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PREM 19/1094

Gas and Electricity Pricing Policy.

Gas and Electricity Industries EFL's

Industrial Energy Policy.

PART 8.

NATIONALISED INDUSTRIES

Part 1: September 1979

Part 8: April 1983.

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~5.4.83~~		~~14.12.83~~					
~~19.4.83~~		~~16.12.83~~					
~~25.4.83~~		~~22.12.83~~					
~~18.5.83~~		30.12.83					
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~~30.11.83~~							
~~5.12.83~~							
~~9.12.83~~							

PART 8 ends:-

DB to RTA [18] 30.12.83

PART 9 begins:-

Ch/Ex to SS/Energy 9.1.84

TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
E(NI)(83)9	19.4.83
E(NI)(83)14	29.6.83
E(NI)(83)6th Meeting, Minutes	5.7.83
LCA to MISC 99(83) 2nd Meeting, Minute 2	27.10.83
C(83)36	13.12.83
CC(83)37th Conclusions, Minute 5	15.12.83

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 OWayland Date 18 April 2013

PREM Records Team

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10 DOWNING STREET

From the Private Secretary

SIR ROBERT ARMSTRONG

Strikes in the gas industry

The Prime Minister was grateful for your minute of 21 December, to which was attached a report by MISC 98 on withstanding a strike in the gas industry.

The Prime Minister agrees that there is no need at present for a meeting of Ministers to consider the report, and she has taken note of its contents. She agrees with the two detailed recommendations in paragraph 5.12 about priority consumers and Service assistance for the maintenance of compressor stations.

I am sending copies of this minute to the Private Secretaries to the recipients of yours.

David Barclay

30 December 1983

CONFIDENTIAL

cc NO.

Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon Peter Walker MBE MP
Secretary of State for Energy
Department of Energy
Thames House South
Millbank
LONDON
SW1P 4QJ

29 December 1983

nbpm
Duty 29/12

Dear Secretary of State,

BGC 1983 CORPORATE PLAN

I am conscious that there has been no collective discussion of this Plan. The preparations for such a discussion were interrupted by the Election.

If you agree, I see little point in now discussing it. The financial figures it contains have been overtaken by the conclusions of the investment and financing review (IFR). There remain, of course, important outstanding issues in this area - pricing policy, gas exports and purchases of gas from overseas - but I do not think the 1983 Plan provides an appropriate basis for discussing them.

That said, it is important to make early progress on these outstanding issues. The Prime Minister has asked that an agreed paper be put to her on the implications of economic pricing. I suggest our officials prepare such a paper with a view to a discussion early in the New Year.

We also need to make progress on the issue of gas exports. In my view we cannot take decisions on the purchase of foreign gas until the issue of exports is resolved. In any case there is a good deal to be said for resolving pricing and exports ahead of the start of the next IFR.

I am copying this to the Prime Minister, to other members of E(NI) and to Sir Robert Armstrong.

yours sincerely

PR

(approved by the Chief Secretary, signed in his absence)

for PETER REES

CONFIDENTIAL

Nat Ind. Policy Pt 8

cc NO.

File

nbpm but Mr Turnbull to see o/r DWB 29/12

Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon George Younger TD MP
Secretary of State for Scotland
Scottish Office
Dover House
Whitehall
LONDON
SW1A 2AU

23 December 1983

Dear Secretary of State,

Thank you for your letter of 14 December about the external financing limits of the Scottish Electricity Board.

I suspect that the problem you envisaged has eased somewhat with our agreement in Cabinet last week that electricity prices in England and Wales should increase by some 2 per cent overall next year.

We have always been sympathetic to your desire to avoid external financing reductions affecting Torness. I was, however, surprised to hear that both Scottish Boards are now seeking higher levels of capital expenditure than those before us at our bilateral. The figures are:

Capital expenditure proposals compared to baseline for IFR 83

	£m cash		
	1984-85	1985-86	1986-87
SSEB IFR (April)	+ 83	+ 69	- 23
IFR Report (July)	+ 55	+ 45	- 23
IFR Bilateral (September)	+ 62	+ 50	- 23
Post-IFR Return (November)	+ 95	+ 68	- 22
NSHEB			
IFR Report (July) and Bilateral (September)	+ 2	+ 1	+ 7
Post-IFR Return (November)	+ 4	+ 9	+ 21

For SSEB, some £7m of the increase for 1984-85 and some £5m for 1985-86 arises from your planning decision on the Torness transmission lines (though you did say the Board would have to absorb these). The rest of the increase for SSEB has been attributed to change in the timing of Torness expenditure. Since, as I commented in my letter of 27 September, this Board declined to provide up-dated figures for our IFR discussion in September, it is reasonable that they live with the consequences. Have they cut back any other capital programmes? Given the history of underspending on Torness, we should be surprised if there was any residual problem that could not be solved by the scheme for rolling-over NI investment to which I referred in my letter of 14 October. No explanation has been offered for the NSHEB increases.

