MT

PART 4

Confidential Filing

Gas and Electricity Pricing Policy

Gas and Electricity Industries EFL's

Industrial Energy Pricing

NATIONALISED INDUSTRIES

Part 1: Sept 1979

Part 4: March 1981

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~13-3-81~~							
~~27-3-81~~							
~~10-4-81~~							
~~15-4-81~~							
~~11-5-81~~							
~~19-5-81~~							
28-5-81							
—ENDS—							

PREM 19/543

PART 4 ends:-

S/S Energy to PM of 28/5/87.

PART 5 begins:-

E (DL) (81) 8 of 1/6/87

TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
E (EA) (81) 18	24.3.81
E (EA) (81) 19	24.3.81
E (EA) (81) 7th Meeting, Minutes	26.3.81
E (81) 39	3.4.81
E (81) 46	6.4.81
LCA to E (81) 14th Meeting, Minute 1	8.4.81
MISC 56 (81) 1	13.4.81
MISC 56 (81) 1st Meeting, Minutes	16.4.81
MISC 56 (81) 2	27.4.81
MISC 56 (81) 3	27.4.81
MISC 56 (81) 4	28.4.81
MISC 56 (81) 5 Revise	11.5.81
MISC 56 (81) 2nd Meeting, Minutes 1, 2, 3 and 4	14.5.81

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 CWayland Date 27 June 2011

PREM Records Team

cc A Duguid

cc Mr Ingham

Mr Tick

Prime Minister

Cabinet Office will set up a further meeting MISC 56 (which I think you will need to chair) as soon as Mr Howell has circulated his further papers.

CONFIDENTIAL

PRIME MINISTER

ENERGY PRICES

I am concerned that we have set no firm timescale for decisions on the issues we face on energy pricing, which are being considered in MISC 56. We are seeking to arrive at a package adequate to contain the industrial pressures for action, without going beyond what we can afford or what would be wise in energy terms. These pressures are not diminishing. I expect them to be manifest again in the House when I answer questions on June 8.

28/5

I plan to circulate to colleagues on MISC 56 on 1 or 2 June those further papers for which I was asked at the Committee's last meeting on 14 May. I trust that the other papers which were commissioned can be made available in the same timescale, so that we can reach decisions as soon as possible thereafter.

I am sending copies of this letter to our colleagues on MISC 56 and Sir Robert Armstrong.

DH.

Secretary of State for Energy

28 May 1981

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ
TELEPHONE: 01-211 3000

01 211 6402

R

15/5

The Rt Hon John Biffen MP
Secretary of State for Trade
Department of Trade
1 Victoria St
London SW1H OET

19 May 1981

Dear John

MONOPOLIES AND MERGERS COMMISSION REPORT ON THE CEGB

I attach a copy of the press statement which I propose to issue on 20 May following the announcement by Sally Oppenheim of the publication of the Report. I have already invited the Chairman to let me have full comments on the Commission's various recommendations in so far as these fall to the Board.

I should be very glad for our officials to remain in touch during the follow-up to the Report, and will write again in due course about the possibility of a further statement in the light of discussions with the Board.

I am copying this letter to the Prime Minister, the Chancellor of the Exchequer, the Secretaries of State for Industry and Scotland and to Sir Robert Armstrong.

Yours ever

David

D A R HOWELL

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DRAFT PRESS STATEMENT

MMC REPORT ON THE CEGB

1 I welcome this major report from the Monopolies and Mergers Commission which goes in great detail into the CEGB's costs and efficiency. The result is a helpful study of the Board's performance, and the Commission have made a number of recommendations for action by the CEGB on which I am seeking the Board's early comments.

2 The Commission criticise the Board's investment appraisals, with particular reference to nuclear power station projects. As I made clear in my statement on nuclear power policy on 18 December 1979, while the orders to which I referred offered a reasonable prospect against which the nuclear and powerplant industries could plan, the precise level of ordering would depend on the development of electricity demand and the performance of industry. Within this general framework, the Board will appraise each project case by case. I shall expect the Board to take full account in their appraisals of the improvements recommended by the Commission.

3 I remain convinced that in an uncertain world it is right to seek to secure this country's future energy supplies, and that continuing nuclear power station orders are required for this purpose.

4 The Commission make recommendations in connection with the calculation of Demand Charges in the CEGB's Bulk Supply Tariff. At my request the Electricity Council are already engaged on a review of the Bulk Supply Tariff.

CONFIDENTIAL

5 The Commission also suggest that the industry's financial target, if it were to be achieved in present circumstances, would result in prices somewhat higher than those contemplated in the industry's current plans. Since the target was agreed in January 1980, circumstances have changed; including reductions in electricity demand. The implications of these changes are already under discussion with the Council.

6 I was glad to note that the Report commends a number of aspects of the Board's operations and that the Commission pay tribute to the ability and dedication of many of those whom they met in the course of their investigation, and to their consciousness of the need to supply electricity at the lowest cost attainable with the present system.

2.

DEPARTMENT OF TRADE
1 VICTORIA STREET
LONDON SW1H OET

TELEPHONE DIRECT LINE 01 215 5662
SWITCHBOARD 01 215 7877

From the
Minister of State
for Consumer Affairs

The Rt Hon Sally Oppenheim MP

Prime Minister
MAP 19/v.

Mike Pattison Esq
Private Secretary
Prime Minister's Office
10 Downing Street
London SW1

15 May 1981

Dear Mike,

Mrs Oppenheim has heard that the Prime Minister has expressed interest in advertising by the British Gas Corporation about their showroom facilities. She thought the Prime Minister may wish to know that she has written to Norman Lamont on the subject and I attach a copy of her letter.

Yours ever,

Peter McCarthy.

PETER McCARTHY
Private Secretary

float

DEPARTMENT OF TRADE
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SWITCHBOARD 01 215 7877

From the
Minister of State
for Consumer Affairs

The Rt Hon Sally Oppenheim MP

Norman Lamont Esq MP
Parliamentary Under Secretary of State
Department of Energy
Thames House South
Millbank
London SW1

5 May 1981

Dear Norman

I must say I was most disturbed to encounter recent Gas Corporation television advertising which seemed to me to be quite simply a direct attempt to influence public opinion in favour of retention of retail showrooms.

As you will be aware no official Government decision has been taken and it certainly would be a misuse of the Gas Corporation's funds if advertising were used for a campaign of this sort whether entirely intentional or not and I must therefore ask you to bring this to the attention of Sir Denis Rooke as soon as possible with a view to these advertisements being discontinued.

Yours Ever
Sally

SALLY OPPENHEIM

cc The Rt Hon Nigel Lawson MP
John MacGregor MP

DEPARTMENT OF TRADE 1 VICTORIA STREET LONDON SW1H 0ET Telephone 01-215 7877

(has seen) NA

Prime Minister

From the Secretary of State

CONFIDENTIAL

Mike Pattison Esq
Private Secretary
10 Downing Street
London, SW1

14 May 1981

Dear Mike,

MMC REPORT: CEGB

I understand that the Prime Minister has asked for a copy of the report by the Monopolies and Mergers Commission on the Central Electricity Generating Board which is to be published on 20 May. I enclose a copy of the report and of the summary which it is intended to attach to our Press Notice next week. As the latter is rather long, we have side-lined the important passages.

I gather that you have received from the Department of Energy Private Office a copy of a letter on this subject from Mr Howell to my Secretary of State of 30 April. I enclose a copy of Mr Biffen's reply.

I am copying this letter to Julian West.

Yours ever,

Nicholas McInnes

N McInnes
Private Secretary

CONFIDENTIAL

SUMMARY OF MONOPOLIES AND MERGERS COMMISSION REPORT ON CENTRAL ELECTRICITY GENERATING BOARD

The Central Electricity Generating Board was referred to the Monopolies and Mergers Commission on 3 June 1980.

The Commission were asked to report on whether the Board could improve its efficiency so as to enable it to reduce its costs or mitigate the effect of any increases in costs in the bulk supply of electricity.

EFFICIENCY

Financial Framework (Chapter 3)

The financial framework within which the Board operates requires it to obtain the Secretary of State for Energy's approval for its capital investment programme for each year and his specific approval before placing major orders. There are two general financial constraints on the electricity supply industry which also affect the Board's performance - the need to meet a financial target and a cash limit on borrowing.

The Commission believes that the Board's cost minimisation programme will help to limit increases in costs. There are, however, limits to the savings in unit costs which any such programme can achieve or which could be brought about by stimulating demand. They believe therefore that if the necessary savings cannot be achieved by these means one consequence of the present financial target will be a considerable increase in the price of electricity to levels somewhat higher than those contemplated in the present plans of the industry.

The Commission find that the Board has a sophisticated system of revenue cost control, which is operated efficiently.

Investment Background (Chapter 4)

The CEGB's investment programme at March 1980 price levels, is expected to double from £600m in 1979-80 to £1,200m in 1986-87. Generation projects account for about 80 per cent of this.

The Commission note that the Demand forecasting of both the CEGB and the Electricity Supply Industry has been seriously inaccurate in the past and has led to the premature ordering of new plant and increased costs. They conclude, however, that there have been changes of method and that the Board's approach is now sound. They recommend that the Board's Demand Charges in the Bulk Supply Tariff should be based on its plans for the development of its generating capacity over the next 10-15 years, rather than on any longer term expectation. In addition, the Demand Charges should be based on a central estimate of the net effective cost of new plant. The Commission believe that the industry's security standard requires further study under the aegis of the Electricity Council. Finally the Commission recommend more effective consultation between CEGB and the Area Boards on tariffs.

Investment Decisions (Chapter 5)

The CEGB's investment decisions are crucially affected by estimates of the future availability of coal and its price and of the costs of nuclear fuel. The Commission find that weaknesses in the CEGB's forecasting of imported coal prices and NCB prices over the long term give cause for concern, and they recommend that the Board should develop an internally consistent view of future domestic and imported coal prices and availability.

As regards nuclear fuel the Commission consider that, because of the uncertainty surrounding the cost of reprocessing of nuclear fuels and the market for uranium, the Board should adopt a sceptical attitude towards nuclear fuel costs.

On construction costs, the Commission say that there is evidence that the CEGB's power station construction programmes have suffered from persistent real price increases. They therefore recommend that a more realistic estimate of construction costs should take account of the Board's experience of real price increases in the past.

The Commission also note that the project construction times are at variance with the estimated contract programme and recommend that this aspect of the work on project appraisal be improved as a matter of urgency.

The Commission recommend that explicit account should be taken of market conditions in the supply of plant and of the relative price effects during construction. They also recommend that the Board should consider adopting a larger start-to-finish allowance for nuclear power stations.

Finally the Commission believe it is important that future investment projects should be assessed on more reliable economic grounds, so that if projects are put forward on other grounds, the cost will be appreciated. They recommend that appraisals should present results associated with the central estimates of all the relevant determining variables, and that sensitivity analysis should be developed further.

Operational Planning (Chapter 6)

Operational planning is designed to make the most efficient use of capital and other resources. The objective is to meet temporal and geographic demand for electrical energy at a pre-set level of security, and to maintain frequency and voltage levels within defined limits at least cost. This is achieved by using a suite of computer models that simulate the national system of fuel distribution, generation and transmission. The simulation procedure calculates the system marginal cost (SMC) for given demands, fuel costs and generation availability and selects the minimum fuel cost allocation.

The Commission conclude that the merit order based on system marginal costing is an appropriate concept for cost minimisation. However under some large divergence from assumed conditions the Commission conclude that it might be better to revert to merit order based on thermal efficiency for day to day planning and they suggest that the CEGB should investigate this. The Commission are satisfied that the Board has an effective operational planning system and that it can respond quickly to changes in planning assumptions. Such failures as occur are mainly due to errors in weather forecasting.

The Commission recommend that the Board ;should undertake a comprehensive cost/benefit study of central on-line scheduling and despatch of plant, and if the net benefits are consistent with the Board's normal criteria it should develop a plan for full implementation.

Fuel Procurement (Chapter 7)

Purchases of coal, fuel, oil, natural gas and nuclear fuel account for some 60 per cent of the CEGB's total costs. Coal has always been the most important fuel. The Commission say that the CEGB has two possible ways of reducing its coal costs - it can seek cheaper sources of coal and transport, and it can seek to ensure that the National Coal Board and British Rail operate as efficiently as possible, and that the benefits of this efficiency are passed on to the CEGB in the form of lower prices.

In the past the only major source of cheaper coal has been imports, but the CEGB has been prevented from taking advantage of such opportunities as were available. This has had the effect of raising the CEGB's costs because of the extent to which it has had to use more expensive home-produced coal. The Commission criticise the understanding between the CEGB and the NCB, because coal prices are related to the retail price index rather than to changes in the costs of the supplies, and because of the absence of any relationship with long-run marginal cost. They therefore recommend that the CEGB should aim to improve the terms and increase the duration of the understanding.

As regards coal transportation the Commission find that the exclusive dealing agreement with British Rail for the transport of coal is a major restriction on competition from alternative forms of transport and they recommend that it be abandoned.

They also recommend that the two industries (British Rail and CEGB) should revise their price variation mechanism in their agreement so as to give British Rail a greater inducement to limit growth of their costs, and to enable the CEGB to benefit from improvements in productivity in rail carriage of coal.

The Commission conclude that the Board is efficient and professional in its procurement of oil. As far as nuclear fuel is concerned they say that CEGB has secured long-term supplies of uranium at prices lower than those on the spot market. They recommend, however, that the Board should seek to negotiate 'call off' clauses in its contracts to keep stock levels as close to requirements as possible, and they should persist with a policy of diversifying its sources of supply.

The relationship between CEGB and British Nuclear Fuels Ltd presents difficulties owing to the lack of competition. The terms of trading provide for BNFL to supply specified information. While this is satisfactory as regards operating costs, the situation is less so as regards investment projects. This, and the Board's own slowness in costing appropriate alternative options, has vitiated a part of the investment appraisal for AGR power stations. The Commission recommend that if a PWR programme is undertaken, the CEGB should seek competitive tenders from BNFL and foreign organisations for supply and reprocessing of the fuel.

Availability and maintenance (Chapter 8)

The Commission examined the maintenance of power stations and are satisfied that they are well managed. They also note that availability of large conventional stations has improved considerably in recent years. However there are continuing difficulties concerning the availability of nuclear plant.

The systems for reporting shortcomings are fragmented: improved reporting systems could enable the CEGB's operating experience to be taken more fully into account in new plant designs.

The Commission recommend that full quality assurance procedures should be introduced at large power stations, with a nominated person independent of other functions responsible for quality.

Plant Spares (Chapter 9)

Plant spares fall into two main groups. Regional spares, which include a large number of items of many different kinds and National spares which include a relatively small number of substantial items (for example, starters, rotors and transformers) usable in more than one Region which it would not be economic for any individual Region to hold. Regional plant spares are held at Power stations.

The Commission conclude that in matters of purchasing and stock control the Board has in the past relied upon the judgement of competent and resourceful engineers capable of managing risk, making repairs, exchanging spares etc. This has helped to maintain a high level of availability in the generating system. However this approach has obscured the need for detailed Operational Research studies and the introduction of more advanced methods of stock control.

Although this may be changing already, the Commission recommend that the Board should develop these methods and, as an interim measure, it should charge interest to Regions on the value of stocks held.

They also recommend that Regions should systematically record the number and percentage of prices challenged in single tender contracts, together with prices asked and prices to be paid, and then compare the results.

