avoided.

9. After this general discussion, you will want to turn to the detail of the outstanding cases:-

(a) Coal As suggested above, I think you will want to ask Mr Howell for a progress report on the result of the negotiating meeting on 31 October. Does the Coal Board seriously believe that it can get by with a cash limit of £834 million (the figure he has now agreed with the Chief Secretary? You might glance at his exchange of letters with the Chancellor (Howell 25 October and Howe 30 October). The cash limit provides for an increase of 13.4 per cent in wage costs over the period, and any excess above this will have to be picked up in coal prices. Is it too early to ask what this means? If so, you should ask Mr Howell to let you have a report as soon as the picture becomes clear.

(b) British Rail Mr Fowler ~~has written~~ wrote to the Chancellor ~~today~~ on 24 Oct 1979 about this. The Treasury bid is for a limit of £705 million, and his proposal is a bid of £750 million. The Treasury figure assumes a pay increase of about 12 per cent, plus a further 2 per cent which is a hangover from an earlier settlement. It also takes a very favourable view of all the commercial risks. The Department of Transport argue that railway pay has fallen behind (8-10 per cent below the peak of 1975 in real terms) and is bound to catch up somewhat; and that the going rate is emerging at something like 17 per cent; but they rest their argument much more on the economic assumptions than on pay. They see no scope for economies in the first year either from closures (because of the long statutory process of consultation), or productivity (because of the slow pace at which agreements are negotiated with the unions). They are convinced, therefore, that a £705 million cash limit would in practice be breached. I believe the Chief Secretary may be prepared to concede something here, though it is not clear how much.

(c) National Bus Company Mr Fowler's letter also deal with this. The main point here is that the cuts in local authority expenditure, and in Department of Transport expenditure on TSG and new Bus Grant, have already reduced the NBC cash flow; that consumer resistance to further fare increases makes them self-defeating; and that the scope for productivity changes, again in the short term, is pretty limited. The consequence of the cash limit proposed by the Treasury (£77 million, against a Transport bid of £85 million) might be a substantial reduction in services. You will want to probe the realities here so that the political consequences can be weighed, not only in rural constituencies but generally.

(d) British Airways There is a gap of £15 million between the Treasury bid of £205 million and the Department of Trade bid of £220 million. The difference arises because the standard inflation factor of 17 per cent is not enough to cope with increased fuel costs and the fare cuts imposed by the CAA. The difference represents one new aircraft. The Secretary of State will argue strongly that, given the impending privatisation of British Airways, it would be silly to make it change its programme in this way, thus damaging the prospects of a satisfactory sale. The £220 million limit proposed by Trade still puts a fairly realistic squeeze on pay and builds in a sizeable allowance for improvements in productivity.

(e) Electricity The Secretary of State for Energy (letter of 30 October to the Chancellor) proposes a cash limit of £187 million. The Chief Secretary is - I understand - prepared to accept this; indeed the Treasury thinks this limit is very tightly-drawn. (It leaves room only for about 12 per cent increase in wage costs, on top of increases already agreed.)

The Secretary of State for Scotland will be writing later today to propose limits of £73 million (South of Scotland Electricity Board) and £59 million (North of Scotland Hydro Board). These have already been agreed at official level with the Treasury.

All these limits are consistent with last week's decisions on electricity prices.

(f) <u>Gas</u> Agreement was reached this morning with the Gas Corporation on a limit of minus £400 million (ie, a repayment to the Exchequer). This is still subject to Ministerial approval, but I am told there will be an exchange of minutes between the Secretary of State for Energy and the Chief Secretary later today. This figure is £100 million better than the Corporation's original offer, and is regarded as very tight indeed.

CONCLUSIONS

10. Subject to the discussion, you might be able to reach the following conclusions:-

(a) to note the cash limits agreed for the coal industry;

(b) to approve the cash limits for gas, electricity (England and Wales) and electricity (Scotland) set out in the Secretary of State for Energy's minutes of 30 and 31 October, and the Secretary of State for Scotland's minute of 31 October;

(c) to endorse the other cash limits listed in Annex A to C(79) 48 [with any changes agreed during discussion];

(d) to agree that the cash limits should be published by the Chancellor of the Exchequer on 20 November [by way of an arranged PQ];

(e) to agree the general approach to proposals of the nationalised industries' chairmen's group suggested by the Chancellor of the Exchequer in paragraphs 6 and 7 of his paper, and the procedure for dealing with the chairmen, individually and collectively, suggested in paragraph 12 of his paper.

P Le CHEMINANT

Cabinet Office
31 October 1979

SECRETARY OF STATE FOR SCOTLAND

SCOTTISH OFFICE
WHITEHALL, LONDON SW1A 2AU

Top Copy on: Econ. Pol. Pt 6, Pub. Exp^n.

CONFIDENTIAL

CHANCELLOR OF THE EXCHEQUER

NATIONALISED INDUSTRY CASH LIMITS 1980/81: SCOTTISH ELECTRICITY BOARDS

1. Following the decisions taken by Cabinet last week on gas and electricity pricing in 1980/81 my officials have had discussions with the Scottish Electricity Boards about the setting of their cash limits for that year. This minute reports the outcome. I am afraid that I shall not be able to take part in the Cabinet discussion tomorrow as I am to be in attendance upon The Queen on Her visit to Glasgow.

2. On the assumption of a tariff increase from April 1980 at the level of the increase in the RPI and a further increase of 5% from October 1980, the anticipated borrowing requirements in 1980/81 at outturn prices amount to £42m for the North of Scotland Hydro-Electric Board (NSHEB) and £73m for the South of Scotland Electricity Board (SSEB). The Board's forecasts assume coal price increases of 17½% from 1 March 1980 and 7½% from 1 November 1980, and oil price increases of 10½% from 1 January 1980, 7½% from 1 July 1980 and 7½% from 1 January 1981. Wages and salaries, which amount to no more than about 16% of the Boards' costs, are expected to increase by 16½% next Spring, in line with the guidance given to the Boards that there should be a reduction in unit wage costs in real terms.