I said in that letter that I could understand your difficulty over large differences in price increases North and South of the border but I remain to be convinced that any difficulties are not largely of the Board's own making. Have they, for example, assumed cost savings on a comparable scale to the ESI? You also mentioned long-run marginal costs in Scotland. As you know, the Treasury has long argued that if trading between Scotland and England and Wales was optimised the marginal costs of the two systems should come into line apart from small differences in transmission costs. Increasing exports of Scottish Electricity, in the ways you discussed with John Moore on Tuesday should therefore have two consequences:

(a) the net proceeds should help directly the cash position of the Scottish Boards

(b) prices should come closer in line.

Clearly you are under pressure from the Chairman of the two Boards. But I am sure you would understand the difficult repercussions of allowing any increases in external financing limits announced only a month ago. We need to send to print early in the New Year, the figures for capital expenditure to be included in the Public Expenditure White Paper. In the circumstances, my inclination is to leave them as agreed at our bilateral.

I am copying this letter to the recipients of yours.

yours sincerely

JSL

for PETER REES
(approved by the Chief Secretary + signed in his absence).

Nat. Ind: Gas & Electricity Policy Pt 8.

file

D89

cc: LCO
HO
D/M
CO

10 DOWNING STREET

From the Private Secretary 22 December 1983

GAS SAFETY RESPONSIBILITIES

Thank you for your letter of 19 December. The Prime Minister is content with the revised timing proposed for the transfer of gas safety responsibilities. She also agrees that your Secretary of State should announce the change by way of an arranged Question after the Christmas Recess.

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

MR. D. BARCLAY

M. F. Reidy, Esq.,
Department of Energy.

SECRET

21 December 1983 17

CCP

MR TURNBULL

MISC 98: WITHSTANDING A STRIKE IN THE GAS INDUSTRY

The important conclusion of this report is the somewhat surprising resilience of the gas system to industrial action.

The effects of any industrial action are likely to be limited, despite the widespread use of gas by all sectors of the community and the common perceptions that safety issues make the gas industry more vulnerable than most.

The Reasons

The terminals can be kept in operation with the co-operation of higher management and less than ten key workers. These are likely to be available.

The national transmission system can be kept going with the co-operation of higher management and a small number of skilled men. The latter can be substituted, if necessary, by personnel from the equipment manufacturers or from the Services.

The distribution system would be vulnerable to the loss of labour for the repair of leaks and essential maintenance. However, 90 per cent of leaks occur on the customer's side of the meter, and could be repaired by non-BGC contract labour.

Leaks in the distribution system on the supply side of the meter are likely to be repaired, at least temporarily, for safety reasons. As a last resort, BGC may have to shut off supplies to whole districts (perhaps 5-10,000 consumers) although this is not likely to be a widespread occurrence.

The Implications

(a) Privatisation - the risk of industrial action is most likely to arise on proposals to privatise the industry, particularly if the existing structure is broken up. The Department of Energy are likely to use this conclusion as an argument against restructuring.

We take the opposite view.

SECRET

If the system is largely resilient to industrial action, we should not be deterred from implementing the most sensible privatisation proposals, irrespective of any threats of industrial action. Sensible proposals should also have the support of higher management.

(b) Pay - a similar conclusion applies towards our approach to future pay rounds.

(c) Strikes in Essential Services - the ability to withstand a strike in the gas industry, in the water industry and - to a lesser extent - in the electricity industry, means that our vulnerability to strikes in the "industrial" essential services is less than we previously thought.

This conclusion is likely to affect our thinking on legislation on essential services. If maintaining continuity of supply is not a major consideration, we have a better political opportunity to introduce desirable industrial relations procedures. Having established this bridgehead in essential services, we could extend these to all industries at a later opportunity.

We should also draw a distinction between "industrial" and "social" essential services. The impact of industrial action on the latter - eg fire, health services - is likely to be greater than on gas, water and electricity. However, the moral pressures upon the work forces not to jeopardise significantly the services to the public will be high.

We suggest that the Policy Unit could pass these thoughts on to Tom King as they alter some of our current perceptions about legislation for essential services.

DLP.