On national spares they recommend that the Board should consider whether its use of a 15 per cent rate of return and three-year pay back is causing under investment in national spares. Finally the Commission recommend the increased use of standard designs owned by CEGB to permit competitive tendering for, and reduced holdings of, spares.

<u>Industrial relations and efficient use of manpower</u> (Chapter 10)

The Commission find that the Board's personnel function is well organised and co-ordinated. Industrial relations are generally good and there are few strikes or other forms of industrial disruptions.

There has been an increase in output per head, very largely due to a 30 per cent reduction in non-building industrial staff, improvements in flexibility of working practices, reduced over-time working and the introduction of work measurement and bonus incentives. There is some evidence of overgrading among engineering staff and some indications of reluctance to accept and cooperate in rationalisation of their grading structure. The Commission believe that the management should put forward a timetable for the introduction of job evaluation; and they say it is important that the engineering staff should cooperate in measures to improve the efficiency of their utilisation and employment.

The Commission consider there is scope for greater efficiency of administrative, clerical and sales staff and they recommend the further implementation of the established clerical work measurement systems and the application of modern office technology.

The CEGB are commended for their achievements in improving the quantity of electricity generated per head over the past fifteen years. In recent years, however, the rate of improvement has slowed appreciably, while at the same time the CEGB's labour costs have been rising faster than the national average. In consequence the Board has been less successful recently in containing the rate of increase in its unit labour costs. The Board and all the trade unions in the industry therefore need to seek to improve productivity and reduce costs further.

Management information systems (Chapter 11)

The function of a Management Information System (MIS) is to provide the decision maker at all levels of management with the best information available relating to the decision to be taken. MIS normally acts as an aid to three categories of management activity, namely strategic planning, management control and operational control.

The Commission find that the CEGB's main Management Information Systems provide adequate information for operational control and functional management control. The systems are not over elaborate. However the Board has no information system which brings together information across all resources so as to give an integrated approach to strategic and corporate planning. At station level there is no uniform system to serve in a convenient form the needs of general management.

They therefore recommend that the Board's management information systems should be comprehensively reviewed and a strategy for the next decade produced.

<u>The construction of power stations</u> (Chapter 12)

The CEGB organises the construction of its power stations through its Generation Development and Construction Division at Barnwood near Gloucester. Nearly three quarters of its effort is directly devoted to managing the client role of the Board vis-a-vis contractors engaged in major power station construction projects. There have been a number of previous enquiries in this area, notably the National Board for Prices and Incomes in 1968, NEDO in 1970 and 1976 and the Price Commission in 1979. The Commission have therefore restricted their investigations to an examination of the ways the Board is implementing its new policies.

The construction of power stations has been bedevilled by labour relations problems for many years amongst contractors undertaking this work. The Commission conclude that whilst many of the weaknesses and failings on power station construction sites discussed in earlier reports remain, some important progress in site labour relations and productivity has been made recently. In particular, steps taken by the CEGB to improve coordination and control at Ince, Littlebrook, Grain, and Drax are welcomed.

There has also been some progress towards the long delayed national agreement for construction sites first proposed by NEDO in 1970. As it is still uncertain as to whether negotiations for a national site agreement can be brought to an early and successful conclusion, however, the Commission recommend that the CEGB should introduce a model agreement for use on its sites.

The design and construction of nuclear power stations have presented severe problems in the past. These must be overcome if the nuclear programme is to be pursued successfully. No arrangement has yet been devised whereby design and safety risks can be borne by any party other than the CEGB and ultimately its customers. The Commission believe that the proposed arrangement for Heysham II, whereby the National Nuclear Corporation (NNC) would act as the CEGB's agent rather than as a contractor is a realistic approach to the problem of performance risk which recognises the inability of the NNC to meet liabilities beyond its fee and capital without guarantees from its shareholders.

The Commission recommend a number of principles which they consider the CEGB should be guided in letting future contracts for nuclear power stations. These include: seeking out potential suppliers and contractors willing to bear performance risks or guarantees of equipment performance; contracts should be let on a firm price basis with appropriate price variation clauses; and there should be unified control over the execution of contracts.

General comment

By way of a general comment, the Commission say that the inter-relationship between nationalised industries raises important issues of public policy about their respective costs and prices. Where nationalised industries, each having a virtual monopoly, deal with each other, the purchaser may not resist the seller's demands as vigorously as it ought, since it can pass on its costs to its customers. Also there can be no certainty that the bargains they strike will lead to the most efficient use of resources. One nationalised industry cannot be at all confident that the charges it pays for another's service or product are actually related to the costs incurred in providing that product or service.

The Commission recommend that the Government should give fresh thought to the objectives set for nationalised industries which deal largely with each other. If, for example, it is considered to be in the national interest that high-cost coalfields shall remain open in the medium term, this might be better done by adjusting the financial objective of the NCB than by raising the price of coal and so making users of coal and electricity pay prices set above long-run marginal costs.

PUBLIC INTEREST

The Commission's terms of reference required them to examine five areas of the CEGB's activities with a view to assessing whether the Board was pursuing a course of conduct which operated against the public interest:

a) its internal cost control and project control systems

b) its management information systems

c) its purchasing policies and methods of stock control

d) its management of plant maintenance and the effect of programmes for plant maintenance on plant availability

e) the planning and appraisal of new investment, and its ability to carry out its proposals for such investment within the cost and the time estimated.

In its internal cost control and project control systems, its management information systems and its management of plant maintenance, the Board is not found to be operating against the public interest.

In respect of its purchasing policies, the Commission feel bound to conclude that the Board could have had lower costs in recent years if it had been free to pursue the objective of cost reduction by every means available. By being prevented from using cheaper imported coal, by pursuing a 'buy British' policy and by ordering power stations 'in advance of need' costs are not now, and are unlikely to be in the future, as low as they could be. As this arises not from lack of efficiency in the use of its existing resources, but from concern on its own or the Government's part for the interests of major suppliers, the Commission conclude that the Board has not been operating against the public interest.

As far as planning and appraisal of new investment is concerned, the Commission find that, while the Board's demand forecasting has improved, there are serious weaknesses in its investment appraisal. In particular a large programme of investment in nuclear power stations, which would greatly increase the capital employed for a given level of output, is proposed on the basis of investment appraisals which are seriously defective and liable to mislead. They conclude that the Board's course of conduct in this regard operates against the public interest.

The Commission note that the CEGB has serious problems in carrying out its investment proposals within the cost and the time estimated. Productivity on site has improved and the Board is taking such steps as are in its power to help solve the problems of industrial relations in site construction. In view of these recent developments the Board is not found to be operating against the public interest.

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

pa

Tim Lankester Esq
Private Secretary
No 10 Downing Street
LONDON SW1

14 May 1981

PM has seen.

Dear Tim,

MONOPOLIES AND MERGERS COMMISSION REPORT ON CEGB

The MMC's Report on the CEGB is expected to be published next week. I understand that the Department of Trade will be consulting you in the normal way about publication arrangements.

On the content of the Report, my Secretary of State thinks that the Prime Minister may find it helpful to see the attached copy of his letter to Mr Biffen of 30 April. Mr Howell has in fact now written to the Chairman of the CEGB, who received a copy of the Report on a personal basis at the beginning of this week, to seek his urgent comments on the Commission's various recommendations and, in particular, proposals for improvement in the Board's investment appraisal procedures. Mr Howell plans to issue a short press Statement to this effect once the Report has been published.

He will consider in the light of the Board's response whether any formal directive under the Competition Act is needed. (S.12(3) of the Act provides a power to require the Board to prepare a plan for remedying adverse effects where a body is found to be pursuing a course of action against the public interest).

The Prime Minister also asked Mr Howell yesterday for a copy of the MMC Report, which request I have passed on to John Rhodes.

Yours ever,

J D WEST
PRIVATE SECRETARY

CONFIDENTIAL

01-211-6402

The Rt Hon John Biffen MP
Secretary of State for Trade
1 Victoria Street
London SW1H OET

30 April 1981

Dear John

MONOPOLIES AND MERGERS COMMISSION REPORT ON THE CEGB

I am writing to give you my initial reaction to this major Report. I have not been able to consult the Chairman of the CEGB since he has not yet received the conclusions of the report.

I attach at Annexes A and B a summary of the Commission's main conclusions and of their major recommendations. Most of the latter require comment and action by the industry.

The Commission commended a number of aspects of the Board's operations;

a) the system of revenue cost control is sophisticated and well-documented

b) cash management is competent

c) internal audit is pursued effectively

d) proper attention is given to the disposal of surplus land

e) contract negotiations are skilfully pursued.

In its day to day business the Board is shown to be efficient and generally operating according to well thought out procedures.

The Commission show concern in three main areas;

i) forecasting of electricity demand

ii) investment appraisal technique

iii) purchasing policies, both of fuel and of power plant.

Forecasting

The industry are criticised for over-optimism in the past, particularly about economic growth, but the Commission find that current forecasting methodology reflects the lessons of the past, and that, given the state of the art, it is sound. I shall nevertheless wish to discuss this finding with the industry when I am able to do so; the latest Electricity Council forecasts still look optimistic.

Investment Appraisal Techniques

The Commission's criticism here is directed particularly to the appraisal of nuclear power stations. It falls into two main parts;

a) doubts about the basic assumptions (fuel costs, construction costs and times)

b) the need for a fuller treatment of sensitivities (showing the combined effects of adverse changes in a number of assumptions as well as the effects of individual changes).

The Commission have dramatized this criticism by their finding that the Board's appraisal methods constitute a course of conduct which, in the terms of the Competition Act 1980, operates against the public interest.

The Commission suggest that the economic case for Heysham II may have unjustifiably reinforced the strategic case for the order. They also state that a large programme of investment in nuclear plant is proposed on the basis of investment appraisals which are seriously defective and liable to mislead.

These are serious criticisms. But there are points to be made on the other side. For instance, a wide range of sensitivities was explored in the appraisal of Heysham II, and it was possible to gain from these a clear impression of the effect of delay and cost escalation. (The Commission were not of course privy to the conclusions of last year's CPRS study on the wider reasons for going ahead.) There is another point. My nuclear policy statement of December 1979 made it clear that future nuclear ordering would depend on electricity demand and the performance of the nuclear and plant industry; each station will be fully appraised.

Nevertheless, the findings of the MMC report on this point will attract wide public attention, and will be seen by many (and in particular by opponents of nuclear power) as calling into question the economic basis for nuclear power station orders. Opponents will make much of this at the Sizewell B public inquiry expected next year. Confidence in our nuclear power policy will be undermined.

3

Against this background, the finding that the Board's investment appraisal procedures operate against the public interest will require careful public handling, as will the Commission's criticisms in this general area. As I understand it, the finding may have been framed to enable me to use the powers under the Competition Act, should I so wish, to require the Board to produce plans for improvements. When I am in a position to take this up with the Board, I shall of course be looking for early proposals for improvement; I shall consider in the light of these whether a formal direction under the Act is needed.

Purchasing Policy - 1) fuel

There are sensitive points here, and much potential for embarrassment. The Commission conclude that;

a) costs have been higher than they might have been because the CEGB have not been able, mainly for reasons of Government policy, to take full advantage of import opportunities;

b) the customer may face an even faster rate of increase in electricity prices unless the Board's capacity to import can be increased;

c) the knowledge that they might be prevented from importing coal has affected the Board's approach to planning for imports.

The Commission raise questions about NCB costs, closure and pricing policies. They state that the CEGB know no more about NCB costs than they can glean from the Report and Accounts.

The Commission conclude that fresh thought should be given to the objectives of nationalised industries which trade largely with each other; and that if it is considered in the national interest that high cost coalfields should remain open in the medium term, this might be better done by adjusting the financial objective of the NCB than by raising the price of coal. They add that there is a danger that present coal pricing policies may make nuclear power appear to offer an economic advantage which it might not have under a policy of LRMC pricing for coal.

Much of this is pertinent to electricity costs. However, the question of imports is still under discussion in the tripartite context, and remains highly sensitive. For the immediate future CEGB is being encouraged to 'buy British' and NCB is negotiating to cut current imports to the irreducible minimum.

The Commission recommend that the Board seek to improve the terms and extend the duration of the CEGB/NCB understanding; we should take the line that this is for commercial negotiation.

Purchasing policy ii) Power Plant and Power Station Construction;

Power Plant

The Commission note that Governments have in the past asked the Board to help the UK plant industry, and that the Board has incurred extra costs thereby. They suggest that if the Government wishes facilities to be established in the UK to manufacture PWR components, this should not necessarily be at the expense of the electricity consumer.

The Commission note that the Board has traditionally pursued a 'buy-British' policy for plant. They raise, as did the Select Committee on Energy, the question of some element of international competition for future UK power plant orders.

It is likely that some major items of plant can at present be procured more cheaply abroad than from British industry. Cheaper plant would improve the economics of new stations and make it easier to defend new orders in the face of slack electricity demand: it would also make a modest contribution to reducing electricity costs.

On the other hand, the consequences for parts of the UK industry could be severe.

I think some element of overseas competition should be seriously considered. My reply to the Select Committee on Energy should state our attitude on this; my officials are in touch with Keith Joseph's in that connection.

The Commission say they are impressed by the results obtained by the Generation Development and Construction Division at Barnwood by insisting that contractors adopt improved quality assurance procedures for the manufacture of power station equipment.

Power Station Construction

The Commission generally endorse the Board's current policies to improve performance:

a) moving from reimbursable to lump sum contracts, with incentives and a "key-date" procedure.

b) setting up site management groups to monitor and harmonize industrial relations policies and practice (especially bonus payments) across all contractors

c) working for a national agreement for large sites

d) completing the design phase before sanction for site work is given

e) replicating plant wherever possible.

They also approve Barnwood's practice of making exacting checks of contractors' designs, and its attention to the detail of costs, specifications and performance.

General

There are a number of other points in the Report which I shall wish to take up with the Board as soon as I am in a position to do so. I propose to handle these in separate correspondence, bringing in other Departments as appropriate.

Public Handling

This is the immediate question. I suggest that a fairly short statement should be made on publication, of which the main elements would be:-

i) welcome this major study, noting that the Board are judged to operate with competence and proficiency in many areas;

ii) note also that serious criticisms are made of the Board's investment appraisal methods. The Government is seeking comments and proposals from the Board with a view to improvement;

iii) these criticisms do not however call for fundamental changes in the government's nuclear strategy; the government's attitude will be stated in the response to the Select Committee on Energy's nuclear Report;

iv) the decision to proceed with Heysham II (and Torness) was based on strategic as well as economic considerations;

v) the Commission have made a number of other recommendations which will be discussed with the Board.

On the need for greater transparency of nationalised industry (and especially NCB) costs, we should say that this will need to be considered in the context of general nationalised industry policy, and that the Commission recognise that the point is one for government i.e. political decision.

The CEGB themselves are of course likely to produce a robust response to many of the Commission's strictures when they are able to do so.

In view of view of their special interest I am copying this letter to the Chancellor of the Exchequer and the Secretary of State for Industry, and also to Sir Robert Armstrong.

Yours ever

David

D A R HOWELL

MMC REPORT: MAIN CONCLUSIONS

The MMC was asked to examine five areas of the CEGB's activities:

A. Internal cost control and project control systems

(i) The CEGB has a sophisticated and well-documented system of revenue cost control. Internal audit is pursued effectively. The Board's cash management is competent. Procedures for approving capital spending are well-defined and properly observed. Costs of work in progress are properly monitored. Contract negotiations and claims under contracts are skilfully pursued by well-qualified staff.