3. For cash limit purposes, compensation to be paid to NSHEB in respect of deficits arising on the Board's smelter account falls to be added to the borrowing requirement. The current estimate of the sum to be reimbursed in 1980/81 is £17m. I propose, therefore, that the cash limits to be set for NSHEB and SSEB for 1980/81 should be £59m and £73m respectively.

4. The combined external financing requirement for 1980/81 of the two Boards is some £19m in excess of the aggregate of the limits (at outturn prices) agreed by Cabinet in July. This increase in the Board's requirements has come about largely as a result of Cabinet's decision on electricity

pricing policy. In the case of NSHEB there has in addition been a substantial increase in the forecast smelter deficit, arising out of a revised assessment of the timing of completion of repairs to reactor 4 at Hunterston B power station and increases in the costs of make-up units from fossil-fuelled stations, which affects the level of the Board's external financing requirement.

5. The external financing limits which I have proposed would be acceptable to the two Chairmen, and I am satisfied that they represent realistic limits which will exercise an appropriate degree of pressure on the Board's operations. I should make it clear, however, that they assume that the Boards will not be obliged to impose further deferments of capital expenditure from the current year to 1980/81 in order to avoid breaching the 1979/80 cash limits. If such further deferments turn out to be necessary, next year's cash limits would have to be revised to accommodate the deferred expenditure. I intend to have further correspondence with John Biffen about this year's cash limits for the Boards.

6. I am copying this minute to the Prime Minister, the other members of Cabinet and Sir Robert Armstrong.

G.Y.

SCOTTISH OFFICE
31 OCTOBER 1979

6

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ

01 211 6402

Top copy on: Econ. Pol, Pt 6, Pub. Exp^n

CONFIDENTIAL
Rt Hon
Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
LONDON
SW1P 3HE

30 October 1979

Dear Geoffrey

ELECTRICITY INDUSTRY CASH LIMIT 1980/81

E Committee decided on 17 October (E(79) 12th meeting) that it was reasonable to have a target of raising the price of electricity in real terms over a 3 or 4 year period in order to achieve full economic pricing, provided that the increase in April 1980 was not larger than that in the RPI. My minute to the Prime Minister of 24 October on electricity and gas pricing proposed that electricity increases of 17% in April 1980 and 5% in October 1980 should be sought as the first part of the implementation of this strategy. Cabinet agreed on 25 October. The effects of this decision on the industry's cash flow and financing requirements for 1980/81 were among the options set out in my minute under reference.

On the basis of the agreed price increases I propose a cash limit for the electricity supply industry in England and Wales for 1980/81 of £187m in out-turn prices (equivalent to £144m at survey prices). The key industry assumptions underlying this figure are as follows:

a) an average price increase for coal in line with the RPI in the Spring of 1980, followed by a 7½% increase in the Autumn; this is tantamount to a 3-4% real increase in March 1980; which is certainly within the bounds of possibility;

b) an increase in salaries and associated costs of 18%; 6% of this arises from this year's pay settlement, and next year's pay settlements are taken as in line with the industry's general inflation assumption of 12%. I do not disagree with the industry's view that the assumption of a 12% pay settlement may prove to be over-optimistic;

c) unit requirements on the CEGB of 232 Twh, an increase of 0.9% on 1979-80 (whereas my Department's latest short-term forecast shows a fall).

This cash limit has been discussed with the industry, who acknowledge that they will have to trim expenditure below present expectations if they are to achieve it.

I invite you to agree to this cash limit.

I am sending a copy of this letter to the Chief Secretary and Cabinet members

Yours

David

D A R Howell

CONFIDENTIAL

Ref. A0517

For minutes, see Econ. Pol, Pub. Exp. Pt 6.

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PRIME MINISTER

Gas and Electricity Prices and Public Expenditure 1981-82 to 1983-84

(E(79) 61)

BACKGROUND

There have been two recent Cabinet or Committee decisions on gas and electricity prices:

(i) E Committee on 17th October (E(79) 13th Minutes, Item 2), which determined the principle of a return to economic pricing, but left the timetable open.

(ii) Cabinet on 25th October, in the context of the Public Expenditure White Paper (CC(79) 18th Conclusions, Minute 5) which decided on the timing of the second price increases for gas and electricity next year: 10 per cent for gas and 5 per cent for electricity, both in October.

2. This paper is about the speed of the return to economic pricing in the remaining years of the survey period. You will want to turn down any attempt at reopening the Cabinet decision: it was taken very rapidly, on the basis of rather thin documentation, but the main principle had already been accepted, and in the public expenditure context, a second increase next year seemed almost inevitable.

HANDLING

3. This is an agreed paper: you should invite the Secretary of State for Energy to introduce it, and then see whether the Chief Secretary, Treasury, wishes to add anything. To the extent that the paper deals with Scottish electricity prices, you will also want comments from the Secretary of State for Scotland (because the two Scottish Electricity Boards are, of course, independent of the English system) but, in general, the Cabinet decision should bind Scotland as well as the rest of the country. There may be some minor adaptation to local circumstances, but no more. The Secretary of State for Social Services has also sought an invitation for this item.

4. The issues which may arise seem to be these:

(a) Do we need to go public soon? The answer must be yes, for three reasons: in order to establish ~~treble~~ three-year financial targets for the gas and electricity industries; in order to give the right signals to consumers, and encourage gas consumers in particular to modify their consumption patterns, order new equipment, instal insulation, etc. (bearing in mind that next year's increases in gas prices will still leave that fuel as much the cheapest option for domestic consumers); and in order to get clear volume figures for the second Public Expenditure White Paper where the contribution which economic pricing can make to the expenditure/revenue situation is very substantial.