DAVID PASCALL

PM

16

Ref. A083/3533

PRIME MINISTER

Withstanding a Strike in the Gas Industry

--- I attach a report by the Official Group (MISC 98) on withstanding a strike in the gas industry. This is the last in the series of reports on withstanding strikes in key industries. The others have dealt with coal, electricity supply, water, telecommunications, the docks and oil tanker drivers, and there was a separate exercise on the lessons of the 1981 Civil Service dispute.

2. The conclusions and recommendations are in the final section (Section V) of the report. The points emerging of particular significance (paragraph 5.10) are as follows:

i. the risk of industrial action is most likely to arise in relation to proposals to privatise the gas industry, depending on the extent to which the existing structure is likely to be broken up, the lead given by top management, and the perceived implications for job security and work practices;

ii. the co-operation of higher management is crucial; as the recent formation of the Gas Higher Management Association has shown many of them are opposed to industrial action; if they continue to co-operate, any industrial action will be significantly less effective; per contra some extreme forms of action by higher management in association with some key staff could bring about the total and immediate cessation of gas supply;

iii. it is difficult for technical and safety reasons to cut off gas supply short of the customer's meter, although some parts of the district distribution system could be cut off as a last resort; the BGC's employees will probably be reluctant to place the safety of the community in jeopardy and thus forfeit public sympathy; therefore, depending on the workers' perception of the safety risks involved, there is some prospect that disruption of supply short of the customer's meter might be limited or, at worst patchy; if, as is not thought probable, the workers did take an irresponsible attitude to safety the consequences would be severe;

iv. if industrial action were to be largely confined to the non-repair of leaks on the customer's side of the meter (which could be remedied by cutting off supply at the meter or by the customer's getting the leak repaired by a private contractor) only a small percentage of domestic consumers would be affected and it should be possible to withstand industrial action for many weeks.

3. The Group's main recommendations (paragraph 5.11) are therefore as follows:

i. in considering possible forms of privatisation for the gas industry, it will be desirable to weigh, alongside all the other relevant factors, the extent to which some forms of privatisation may substantially increase the risks of industrial action;

ii. the attitudes of higher management and their key staff will be crucial and it will clearly be important to make every effort to win their support for, or acquiescence in, whatever proposed form of privatisation Ministers may decide on;

iii. in the event of industrial action both the Government and the top management of the BGC would need to exploit fully the likely reluctance of the workforce to be seen to be endangering the safety of the community, as this could limit industrial action to a scale and type which could be endured for many weeks.

4. There are also two detailed recommendations for further work in paragraph 5.12, one concerning priorities for essential gas consumers and the other about possible provision of Service assistance with the maintenance of compressor stations in the national transmission system.

5. Ministers may also wish to note that a proposed new tax protocol could increase the risks of disruption of supply from the Anglo-Norwegian Frigg Field, but that these risks would be carefully weighed and brought to the attention of Ministers before a decision was taken to bring the new protocol into force.

6. Unless there are points which you or the other Ministers receiving copies of this report wish to discuss, you will probably conclude that there is no need for a meeting of Ministers to consider the report and that it will be sufficient for the time being for Ministers to take note of the conclusions and main recommendations. The most appropriate time to consider the main recommendations at i. and ii. in paragraph 3 above will be when Ministers consider possible forms of privatisation for the industry and the handling with the BGC and its workforce of whatever proposals Ministers decide on. The main recommendation at iii. in paragraph 3 will need to be kept in mind in the event of industrial action. It would however be helpful if Ministers were to endorse now the two detailed recommendations about priority consumers and Service assistance for the maintenance of the compressor stations.

7. I am sending copies of this minute and the attached report to the Home Secretary, the Chancellor of the Exchequer and the Secretaries of State for Energy, Defence, Scotland, Trade and Industry and Employment, with the request that these papers should be seen only by those in their Departments who have already participated in the work of the Official Group (MISC 98) or who are specifically authorised by their Minister to see them for the purposes of giving essential advice.

RA

ROBERT ARMSTRONG

21 December 1983

WITHSTANDING A STRIKE IN THE GAS INDUSTRY

I INTRODUCTION

1.1 This report considers possible industrial action in the gas industry. Gas supplied by the British Gas Corporation (BGC) is used in over 15 million households and accounts for about half of the national domestic fuel supply for heating and cooking. Gas accounts for some 21 per cent of the UK's primary energy needs, and just over 30 per cent of all industrial energy use.