(ii) The merit order based system of marginal costing is an appropriate method of cost minimisation. The Board has an effective operational planning system. The procedures for short-term planning of generation are effective in monitoring security of supply at a cost consistent with good management.

(iii) Industrial relations are generally good. Output per head has increased, but in recent years the Board's labour costs have been rising faster than the national average.

B. Management Information Systems

(iv) The Board's main management information system provide adequate information for operational control and functional management control. But there is a need to bring together information across all resources.

C. Purchasing Policies and Stock Control

(v) The CEGB should aim to improve the terms and increase the duration of the understanding with the NCB.

(vi) The exclusive dealing arrangement with British Rail should be abandoned. The CEGB should put greater pressure on BR, though the terms negotiated, to reduce its costs.

(vii) The CEGB should seek to negotiate better terms for the purchase of uranium. The Board should also seek better cost information from BNFL as regards the latter's investment projects. If a PWR programme is undertaken, the CEGB should seek competitive tenders from BNFL and abroad.

(viii) The Board should develop operational research studies and more advanced methods of stock control. The Regions should systematically record the number and percentage of prices challenged on single tender contracts, together with prices asked and prices to be paid, and then compare the results. Increased use of standard designs owned by the CEGB is encouraged to permit competitive tendering for, and reduced holdings of, spares.

(ix) The Commission implies that the Board's "buy British" policy has increased costs to consumers.

/D.

D. Management of Plant Maintenance

(x) Maintenance at power stations is well-managed and the effect of programmes for plant maintenance has been to increase plant availability, though the Commission make some recommendations for improvement (eg on quality assurance procedures).

E. Planning and Appraisal of new investment

(xi) The esi should review the generation security standard. (c.f. the Select Committee's recommendation that the Government should review security of supply standards).

(xii) The Board should develop an internally consistent view of future domestic and imported coal prices and availability.

(xiii) The Board's basic estimate of net effective cost should be a central estimate; their present assumptions are too optimistic as regards cost of plant, construction times, and, as regards new AGR plant, output rating and availability.

(xiv) The Board should develop its sensitivity analysis, and present outcomes associated with central estimates of all the relevant determining variables. This would lead to a more dependable assessment of the economic case than was presented for Heysham II.

Overall, the Commission finds that the Board's appraisal of new investment is seriously defective and liable to mislead, and, in this respect, its course of conduct operates against the public interest.

F. Ability to carry out proposals within the cost and time estimated

(xv) There are still weaknesses and failings on power station construction sites, although some important progress in site labour relations and productivity has been made recently. The CEGB should seek to introduce a model agreement for use on its sites, while no national agreement exists.

(xvi) NNC should act as the CEGB's agents in procuring plant for the nuclear island at Heysham II. It is doubtful whether there is any way that the risks associated with construction can be removed from the CEGB's shoulders.

(xvii) For the future, there should be unified control over the execution of nuclear power projects. The Commission believe that this was the Secretary of State's intention when he spoke of NNC assuming "total project management responsibility".

G. Other matters

(xviii) Demand charges in the BST should be based on the Board's plans for development over the next 10-15 years.

(xix) There should be more effective consultation between CEGB and Area Boards on tariffs so as to improve cost messages.

/(xx)

(xx) The Government should give fresh thought to the objectives set for the nationalised industries which deal largely with each other. It would seem wrong that the electricity consumer should pay the costs of keeping high-cost coal-fields open in the medium-term.

(xxi) Costs have been increased by the ordering of power stations ahead of need at the request of Government.

MMC REPORT - MAJOR RECOMMENDATIONS

BST (4.65 to 4.68)

i) Demand charges should be based on the planned development of generating capacity over the next 10 to 15 years; they should be based on what the MMC call "central" estimates of Net Effective Costs (ie more pessimistic than the Board's present "basic" estimates).

ii) There is a need for more effective consultation between the CEGB and Area Boards; this aspect of the Secretary of State's statement of July 1980 is welcomed.

Security Standards and the Planning Margin (4.67 to 4.72)

The security standard requires further study by the Electricity Council; the MMC urge that any future review should involve full consultation with representatives of consumers.

Investment Planning and Appraisal (5.134 to 5.174)

i) The Board should devote more time and effort to developing an internally consistent view of the future prices and availability of both domestic and imported coal. In so doing, they should consult closely with the Department of Energy.

ii) In developing estimates of construction costs for use in investment appraisal, explicit account should be taken of market conditions in the supply of major items of plant (long intervals between orders lead to unreliable estimates of the cost of new plant; negotiated tenders put prices up) and of relative price effects (tendency of power plant prices to rise faster than the general rate of inflation). The Board should adopt a larger start to finish (contingency) allowance for nuclear than for conventional stations.

iii) The Board should improve its estimating of construction time.

iv) Assumptions on nuclear plant performance (particularly AGR) are optimistic; a more realistic (cautious) central estimate should reflect past difficulties

v) Presentation of investment appraisal results, both internally and externally, falls short of standards necessary to understand the robustness of NEC estimates.

As a minimum, there should be a much more thorough explanation of the results of combined sensitivity tests for outcomes which are more likely than the CEGB's "basic" Net Effective Costs (optimistic) and extremely pessimistic outcomes.

But the MMC recommend the further step of reorienting the approach, presenting outcomes associated with central estimates of all variables: the CEGB regard this as planning for failure.

vi) The Board should develop its work on the analysis and forecasting of lifetime repair and maintenance costs; this underpins estimates of the net avoidable cost of life extension. Life extension potential should be reflected in investment appraisal.

vii) The economics of conversion of existing oil fired plant to coal firing should be reassessed as a matter of urgency.

Fuel procurement

i) The Commission welcome the statement in the CEGB's annual report for 1979-80 that a modest increase in coal imports was planned for 1980-81, and that the Board was keeping under review the scope for increasing coal importing facilities.

ii) The CEGB should seek to improve the terms and extend the duration of the understanding with the NCB.

iii) The exclusive dealing clause on the transport of coal in the CEGB's arrangements with BR should be abandoned; the CEGB and BR should revise the price variation mechanism so as to give BR more incentive to reduce the growth of its costs and to enable the CEGB to benefit from improvements in productivity.

iv) The Board should negotiate flexible "call-off" clauses in new contracts for uranium supply; they should press forward with diversification of uranium supply.

v) Consideration should be given to appointing one or more CEGB representatives to the BNFL Board.

vi) The Board should urgently provide information to BNFL on options for dealing with irradiated AGR fuel.

vii) If a PWR programme is undertaken, competitive tenders for supply and reprocessing of fuel should be sought from BNFL and foreign organisations.

Manpower (10.59 to 10.68)

The Board and the unions should co-operate in securing further improvements in the efficiency with which the industry's manpower is used at all levels.

Power Station Construction (12.123 to 12.134)

i) in view of uncertainty about the prospects for a National Agreement for large sites, the Board should use its recent experience at Grain and Drax to produce and establish its own model site agreement: this should be initiated before it contracts for the construction of a new power station.

ii) In letting contracts for nuclear power stations, and in particular for the first PWR, the Board should be guided by the following principles:

a) it should ascertain from potential suppliers, British and foreign, whether they are prepared to bear any of the plant performance risks, and weigh this against probable cost of its own remedial action or permanently sub-standard performance.

b) if the main contractor is to have the limited resources NNC now has, guarantees of equipment performance should be available direct to CEGB

c) as many contracts as possible should be let on a firm price basis, with the Board's key date incentive system applied

d) contractual responsibility, and size of contract should be related to the contractor's financial resources and the risk he is willing and able to bear

e) there should be unified control over the execution of projects; the Commission believe that this is in line with the Secretary of State's policy for NNC as announced in December 1979.

FILE

HS

Cf. White

cc NIO

10 DOWNING STREET

THE PRIME MINISTER

15 May 1981

Dear Mr. Henderson

Thank you for your letter of 11 May. I am delighted that the decision on electricity charges in the Province has been so well received and grateful for the role you played.

Yours sincerely

Margaret Thatcher

R.B. Henderson, Esq.

VLB

DEPARTMENT OF TRADE 1 VICTORIA STREET LONDON SW1H 0ET Telephone 01-215 7877

From the Secretary of State

CONFIDENTIAL

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

14 May 1981

Dear David,

MONOPOLIES AND MERGERS COMMISSION REPORT - CEGB

Further to my letter of 7 May, I confirm that I am broadly content with the line you propose to take on publication of the CEGB report on 20 May - as set out in the five points in the last page of your letter of 30 April. I hope, however, that you will not be taking too defensive a line in dealing with the Commission's criticisms of the Board's investment appraisal. Clearly we should resist attempts to use the report for attacks on Government policy. On the other hand, the Commission's criticisms of the Board's past performance in this field are well argued and we should avoid appearing to dismiss them out of hand. Perhaps you could let me see a draft of your press notice before it is finalised.

Sally Oppenheim will be announcing publication of the report on the 20th by means of an arranged PQ and Answer, which will be incorporated in a separate press notice to be issued on the same day. We shall let you see a draft shortly.

Follow-up to the report lies chiefly with you. I should, however, like my own officials to keep in touch with yours during the initial discussions with the Board so that I can keep track of progress. I think there is much to be said for the Government issuing a further press notice when your discussions with the Board have been completed,

CONFIDENTIAL

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From the Secretary of State

and it has been agreed what action is to be taken. This was the procedure observed in the case of the Inner London Letter Post, where, as in the present report, there was an adverse public interest finding.

I am copying this letter to the Chancellor of the Exchequer, the Secretary of State for Industry and to Sir Robert Armstrong.

Yours,

John Biffen

JOHN BIFFEN

CONFIDENTIAL

A. Duguid

CONFIDENTIAL

Qa 05367 13 May 1981

To: MR LANKESTER

From: J R IBBS

CF pls inform CPRS that Chancellor will be chairing this mtg tomorrow

INDUSTRIAL ENERGY AND ELECTRICITY PRICES

1. In MISC 56(81)3 the Secretary of State for Energy proposes, as part of a package of measures, a scheme of the kind recommended by officials in MISC 56(81)4; broadly equivalent to pricing electricity down to short-run marginal costs for the largest consumers. Mr Howell's paper underlines the problems inherent in such a scheme; there will be criticism from those who do not benefit, and equally criticism from those who do qualify but for whom the benefits have only a small impact on the overall price disadvantage they face; in addition there are possible legal and EEC complications.

2. However, in the view of the CPRS the economic implications of energy price levels are more far-reaching than the immediate difficulties in constructing a scheme. The fundamental issue at stake is whether there is a case for keeping energy intensive industries based on electricity in the UK. If not, then assistance on prices should not be given.

3. If Ministers do believe that such industries should be retained, then clearly a temporary scheme having only a fairly modest effect on the energy price handicap would not encourage investment and keep such industries in the UK. On the other hand, more long lasting substantial discounts could be justified economically only as a bridge until electricity costs are brought down to a competitive level. At the previous meeting of MISC 56 the Secretary of State for Energy was invited to circulate as soon as possible a memorandum on the longer-term prospects for reducing the cost of electricity. If Ministers are attracted to a scheme along the lines suggested by Mr Howell, the CPRS recommends that they defer a final decision on implementation until they have discussed the prospects for low cost coal and a more rapid nuclear programme. However, Ministers should be aware that a necessary consequence of pricing

down to short-run marginal costs is that the energy intensive industries would, by definition, be making no direct contribution to the investment in new efficient generating capacity from which they will ultimately benefit.

4. Mr Howell implies in his conclusions that Ministers should be looking at ways other than lower electricity prices if they wish to assist industry. It is important that Ministers should realise from the outset that to have significant impact such alternatives are likely to entail large sums of money, and will not lend to the retention in this country of energy intensive industries based on electricity.

5. I am sending a copy of this minute to the Chancellor of the Exchequer and to Sir Robert Armstrong.

JR

Ulster Television Limited
HAVELOCK HOUSE, ORMEAU ROAD, BELFAST BT7 1EB TEL: 28122 TELEX: 74654
19 Marylebone Road, London, NW1 5JJ - 01-486 5211

May 11, 1981.

The Rt. Hon. Mrs. Margaret Thatcher, PC, MP,
Prime Minister,
House of Commons,
LONDON. SW1A OAA

Dear Prime Minister,

It was with great pleasure that I saw the news announcing your decision on electricity charges in the Province. This honoured pledge will bring great heart to many here who see social and economic reconstruction as being the real answers to remove futile violence and talk. We here simply seek an equal start in all matters and this will give great heart to many who see with sympathy the great difficulties which the present situation here has posed.

I take the liberty of writing direct to you - as I have also written to the Secretary of State - in view of the fact that you were kind enough to discuss the issue with me at Stormont and again at Downing Street. Some pride is taken in this building in that it was here that I was able first to submit the idea to the main business bodies who meet informally in my office three times a year on matters of common concern which was accepted in due course by your colleagues.

I write, of course, in my capacity as past President of the Northern Ireland Chamber of Commerce and Industry but, if I may be so bold, we here would welcome a visit and a screen interview with you on your next visit to Northern Ireland.

With respects and thanks.

Brum Henderson.

R. B. HENDERSON.

Copy to : The Secretary of State for Northern Ireland,
The Rt. Hon. Humphrey Atkins, M.P.

CONFIDENTIAL

File

E(EA) Nat Ind

D/I

D/M

DOE

SO

WO

10 DOWNING STREET

From the Private Secretary

11 May 1981

CF to file

D/Trade

D/N

Chief Sec, HMT

+ CO

NORTHERN IRELAND ELECTRICITY TARIFFS

This is just to confirm for the record, that the Prime Minister was content with the draft Written Answer which your Secretary of State submitted with his minute of 6 May.

I am sending copies of this letter to the Private Secretaries to the members of E(Ea) and to David Wright (Cabinet Office).

T. P. LANKESTER

M. W. Hopkins, Esq.,
Northern Ireland Office.

CONFIDENTIAL

D59

CONFIDENTIAL

Prime Minister

N10 and Treasury have now agreed how the N.I. electricity subsidy will be financed this year; later years will be dealt with in the PESC round. Mr Atkins would like to announce by Written Answer tomorrow (Friday). Content with draft (Flag A)?

1

c. Press.

SECRETARY OF STATE FOR NORTHERN IRELAND

PRIME MINISTER

MT

NORTHERN IRELAND ELECTRICITY TARIFFS

1. When you and the Chief Secretary and I met on 3 April to discuss tariff policy for Northern Ireland electricity, we agreed the way ahead on tariff levels, and that funding arrangements should be settled between the Chief Secretary and myself.

2. This has not been easy for either of us. I have, however, now agreed with the Chief Secretary that, of the total of £87.4m in cash terms which it was estimated would be required in 1981-82 to achieve the first step in bringing Northern Ireland domestic and industrial tariffs into line with highest England and Wales tariffs, £44.9m will be found from the Contingency Reserve, and I will contribute £10m in addition to £32.5m which is already provided for Electricity in my existing PES allocation.

R. 7/5

3. I have also agreed with the Chief Secretary that if, in the event, the cash cost of the subsidy to the NI Electricity Service in 1981-82 is less than the anticipated £87.4m, then the drawing on the Contingency Reserve will be correspondingly reduced. If it proves greater than anticipated, there will be further discussion between myself and the Chief Secretary.