(b) Exact phasing of the return to economic pricing. The decision in E on 17th October turned on the idea that it might be slightly easier to start the return in October 1980 than in April 1980. Clearly, it is very difficult to forecast the trend of retail prices more than a year ahead. The Chancellor of the Exchequer will, I think, argue that the worst will be over by next autumn, and that a slow downward trend in the movement of the RPI should have set in. The paper demonstrates that, once the initial step has been taken, the RPI weight of the successive stages thereafter is small, compared with the size of the steps necessary simply to keep pace with costs. I understand that you are worried at the prospect of successive large gas price increases each April - always a bad month for the RPI: but to defer the April 1981 increase till October might cost, I am told, about £70 million on gas, and more on electricity.

(c) Electricity - special points. The only real problem is the speed of adjustment in Scotland, where prices have tended to fall a little short of those in England and Wales. I believe that the Secretary of State for Scotland does not disagree in principle with the changes proposed; but if he demurs, you might invite him to discuss the exact timing and speed of transition with the Chief Secretary, Treasury. It is common ground that electricity prices will have to rise by sufficient to cover movements in oil and coal prices (including the effects of increases in miners' pay).

(d) Gas. This has always been the main problem; but the Committee has accepted the principle of a return to economic pricing (related to a very wide range of 25-50 per cent underpricing). The Committee agreed to move over four years to the oil-related level, and the phasing proposed in this paper would achieve that. The separate question of gas profits, taxation, etc., is already the subject of internal work in the Department of Energy following the previous E discussion. But this is not due for completion until December, which may be too late for action in the 1980 Finance Bill. You might therefore wish to press for an earlier report, which should involve Treasury as well as Energy Ministers.

(e) Targets. The Secretary of State for Energy now proposes to set new targets for gas and electricity (and the Secretary of State for Scotland would presumably follow suit for his two Electricity Boards). You will note one minor point: the proposal is to set a target rate related to current cost operating profit as a percentage of revalued net assets. This assumes a move to inflation accounting which has not yet been universally accepted for the nationalised industries (though the gas industry's current accounting practices come very close to it). In fact, E(EA) is to take a paper on the whole question of current cost accounting for nationalised industries at its meeting on 7th November. You might make the Committee's decision on targets one of principle, leaving the exact expression of the target conditional on the outcome of the general discussion in E(EA).

(f) Cash limits. The majority of cash limits for the nationalised industries are for discussion at Cabinet on 1st November. The cash limit for coal has already been agreed bilaterally (and reported to you in Mr. Howell's minute of 29th October). This paper implies (paragraph 7) that the limits for gas and for electricity will not be agreed in time for Cabinet discussion on 1st November. This is because the Department of Energy have so far felt unable to talk to the gas industry about cash limits for next year until they were able to tell them the decisions on pricing. It will obviously be untidy if the gas and electricity cash limits cannot be settled on 1st November. You will want to press Mr. Howell on this and to find out how much delay the Chancellor is able to accept. If in the event firm proposals cannot be brought to Cabinet on 1st November, the Secretary of State for Energy will need to agree these two limits with the Chief Secretary, and (because of their implications for pay) the Secretary of State for Employment, within whatever timescale the Chancellor is prepared to accept. The Secretary of State for Scotland should take similar action for his Boards. /Note: the reference to "late November" in the paper is misleading: it is still the intention to publish cash limits for all the nationalised industries on 20th November, the same day as the RSG announcement is made./

(g) 1981-82. The paper raises the question whether the increases for the year after next should be rather larger than average, so as to make good the shortfall on the gas industry's net repayments to the Exchequer and to help with the public expenditure bulge now foreseen for that year. (The reason for the shortfall is apparently the additional investment now needed to cope with increased demand rather than the reshaping of price increases.) The Chief Secretary may urge this course, basing himself on the figures in Annex B of the paper which show that, after allowing for Corporation Tax receipts, he will be £220 million light on his expected contribution from gas and electricity in 1981-82 though doing better than expected in subsequent years. If the Committee want, on this account, to look for a bigger contribution from the industries in 1981-82 the figures in paragraph 6 suggest that electricity prices will have to bear the adjustment - £220 million requires only an extra $5\frac{1}{2}$ per cent on electricity prices but an extra 20 per cent on gas prices.

CONCLUSIONS

5. Subject to the discussion, I think the conclusions on this item might be:

(i) To agree to the profile of gas and electricity price increases suggested in E(79) 61 /or alternatively to agree that the profile should be adjusted to allow for increases in October rather than April from 1981 onwards, and that the effects should be reported to you/ /and, possibly, to agree to a further increase in electricity prices in 1981-82 to eliminate, or contribute towards eliminating, the shortfall in net revenue now foreseen for that year as against the Chief Secretary's earlier paper/.

(ii) To agree that the Secretaries of State for Energy and for Scotland should set financial targets related to these figures, and expressed in terms of current cost operating profit as a percentage of revalued net assets for both industries (subject to any points made by E(EA) on 7th November when they consider current cost accounting).

(iii) To invite the Secretary of State for Energy and the Secretary of State for Scotland, in consultation with the Chief Secretary, Treasury, and the Secretary of State for Employment, to establish cash limits for the gas and electricity industries for 1980-81 consistent with the decisions already taken about price increases in that year; to report these to Cabinet in time for the discussion on 1st November of the cash limits for other nationalised industries; or, if this course is not practicable, to establish them within whatever time frame meets the Chancellor of the Exchequer's convenience and report them to you for endorsement. /Note: you may in any case feel it necessary to tell Cabinet on 1st November of E's decisions on gas and electricity prices./

(iv) /if necessary/ To invite the Secretary of State for Energy, in consultation with the Chief Secretary, Treasury, to bring forward proposals before the end of the year for dealing with the presentation of problem caused by very high profits in the gas industry, and possible taxation methods of dealing with these, with a view to action in the 1980 Finance Bill.

(v) To agree that there should be an early announcement about the return to economic pricing for gas and electricity, and that the Secretary of State for Energy should clear the timing and the draft of such an announcement with the Chief Secretary, Treasury, and any other Ministers concerned, and with your office, as soon as possible.