1.2 The BGC, which has a virtual monopoly of piped gas supply in Great Britain, is organised in twelve regions under the management of the Corporation's Executive. BGC's Headquarters, to whom Regions are accountable, has responsibility for the acquisition and national transmission of gas as well as for the overall strategy, planning and direction of the industry. The Regions have responsibility for the distribution of gas to some 16 million customers and for the activities of service and distribution workers.

1.3 Virtually all the supplies of gas in Great Britain come from the North Sea via four receiving terminals on the East Coast (Bacton and St Fergus, which handle the major share, together with Theddlethorpe and Easington). Gas is distributed via the fully-integrated national transmission system.

1.4 This report considers -

- the industrial relations background (Section II)
- the nature and effects of industrial action (Section III)
- the scope for mitigating the effects of industrial action (Section IV)

The conclusions and recommendations are summarised in Section V. The Group has not considered it right at this stage to consult the BGC on its conclusions and recommendations or to have full and frank discussions with them on the matters discussed in the report.

II. THE INDUSTRIAL RELATIONS BACKGROUND

2.1 The BGC's employees fall into the following groups:

i. Manual workers: 42,000, of which over 90 per cent union members

Main unions: General Municipal, Boilermakers and Allied Trades Union (GMBATU): 32,000

Transport and General Workers Union (TGWU): 4,000

Various craft unions under umbrella of the Confederation of Shipbuilding and Engineering Unions (CSEU): 1,500

Settlement date: mid-January

ii. Administrative, professional, technical and clerical staff: 55,000 of which over 80 per cent union members

Main union: National and Local Government Officers' Association (NALGO): 42,000

Settlement date: 1 June

iii. Higher management: 4,000, of which about two-thirds union members

Main unions: NALGO: about 1,300

Gas Higher Management Association (GHMA) (not affiliated to TUC): about 1,300

Settlement date: 1 June

Recent industrial action

2.2 There has been comparatively little industrial action in the gas industry. The first national industrial action in the industry this century took place in February 1973 at a time when a considerable proportion of the supply still consisted of manufactured gas. Selective industrial action by manuals over pay for a 6 week period led to the loss of some supplies of manufactured gas to industry.

2.3 Since the industry went over entirely to natural gas, with the exception of the one-day strike in 1981, onshore industrial action has taken the form of a work-to-rule and/or overtime bans rather than all-out strike. Action since 1973 has been limited to the following:

<u>February 1976</u>: Staff, mainly instructors, supervisors and computer personnel took selective regional industrial action over steps taken by the employers to honour agreements with the manuals. The action varied between regions: there were one-day stoppages involving several thousand staff in some regions and longer stoppages involving small numbers of staff, in particular the computer personnel, in other regions. The action lasted about 3 weeks before it was called off after a settlement based on a staff efficiency agreement. Gas supplies to consumer were not affected and adequate safety cover and emergency services to the public were maintained.

<u>July 1981</u>: The manuals and staff gas unions called an official one-day strike on 18 July as part of their joint campaign against the Government's decision that BGC should withdraw from gas appliance retailing and dispose of its showrooms. About 95 per cent of BGC's total workforce supported the strike, the majority of those remaining at work being high management grades. Gas supplies to consumers were not affected (due mainly to low seasonal demand) but provision of safety cover varied between regions and in some cases there were serious deficiencies in safety cover.

<u>October 1981</u>: There was a phased sequence of industrial action by shift workers in support of a claim for increased allowances. Support for this action was patchy, with four regions completely unaffected (it was estimated that 600 out of 1600 shift workers came out). The dispute lasted 26 days before being called off owing to lack of support. Significant factors enabling BGC to withstand the action were widespread co-operation from higher management in replacing striking shift workers and lack of support for the strike from day workers. Supplies to consumers were not affected as a result of the shift workers' action. Adequate safety cover and emergency services to the public were maintained.

2.4 There was however in October 1981 a risk of loss of supply when the Anglo-Norwegian Frigg field was shut down for 4 days as a result of strike action over a pay dispute between the workers and the field operator. Supplies to industrial customers had to be interrupted in accordance with the terms of their contracts. Arrangements were in hand to take emergency powers under the Energy Act 1976 to relieve the BGC of its statutory and contractual obligations to supply and to restrict the use of gas when the dispute was called off.

Attitudes to industrial action

2.5 The fact that industrial action by the BGC's employees has so far been very limited is probably the result of the following:

i. the workforce generally earn substantially more than the national average and their relative position has improved over the last 5 years or so;

ii. the operational safety factor in this industry is a powerful inhibiting influence against reckless stoppages or other action which might lead to explosions;

iii. there is a tradition, particularly amongst professional and managerial grades, that the service of an essential public utility should be maintained;

iv. the main unions, the GMBATU and NALGO, have traditionally been regarded as moderate both politically and in their attitudes to industrial action, although both unions were involved in the National Health Service dispute in 1982 and the GMBATU played a prominent role in the water industry strike earlier this year; any official national industrial action by either of these two unions would probably be preceded by some form of consultation with the membership.