4. It has also been agreed that funding of the agreed tariff policy for 1982-83 and beyond should be settled in the context of the 1981 Public Expenditure Survey. Firm PES provision for electricity for 1982-83 and 1983-84 at present stands at £10m (at October 1980 prices). The Chief Secretary is aware that I shall be making an additional bid in the Public Expenditure Survey for whatever is required over and above the £10m.

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SECRETARY OF STATE FOR NORTHERN IRELAND

5. I am confident that the terms of the announcement which I enclose (in the form of an arranged PQ and answer) are consistent with the agreement which I reached with the Chief Secretary. I am sending a copy of this minute and enclosure to him, and subject to his agreement tomorrow (he is heavily engaged on the Finance Bill tonight), I propose to announce the decision on Friday. This will be in time for a Northern Ireland Electricity Service Board Meeting on that day - further delay would add to the costs and I am anxious at this time of tension to remind the Province of the Government's commitment on electricity.

6. I am also taking advantage of the announcement on tariffs to announce the decision not to complete Phase II of the Kilroot Power Station. There has been very considerable public interest in Northern Ireland in the future of Phase II as well as in the tariff question and I consider that on balance it would be better to round off all the major outstanding electricity issues together.

7. I am copying this minute to all members of E(EA) and to Sir Robert Armstrong.

pp H.A.
(Signed on behalf of the Secretary of State in his absence)

6 May 1981

CONFIDENTIAL

E.R.

A

Q. To ask the Secretary of State for Northern Ireland if he will make a statement clarifying the outcome of the review of electricity policy in Northern Ireland having regard to the Prime Minister's commitment of 5 March to bring Northern Ireland electricity charges more closely into line with those in England and Wales and to keep them there.

A. Mr rt hon Friend the Prime Minister indicated in Belfast on 5 March that the Government has accepted, in the light of its review of electricity policy, that the present differentials in electricity tariffs between Northern Ireland and England and Wales constitute an unreasonable burden on the Northern Ireland community and that tariffs in Northern Ireland should be brought more closely into line with those in England and Wales and kept there. Without assistance from public funds a tariff increase of the order of 35% would have been required on 1 April.

In fulfilment of this undertaking I have asked the Northern Ireland Electricity Service to limit this year's tariff increases to produce the following results:-

(a) Charges to industrial consumers to be on a par with the highest in England and Wales;

(b) Charges to domestic consumers (last year some 14% above the highest in England and Wales) to be not more than 5% above the highest in England and Wales.

From 1 April 1982 the remaining differential of 5% in domestic tariffs will be totally eliminated. These relationships will be maintained thereafter.

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It is estimated that the support required for the NIES in 1981-82 from public funds will be some £88m at outturn prices. £32½m is already provided in Northern Ireland's PES, the Contingency Reserve will contribute an additional £44.9m and the balance can be made available from the existing NI Programme (eg because of revised requirements for demand-determined services and the identification of additional receipts) without reducing the level of other services.

In the light of the review of electricity policy I have concluded that there would be no justification for completing the second stage of Kilroot power station as an oil-fired plant nor for incurring the additional costs which would be involved in its conversion to coal-firing. I have, however, asked the NIES to undertake, in conjunction with my officials, a comprehensive re-evaluation of its future policy on generating plant, consulting as appropriate the electricity supply industry in England and Wales and Scotland and other relevant energy interests such as the National Coal Board.

KL(O/R) to see MS

Nat Ind

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

01-211-6402

CONFIDENTIAL

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
Parliament Street
London SW1P 3HE

15 April 1981

INDUSTRIAL ELECTRICITY PRICES

I thought it might be helpful to our discussion tomorrow if I were to let you and other colleagues have my initial reactions to the proposal in Keith Joseph's paper on industrial electricity prices (MISC 56(81)1).

E(81) 14th Mtg Item 1 8.4.81.

We all recognised at last week's E Committee discussion the major difficulties in the way of any selective solution to the problem of industrial electricity prices. My original proposal (in E(81)39) was an attempt to minimise these by concentrating help on a limited number of companies. I recognised that selecting these companies would be difficult. Keith's paper confirms this and proposes an alternative and wider form of selection to overcome the difficulty.

I am grateful for his helpful suggestion. At the same time it must be recognised - as indeed the paper does - that this would not avoid the basic problems of such selective help (legal difficulties over payments to the esi; the undue preference statutes and likely EC complications). Indeed this proposal raises further problems; it would not satisfy those with the biggest price disparities with France and Germany; it excludes many companies (particularly in iron and steel) who have been complaining most strongly; it is only roughly based on the difference between prices and the esi's SRMC and could be criticised as inconsistent with our policy of economic energy pricing.

Nevertheless I should be prepared to take this proposal further if I could be convinced that it offered a solution that would satisfy our critics. We are already being told that the steps we have so far taken on industrial electricity prices are not enough. It would be foolish to offer more if this too were to prove inadequate. I have doubts about the proposal on this score. But we have not had time to look at the difficulties in detail. Perhaps officials could modify the proposal so that it better fits those companies Keith believes should be helped. In particular officials might identify those industrial sectors which Keith suggests can justify themselves economically.

I suggest therefore that officials should be asked to examine Keith's proposal on this basis and report back quickly. In the meantime I have asked mine to continue to explore as a separate issue the possibility of one-off solutions to the problems of individual companies (such as ICI) through the cheap coal route indicated in my E Committee paper.

I am copying this to the members of MISC 56 and to Sir Robert Armstrong.

D A R HOWELL

SP

SECRETARY OF STATE FOR EMPLOYMENT

MS

Caxton House Tothill Street London SW1H 9NA

Telephone Direct Line 01-213 6400 GTN 213

Switchboard 01-213 3000

Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
Treasury
Great George Street
LONDON SW1

13 April 1981

Dear Geoffrey

HORTICULTURE

I have been following closely the exchanges you have been having in recent weeks with Peter Walker and David Howell about the glasshouse sector of the horticultural industry. It seems to me from Peter's letter of 6 April in particular that the case for helping this industry to meet unfair competition from the Dutch, as the Germans, French and Belgians are doing, is a compelling one - and stronger than it was when we considered this question in E Committee in April last year. I hope therefore that it can be agreed that we should revert to the matter in E very soon.

I am copying this letter to the Prime Minister, members of E, the Secretaries of State for Scotland, Wales and Northern Ireland and to Sir Robert Armstrong.

Yours ever

Jim

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JS

SUBJECT.

10 DOWNING STREET

From the Private Secretary

10 April 1981

Dear John.

INDUSTRIAL ENERGY PRICES

At the meeting of the Ministerial Committee on Economic Strategy on 8 April the Prime Minister said that she would arrange for a group of the Ministers directly concerned to consider further the amount of the reduction of the duty on derv, and the timing of the amendment to the Finance Bill; the scope for further measures to reduce the cost of electricity to industrial users; and the possibility of reducing the prices of foundry coke.

The Prime Minister has decided that she will chair this group (MISC 56) and that the Members will be:-

Chancellor of the Exchequer
Secretary of State for Industry
Chancellor of the Duchy of Lancaster and
 Paymaster General
Secretary of State for Scotland
Secretary of State for Energy
Mr. Ibbs

Each member may, if he wishes, bring one official with him to meetings.

If it is necessary for the group to meet while the Prime Minister is away she would like the Chancellor of the Exchequer to take the chair.

I am sending copies of this letter to the Private Secretaries of each of the members of the Group, to Robin Ibbs and to Sir Robert Armstrong.

Yours ever,

Tim Lankester.

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

From the Secretary of the Cabinet

CP
PM typs for my signature
R

Mr. Lankester.

I spoke to Mr. Whitmore about this earlier today. On the basis of that discussion, the Secretariat think it might be useful for you to write to the Departments concerned on the lines of the attached draft.

DJWright 10/4

CONFIDENTIAL

D R A F T   LETTER FROM MR T P LANKESTER TO MR A J WIGGINS.

INDUSTRIAL ENERGY PRICES

At the meeting of the Ministerial Committee on Economic Strategy on 8 April the Prime Minister said that she would arrange for a group of the Ministers directly concerned to consider further the amount of the reduction of the duty on derv, and the timing of the amendment to the Finance Bill; the scope for further measures to reduce the cost of electricity to industrial users; and the possibility of reducing the prices of foundry coke.

2. The Prime Minister has decided that she will chair this group (MISC 56) and that the Members will be:-

Chancellor of the Exchequer
Secretary of State for Industry
Chancellor of the Duchy of Lancaster and Paymaster General
Secretary of State for Scotland
Secretary of State for Energy
Mr Ibbs

Each Member may, if he wishes, bring one official with him to meetings.

3. If it is necessary for the group to meet while the Prime Minister is away she would like the Chancellor of the Exchequer to take the chair.

4. I am sending copies of this letter to the Private Secretaries of each of the Members of the Group, to Robin Ibbs and to Sir Robert Armstrong.

T P LANKESTER.

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File AG

10 DOWNING STREET

From the Principal Private Secretary

SIR ROBERT ARMSTRONG

ENERGY PRICES

The Prime Minister has seen your minute AO4678 of 8 April 1981.

She has decided that she should chair the new group herself and she agrees that the other members should be those listed at the end of paragraph four of your minute. She is content for each Minister to bring one official with him.

The Prime Minister agrees that the group should be a MISC group and not a sub-committee of E.

FERW.

9 April 1981

AN

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Ref. A04678

PRIME MINISTER

No - I will chair the group. Agree composition MT

Energy Prices

The Ministerial Committee on Economic Strategy decided this morning to narrow down the range of options to be pursued to

(1) a reduction of the duty on derv in the Committee Stage of the Finance Bill;

(2) something on electricity prices for intensive energy using industries, preferably by adjustments of the tariff structure;

(3) foundry coke

and to remit these subjects for further study by a small group of Ministers.

2. This group may well need two or three meetings, but will not need, I think, to be a permanent body. I recommend therefore that it should be a MISC group, not a new Sub-Committee of E.

3. My impression this morning was that the Chancellor of the Exchequer would like to chair the group, and was thinking in those terms. You may well want to chair it yourself. But there are three reasons why it might make sense to leave it to the Chancellor:

(i) the group will almost certainly need to meet while you are away;

(ii) your diary is already very full between now and the time of your departure;

(iii) there may be something to be said for your not being in the chair of the small group, so that you may be, and be seen by your other colleagues to be, uncommitted to its recommendations when they come back to E.

4. The group should clearly include, besides the Chancellor, the Secretaries of State for Industry and Energy. As it will be concerned with issues of Parliamentary tactics on derv, the Chancellor of the Duchy ought to be on it. The Secretary of State for Scotland is the sponsoring Minister for the Scottish electricity boards, and I believe could make a useful contribution. I doubt

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whether the Secretary of State for Employment need be included, unless you want to add him for political reasons. Suggested membership, therefore:

Chancellor of the Exchequer

Secretary of State for Industry

Chancellor of the Duchy of Lancaster and Paymaster General

Secretary of State for Scotland

Secretary of State for Energy

Mr. Ibbs

5. I suggest that each Minister should be able to bring one official with him.

Why?
MT

— Spoke to the Prime Minister who accepted that there would be advantage in having expert advice available.
[illegible]

RA

ROBERT ARMSTRONG

Prime Minister.

Do you wish to take the chair? Or are you happy to leave it to the Chancellor?

Content with the proposed membership otherwise?

Agree the group should be a MISC group, rather than a sub-committee of E?

[illegible]

8th April, 1981

CONFIDENTIAL

A

Energy

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

Tim Lankester Esq
10 Downing Street
London SW1

7 April 1981

Dear Tim,

ELECTRICITY PRICES TO LARGE USERS

I attach the note on short run marginal cost pricing of electricity for which you asked this morning as a contribution to tomorrow's discussion of my Secretary of State's paper E(81)39.

I am copying this to the private secretaries to the members of E, the Secretaries of State for Scotland and Wales, the Chancellor of the Duchy of Lancaster, the Parliamentary Secretary to the Treasury and Sir Robert Armstrong.

Yours ever,

John

J D WEST
Private Secretary

ELECTRICITY PRICES TO LARGE USERS

1 This note discusses the extent to which a change to prices on the basis of Short Run Marginal Costs (SRMC) by the electricity supply industry would eliminate the price disparities identified in the NEDO Task Force Report.

2 This Report showed a wide range of price disparities (10-35% or more) for some large UK users of electricity with the greatest disparities for consumers with the biggest load factors. At lower load factors, particularly with Germany, the disparities narrowed or disappeared.

3 For those large users able to take advantage of the additional measures of flexibility announced in the Budget Statement and introduced by the industry from 1 April, the gap has been closed by up to 8%.

4 We have considered whether pricing by the electricity supply industry at SRMC for these large users would close the remaining gap which is still substantial (the attached Annex defines SRMC). The Electricity Council have confirmed that pricing at SRMC for the largest users with the highest load factors would reduce prices by around 5-10%. In general those with the largest load factors will benefit least. Thus pricing down to SRMC would not close the gap with continental prices for the largest consumers.

5 The basic reasons for the wide disparities with France and Germany are:-

(i) France: higher proportion of hydro and nuclear capacity at present (45% as against 14% UK), with the firm prospect of a predominantly nuclear system by 1985 (50% as against 12% UK). This results in a lower cost structure, with prices significantly below ours across all categories of consumer;

(ii) Germany: a lower cost base (eg brown coal) and a tariff structure in which the unit rates fall sharply as load factor increases. This results in prices to large users which are thought to be below SRMC. The German electricity supply industry is composed of many different utilities, and pricing practices are not uniform.

These cost differences have been magnified with the appreciation of sterling particularly over the past year.

6 If the supply industry were to price at SRMC levels to all monthly-billed industrial consumers this would reduce prices by about 25% and reduce the industry's revenue by about £850m. If this were to be confined to large users with a maximum demand of 20 MW or more (74 consumers in England and Wales) the figures would be 15% and £100m respectively. These include a number of users with a relatively low load factor, including some steelworks. There are only 16 consumers over 20 MW with a load factor in excess of 60%. Their prices are about 5-10% over SRMC.

7 Reference has already been made in para 7 of E(81)39 to the difficulties of following a selective approach. These apply whether selection is based on individual firms or a category of consumer. Almost inevitably, competing firms in the same sector would be treated differently. In addition the legal uncertainties over undue preference and in the European context-state aids to industry - could also apply. The electricity supply industry would seek compensation, for which there are no existing powers. The practical aspects of assisting a category of customers as discussed in this note, rather than selected individual firms as proposed in E(81)39, would need discussion with the industry.

Department of Energy
7 April 1981

ANNEX

SHORT RUN MARGINAL COSTS

SRMC is the additional cost of increasing output without capital expenditure to meet extra demand on the system.

2 This is primarily the fuel cost. It also includes an allowance for energy losses in the transmission and distribution system plus some associated repair, maintenance and manning costs of power stations. These short run costs vary considerably depending on the kind of power station being run at the margin to meet demand. They will be higher during the day and at times of peak demand and lower at night. The SRMC price to the individual customer will therefore vary with his pattern of consumption.

3 But in general the very large user will use electricity more continuously and will seek to manage his demand more effectively. If so his current price will include a smaller element of fixed costs and will be closer to SRMC levels, so that the difference between his current price and SRMC will be less. An average figure can be misleading as the load characteristics for these consumers are so varied. An indication of how widely these can vary even within the same

... industry was given in the NEDO Report (Table 12 attached).