ROBERT ARMSTRONG

ROBERT ARMSTRONG

29th October, 1979

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Original on Econ Pol.
Public Exp ~~Nat Ind Sept 1979~~
~~Gas pricing policy~~

PE 6

Nat Ind

PRIME MINISTER

PUBLIC EXPENDITURE IN 1980/81 AND GAS AND ELECTRICITY PRICES

E Committee on 17 October decided that price increases next April for electricity and domestic gas should not exceed the RPI increase over the previous 12 months, but invited the Chief Secretary and myself to propose alternative phasing for price increases over a 3 to 4 year period which would achieve a correction of under-pricing comparable with that which I had proposed. The Chancellor minuted you on 19 October drawing attention to the public expenditure consequences of this decision and suggested that these could be considerably eased if a start was made on the correction of under-pricing before the end of 1980/81 but after the RPI rise should have passed its peak. A decision on this is needed before the public expenditure figures in the White Paper can be settled.

As E Committee asked, the Chief Secretary and I will be bringing forward to the Committee as soon as possible proposals for a rephasing of price increases over the whole 3 to 4 year period projected for financial targets. In view of Thursday's Cabinet discussion of the Public Expenditure White Paper and of cash limits, however, he and I have now agreed on our recommendations for 1980/81.

We propose a 3 or 4 year programme designed to remove under-pricing. For domestic gas prices, we propose an autumn 1980 increase of 10% to follow on the April increase - a deferment of the 10% real increase I originally recommended should be introduced in April. We assume this would be in October (though we cannot dictate this to the industries). Thereafter, we propose annual real price increases, in April, of 10%, which in money terms would be additional to whatever price increase was necessary to keep pace with the RPI, for the next 2 years. A weaker alternative would be to spread the correction of under-pricing over 4 years rather than 3, with a 7½% increase in autumn 1980, and real increases of the same amount each April in the 3 succeeding years. This would however leave us with a larger public expenditure gap than the first option. Any lower level of real increase would further exacerbate our public expenditure problems as well as prolonging the present serious

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imbalance between industrial and domestic gas prices.

For electricity, we propose a further increase of about 5% in the autumn of 1980 to follow the April RPI increase. This would have the effect of correcting underpricing by broadly the same amount which I originally proposed, ie 2½% in 1980/81, though in public expenditure terms it would leave a larger shortfall. A second price increase of much less than 5% would do little to correct underpricing and would probably not be regarded as worthwhile by the industry. Thereafter, a similar rate of progress towards full economic pricing could be achieved as under my original proposals - approximately 1% pa correction of under-pricing from 1981/82 onwards. As an alternative, we are also examining a faster rate of progress, involving a 2% correction of under-pricing in 1981/82. These real price increases would be additional to whatever increase was necessary to keep up with the electricity industry's costs, which mainly because of likely coal and oil prices, will probably rise somewhat faster than the rate of general inflation.

In our report back to E Committee, we will deal with the impact of these proposals on public expenditure subsequent to 1980/81. The table below shows the public expenditure impact of our proposals in 1980/81. The first column shows that there will still be a marked shortfall as compared with what we had planned to achieve in July; the second column shows the extent to which that shortfall would be increased if we do not adopt the pricing proposals recommended.

£M	Shortfall against public expenditure figures for gas and electricity (excl Scotland) agreed by Ministers in July	Savings compared with latest Draft White Paper figures (no real price increases in 1980)
Gas: Preferred option (10% autumn 1980)	230	50
Electricity: (5% autumn 1980)	170	110

(3)

I understand that Scottish Office officials have advised that if, as might well be the case, the Scottish Electricity Boards follow the same pricing path in 1980 as the industry in England and Wales, the comparable figures for shortfall and savings would be £20M and roughly £10M. On that assumption, adoption of the preferred option for gas and electricity would produce combined savings of £170M, with a direct RPI impact of .3%. If you agree with these pricing proposals, we recommend that they be reflected in the 1980/81 Public Expenditure White Paper, and also in the cash limits for the industries.

I am copying this minute to other members of the Cabinet and Sir John Hunt.

DH.

Secretary of State for Energy
24 October 1979

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Ref. A0424

PRIME MINISTER

Pricing Policy and a Financial Target for the Electricity Supply Industry (England and Wales)

(E(79) 52)

BACKGROUND

This is a companion proposal to that on gas pricing, which will have been dealt with earlier in the meeting. In the case of electricity current prices are much nearer to "economic levels". If "economic level" is taken to be the long-run marginal cost of providing an additional unit of output (Annex A), then they are about 5-10 per cent underpriced in real terms. The paper proposes a price increase of $2\frac{1}{2}$ per cent greater than costs in 1980, and about 1 per cent per annum thereafter.

In cash terms this will mean a 22%. increase R.

2. In 1980-81 the industry would be about £83 million short of its financial target even allowing for the $2\frac{1}{2}$ per cent real terms rise in prices. Thus unless they can make economies, the price rise next year would need to be 4 per cent in real terms ($2\frac{1}{2}$ per cent plus $1\frac{1}{2}$ per cent extra) if the proposed cash limit is to be achieved.

3. The effect in time of the proposed real terms price increases would be to produce very large cash profits on a historic cost accounting basis - but when these are viewed in terms of the costs of replacing plant (current cost accounting) the projected returns look reasonable in relation to the expected return on new public investments. The industry would as a result of this income be able to finance from its own resources, and not borrowing, the major investments in plant that will be needed to cope with the long-term shift away from oil and gas. This would reduce the PSBR - with figures for income greater than the Chief Secretary has so far assumed in years after 1980-81.

4. The industry's assumptions about future costs are different from the Department of Energy's and may or may not be right; this could affect the price rises needed in money terms in each year. But the proposed strategy of an initial

rise of $2\frac{1}{2}$ per cent (or 4 per cent) above costs and 1 per cent above costs thereafter is not affected by the assumptions. And the first of these rises is already built into the public expenditure figures for 1980-81 on which Cabinet reached decisions in July.