Further information relevant to points i. to iii. is provided in the following paragraphs.

Recent pay history

2.6 In recent pay rounds settlements for the gas industry manuals have been roughly at the same level as for the electricity supply manuals; in both cases perceptions of the settlement for the miners were undoubtedly influential. Settlement levels have been broadly comparable to those in the other state monopolies. Last year both gas and electricity reached settlements somewhat lower than both the perceived and the actual settlement for the miners. But inflation was falling steadily at the time and all these settlements were in line with the RPI at the time agreement on each was reached.

Table 1

	1980/81	1981/82	1982/83
Gas manuals:	12%	7½%	5 1/4%
Electricity manuals:	12%	7½%	5½%
Miners:	9 3/4%	7½%	6½%
(Presented as equivalent on rates to:)	(13%)	(9%)	(8-9%)
Water manuals:	12 1/4%	8 3/4%	10%
Average over public trading sector:	9½%	7½%	5½%
Average over whole economy:	8½%	7%	5½%

2.7 Current average earnings for gas industry manuals are substantially higher than the whole economy average. They are similar to those in electricity, and fall between the higher earnings of underground coal workers and the lower earnings of surface coal workers.

Table 2 (NES 1983)

Average earnings levels	
Manuals - whole economy	£143.6
Gas manuals	£174.2
Electricity supply manuals	£173.3
Water manuals	£148.0
Coal - underground	£188.6
Coal - surface	£159.5

2.8 There is no evidence of any special pay issue which might affect the gas industry pay negotiations in the current round. The miners' settlement and the RPI will be significant - both may point to settlement levels similar to those in the last round.

Union attitudes to safety and health

2.9 Given the nature of the industry, both major unions would undoubtedly issue guidance to their members on the conduct of any major industrial action particularly as regards safety considerations. In the water strike GMBATU issued a mandatory Code of Conduct requiring the maintenance of supplies to priority consumers such as hospitals and old people's homes. The TUC's guidance on the conduct of industrial disputes issued to all affiliated unions calls for arrangements to be made to ensure the maintenance of supplies and services "essential to the health and safety of the community". The precise application of such principles in particular circumstances can, however, give rise to much argument at local levels, and they provide no reliable guarantee that safety and health will be effectively safeguarded.

Attitudes of higher management

2.10 The one-day strike in July 1981 precipitated the formation of the Gas Higher Management Association (GHMA) by managers and professional grades who were opposed to industrial action in an essential service and had come to the view that their professional responsibilities were incompatible with continued membership of NALGO. Of the 4,000 managers and professionals, about a third are now members of GHMA, a third remain members of NALGO, and the remainder are largely non-unionist (a few may be members of other unions). GHMA was registered as a trade union in December 1981 and applied for a certificate of independence in June 1983. It is not affiliated to the TUC.

2.11 The constitution of the relevant part of the industry's negotiating structure - the NJC for Higher Management - is now under review. BGC has given NALGO notice of termination of the current constitution, and has told them that from early next year seats on the NJC will be allocated to NALGO and GHMA on a 50:50 basis. It is too early to judge how these developments will work out or, indeed, whether GHMA will prove to be a durable grouping. However, the history of this breakaway clearly indicates reluctance on the part of many managers and professionals to be associated with industrial action (it seems probable that many of those remaining in NALGO do so for reasons not connected with their attitudes to industrial action). Recent experience in the British Telecom dispute illustrates similar attitudes amongst higher grades in that service.

Issues likely to give rise to industrial action

2.12 The analysis in the preceding paragraphs suggests that the propensity of BGC's employees to take industrial action is not normally high and that there is in particular a relatively low risk of industrial action on pay issues in BGC. There is a higher risk of industrial action arising from job losses and/or privatisation, which is assessed in the following paragraphs.

Job losses

2.13 Job losses from showroom closures, decline in customer service work in some areas and efficiency measures could give rise to industrial action in the short term. Unless they were linked to the Government's privatisation plans, action would be more likely to be local than national.