TABLE 12

PROFILE OF LARGE INDUSTRIAL CONSUMERS

1 Distribution of Consumers by size and load factor

Max Demand in MW:-	1.0-2.5	2.5-5	5-10	10-20	20-40	40+	Total
load factors:-							
under 30%	349	92	35	13	5	9	503
30-50%	921	345	148	45	17	13	1489
50-70%	339	203	92	30	12	6	682
over 70%	47	44	34	24	8	4	161
Totals	1656	684	309	112	42	32	2835

2 Distribution in Major Industry Sectors

a by maximum demand (MW)

	1.0-2.5	2.5-5	5-10	10-20	20-40	40-100	over 100	Total
Chemicals	34	23	11	5	12	5	1	91
Iron & Steel	84	49	22	18	8	14	9	204
Paper & Board	38	37	13	3	3	-	-	94

b by % load factor

	Under 20	20-30	30-40	40-50	50-60	60-70	70-80	over 80	Total
i Over 1 MW									
Chemicals	9	10	12	8	21	20	6	5	91
Iron & Steel	42	52	59	26	19	4	2	-	204
Paper & Board	1	3	7	21	25	24	10	3	94
ii Over 20 MW									
Chemicals	3	-	2	-	2	1	4	6	18
Iron & Steel	-	6	11	2	7	5	-	-	31
Paper & Board	-	-	-	2	1	-	-	-	3

Sources:-

Electricity Council Surveys
for 1977/78 and 1978/79

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

John Wiggins Esq
Private Secretary to the
Chancellor of the Exchequer
Parliament Street
London SW1P 3HE

7 April 1981

Dear John,

DERV PRICES

As you will know there has been considerable concern over the relative level of UK DERV prices compared to other EEC countries following the Budget changes. The greater part of the differences arises from our higher duty levels but there has also been criticism of the relative level of net prices charged by the oil companies.

In part this has focussed on figures which were given in a recent written reply to a PQ by Michael Brown on retail DERV prices (reproduced in column 1 of the annex). Retail prices are not typical of the UK market where it is estimated that about 83% of consumption is sold under contract at rebates equivalent to about 15p/gallon off retail prices. Continental consumers also enjoy comparable rebates on their contractual purchases which are however typically a smaller proportion of consumption (estimated to range from 35% in Italy up to 65% in Germany). When account is taken of different purchasing patterns the disparity in overall average net prices is substantially reduced (column 2 of the annex).

My Secretary of State has considered whether to give these figures some wider circulation, eg through an arranged PQ, but has concluded that to do so would simply draw further attention to the continuing wider disparity in duty inclusive prices. In responding to questions however we intend to make the following points:

(a) the oil companies did not raise DERV prices in their latest increases; in taking account of competition in the market some of them have also acknowledged to us that the disparity with the rest of the EEC was a factor in their decision;

(b) the effects of sterling appreciation have also overstated increases in the UK when prices are converted into a common currency; when expressed in national currencies figures produced by the European Commission show that UK consumers have faced a lower overall percentage increase in DERV prices than other members since the beginning of 1978.

I am copying this letter to Private Secretaries of Ministers on E Committee, and to Godfrey Robson and John Craig.

Yours ever,

John

J D WEST
Private Secretary

Annex

DERV - estimated net prices, p/gallon

	retail sales[1]	average, including[2] commercial and contract
Belgium	68.5	61.8
Denmark	69.2	-
F R Germany	64.9	55.8
France	62.9	60.4
Ireland	68.2	-
Italy	60.9	55.1
Netherlands	65.1	60.6
USA	59.6	-
UK	77.2	65.1

1 As at 16 March (US: 16 February); EEC Weekly Bulletin and "Oil and Gas Journal"

2 As at end February: Private estimates provided by Oil Prices Assessments Ltd.

01-405 7641 Ext. 3417
Communications on this subject should be addressed to
THE LEGAL SECRETARY
ATTORNEY GENERAL'S CHAMBERS

ATTORNEY GENERAL'S CHAMBERS,
LAW OFFICERS' DEPARTMENT,
ROYAL COURTS OF JUSTICE,
LONDON, W.C.2.

Our Ref: 400/81/72

7 April 1981

G Claydon Esq
Department of Energy
Thames House South
Millbank SWI

Dear Claydon,

FRIGG OIL AGREEMENT

not copied to us

With reference to Denys Long's instructions of 2 April, I have now taken the Attorney General's views on the proposal to remit HFO duty on parts of manufacturing industry accounting for about 30% of total consumption (on 1980 figures).

2. On the basis of his earlier advice to the Chancellor of the Exchequer (copy attached), the Attorney General thinks that remitting HFO duty to this extent results in a proportion far enough below the "danger" level of 50% mentioned in that advice to allow a reasonable chance that the Frigg contract would not be affected. Or, putting it another way, to allow a reasonable chance that a court or tribunal would hold that the contract was not frustrated <u>and</u> that the value of "S" in the price formula remained the same.

3. The Attorney General has commented, however, on what could happen if in future years the consumption of exempted users increased relative to non-exempted users. For example, suppose that in 1981 the steel industry reverted to its 1979 level of consumption but the 1980 figures were maintained for other users; this would result in the exemptions for 1981 rising from about 30% to about 34% of the total consumed. And the increase could rise much closer to the "danger" level if the growth of consumption in the steel industry were matched by that of other exempted users in the manufacturing sector, but not by that of users in other categories.

4. It is of course very improbable that precisely such changes would take place but these examples illustrate that the 30% criterion is good only in respect of the 1980 figures and that the proposal to exempt particular users will have different effects in succeeding years according to the growth and pattern of consumption. The Attorney General's views must therefore be on the basis of exemptions covering 30% or about 30% of the total consumed, and cannot be taken as "proofing" the situation for 1981 or any future years.

/5. You

01-405 7641 Ext.

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THE LEGAL SECRETARY
ATTORNEY GENERAL'S CHAMBERS

ATTORNEY GENERAL'S CHAMBERS,
LAW OFFICERS' DEPARTMENT,
ROYAL COURTS OF JUSTICE,
LONDON, W.C.2.

5. You also mentioned to me yesterday another factor, namely that exemptions are presently running at a figure of less than 10% of the total consumed, so that exemptions raising that figure to 30% would represent a large "quantum leap". The Attorney General agrees that this is so but would not regard it as sufficient to frustrate the contract or alter the value of "S". Powers of exemption were in force and had been exercised at the time the Frigg contract was entered into and the parties must be taken to have been aware, at that stage, that the coverage of the exemptions could be altered at any time under these (now consolidated) powers. The Attorney General does not believe that the new proposal would amount to a material change of circumstances sufficient to frustrate the contract in the sense that its performance would thereby be rendered entirely different from what the parties contemplated at the outset (one of the tests of frustration).

6. Although the Attorney General's advice is basically favourable, it is subject to three "caveats".

(1) In forming his views the Attorney General has relied heavily on the conclusion reached by the Working Group on Fuel Oil and Gas Oil Duties that an international tribunal applying the ICC Rules (the most likely forum for challenging the proposal) would interpret references in the contract to "the excise tax" as references to "the duty levied on the majority of the oil consumed". The Attorney General has no reason to doubt this conclusion but has no means of assessing it independently;

(2) It does not follow from the fact that a court or tribunal might conclude that "S" in the price formula was unchanged by the proposal that the Norwegians would not respond initially by challenging it; litigation could take a long time and be very disruptive but your clients are probably in the best position to guage this.

(3) It follows that the Attorney General can give no guarantee either that the Norwegians would not litigate or that a court or tribunal would uphold HMG's position; your Secretary of State would have to be prepared to take a calculated risk, although the Attorney General's assessment is that his chances of success would be better than even.

7. Since this subject is to be taken at "E" Committee tomorrow ((see paragraph 3(a) of paper E(81)39)), and the Attorney General may not be present as he may be out of the country, I am copying this to the Private Secretaries to all members of "E" and to the other Ministers who are invited - the Secretaries of State for Scotland and Wales, the Chancellor of the Duchy and the Parliamentary Secretary Treasury. Also to the Chief Whip's Private Secretary and to Sir Robert Armstrong.

Yours sincerely
J R Mallinson
pp J R Mallinson

ATTORNEY GENERAL

ROYAL COURTS OF JUSTICE
LONDON, WC2A 2LL

01-405 7641 Extn 3201

CHANCELLOR OF THE EXCHEQUER

EXCISE DUTY ON HEAVY FUEL OIL AND THE PRICE OF GAS UNDER THE FRIGG AGREEMENT

I understand that you have asked for my urgent advice on how far you can go in removing this excise duty to help manufacturing industries without affecting the price of Frigg gas. Obviously there has been no time to consult those with experience of international arbitrations or to search for precedents (though the Frigg price formula does not resemble anything I have seen before). My views are as follows.

If you were to introduce a lower rate for certain categories of user, it would no longer be possible to discover "the excise tax" needed to calculate the price of Frigg gas. I think the definition of "S" excludes the possibility of equating "S" to the average duty paid in the United Kingdom on heavy fuel oil. To have two rates of duty would lead to a dispute which would be referred under the Agreement to arbitration. The arbitrators would be likely to hold that it was no longer possible to make the price formula work and that the change had undermined the basis on which the Agreement rests. The result would be the need to re-negotiate a new price formula.

If you were to deal with the problem by allowing the oil to be delivered to the favoured users without payment of duty, there would still be only one figure which could be substituted for "S" in the price formula. If, however,

/the

ATTORNEY GENERAL

ROYAL COURTS OF JUSTICE
LONDON, WC2A 2LL

01-405 7641 Extn

the proportion of oil delivered without payment of duty became large enough, the Norwegians could claim that the present exceptions (no doubt regarded as de minimis when the Frigg Agreement was negotiated) had become the rule and that this was a change which undermined the basis on which the Agreement rests. At what proportion do we reach the point at which this argument would prevail? I cannot give a definite answer. The nearer the proportion of duty-free oil approaches 50% of the total, the more dangerous our position. I think that it would be wise to assume that if the proportion reached 50%, we would be faced with re-negotiation. No doubt in considering where to draw the line it will be necessary to consider also the effect of the proposed change on current negotiations with the Norwegians on other matters.

M.H.

23 February 1981

Ref: A04661

CONFIDENTIAL

PRIME MINISTER

Supplementary Brief on Energy Prices

This is an aide-memoire on the points which emerged at your briefing meeting this morning in so far as they bear on Mr. Howell's specific proposals on energy prices. The two main difficulties foreseen were:-

(a) The stand on the fuel oil and DERV duties taken by the Chancellor in the Budget speech.

(b) The practical difficulties of defending selective help to named companies and industries against the assaults of those excluded from relief.

2. Against this background the tentative judgments reached on Mr. Howell's specific proposals were:-

(a) Heavy fuel oil: Leave alone. This not only because of the problem of discrimination and possible difficulties with the Frigg contract but also because the tax is, in reality, more one on the producer than the consumer.

(b) Derv: An across the board cut of, say, 5p is a starter. The benefit, though modest, would work through to many companies and consumers dependent on road transport. Cost approximately £50 million.

(c) Gas: Action already taken probably suffices for the time being. Review in the autumn.

(d) Electricity: Across the board cuts too expensive but discrimination in favour of named companies too difficult. Preferred solution to devise a new tariff which would aid the heavy users without requiring them to be separately identified in advance. Robin Ibbs is pursuing with Department of Energy.

See D/Energy note at flag A

(e) Foundry coke: A clear case for action with limited cost. Possible complication arising from the fact that National Smokeless Fuels is a limited company and cross subsidisation by NCB therefore difficult. But ingenuity should find a way. Department of Energy to be asked to explore.

3. Longer-term issues. Among those identified were:-

(a) Speed up the PWR programme.

(b) Break up the Coal Board into regional units.

(c) Break the gas monopoly.

(d) A renewed drive for greater efficiency in the nationalised fuel industries.

RTA

Robert Armstrong

7th April 1981

Nat Gas & Electric

2

MINISTRY OF AGRICULTURE, FISHERIES AND FOOD

WHITEHALL PLACE, LONDON SW1A 2HH

From the Minister

CONFIDENTIAL

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

6 April 1981

Dear Geoffrey,

My many thanks for your letter of 25 March in response to my minutes of 5 and 18 March.

As you know, I wrote these minutes because I was concerned that in the Neddy Report on energy and industry it was clearly disclosed that the fishing industry and horticulture were the two most suffering industries.

We have, of course, dealt with the fishing industry by giving grants of a nature that can, if they wish, go towards meeting their massively increased fuel bills.

I think you will agree that the measures you announced on 10 March regarding electricity and gas charges to industrial users quite clearly recognise the arguments of industry and for a number of industries improve their situation.

We are, however, left with a situation in which one industry, namely the horticulture industry in which 40% of its direct costs goes on heating, is being destroyed by a powerful Dutch horticulture industry who are paying 30% less for their glasshouse heating than our own producers, giving the Dutch producer an advantage of something like 9 pence per pound on a tomato crop.

The results are quite clear. The import of Dutch tomatoes last summer was 60% up in volume on the previous year. The result of this was that the British horticulture industry operated at a substantial loss, particularly as since 1978 fuel prices have advanced by two-thirds.

Such is the ghastly distortion of competition which results from this situation that the Commission have given permission for national aids to be granted in order that national industries can survive during the period that the Dutch differential remains.

The only other three countries adversely affected by the Dutch action and the Commission's permission are Germany, France and Belgium, all three of which have decided to proceed with national aids in accordance with Commission agreement and aids which they consider are sufficient to guarantee the survival of their industries during this period of unfair competition.

It is because of the unique nature of this problem, the fact that it is temporary and the fact that the Commission have approved of action being taken that David Howell has supported me in the view that an "adaptation" aid should be provided.

David Howell has further pointed out that other European countries have recognised the importance of supporting their industries to the extent approved by the Commission, and that the proposition is not for the payment of an operational aid but for transitional aid for a fixed period to enable an essentially viable industry to withstand the temporary competitive pressure it is facing.

You will know from Press reports that recently I have had 2,000 small businessmen in the glasshouse sector demonstrating outside my Ministry, genuinely arguing that the Governments of France, Belgium and Germany have recognised the problem involved and that we have not.

In this context I must reply to Keith's letter for three reasons. Firstly, Community countries are not giving any energy aid to other industries because there is no European country that is providing the low cost energy to other industries that the Dutch Government are providing to their horticulture. Secondly, the green pound he mentions does not apply to tomatoes and, thirdly, such disciples of the free market as Germany, Belgium and France all consider that this aid is necessary.

But I must also ask Keith one further crucial question, that having made massive losses in 1980 and being certain of bankruptcy in 1981, is it really in the interests of our economic strategy to refuse to give an aid that France, Germany and Belgium are providing and so destroy hundreds of small businesses and become a permanent importer of the crops they previously produced.

CONFIDENTIAL

I would be grateful if we could have urgent discussions with either you or Leon Brittan on this problem, if you prefer in E Committee.

I am copying this letter to the Prime Minister, members of E Committee, and to the Secretaries of State for Scotland, Wales and Northern Ireland.

PETER WALKER

A04646

PRIME MINISTER

Industrial Energy Prices
E(81) 39

BACKGROUND

The Secretary of State for Energy argues, in E(81) 39, that the Budget measures are seen as an inadequate response to the problems of industrial energy prices and that further assistance is now needed.