HANDLING

5. You might ask the Secretary of State for Energy to introduce the paper, and ask the Secretary of State for Scotland what proposals he has for action in Scotland. You might then obtain comments from the Chief Secretary, the Secretary of State for Trade and Sir Kenneth Berrill. Mr. Jenkin's views will probably have been covered in the discussion on gas prices.

CONCLUSION

6. Subject to the discussion you might conclude that the Committee -

(i) Agree the Secretary of State for Energy's proposals (as set out in paragraph 12 of the paper).

(ii) Agree that the handling of the announcement will need great care and invite the Secretary of State for Energy to circulate his proposals for this.

John

JOHN HUNT

16th October, 1979

Rk

CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon David Howell MP
Secretary of State
Department of Energy
Thames House South
Millbank
LONDON
SW1

R.

15 October 1979

BRITISH GAS CORPORATION: ADDITIONAL CAPITAL INVESTMENT

Further to my letter of 8 requested October I am now writing about the proposals in your letter of 4 October for substantial additional capital expenditure by the British Gas Corporation for the years to 1984-85.

First, on the need for the additional expenditure, I accept that BGC have made out a case for their proposal, though I should like to make the two following comments:

(i) You say that delaying investment in additional capacity by only a year would mean 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 threefold, compared with the present criteria. I agree that this risk is unacceptable. But so that we are in a position to judge the value of future gas investment which might be less justified in terms of security supply, I think that it would be worthwhile to study in a little more depth why BGC regard the present criteria as necessary.

(ii) I note your doubts about BGC's ability to maintain over the full period under consideration the present level of restriction on supply. I also recognise that there will be pressure on BGC to relax these controls. But in the present public expenditure climate, and with prices well below realistic levels (as they will be for two or three years even if colleagues accept your pricing proposals) I am sure that any relaxation in restraint would be unacceptable if it led to proposals for additional public expenditure.

Turning now to the public expenditure consequences of the proposals, let me say first that I welcome your intention of asking British Gas to look again at the financing of the purchase of the two Southern Basin fields, Rough and Hewett, which if bought by lump sum payments would add some £190m to public expenditure in the PES period. I recognise that payment from revenue will have consequential effects on the Corporation's cash flow, but such effects will presumably be spread over a period of time, reducing the impact in the PES period.

The costs of the other parts of BGC's proposals, additional capital investment including bringing forward the development of the Morecombe field, the fourth feeder from St Fergus and Peak Shaving LPG/Air Plant, amounts to £217m. I understand that, according to your Department's present estimates (which need to be confirmed with BGC) that this expenditure falls as follows:

£m

1980/81	1981/82	1982/83	1983/84
48	51	100	18

As you know, Cabinet agreed in July on BGC's external financial requirement for 1980-81 which encompassed their investment programme for that year. This programme did not, of course, make allowance for the expenditure of £48m referred to above. I understand that if colleagues accept the proposal for a 10 per cent increase in real gas prices from 1 April next year, BGC will be able to keep within the external financing requirement agreed by Cabinet, even after taking account of the extra £48m expenditure. Nevertheless, in view of the extremely tight public expenditure position for 1980-81 I would want you to ask the Corporation to absorb the £48m; ie the expenditure should be found from compensating savings and not from extra sales proceeds from the higher prices. I suggest this because BGC have underspent their cash limit in recent years by an average of £200m a year. I should therefore find it very difficult accept that the Corporation could not find £48m from internal savings without having recourse to the extra proceeds from the higher gas prices. If the Corporation prove difficult, I suggest that you should remind them that the sale of their share in Wytch Farm would more than compensate for the extra £48m.

I think that there is an equally good case for asking the Corporation to absorb the extra costs in the later years, though I recognise that the scale of the expenditure in 1982-83, £100m, might make it difficult for them to do that in that year.

So to sum up, I accept the case for the extra investment of £407m. I welcome your intention to ask BGC to spread the cost of the Rough and Hewett gas storage fields by making payments for them out of revenue. However, I do not accept that the cost of the remaining £217m investment should be found from the proceeds of higher gas prices. The Corporation's record in estimating their cash limits suggest that their forecasts consistently contain a substantial element of fat. They should therefore be asked to absorb the cost of the £217m without recourse to the proceeds from higher gas prices.

I am sending a copy of this letter to Sir Keith Joseph and to the other members of E Committee (together with a copy of yours) since I understand that you propose to refer to this additional gas investment in your paper on gas prices which the Committee will consider on 17 October.

A copy also goes to Sir John Hunt.

JOHN BIFFEN

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CHIEF SECRETARY

- 4 OCT 1979

Mr Monck
PPS PS/FST
PS/MST PS/MST(L)
Sir A Rawlinson
Sir L Airey
Mr F Jones
Mr Lovell
Mr Unwin
Mr Bridgeman
Mr GP Smith
Mr Wicks
Mr Wiggins
Mr Thornton
Mr Ridley
Mr Cardona

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
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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

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Nat Ind

Ref. A0422

PRIME MINISTER

Gas Pricing Policy

(E(79) 51)

BACKGROUND

E(EA) considered this subject just before the Conference and the Secretary of State for Industry reported their conclusions to you in his minute dated 5th October. Your own comments were set out in Mr. Lankester's letter of 8th October; you were very reluctant to go along with a price increase from 1st April next of 10 per cent over and above the rate of inflation. The argument is, of course, entirely about the domestic and small commercial tariffs. Industrial and large commercial gas users pay non-tariff prices which are individually negotiated, oil-related, and much higher than the prices charged to domestic consumers.