2.14 Nevertheless, NALGO are reported in the press to have threatened a major campaign including strike action to oppose job losses generally. This is a result of recent press speculation that BGC intend to close some 200 uneconomic showrooms. Part of the NALGO campaign would be aimed at achieving shorter hours, longer holidays and early retirement. BGC have not confirmed that the figure of 200 showroom closures is accurate, and there seems no ground to believe that jobs will be threatened as a result of proposed closures. Strikes in late September 1983 caused showrooms to be closed for one day in the Aldershot area, but the action was short-lived and had no effect on gas supplies. The Department of Energy is not aware of further strikes over job losses arising from showroom closures.

2.15 Compulsory redundancies and redeployment arising from either reduced workload or the Corporation's efforts to improve efficiency could give rise to local disputes similar to the recent dispute among fitters in the North Thames Gas region. In this dispute, the redeployment of 20 fitters to an adjacent area led to short-lived, unofficial action among 400 fitters in the region. Emergency cover was maintained.

Privatisation

2.16 Government proposals to privatise BGC in whole or in part are the issue most likely to give rise to industrial action of a more serious kind than has been seen hitherto in the industry. Following press speculation in August 1983 that the Government was planning to sell off the entire Corporation, the gas unions stated to the press that they would take industrial action if privatisation proposals went ahead. The unions, under their umbrella organisation GUARD (Gas Unions Against [the Monopolies and Mergers Commission] Report for Dismantling BGC), recently met the Secretary of State for Energy and registered their wish to be consulted about the Government's policies in relation to BGC privatisation.

2.17 The extent of, and level of support for, industrial action against privatisation will be critically dependent on the nature of any proposals eventually put forward. There is some evidence that proposals involving the break-up of the present structure of the industry would be more strenuously opposed than a transfer to the private sector of the industry as a whole. The attitude of employees could to a considerable extent be expected to follow the lead of top management, and the Government may find that vigorous efforts are needed to bring home to management the benefits of the proposals. It is generally accepted that the attitude of the Chairman of BGC to the Government's decision in 1981 that the Corporation should dispose of its showrooms made a significant contribution to the "success" (95 per cent of the workforce) of a one-day protest strike, although there was no question of management participation in the strike itself. Otherwise, the attitude of employees would depend on the implications of the proposals for the security of their livelihoods and their work practices, and on how the proposals squared with employees' attitudes towards the industry both generally and as an employer. The attitude of trade unions both in the industry and more generally in the TUC would no doubt be influenced by a perception on their part that the gas industry is close to the heartland of the nationalised sector of the economy.

2.18 The threat of industrial action over privatisation which has already been made by the gas unions must be regarded as a serious one and Ministers will have it in mind when they come eventually to discuss proposals. Ministers in the Department of Energy are currently reviewing privatisation objectives in relation to the industry, including BGC's appliance retailing business, and it is likely that the Secretary of State will bring forward proposals sometime in the New Year. Matters could be expected to come to a head quickly once any proposals were announced.

Industrial relations outside the BGC

2.19 As the 1981 strike in the Frigg field showed, gas supply may be vulnerable to industrial action outside the BGC. This could arise in three areas:

i. offshore in the Frigg field;

ii. offshore on the United Kingdom Continental Shelf (UKCS);

iii. at the oil company ends of the onshore terminals.

Offshore: supplies from Frigg

2.20 The Frigg field at present provides some 35 per cent of British gas supplies. In addition to the dispute in October 1981, workers in the Norwegian sector of the Frigg field took strike action over pay in July 1980 and October 1982 and threatened a strike in April 1983 but gas supplies to Britain were not affected on these other occasions. An important factor in reducing the risk hitherto has been a reluctance of the workers to allow the strike action to affect supplies from the UK sector of the field because of a tax protocol between the UK and Norway which gives workers in the UK sector substantial taxation benefits. It is proposed, however, to amend the tax protocol, probably within the next two or three years, removing the taxation benefits. Together with falling reservoir pressure, this will increase the risk that, in the event of future disputes, we shall not be able to count on the maintenance of supplies from the UK side of the field. The Norwegian workers clearly have a high propensity to go on strike. However, Norwegian legislation provides machinery to bring strikes to an early end through Government-enforced arbitration, provisions which Norwegian workers have so far respected. There are therefore grounds for hoping that, when a strike does occur, the dispute will be resolved quickly enough to avoid disruption of British gas supply.

Offshore: UKCS

2.21 At peak winter demand gas supply would be particularly vulnerable to the loss of production from the largest UKCS field, Leman, which contributes 20 per cent of peak supplies. Strikes on UKCS installations are however rare. Attempts to spread such isolated disputes as have taken place have so far come to nothing, or at worst have been short-lived and have not affected production.