2. The main relevant Budget measures were -

Increases

20p increase on petrol duty - yield £910 million a year.
20p increase on derv duty - yield £270 million a year.

Concessions

	£ million
Increase in Gas External Financing Limit	73
Increase in Electricity External Financing Limit	45
Grants for conversion of oil fired boilers to coal use	50
Total	168

The increase in the gas and electricity EFLs were directed to helping large industrial users.

3. The Secretary of State for Energy now proposes -

(i) Remitting 100 per cent of the duty on heavy fuel oil to selected energy intensive industries (his paragraph 3a and Annex A) - cost £40-50 million.

(ii) Reducing duty on derv by 3p/4p below that on petrol (paragraph 3b) - cost £40-55 million.

(iii) Reductions in electricity prices to selected industrial users (paragraph 7 and Annex B)
- cost £50 million plus.

(iv) Assistance for one-off schemes (paragraph 8)
- cost unquantified (and indeed the nature of the schemes left very vague).

(v) Subsidy of foundry coke (paragraph 9)
- cost £10 million.

Total cost, say, £150 million plus a year.

4. The Secretary of State for Energy has rejected across-the-board gas and electricity price cuts for industrial users mainly on the grounds of the very high costs - paragraph 5 of his paper. While the selective approach provides for assistance to be channelled to those which most obviously need it, and for the overall costs to be reduced, it raises a number of difficult questions over the basis of selection of the firms or sectors to be helped, the legal constraints of such help, the legislation to provide for that help, the need to avoid EC complications, and problems of confining the assistance both in terms of time and of the industries to be covered. I suggest that the Committee will need to consider these problems in relation to each of the measures proposed by the Secretary of State for Energy and I list below some of the points which you might wish to cover.

HANDLING

5. After the Secretary of State for Energy has introduced his paper, you might invite the Chancellor of the Exchequer to give his general views on -

(i) The problems of introducing so soon after his Budget further measures which would increase the PSBR by around £150 million and the public expenditure totals by around £50 million a year.

(ii) The possibilities for any offsets to those increases.

(iii) Whether, if concessions of this order are to be made, he judged that priority should be given to the proposals put forward by the Secretary of State for Energy.

(iv) His general willingness to be seen to reverse engines so quickly on his Budget proposals affecting diesel and heavy fuel oil.

The Chancellor of the Duchy of Lancaster, the Chief Whip and the Secretary of State for Industry will all probably wish to give their views on the general case.

6. You might then turn to the particular proposals and work through them with a view to deciding which measures the Committee supports in principle and which, therefore, should be the subject of further and more detailed proposals. In particular you will wish to consider what should be the basis of selecting the firms to be helped, how difficult it will be to hold the line, and how realistic it is to assume that the concessions could last for one year only. They will have to cover the whole of the United Kingdom and the costs may turn out to be higher when the calculations are done for Scotland and for Northern Ireland.

7. On the proposed concession on heavy fuel oil the Secretary of State for Energy should be able to report what advice he has had from the Attorney General on whether there would be any complications over the Frigg gas contract. An amendment would have to be made to the Finance Bill, either to provide for exemptions to be made by order or listing those firms or sectors to be exempted. Further work involving the Departments of Energy, and Industry and the Treasury, would be necessary to select the exemptions. You might ask whether there is any risk that, if duty exemptions were to be made, the oil companies would take the opportunity to increase the underlying price. You might also ask whether our fuel oil market is as competitive as it might be. At an earlier stage there were suggestions that a reference to the Monopolies Commission might be useful. Is there any mileage in this?

8. A cut in the duty on derv would be easier in legislative terms since it would be across-the-board. The amendment to the Finance Bill would, however, have to provide against concessions retrospective to the date of the Budget,

otherwise there would be severe administrative difficulties. You will wish to probe the industrial case for this concession - its effects would appear to be widely and thinly spread through reductions in transport costs - and, again, whether there is any risk of the companies taking the opportunity to push their prices up higher than otherwise.

9. If there is to be selective help on industrial electricity prices the Committee will again need to consider which are the firms and sectors to be helped and for how long. The costing of £50 million plus is very much a guess by the Department of Energy, and further work will be necessary on it. There is a risk that a selective approach could be challenged in the Courts - most probably by those industrial users not selected, or by domestic consumers if there were any suspicion of cross-subsidies - on the grounds that it represented undue preference and discrimination contrary to the statutes. The electricity supply industry would therefore need Government assurance of amending legislation if there were such a legal challenge. The implication of paragraph 3 of Annex B is that the National Coal Board might have their EFL increased to enable them to supply cheaper coal to the CEGB who would then supply large industrial consumers directly; this, too, needs further examination.

10. It is not clear whether assistance of one-off schemes, as proposed in paragraph 8 of the paper, would be necessary if the main proposal of selective assistance to large industrial customers were to be implemented.

11. You will wish to establish how the £10 million to enable National Smokeless Fuels Limited to reduce the prices of their foundry coke would be found.

CONCLUSIONS

12. In the light of the discussion you will wish to reach conclusions on the general case for new measures of financial assistance to industrial energy users and on each of the particular proposals put forward by the Secretary of State for Energy.

13. You will also wish to commission further detailed work on each of the proposals which the Committee wants to be pursued. The aim would be to clarify the financial, legislative, and EC implications and to put forward firm proposals as a basis for implementation. You will wish to indicate how quickly this work should be completed; and this, in part, will be determined by the need to amend the Finance Bill in time. You might ask the Chancellor of the Exchequer to take the lead on those items involving amendment to the Finance Bill consulting the Secretary of State for Industry, who will be heavily involved in the selection of exempted industries, and the Secretary of State for Energy. The Secretary of State for Energy might take the lead for the remaining items consulting the Chancellor of the Exchequer and the Secretary of State for Industry and also, as necessary, the Secretaries of State for Scotland and for Northern Ireland.

RTA

Robert Armstrong

6 April 1981

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

Note: reply after E mtg.

T P Lankester Esq
Private Secretary
10 Downing Street
London
SW1

6 April 1981

BF 9/4

Dear Tim,

I enclose a draft reply to Mr Horner's letter of 20 March to the Prime Minister about energy prices which you sent me on 23 March.

The correspondence is the subject of a question from Sir David Price down for oral answer (but unlikely to be reached) by the Prime Minister on 7 April. Ministers will not by then have considered collectively the proposals for further concessions which my Secretary of State is bringing before E. But it would be possible, if the Prime Minister prefers, to delay replying to the CIA until decisions have been taken on these.

Also enclosed, for your background information, are notes on the CIA's estimates of the cost disadvantages they face and the value of the Budget concessions.

I am copying to John Wiggins whose officials have already consulted ours.

Yours ever,

J D WEST
Private Secretary

Enc

PRIME MINISTER

This memorandum deals with the principles of energy pricing (paragraphs 1-4) and the Department of Energy's suggestions in their memo (paragraph 5). This is for the meeting at 10.00 on Tuesday, 7 April 1981.

AW

6 April 1981

cc Mr. Hoskyns
Mr. Wolfson
Mr. Duguid
Mr. Strauss
Mr. Lankester

MEMORANDUM ON THE PRICE OF ENERGY

1. Basic Principle

The main point is that the prices of energy should behave as they would do in a perfectly free, competitive environment. For a given supply of energy on the market the price should be such that that quantity is distributed to the people who most value it. The price of a given supply then is determined by demand. The rule of the energy authorities is to supply energy such that the supply price is equal to the demand price and equal in turn to the additional costs of getting the most expensive unit of energy to market.

The cost of supplying energy in1981 includes not only the resources, such as labour and capital, used up; we must also take account of the fact that the quantity of energy available for future years will be thereby diminished. This can be thought of a simply a royalty payment for energy extraction today. That royalty payment will depend upon the expected future levels of energy and other prices and the expected costs of recovery.

2. Arguments for reducing energy prices

There is a valid argument that some forms of indigenous energy in the United Kingdom should be priced lower than those of our competitors. The most obvious case is where we have domestically produced energy sources and the energy is exported, such as in the case of North Sea Oil. Our energy price should be below the delivered price in foreign ports by the amount of the freight charge. But that is the only difference. If the price in the UK were below this level, then we should be denying ourselves the higher volume of resources which we will get by exporting that energy to foreigners and we shall be using it inefficiently in domestic consumption.

If per contra we have an energy source that is imported then there is, of course, no reason why the price for domestic users should in any way differ from the ordinary international market price with the freight elements added it.

/There are, of course,

There are, of course, more problems with an energy source that cannot conceivably, that is to say at any constellation of relative prices, be exported. Such may be the case with certain natural gas components. The principle, however, is that one should price the natural gas according to the extent to which it is substitutable for a traded energy source, such as oil. This amounts to very much the same thing as saying that, for a given supply of gas, the price should be such that it just clears the market - that is to say there is little or no interruption in supply. (There may of course be contracts where such interruption is negotiated.) Then the supply, and the rate of depletion of our gas reserves, should be determined in the same way as those for oil discussed above. The notional royalty payment should reflect the expected future prices and costs of energy. As before these are primarily determined by expected world market prices for energy sources, and I suppose one also should take into account the probabilities of political disruption, although in principle these should be also reflected in expected future market prices.

3. Invalid reasons for lowering energy prices in the UK

There is no reason at all, except that discussed above, why the energy price of an indigenous source should be less than that of an imported source of energy. In fact if the two sources are not perfect substitutes then there may very well be a good reason for keeping the price of domestic non renewable energy above that of the imported source. This will economise on domestic supplies and they can be regarded as the effective store against future expected political or natural events which may interrupt foreign supplies in the future. In other words there is an argument for having a somewhat lower rate of depletion than a simple calculation of economics might produce.

A second argument for keeping domestic prices low is to help in the fight against inflation. The contrary is true, it will exacerbate inflation. Inflation is brought about by the continuous pressure of monetary demand. This causes a continuous and persistent increase in the price level. A once and for all, "at a stroke"

/reduction in the price

reduction in the price level will in fact release more of the existing money demand to drive up the prices of goods other than oil and other energy goods. The effect is not only to transfer price increases to other goods but to reinforce them.

On an accounting level, it is clear that the reduction of energy prices, insofar as they are publicly produced, will give rise to an increase in the public sector borrowing requirement. This gives rise to the usual problems: it will have to be financed either by borrowing long dated gilts, so driving up interest rates, or by increasing the money supply. This is, of course, the normal source of inflationary pressure.

4. Advantage in foreign trade

It is often argued that our competitors, the French, the Germans and particularly the Americans, subsidise the use of energy in industry. If we do not do so our industry will be disadvantaged relative to the industries of our competitors. We shall lose markets and this will generate unemployment, falling on the PSBR, and so generate inflation. Again this argument is erroneous. If the Americans subsidise the energy industries then necessarily they are taking money from other low energy industries in order to provide the subsidies. Their energy intensive industries will expand too much at the expense of the energy efficient industries. If America wishes to supply Britain with energy, congealed in energy intensive goods, at lower prices than the international market price, then we should indeed welcome it and we should adapt our industry accordingly. (I am assuming that this is not a short term operation merely to damage our industry and for the Americans to get markets, after which they will put up the price of their products.) It seems impossible to complain of being allowed to buy energy intensive goods at below market price. Furthermore if, as everyone argues, the price of energy in real terms is going to continue to increase then our industry, adjusted to a low energy intensive profile, is likely to be in a much better position in the future than those over-expanded energy intensive industries in the United States etc. Indeed it might be argued from this that there is some case for imposing a tax on energy over and above its international price. I would, however, argue against this because I believe that the free market is probably a much better judge of future energy prices than anyone else. The best way to "help industry" is to maintain monetary stability, reduce the PSBR and the level of interest rates. This will not discriminate in favour of energy intensive industries and will provide a healthy basis for expansion of an energy-efficient economy. It is probably true that energy intensive industry will give a very small increase in employment per £1million subsidy whereas other industries will generate many more jobs.

5. The Department of Energy suggestions

a. Budget Assistance

i. HFO

The argument that HFO should be remitted but only for a select group of heavy users (paper, chemicals, textiles, etc) is highly discriminatory and favours large firms with energy intensive processes. If we can get away with 30% on the Frigg contract, then it would be better to spread the benefit equally over all HFO users (I do not know the legal constraints here.)

ii. 3/4 pence off the 20p tax increase on DERV

This is among the more attractive of the proposals. It avoids discrimination against small business, and generally reduces the costs of the highly competitive road haulage trade. Road haulage is an input into virtually all industries, especially building and contracting. A tax increase of 16 or 17 pence will be still greater than valorisation.

b. Non Budget proposals

iii. Lower electricity prices to selected bulk users

This seems to be the worst of the Department of Energy's suggestions. The evaluation of fuel prices at the present low DM and high sterling may mean that the margin is quite transitory and could disappear in a few weeks or months. It is not clear whether the relatively high electricity prices to customers with super-loads etc are due to fears of undue preference in the UK or to subsidies on the continent.

/If the continent

If the continent supplies this bulk electricity at a discount below short run marginal cost, then there is no reason why we should make the same mistake. If, however, Swedish or Norwegian hydro electricity is low cost, must be consumed near source and so is cheap relative to fossil electricity, then it is best not to subsidise our paper or glass industries to match their energy costs.*

A good case for reducing tariffs exists if electricity to bulk users is priced well above short run marginal costs It may well be that the fear of charges of "undue preference" prevents the esi from reducing tariffs to retain demand. Then there should be room for negotiation - rather like that practised by the NCB with its large customers - to ensure mutually profitable deals. (The present prices may be too high if there is considerable excess capacity, and, as normally planned, the tariffs are designed to cover the amortized capital costs of the generating and distribution plant.) This needs to be probed. But this should not be allowed to increase the PSBR. It will give flexibility to save demand which would otherwise disappear - but still they will contribute a profit to the esi.

iv. Foundry Coke (NSF Ltd.)

The problem here is the over-capacity of the continuous process - it is now working at about 50% of capacity. Loading the long run marginal costs on this low throughput have given the NSF high costs which cannot be cross subsidised. This is quite a small item (about ½million tonnes) with transitory problems with respect to the ECSC subsidy. The Department of Energy does suggest an appropriate policy. The fault is the over-capacity (as in BSC) and the price must be internationally competitive. The losses ought to be written off.

*This does not mean that the industries will necessarily locate in Scandinavia - Japan, for example, imports timber from Oregon and exports plywood to California, because she is very efficient.

c. Gas

I agree with the Department of Energy.

d. General

The exchange rates play an enormous role in these relative prices. Any subsidy ought to be conditional upon exchange rate movements. A formular could be derived which made the subsidy vary with the appropriate basket of exchange rates.

6 April 1981

MR LANKESTER

Nat Industries Gas & Elec

MEMORANDUM ON THE PRICE OF ENERGY

1. Basic Principle

The main point is that the prices of energy should behave as they would do in a perfectly free, competitive environment. For a given supply of energy on the market the price should be such that that quantity is distributed to the people who most value it. The price of a given supply then is determined by demand. The rule of the energy authorities is to supply energy such that the supply price is equal to the demand price and equal in turn to the additional costs of getting the most expensive unit of energy to market.

The cost of supplying energy in 1981 includes not only the resources, such as labour and capital, used up; we must also take account of the fact that the quantity of energy available for future years will be thereby diminished. This can be thought of as simply a royalty payment for energy extraction today. That royalty payment will depend upon the expected future levels of energy and other prices and the expected costs of recovery.