2. Discussion now is timely because it is necessary to take a view on the future course of gas prices as a preliminary to the public expenditure Cabinet on 18th October, and as a basis for the discussion of cash limits for nationalised industries on 25th October. The gas pricing issue is not however solely one of public expenditure - though it is very important in this context - but is also of considerable importance for energy policy generally and for energy conservation in particular. In addition acceptance of the present proposals, or something like them, would unlock the way to further increases in electricity prices (on which there is a separate paper at this meeting) and of coal prices, both of which are affected by the present unassailable competitive strength of gas in the domestic market. Against this are the political difficulties of a steep increase with its implications for the RPI and the particular problem of fuel costs and the poor.

3. The economic arguments are clear enough. It is common ground that gas is severely underpriced to the domestic consumer. The reasons for this are historical and need not concern the Committee. What matters is that the rise in the price of oil has created a very big "economic rent" in North Sea gas production (notably from the southern gas basin) and that, under present arrangements, much of this rent goes to the domestic consumer rather than to the taxpayer or the off-

shore producer. In the parallel situation of North Sea oil a major part of the economic rent comes to the taxpayer through PRT etc. But the southern basis gas fields do not pay PRT and the producers' price is severely limited by the contract terms on which the in gas is purchased by the BGC. Mr. Howell is known to have toyed with the idea that the price paid for southern basin gas should be raised to free market levels and then taxed through PRT. But while this might ease presentation - by reducing BGC's profits - it would also involve giving the southern gas producers a major uncovenanted financial benefit and Mr. Howell is not pressing this idea at the moment.

4. It is also common ground that the present artificially low gas price is having undesirable side effects e.g. in over-stimulating the demand for gas (BGC is asking for an extra £400 million of investment in transmission and storage facilities over the next five years) and is cutting expensively into the markets for electricity and coal. More widely our present gas pricing policy is as open to attack as leading to economic distortion as is the oil pricing policy of the United States.

HANDLING

5. You might ask the Secretary of State for Energy to introduce his paper, and then call for comments from the Chancellor of the Exchequer (or the Chief Secretary if he prefers); from the Secretary of State for Industry (under whose chairmanship E(EA) discussed the proposal earlier); and the Secretary of State for Employment. Other Ministers and Sir Kenneth Berrill may wish to join in.

6. The issues which arise can be grouped as follows:-

(a) The extent of underpricing. Not strictly relevant to the immediate steps. Mr. Howell's view is that the right benchmark is the equivalent price of oil. This is certainly the easiest to estimate, being directly market-related. On that showing, gas is something like 30-35 per cent behind.

(b) The speed of adjustment. Mr. Howell suggests a phased move over three years. This would certainly help the PSBR. A longer period takes the adjustment outside the life of this Parliament (though if the real price of oil increases during the period further adjustments would be needed).

(c) Size of the first step. Your colleagues may well find, as you did, the prospect of a 23-27 per cent increase in gas prices next April a daunting one. If so, you will wish to go for a lower figure. But a strong case on merits can be made for various additional revenue in this way and in any case the issue is not a straight choice between revenue and prices. Given a PSBR target, and other things being equal, any alternative action taken by the Chancellor in the Budget is likely to be at least as unpleasant as putting up gas prices and often harder to defend.

(d) Timing of first move. It may be argued that the first step of the phased introduction of higher prices should be delayed - say to October next - in order to give consumers a chance to adjust. But this is unlikely to help much because most consumers are locked into their heating systems and anyway, even after the proposed price increase next year, gas would still be the best buy. And, of course, revenue would be lost.

(e) Signalling future price increases. The real problem is to persuade people, sufficiently far in advance, that gas will eventually lose its competitive edge over alternative fuels. Paragraph 6 of Mr. Howell's statement (Annex B) seeks to do this but ties the Government to a three-year programme in a situation where the price of oil - and hence the gap to be filled - is quite unpredictable. It might be better to phrase the statement in terms of "until the price of gas reaches an economic level".

(f) Excessive profits. There remains a cosmetic problem of very high profits for BGC. Mr. Howell proposes to come back to this issue later, and you might agree to this swiftly, ruling out of order any further discussion of this complicated issue at this stage. It is not relevant to the immediate decision before the Committee.

(g) PSBR or public expenditure? Some of your colleagues may stumble over the relationship between the gross or net profits of BGC (which is almost the only nationalised industry to pay significant quantities of Corporation Tax). Net profits affect the public expenditure totals: gross profits (including Corporation Tax) affect the PSBR. You may feel that the significant figure is PSBR: public expenditure cuts are a means towards reducing the size of the PSBR, and not (in this case anyway) an end in themselves although it is only the public expenditure figures which will chalk up in the Cabinet operations on Thursday.

(h) Cash limits. No decision on the cash limit is needed at this meeting. It would be included in the detailed proposals which the Chancellor is bringing forward on 25th October. Staff costs are approximately 20 per cent of BGC operating costs.

(i) Protecting the poor consumers. The arrangements which you have approved for this winter cover only electricity consumers and the proposed gas price increases would come in, at earliest, next April. Given that the intention in future is to concentrate help with fuel costs through the social security system you may feel that the reference at the end of Mr. Howell's draft statement (Annex B) to "keeping the position under review" is an unnecessary hostage to fortune.

CONCLUSIONS

7. These must depend very much on the course of discussion, and your own guidance to the Committee. The Secretary of State has set out eight very clear conclusions. The only one of these which may be significantly altered in discussion is (ii), and you may need to substitute another figure for the 10 per cent real terms increase proposed there. Otherwise, you might aim to endorse all the other recommendations subject only in the case of (v) to inviting Mr. Howell nearer the time to clear the text of his statement with you and other colleagues in the normal way.

JOHN HUNT

15th October, 1979

Prime Minister

P
16/1.

Qa 04203

To: MR LANKESTER

From: SIR KENNETH BERRILL

Domestic Gas Pricing

1. The case for bringing the price of gas to United Kingdom domestic consumers up to parity with other domestic fuels is strong indeed. There are arguments on the grounds of conservation; on the grounds of equity (why should this particular group gain such benefits from North Sea gas at the expense of other taxpayers?); and the needs of the PSBR (the receipts assumed from the British Gas Corporation (BGC) in the PESC calculations would now require an increase in domestic gas prices of <u>over</u> 10 per cent in <u>real</u> terms).