Oil company end of terminals

2.22 A high proportion of supplies comes from two terminals, St. Fergus (35 per cent) and Bacton (45 per cent). The oil company end of each terminal is split (into two at St. Fergus, into three at Bacton) and any strike would be likely to be on a company basis and to affect only one company terminal. The staff are not unionised and there is no history of industrial action. The terminals are moreover highly automated and can be operated by a few key staff. There is therefore little risk of disruption to gas supply arising from industrial action by oil company employees at terminals.

Overall position

2.23 The overall position can therefore be assessed as follows:

i. there has been a low propensity to take industrial action by BGC's employees, because they are relatively well paid, are concerned about safety, are represented by traditionally moderate unions and, in the case of managerial grades, have a culture which is antipathetic to industrial action;

ii. there appears to be little risk of industrial action over pay;

iii. there is a somewhat greater risk of action of job losses although this is more likely to be local than national;

iv. the issue most likely to provoke industrial action is privatisation, depending to some extent on how far the existing structure is likely to be broken up, on the lead given by top management, and on the perceived implications for job security and work practices;

v. with the exception of workers in the Frigg field, where it is hoped that any strike would be settled quickly under the Norwegian arbitration arrangements, the risks of industrial action outside BGC affecting gas supplies are low.

III. THE NATURE AND EFFECTS OF INDUSTRIAL ACTION

Introduction

3.1 The gas industry has four main functions, all of which are potentially vulnerable to industrial action. These functions are:

(a) the production and landing of natural gas;

(b) the transmission and storage of natural gas received by the Corporation and supplies to the regions, including the monitoring of the transmission system and compressor stations;

(c) the supply of gas to consumers including the construction, repair and maintenance of distribution and service pipes; and

(d) the provision of service to customers including the sale of appliances and the installation, repair and maintenance of customers' appliances and pipework.

3.2 The possible effects of industrial action are described below. If the workers were so minded, the effects described could be brought about by action short of outright strike, though it should be borne in mind that industrial action on the mainland in recent years has not, in fact, posed any particular threat to gas supplies (see 2.3 above).

Production and landing of natural gas

3.3 Apart from the BGC end of the terminals, the production and landing of natural gas are dependent on employees other than those of the BGC. The likelihood of prolonged industrial action by non-BGC employees has been assessed in the preceding section. The risk is not thought serious except in respect of Norwegian employees in the Frigg Field, and in the latter case there are grounds for supposing that the action would not be prolonged. There remains the possibility of industrial action affecting the BGC ends of terminals. If the BGC ends of the terminals were not kept in operation the entire British gas supply system would have to be shut down. This risk is however assessed as having a very low probability. The BGC ends of the terminals, like the oil company ends, are highly automated and are operated by a small number of key shift workers. (Three people on each shift at Bacton). During the industrial action in 1981 some of the shift workers at the onshore terminals went on strike but the higher management stepped in and, with the help of some workers who did not go on strike, kept the terminals operating normally. The probability is that, because of the very serious and rapid effect of putting the terminals out of action, the unions would not wish to raise the stakes in this way and that, as in the past, some way would be found to keep them going.

Transmission

3.4 If the national transmission system were to fail, gas supply could be cut off entirely to one or more regions of the country. The transmission system is however the BGC operation which is the least immediately vulnerable to industrial action. With centralised and largely automatic control there is little scope for bringing about an immediate shutdown. The risk is of loss of essential maintenance, in which 2,500 skilled workers are normally involved. The crucial need is to keep in operation 44 compressor stations, driven by aero-engines, to maintain pressures and to increase gas flow. These are normally checked after around 1,000 hours of operation. The checks are not however required for safety reasons. If repairs were necessary and the skilled maintenance workers (CSEU members) were on strike the BGC would need to seek assistance from the manufacturers (Rolls Royce) or possibly from the armed services (see 4.17 below). If progressive closure of parts of the system were to occur, precautions (to prevent the formation of an explosive gas/air mixture) would have to be taken to preserve public safety while outlets were being closed.

Distribution and service

3.5 Industrial action by BGC employees would be most likely to have significant impact on the repair and maintenance of the distribution system (ie. between the national transmission system and the customer's meter) and the repair and maintenance of customers' appliances and pipework. Some of this work (for example the fitting of new appliances and routine servicing of appliances) can be postponed with only minor inconvenience to the consumer. A considerable part of the work consists however of essential maintenance of the distribution system or emergency attendance to deal with faults which involve, or may involve, gas leaks. Of the 16 million jobs carried out each year in distribution and service, some 2½ million are emergency work.