2. Arguments for reducing energy prices

There is a valid argument that some forms of indigenous energy in the United Kingdom should be priced lower than those of our competitors. The most obvious case is where we have domestically produced energy sources and the energy is exported, such as in the case of North Sea Oil. Our energy price should be below the delivered price in foreign ports by the amount of the freight charge. But that is the only difference. If the price in the UK were below this level, then we should be denying ourselves the higher volume of resources which we will get by exporting that energy to foreigners and we shall be using it inefficiently in domestic consumption.

If per contra we have an energy source that is imported then there is, of course, no reason why the price for domestic users should in any way differ from the ordinary international market price with the freight elements added in.

There are, of course, more problems with an energy source that cannot conceivably, that is to say at any constellation of relative prices, be exported. Such may be the case with certain natural gas components. The principle, however, is that one should price the natural gas according to the extent to which it is substitutable for a traded energy source, such as oil. This amounts to very much the same thing as saying that, for a given supply of gas, the price should be such that it just clears the market - that is to say there is little or no interruption in supply. (There may of course be contracts where such interruption is negotiated.) Then the supply, and the rate of depletion of our gas reserves, should be determined in the same way as those for oil discussed above. The notional royalty payment should reflect the expected future prices and costs of energy. As before these are primarily determined by expected world market prices for energy sources, and I suppose one also should take into account the probabilities of political disruption, although in principle these should be also reflected in expected future market prices.

3. Invalid reasons for lowering energy prices in the UK

There is no reason at all, except that discussed above, why the energy price of an indiginous source should be less than that of an imported source of energy. In fact if the two sources are not perfect substitutes then there may very well be a good reason for keeping the domestic source price above that of the imported source. This will economise on domestic supplies and they can be regarded as the effective store against future expected political or natural events which may interrupt foreign supplies in the future. In other words there is an argument for having a somewhat lower rate of depletion than a simple calculation of economics might produce.

A second argument for keeping domestic prices low is that to help in the fight against inflation. The contrary is true, it will exacerbate inflation. Inflation is brought about by the continuous pressure of monetary demand. This causes a continuous and persistent increase in the price level. A once and for all, "at a stroke" reduction in the price level will in fact release more of the existing money demand to drive up the prices of goods other than oil and other energy goods. The effect is not only to transfer price increases to other goods but to reinforce them.

On an accounting level, it is clear that the reduction of energy prices, insofar as they are publicly produced, will give rise to an increase in the public sector borrowing requirement. This gives rise to the usual problems: it will have to be financed either by borrowing long dated gilts, so driving up interest rates, or by increasing the money supply. This is, of course, the normal source of inflationary pressure.

4. Advantage in foreign trade

It is often argued that our competitors, the French, the Germans and particularly the Americans, subsidise the use of energy in industry. If we do not do so our industry will be disadvantaged relative to the industries of our competitors. We shall lose markets and this will generate unemployment, falling on the PSBR, and so generate inflation. Again this argument is erroneous. If the Americans subsidise the energy industries then necessarily they are taking money from other low energy industries in order to provide the subsidies. Their energy intensive industries will expand too much at the expense of the energy efficient industries. If America wishes to supply Britain with energy, congealed in energy intensive goods, at lower prices than the international market price, then we should indeed welcome it and we should adapt our industry accordingly. (I am assuming that this is not a short term operation merely to damage our industry and for the Americans to get markets, after which they will put up the price of their products.) It seems impossible to complain of being allowed to buy energy intensive goods at below market price. Furthermore if, as everyone argues, the price of energy in real terms is going to continue to increase then our industry, adjusted to a low energy intensive profile, is likely to be in a much better position in the future than those over-expanded energy intensive industries in the United States etc. Indeed it might be argued from this that there is some case for imposing a tax on energy over and above its international price. I would, however, argue against this because I believe that the free market is probably a much betterjudge of future energy prices than anyone else.

3 April 1981

cc Mr HOSKYNS
MR WOLFSON
MR DUGUID
MR STRAUSS
MR LANKESTER

CONFIDENTIAL

file UB/X/Ro

SUBJECT.

10 DOWNING STREET

From the Private Secretary

3 April 1981

cc. Master set.

NORTHERN IRELAND ELECTRICITY SUBSIDY

As you know, the Prime Minister held a meeting this morning with your Secretary of State and the Chief Secretary to discuss the question of the Northern Ireland electricity subsidy. They had before them Sir Keith Joseph's minute of 31 March reporting on the E(EA) discussion on this subject on 26 March.

Mr. Atkins explained the difference of view which had emerged at the E(EA) meeting. There was agreement on industrial tariffs, and also on the level of domestic tariff as from 1 April 1981; but there was disagreement on the level of domestic tariffs for later years. He had suggested that domestic tariffs should be brought down to the highest tariffs in England and Wales within two or three years; the Chief Secretary, supported by other members of the Committee, had argued that any commitment on domestic tariffs should go no further than indicating that they would not be more than 5 per cent above the highest level in England and Wales following the 1981 changes, though the possibility of further reductions would be kept under review.

Mr. Atkins went on to say that he was most concerned about the political reaction which was likely to follow if only the Chief Secretary's proposals were adopted. He did not believe that the latter would be regarded in Northern Ireland as fulfilling the commitment which the Prime Minister had made in her recent speech in Belfast. He very much hoped, therefore, that the Prime Minister would agree that domestic tariffs should be brought down to five per cent above the highest in England and Wales immediately and preferably to the highest level itself in 1982. He recognised that the proposed subsidy would be expensive; but it would not be possible to find substantial savings from other Northern Ireland programmes, and therefore the bulk of the money would have to come out of the contingency reserve.

The Chief Secretary said that there were essentially two issues. First, there was the question of money: the extra expenditure implicit in his own proposal would be very considerable, and it would be even more costly if Mr. Atkins' proposal was accepted. He felt that his proposal would be taken as fully consistent with the Prime Minister's statement that Northern Ireland electricity tariffs would be brought "more closely into line with those in England and Wales", and thus defensible. Whatever level of subsidy was decided, he would have to ask the Northern Ireland Office to make a substantial contribution towards it out of their other programmes. Secondly,

CONFIDENTIAL

/there was

there was the question of whether the Northern Ireland tariff should be related to the highest or to the average tariff in England and Wales. His impression had been that the Northern Ireland Office had been pressing for a relationship with the average tariff. In the Treasury's view, it would be far more defensible to relate the Northern Ireland tariff to the highest tariff in England and Wales.

Summing up their short discussion, the Prime Minister said that the Chief Secretary's proposal would not - in her view - be seen as going far enough to meet the commitment which she had given in Belfast. Her own interpretation of the commitment was that domestic tariffs would be brought more closely into line with the average of tariffs in England and Wales. She thought it would be consistent with this if there was a firm commitment to bring the domestic tariff down to the level of the highest tariff in England and Wales by 1982. The domestic tariff should, therefore, be brought down to five per cent above the highest level as from 1 April 1981, and this should be accompanied by a statement that it would fall to the highest level in April 1982. The Northern Ireland Office would have to make a contribution to the extra expenditure involved, perhaps by reductions in the health or education programmes; precisely how much would be found from Northern Ireland programmes and from the contingency reserve would have to be settled between your Secretary of State and the Chief Secretary, as would also the method of paying the subsidy. No announcement should be made until the financing arrangements were agreed.

I am sending copies of this letter to the Private Secretaries to the members of E(EA) and to David Wright (Cabinet Office).

T. P. LANKESTER

Roy Harrington, Esq.,
Northern Ireland Office.

SECRETARY OF STATE
FOR
NORTHERN IRELAND

NORTHERN IRELAND OFFICE
GREAT GEORGE STREET,
LONDON SW1P 3AJ

Rt Hon Peter Walker MBE MP
Minister of Agriculture, Fisheries & Food
Whitehall Place
London SW1A 2HH

2nd April 1981

Dear Peter.

I have seen your letter of 18 March to Geoffrey Howe about the highly critical condition of the glasshouse sector of the horticulture industry.

I agree entirely with what you have said although I am sorry it would bring only a limited benefit to Northern Ireland where we have only 15 acres of heated glasshouses!

On the other hand Northern Ireland would benefit significantly if the aid could be extended to the mushroom growing sector. Northern Ireland produces about 10% of the mushrooms grown in the UK despite having to face ever-increasing costs - especially heating and transport. Oil is the principal source of heating - about 1m gallons are used yearly for this purpose.

I appreciate that your argument about Dutch competition does not apply to mushroom growers and therefore I understand that it would be more difficult to make a good case for them, but I hope you will consider doing so nonetheless.

I am copying this letter to the recipients of yours.

Yours ever

Humphrey

jg

Arranged for Friday 3rd April at 12.15.
ℰℓ 1/4

1

PRIME MINISTER

cc Mr. Alexander

Northern Ireland Electricity Subsidy

Sir Keith Joseph's minute below reports on a recent meeting of E(EA) at which the Committee was unable to reach agreement on the subsidy to be paid on Northern Ireland electricity. He has passed the issue to you for decision.

The Committee agreed that, as from 1 April, Northern Ireland industrial tariffs should be set so as to be no higher than the highest level in England and Wales, and that domestic tariffs should be set 5 per cent above the highest in England and Wales.

The Committee disagreed on:-

(i) the method of subsidy;
(ii) the commitment for later years.

I think that you should tell the Secretary of State for Northern Ireland and the Chief Secretary to sort out the question of method of subsidy between themselves. The question of commitment for later years is more difficult, and depends partly on how people in Northern Ireland interpret the statement you made in Belfast. The Chief Secretary, supported by everyone else on the Committee except Mr. Atkins, argues that the commitment should go no further than indicating that industrial tariffs in Northern Ireland will never be higher than the maximum elsewhere in the UK and that domestic tariffs will never be more than 5 per cent higher than in England and Wales. He believes this would be consistent with your statement that - "We have decided to bring Northern Ireland electricity tariffs more closely into line with those in England and Wales and to keep them there". Mr. Atkins, however, wants to say that there will be further adjustments within 2-3 years which will bring domestic as well as industrial tariffs down to the highest levels in England and Wales. He says that this is the least that Ian Paisley and others are expecting.

Yes
MT

Both the Chief Secretary and Mr. Atkins have asked if they can see you to discuss this before a decision is taken. May I set up an early meeting? I don't think we need any other Ministers.

TL

31 March 1981

PV

CONFIDENTIAL

PRIME MINISTER

NORTHERN IRELAND ELECTRICITY SUBSIDY

You will recall that in your speech in Northern Ireland on 5 March you referred to 'the high tariffs of the last few years' for Northern Ireland electricity, and you went on to say that:

> 'The Government accepts that these tariffs are an unreasonable burden upon the Northern Ireland community and that they are a real obstacle to economic development. We have been examining the best way of tackling the problem. We have decided to bring Northern Ireland electricity tariffs more closely into line with those in England and Wales and to keep them there. The tariff increases due on 1 April will be reviewed in the light of this decision. Because of the importance of energy costs to the whole Northern Ireland economy, this is a major decision of principle.'

E(EA)(81) 7th Mtg.

2 E(EA) Sub-Committee considered on 26 March, on the basis of papers by the Secretary of State for Northern Ireland (E(EA)(81)18) and by the Chief Secretary, Treasury (E(EA)(81)19), two alternative methods of meeting that commitment. We agreed

that the increases on 1 April should be such as to reduce Northern Ireland industrial tariffs forthwith to the level of the highest in England and Wales and domestic tariffs to 5% above the highest. The Sub-Committee could not, however, reach agreement on the extent to which the Secretary of State for Northern Ireland should commit the Government now to further reductions in future years. In view of this disagreement and of its relevance to the commitment in your speech, it was agreed that I should present the issues to you for decision.

The Secretary of State for Northern Ireland's Proposal

3 The Secretary of State recommends an approach whereby a subsidy would be paid to bring Northern Ireland electricity generating costs into line with the bulk supply tariff which the CEGB would charge in England and Wales for an area board with similar characteristics of demand to Northern Ireland. The ultimate tariff would then be derived by adding on the (unsubsidised) cost of distribution in Northern Ireland. The effect of this at present should be to bring overall tariffs in Northern Ireland down to the equivalent of the highest tariffs in England and Wales. The Secretary of State would like to implement this change in full over two years, or three if necessary, with an interim step in April 1981 as described in paragraph 2 above.

4 The Secretary of State regards it as essential that he should be able to announce, when the April 1981 tariffs are implemented, that further changes to bring Northern Ireland

tariffs down to the highest levels in England and Wales will be completed within a specified time. He judges that otherwise Mr Ian Paisley and others will claim that you and he are reneging on both the specific commitment quoted in paragraph 1 above and your frequently repeated undertakings that the people in Northern Ireland will be treated in the same way as those in the rest of the United Kingdom. The Secretary of State argues that his method would satisfy Northern Ireland consumers' opinion by putting them on the same footing as those in the rest of the United Kingdom where the CEGB and the Scottish Generating Boards give their Area Boards a standard supply tariff with the effect that consumers on the offshore islands are subsidised by main land consumers.

<u>The Chief Secretary: Treasury's Proposals</u>

5 The Chief Secretary agrees on the figures for the interim increases from 1 April 1981 but not on the method of determining the subsidy or on the terms of the longer term commitment. He recommends that the subsidy should be based on final supply tariffs, rather than bulk tariffs, and set so as to ensure that the industrial tariff in Northern Ireland is never higher than the maximum elsewhere in the UK and that for domestic tariffs the differential above the highest in England and Wales should not widen beyond the 5% following the 1981 changes. It would be announced that the differential would not be allowed to increase and that the possibility of further reductions would be kept under review.

6 The Chief Secretary argues that his approach, while allowing for a generous and continuing subsidy, avoids the unquantifiable and substantial commitment to public expenditure inherent in the Secretary of State for Northern Ireland's proposal and the possibility that, under the Secretary of State's method, Northern Ireland consumers could be subsidised to the extent that they would pay less than consumers in England and Wales.

<u>The Views of E(EA)</u>

7 All Members of the Sub-Committee supported the Chief Secretary's recommendations for the following main reasons:

a Under the agreed interim increases from 1 April 1981 the subsidy to Northern Ireland consumers will increase from the present provision of £30 million to £76 million;

b The increase in the subsidy of £46m is as much as the whole of the concession in the Budget to industrial users of electricity and they, and taxpayers in Great Britain generally, would be highly critical of any open-ended commitment to yet higher subsidies in later years; and

c The Chief Secretary's approach could be presented as a prompt and generous fulfilment of your commitment of 5 March as distinct from interpretations which Paisley and others might choose to put on that commitment.

8 Nevertheless, the Secretary of State for Northern Ireland argued strongly that, in the unique circumstances of the Province, anything less than his proposal and an undertaking to bring Northern Ireland domestic tariffs down to the level of the highest in England and Wales over a specified period could be considered as a departure from your and his commitments.

9 In the meantime the Secretary of State for Northern Ireland has told the Northern Ireland Electricity Service to defer settling their tariffs for 1 April until a decision is reached. He will be discussing with the Chief Secretary how the additional finance needed for 1981-82 (£46 million) is to be found and he will also be considering urgently whether there is a possible alternative to a long-term subsidy, through the conversion of part of Northern Ireland generating capacity to coal, or through the creation of a physical electricity linkage with Scotland.