2. But powerful though these arguments are, there is no doubt of the political difficulties of making such a large increase in domestic gas prices next year (say 25 per cent or over). It is not the fault of this particular group of consumers that they have been protected from the increase in world energy prices in this way.

3. It is important that these consumers (and others who would like to join them) should get the plain message that their privileged position will be phased out over, say, three years. But there may be a political case for tempering the shock a little in the first year - when the rate of inflation on other goods and services is expected to be quite high.

4. One alternative would be to have a price increase of, say, 20 per cent rather than 25 per cent. Another would be to have two increases during the year (April and October) so that the shock of the 25 per cent was slightly mitigated. The second option is both less expensive and less useful since domestic gas consumption between April and October is not very large. ?

5. The cost of any such concessions is, however, considerable. A reduction in the increase in price from 25 per cent to 20 per cent would reduce BGC's profits by around £100m. which would be added to the PSBR. This would be additional to the short fall which the Chief Secretary expects from even a 25 per cent rise.

6. I am sending a copy of this minute to Sir John Hunt.

KB

15 October 1979

15 OCT 1979

cc Mr Wolfson / Mr Hoskyns

Prime Minister

For E Committee on Wednesday

TL 12/10

PRIME MINISTER

GAS PRICING POLICY

I have seen Keith Joseph's minute of 5 October reporting E(EA)'s discussion, and your Private Secretary's letter of 8 October recording your doubts about the gas pricing proposals as they stand; and I have now seen David Howell's minute of 8 October.

2. I am writing to say that I agree with David Howell's approach to gas prices.

3. Domestic gas prices are severely underpriced and the consequences are clear: distortion of the energy market with unfair competition for electricity and domestic coal; excess demand for domestic gas leading to difficulties of supply, particularly for industrial consumers; and substantial increases in public expenditure through lost gas sales at a time when there is intense pressure for public expenditure reductions. Indeed, my public expenditure proposals to Cabinet will rely on increases in domestic gas prices of the level proposed by David Howell. Failure to achieve the reductions envisaged for the gas industry would require even harder decisions on other programmes.

4. I recognise that the level of gas price increases proposed will be unwelcome, but so are all the alternatives. And surely in circumstances where a commodity like gas is in excess demand, our solution should be to rely on the price mechanism to bring supply and demand into balance. The alternative would be to rely on petty Commissars on the local Gas Boards to make decisions about who does and who does not receive gas supplies.

5. I also recognise the presentational problem of high gas profits, but an Exchequer charge on gas could be devised to deal with that and to transfer the benefits of BGC's monopoly position to the general taxpayer. The first step however must be to endorse David Howell's proposals on gas prices.

6. I am sending copies of this minute to members of E and E(EA) Committees, Patrick Jenkin and Sir John Hunt.

A. C. Pirie

pp JOHN BIFFEN
12 October 1979

[Approved by the Chief Secretary
and signed in his absence]

820

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ 211 6402

The Rt Hon Sir Keith Joseph Bt MP
Secretary of State for Industry
Department of Industry
Ashdown House
123 Victoria Street
London SW1

10 October 1979

Dear Keith

R 10/10

GAS PAY NEGOTIATIONS

I am writing to let you know that the Gas Staffs and Senior Officers last week voted to accept a pay offer from British Gas. Payment will be backdated to 1 July last, their annual settlement date.

The main provisions of the agreement are:-

(i) consolidation of existing productivity bonus into basic rates from 1 July;

(ii) a 14-15% increase in the consolidated basic rates from 1 July;

(iii) a further 3% increase in basic rates from 1 January next.

The effect on the wages bill is a 16.9% increase in the current year and an 18.9% increase in a full year.

The British Gas Higher Management accepted a very similar offer last month. This provided for a similar consolidation of productivity bonus and an increase of 15% - 16% in basic rates from last July, with a further 3% on basic rates from next January.

I am copying this letter to the Prime Minister, the Chancellor of the Exchequer, colleagues on E(EA) and Sir John Hunt.

Yours ever

David

D A R Howell

10/10

overtaken

Prime Minister

TL

16/10

Simply to note at this stage. But you might like to ask the Chancellor for his views before next week's E meeting.

TL 9/10

2

PRIME MINISTER

GAS PRICING POLICY

Flag A

Your Private Secretary's letter to Keith Joseph's Private Secretary of 8 October expresses agreement that I should bring forward a paper on gas prices but expressed serious doubts about my proposals for a 10% real increase next year. I can well understand these and will of course seek to justify the proposals at the appropriate time.

In the meantime, since this is obviously a major political issue, as much as a departmental one, I thought it might be useful for you to have briefly in advance some background to the view we have reached so far and why it has been reached. I hope this will be helpful to you in preparation for our discussion.

The price the domestic consumer pays for gas averages about 20p a therm. This is 4p a therm less than the industrial consumer with a regular supply contract pays, despite the fact that it costs about 4p a therm more to supply the domestic consumer. British Gas broadly relate their prices to industry to that of the competing oil product (which, however, is at present about 30p a therm). This is done because otherwise there would be no way of controlling demand apart from some form of rationing.

There is clear evidence that domestic gas is at least 25% under-priced and probably nearer 50%. Even the Price Commission recognised the case. This explains the general perception that gas is a bargain as well as being a secure source of energy for those fortunate enough to have access to it (by no means all are in this position). These factors also explain the dramatic increase in demand which the Gas Corporation have experienced this year in the face of oil price rises and uncertain oil supplies. This increase in demand has far outstripped British Gas' planned expansion of supplies and although they are proposing to advance capital expenditure to meet his demand, they have also had to impose severe demand restraints. Supplies to industry could be interrupted this winter.

If we do nothing about correcting the degree of underpricing, domestic demand will continue to grow (given statutory rights to supply) to the detriment of new industrial customers seeking a supply, and with a very real prospect that some time during the next two or three years BGC will fail to meet peak winter demand.

In addition, continued underpricing will mean that the nation at large (as against those on gas supply) will not reap the full benefit of North Sea gas; and we shall also be encouraging it to be used wastefully which will bring forward the day when North Sea gas supplies have to be replaced by far more expensive sources of energy.

Price increases of 10% p.a. in real terms will be politically controversial, but I believe we have to give a clear signal of our intention to allow economic and market forces to work and to do so early on in this present Parliament. Moreover, a 10% price rise is the only way British Gas can meet the contribution we are seeking from them to meeting public expenditure over the next few years. Anything less would mean that more would have to be found from other programmes.

These are some of the main reasons behind the proposal coming before you. Obviously, if it were agreed we would need to pay very special attention to how we presented such price rises publicly. The resulting high 'profits' for British Gas will make this task no easier. My paper to colleagues will suggest how we might tackle this.

eg. Gas tax and/or PRT on Southern basin gas (PRT is already levied on the newer fields).

I am sending copies of this minute to colleagues in E and E(EA) Committees, Patrick Jenkin and to Sir John Hunt.

DH.

T 9/10

Secretary of State
Department of Energy

9 October 1979

CONFIDENTIAL

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10 DOWNING STREET

From the Private Secretary

8 October 1979

Gas Pricing Policy

The Prime Minister was grateful for your Secretary of State's minute of 5 October in which he reported the conclusions of the E(EA) discussion on gas pricing.

The Prime Minister is content for the Secretary of State for Energy to bring forward a further paper on this subject to E Committee. However, she has asked me to say that she has serious doubts about the proposals as they stand. In particular, she would find it very difficult to go along with a price increase from 1 April of 10 per cent over and above the then going rate of inflation.

I am sending copies of this letter to Private Secretaries to members of E and E(EA) Committees, to Don Brereton and Martin Vile (Cabinet Office).

TPL

I.K.C. Ellison, Esq.,
Department of Industry.

CONFIDENTIAL

CONFIDENTIAL

1

Prime Minister

This will come to E on 17 Oct. These proposals would be more palatable politically if we gave some of the extra revenue back to the poor - especially pensioners. (If we help non-pensioners, we of course worsen the incentive problem). Shall I ask Mr Jenkin to circulate a paper on the possibilities?

TL 5/10

cc Mr Wolfson
Mr Hoskyns

PRIME MINISTER

I am very much against this policy

GAS PRICING POLICY

E(EA) discussed this subject on 2 October, on the basis of a paper by David Howell (E(EA)(79)47) which was presented in his absence by Norman Lamont.

David Howell's paper argued that gas supplies to domestic consumers are at present significantly under-priced. The degree of under-pricing can be estimated variously from 25 per cent to 50 per cent, depending on the basis of calculation, but even the Price Commission concluded that the domestic tariff was 30-35 per cent too low. The under-pricing is, of course, increasing demand for gas as a domestic fuel. If nothing is done, British Gas will need a quite disproportionate investment programme to keep pace with the demand, and meanwhile the need to supply domestic consumers is squeezing out industrial consumption. The American experience shows all too clearly the dangers arising from continued under-pricing of energy.

The Government does not, of course, set domestic gas prices, but it does set the British Gas Corporation's financial targets. At the meeting Norman Lamont recommended that we should set these targets at levels which would require domestic gas prices to rise by an average of 10 per cent a year <u>in real terms</u> over the next

I thought we were going to consider PRT on gas as on oil? MT

/3 years.....

3 years or so. This would more or less eliminate the under-pricing, depending on the method of calculation used, by the end of the period. David Howell believes that increases of this size will enable supply and demand to be brought into balance and secure the public expenditure saving he has agreed bilaterally with the Chief Secretary, even after allowing for increased investment and discounting additional benefit from increased corporation tax.

The first increase would take effect from 1 April 1980, and the cash increase would be 10 per cent above the then going rate of inflation. No

E(EA) recognised that this was a major political issue, and did not attempt to reach final decisions. We have asked David Howell to prepare a further paper for consideration, if you agree, by Cabinet or E Committee in the week after the Party Conference. But you may like to know E(EA)'s initial reactions.

No one on the Sub-Committee questioned the case put forward by Norman Lamont, and one or two colleagues suggested that the increase might sensibly be faster than that proposed. But we were in no doubt that the increases would cause a major political row which would be all the greater because the gas industry is already so profitable.

We all agreed, therefore, that presentation would need very careful handling. It was suggested that the increases should

/be presented......

be presented as one part of a coherent strategy on energy conservation and on the depletion of North Sea reserves. It was also suggested that in the announcement this autumn we should reveal our hand not only for next year but for the two years following, ie that we should announce a policy of continuing real price increases, with the reasons for it. This would have more effect than a single price increase on domestic consumers' decisions and should therefore help to reduce the pressure of domestic demand for gas over the next few years.

A 10 per cent rise in domestic gas prices increases the RPI by 0.16 per cent. We noted that the increases would have an effect on wage claims, but did not see this as a reason for shrinking away from them. We also noted that the price rise would bear relatively heavily on poorer households, who have of course enjoyed a greater relative benefit from the fall in real gas prices over the last few years. Norman Lamont argued that this problem should be dealt with through the Social Security system not through gas pricing, but as a Government we need to note that there will be pressures on us to divert some of the extra revenue towards relieving the worse-off rather than reducing the PSBR.

Finally, we did not reach any conclusions on the British Gas Corporation's profits, but there were suggestions that part of them should be creamed off by a special gas tax, to make it clear that the economic benefits of increased prices were being passed

/back to......

back to the community.

I am copying this minute to other members of E and E(EA), to Patrick Jenkin and to Sir John Hunt.

KJ

K J

5 October 1979

Department of Industry
Ashdown House
123 Victoria Street
London SW1

5 OCT 1979