10 I am copying this to colleagues on E(EA) Committee, to Humphrey Atkins and to Sir Robert Armstrong.

KJ

K J

31 March 1981

Nat Ind.

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

The Rt Hon Peter Walker MBE MP
Minister of Agriculture,
Fisheries and Food
Whitehall Place
London SW1A 2HH

27 March 1981

30/3

Dear Peter

INDUSTRIAL ENERGY PRICES

Thank you for copying to me your letters of 5 and 18 March to Geoffrey Howe, in which you draw attention to the particular problems facing the trawler and glasshouse industries. As you say, neither of these heavily oil-dependent industries pay duty and the package of energy-related measures announced in the Budget will be of limited assistance to them. The problems arise partly from subsidised or artificially low energy prices available to some European competitors and, in the case of trawlers, from price differentials which the Lowestoft trawlermen have already shown they can do something to close by bringing in cheaper oil from abroad.

Pt 3 Pt 4

As I mentioned in my letter of 1 December, I do see a strong case for short-term, non-energy related, aid to enable these essentially viable industries to withstand the competitive pressures they are facing. Measures specifically to help with horticulturalists' fuel costs such as those suggested in para 5 of your letter of 18 March, could I think be justified because of the recognition by both the Government and the European Commission that Dutch pricing distortions have created unique and very difficult problems for the industry, though it would still be presentationally preferable to avoid the label "fuel" subsidy. I see merit on energy grounds in encouraging the growers to convert from oil to coal. I hope, however, that if there is to be additional encouragement we can avoid offering it in the form of a higher capital grant than will be available to industry generally or in a way that casts doubt on the efficacy of the general conversion scheme.

I am copying this letter to recipients of yours.

Yours ever
David

D A R HOWELL

~~CX~~ Duplicat
Walto's

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

25 March 1981

Rt. Hon. Peter Walker MBE MP
Minister of Agriculture, Fisheries and
Food

Dear Peter

INDUSTRIAL ENERGY PRICES PART 3

You wrote to me on 5 March about the work of the NEDC Task Force on industrial energy prices and its bearing on the fishing and glasshouse industries and again on 18 March with a more specific proposal about the latter.

I have considered the points made in your letters in the light of the Task Force's report and of the measures which were announced in my Budget Statement regarding the prices for electricity and gas charged to industrial users. As I explain below, however, these measures in no sense constitute a fuel subsidy to the industries concerned and they were directed at a quite specific problem identified by the Task Force of an entirely different kind from that faced by the fishing and horticultural industries. Accordingly, I see no reason for us to change the conclusions which we reached in discussion at the E Committee last year that there was no case for any further subsidies for the horticulture industry and that any money provided for fishing should not be related to fuel costs.

The measures which I announced in the Budget Speech related to a conclusion reached by the NEDC Report that "a limited but important number of large users of electricity and gas pay more for supplies than competitors in Europe". There is no suggestion in the Report that this problem arises because of subsidies paid in other European countries. The factors mentioned in the Report included differences between countries stemming from different national energy or energy programmes and to differences in market structures and pricing practice.

/The action

The action to which I referred in my Budget Speech is intended solely to permit a somewhat greater degree of flexibility in pricing policy by the gas and electricity industries. The measures in question constitute neither a fuel subsidy to the industries concerned nor are they intended to compensate for subsidies paid to industries in other countries. On the contrary in announcing the measures we have made it clear that the Government remains committed to the economic pricing of energy and that it would not be appropriate to base prices on cost structures in other countries or adjust them to take account of fluctuations in the exchange rate. I am enclosing with this letter a note of the detailed measures in question. You will see that they relate to gas and electricity prices only and not to oil.

As you know, the horticultural industry uses fuel oil and the trawler industry gas oil and marine diesel oil. The report analyses the position regarding these fuels in some detail, but reveals no evidence that there is anything in the structure of the market for oil products which is likely to leave UK users at a permanent disadvantage compared with their European competitors in general. Leaving aside the effects of temporary fluctuations there appears to be no question of the fishing and horticultural industries suffering any hadicaps additional to those which may result from the subsidies paid to the French and Italian fishing industries and from the low gas prices charged in the Netherlands. On the contrary in comparison with many other fuel users in the UK the fishery and horticulture industries already have the advantage (equivalent to a subsidy) of widespread exemptions on duty on oil products.

We are therefore left, with the question of the appropriate reaction to the subsidies paid to French and Italian fishermen and to the lower prices enjoyed by Dutch horticulturalists. Having considered both points afresh, I see no reason to change the view we reached in the E Committee last April that to give fuel subsidies to either of these two industries would be incompatible with our policies on industrial subsidies generally and on the full economic pricing of energy. And the risk of repercussions arising from the grant of a fuel subsidy in these two cases is even greater than it was last April, given the likely pressures from other industries, such as paper and board and chlorine which are at least as energy dependent as fisheries and horticulture. More generally, you will know that there were strong representations to me from manufacturing industry as a whole before the Budget for exemption from the duty on heavy fuel oil. Given the effect of reducing the duty on the costs of gas purchases by the British Gas Corporation and therefore on the UK's gas import bill, the most I was able to do in present circumstances was to maintain the duty at its previous level. It would hardly be possible to defend now giving direct fuel subsidies to two industries only, - industries

/which are

which are already exempt from the fuel oil duty, and at an additional cost to public funds.

As regards the fishing industry, we agreed in August last year to give a temporary operating subsidy to the value of £14 m pending a settlement in the Common Fisheries Policy negotiations. It has already been agreed that we should review the case for a further instalment of temporary assistance, in view of the lack of agreement in Brussels and the exceptional political sensitivities involved. I understand that you will be circulating a paper to E Committee on this question for discussion next week. I recognise the strong arguments in favour of a further instalment of aid. But this can readily take the same form as the £14 m given last year since for the reasons set out above I would remain opposed to giving any part of the assistance in the form of a fuel subsidy.

Finally, in your 18 March letter you also mention the question of grants to glasshouse growers for conversion of boilers to coal-firing. I am prepared to agree that our officials should consider on what terms the horticultural industry might have access to the new conversion scheme, where that is more advantageous to it than the Agriculture and Horticulture Capital Grants Scheme. But there can be no question of the industry benefiting from both schemes. That would be quite impossible to defend to other industrial energy users.

GEOFFREY HOWE

cc Mr Brugher
Mr Wicks
Mr Thornton
Mr Andrew

DEPARTMENT OF ENERGY

Reference No 38

March 10, 1981

Thames House South, Millbank, London SW1P 4QJ. Telephone: 01-211 3000
Press Office Direct Line: 01-211 4545 (10 lines)

PRESS NOTICE

(Out of hours: 01-215 7877)

+ cc Mr Fitcher

INDUSTRIAL ENERGY PRICES: GOVERNMENT ANNOUNCES £168M PACKAGE

A £168 million package aimed at helping large industrial energy consumers, was announced by the Government today.

Industrial consumers of both gas and electricity will benefit. And new incentives are offered to industry to convert costly oil-fired boilers to coal.

Main points from the package are:

Gas: British Gas Corporation will hold the prices at which they renew industrial contracts at present levels until December 1981.

Coal: Industry is to get Government grants to convert boilers from oil to coal.

Electricity: The electricity supply industry in England and Wales is to offer new flexibility in its pricing arrangements.

Gas

The British Gas Corporation is not increasing renewal prices for interruptible gas supplies from their December 1980 level despite recent fuel oil price rises.

The new measures announced today will extend the relaxation of industrial pricing policy introduced last year and will be particularly helpful to large and energy intensive users. Under the new measures:

- renewal prices for all gas purchased on contract by industrial customers will be held at their present levels until December 1, 1981
- the existing provision for price escalation of 1p/therm per quarter in firm gas contracts (ie gas supplied on a continuous basis) will not be applied in the period to December 1, 1981.

The Government is adjusting the previously published 1981/82 External Financing Limit for the British Gas Corporation of minus £390 million by £73 million.

Coal

The Government is committing £50 million over two years for grants to industry towards the eligible cost of converting boilers from oil to coal. Coal is the cheapest fuel for bulk industrial use and today's move will help industry take advantage of this. Expenditure in 1981/82 will be found from the Contingency Reserve. The Government is consulting urgently with the European Commission, NCB, NUM, boiler-making industry and other interested bodies about details of the scheme which will be announced as soon as possible.

Electricity

The package for large industrial electricity consumers is:

- The electricity supply industry in England and Wales will offer a new arrangement to customers who can take advantage of load management terms. This will mean that larger industrial consumers who can adjust their demand at short notice can cut their electricity costs.
- Additional flexibility will be introduced by area boards into their special agreements with industrial customers with the aim of reducing as far as possible the impact of rising electricity costs.

These measures could yield benefits of up to eight per cent on costs to some large industrial consumers. They will affect the industry's ability to meet its financial target and the Government is adjusting its 1981/82 External Financing Limit of minus £210 million by £45 million.

At the request of the Energy Secretary, the supply industry has been reviewing the bulk supply tariff under which the CEGB supplies power to area boards. The position of large consumers is being covered in this review.

Measures already in operation

Today's moves are additional to steps which have already been taken by the gas and electricity industries over the past year to assist their customers. The measures already in force are:

- BGC has relaxed its market related pricing for existing firm gas customers. The renewal price is currently some 70% of the gas oil price.

- In the case of firm gas consumers who are on new three year contracts at higher prices BGC has arranged that the price will fall to the general firm contract renewal level after the first year of the contract.

- Area Electricity Boards have been taking an active role in ensuring that their industrial customers obtain maximum benefit from the flexibility availabile in existing tariffs.

Background

1. The measures announced today follow the Government's consideration of the NEDC Energy Task Force's report, published on March 4. This found that, while prices for the vast majority of industrial customers remain in line with Europe, a limited but important number of large users of electricity and gas are paying more for supplies than competitors on the Continent. It also drew attention to industry's difficulties during the recession in finding the capital to convert equipment to coal use.

2. Ministers have made clear that the Government remains committed to economic pricing of energy and that it would not be appropriate to base prices on cost structures in other countries or adjust them to take account of fluctuations in exchange rate. The Task Force found that these were major causes of disparity for large users.

3. BGC's renewal prices for the first quarter of 1981 were 29p/therm for firm gas and about 24p/therm for interruptible gas. BGC planned to raise the firm gas renewal price by quarterly stages to 32p/therm in September 1981. Existing firm gas contracts provide for an escalation in price by 1p/therm a quarter to keep in line with this planned renewal price. Since the renewal price is now to be held, this provision will not now be applied in the period to December 1, 1981.

CC Duguid NB Prime Minister
Yet 19/3

MINISTRY OF AGRICULTURE, FISHERIES AND FOOD
WHITEHALL PLACE, LONDON SW1A 2HH

From the Minister

Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
London SW1

18 March 1981

Dear Geoffrey,

GLASSHOUSE ENERGY

Pc 3

I wrote to you on 5 March about the highly critical condition of the glasshouse sector of the horticulture industry.

In the absence of a reply when I met the NFU President and representatives of glasshouse growers last Friday - and when I addressed a demonstration of growers gathered in Whitehall in support of their representatives - I was unable to be more explicit than that their very serious plight was recognised by the Government and was receiving our close attention.

The growers told me that without financial assistance towards heating costs to offset gas price subsidies given to Dutch growers, the future of many would be in jeopardy over the next few months when the marketing season for their produce gets fully under way. They pointed out that the glasshouse sector is highly efficient and labour intensive, employing some 20,000 people. Compared with their Dutch counterparts their energy costs represent between 4½p and 9p a pound extra on the price of tomatoes. They pointed out that it was scarcely surprising that last year's imports of Dutch tomatoes were 63% up on 1979 in the months March to June, and 37% higher for the season as a whole. Lettuce imports increased by 36% and flowers and plants were up substantially. Put another way, the Dutch growers have a cost advantage of £10,000 an acre against heavy fuel oil costs, and nearly twice as much against light/gas diesel oil prices. The broad thrust of the NFU's case is beyond dispute.

I am finding it increasingly impossible to defend the position in which the Government is now placed on this matter. The NEDC Task Force Report identified the sector as the most energy intensive of all the major sectors of industry which were examined. It acknowledged, moreover, that this sector out of the whole of industry is uniquely disadvantaged because the energy costs of its foremost competitors, the Dutch, are at artificially low levels which Community action conspicuously fails to remedy.

When other seemingly less efficient industries are receiving such very large sums from Government funds the glasshouse growers find it most difficult to accept refusal of their request for temporary assistance. The very survival of this industry is now at stake and I must ask you therefore for your immediate agreement to the following measures of relief.

First, I would require additional funds to be made available to my Department to finance a temporary fuel subsidy scheme for oil used in glasshouse heating on lines which David Howell has already indicated would be acceptable to him in terms of energy policy objectives. Such a scheme would need to accord with EC Commission guidelines under which several other Mamber States have already introduced oil subsidy schemes to assist growers to adapt to Dutch competition. The main condition is that the aid must be related to the increase in oil prices between January 1978 and 1980. The total costs of a scheme of this nature would be of the order of £5.5m. Given the pressures on my other programmes and the very tight limits which have been set on our estimates for 1981-82 I cannot contribute any offsetting savings towards the cost of this subsidy which would therefore represent a claim on the contingency reserve.

Second, I would want to augment the grants already available to glasshouse growers for conversion to coal firing. I have recently been in touch with representatives of the National Coal Board about the prospect of preferential volume prices for coal supplied for glasshouse heating and am now in process of setting up tripartite discussions with leading growers in the vicinity of the Selby coal-fields with a view to pushing the changeover from oil to coal fired boilers. However, neither the existing 15 per cent grant (with a 5 per cent supplement where a development plan is involved) under the Agriculture and Horticulture Capital Grant Schemes operated by my Department nor the marginally improved rate (by 10 per cent) under the new boiler conversion scheme for industry announced in the Budget is a sufficient incentive to encourage conversion by glasshouse growers who already have efficient oil fired boiler systems.

If we seriously intend to get the most efficient growers to make the change - and that is my objective - an adequate contribution from public funds would be to aggregate the grants by allowing growers to qualify under both the new boiler conversion scheme and the existing capital grant schemes operated by my Department.

I hope very much that you will be able to give early agreement to these proposals. In view of the urgency my officials have not been able to talk to yours ahead of this letter about the figuring, but I have asked them to get in touch immediately.

I am copying this to David Howell, George Younger, Nicholas Edwards and Humphrey Atkins; and since my previous letter was also copied to the Prime Minister and other members of E Committee, I am copying this one to them also. As regards the parallel problems of the fishing industry, to which my previous letter also referred, I hope to be putting a paper to E Committee next week.

PETER WALKER

Nat Ind

01-211-6402

Rt Hon George Younger MP
Secretary of State for Scotland
Scottish Office
Dover House
Whitehall
London SW1

13 March 1981

Dear George

SCOTTISH ELECTRICITY BOARDS' TARIFF INCREASES

Your letter of 5 March to Leon Brittan invited me to let you know whether I had any plans to revise the financial targets agreed last year for the CEGB and Area Boards in England and Wales.

I have no such plans at present but the industry has indicated that it will be making proposals to me shortly on its financial targets in the light of its latest circumstances. I shall consider these proposals when they are received in consultation with the Treasury and will keep you informed.

I am copying this to the recipients of your letter.

Yours ever

David

D A R HOWELL

PART 3 ends:-

12.3.87

PART 4 begins:-

13.3.87