3.6 Of the emergency work, some 90 per cent is accounted for by reported leaks on the customer's side of the meter. If the manual workers were on strike, customers would be told to shut down their supply at the meter. Although these customers (whose numbers might increase at a rate of 20,000 to 40,000 a week) would lose their gas supply with considerable hardship to themselves individually, the effects would be isolated and scattered, and it would be open to the customers concerned to try to get the repairs undertaken by private contractors.

3.7 In dealing with the remaining 10 per cent of leaks on the supply side of the meter the option of making safe by cutting off very small areas from gas supply is not in practice available. The local distribution system does not have a valve system suitable for this purpose. The district (as opposed to the local) distribution system does have governors and sections of it could be closed in a serious emergency involving major loss of gas supply (resulting for example from failure in production offshore, in the terminals or in the national transmission system). Closure would however be regarded as a last resort since it would not result in complete safety for the public because of possible explosive air/gas mixtures in the mains. Purging the affected parts of the system would be time-consuming and would require many staff. Moreover resumption of supplies would entail a fitter calling at every customer's premises to check the pipes and appliances before the gas supply was switched on again at the meter (a task which might take three weeks for 10,000 domestic consumers).

3.8 Every effort would therefore have to be made to repair leaks in the distribution system. The National Agreement relating to emergency cover would probably be interpreted by the unions as requiring them to undertake temporary repairs in the distribution system by "taping". However, depending on the circumstances of a particular leak, BGC might well not regard such temporary repairs as fully adequate, since gas would continue to escape albeit at a reduced rate. They would then have to consider whether it was practicable to effect more permanent repairs by management action, possibly with the help of contractors' labour. Only if this proved impracticable, either because of contractors' attitudes, or because the number of serious leaks exceeded the capacity to effect permanent repairs, would BGC have to adopt the "last resort" course of cutting off supplies to whole districts, affecting in each case perhaps 5,000 - 10,000 consumers.

3.9 There remains the work involved in essential maintenance to permit the continued supply of gas through the distribution system. This depends on relatively few workers. The management might seek to invoke the National Agreement on emergency cover because of the difficulties described in paragraph 3.7 above in closing down safely parts of the distribution system. If the few workers involved were not prepared to carry out the essential maintenance, every effort would be made to carry out the task by management action, possibly with the help of contractors' labour.

3.10 BGC use around 11,000 contract workers on a range of routine and emergency work on the distribution system and in connection with the installation and maintenance of appliances. The number of contract workers varies from region to region according to their labour needs at the time. The extent to which this contract labour could be used by BGC when their own employees were taking industrial action would vary from region to region and would depend on the nature of the dispute, on whether or not they were unionised and on the degree of support for action from the BGC employees and from the public.

<u>Overall assessment of nature of industrial action</u>

3.11 The analysis in the preceding paragraphs suggests that industrial action, in the form either of an all-out strike or of action short of it, would be most likely to result in the cutting-off of supplies to individual customers, rather than the failure or closure of the system as a whole, or of many parts of the system. But there is a risk that leaks in the low-pressure parts of the system could not be repaired promptly and effectively and that this could lead to a slowly growing number of small districts suffering a complete loss of gas supply. The remaining paragraphs of this Section assess the vulnerability of particular groups of customers to loss of gas supply.

<u>Effect on consumers</u>

3.12 In 1982/83 the BGC's customers were broken down as follows:

Domestic	15,347,000
Commercial	499,000
Industrial	83,000
Total users	15,929,000

The main impact of industrial action would probably be on those domestic consumers (about half of all households) who rely on gas for heating and cooking. As explained in paragraph 3.6 above only a very small percentage of such households would be likely to be affected (eg. 300,000 or about 2 per cent) even if the strike were to last for, say, ten weeks. Moreover some of these households might have alternative facilities for meeting some of their heating and cooking needs, and many of them could be expected to try and get their appliances or pipework repaired by private sector labour although, particularly in some parts of the country, the availability of such labour might be insufficient.

Industrial effects

3.13 Just over 30 per cent of all energy used by industry is natural gas. It is used extensively in industry for both process work and space heating. Some firms use very large quantities and would have to cease operations altogether if supplies were cut off unless they had an alternative source of energy on standby. Such standby arrangements are required for those industrial consumers, responsible for about 45-50 per cent of industrial consumption, who are on interruptible contracts. The ability of such firms to withstand a gas shortage would depend on the level of their alternative fuel stocks (likely to be related to the number of days of interruptibility remaining under their contracts when an emergency occurs) and the availability of new supplies of their alternative fuel. Interruptions under the terms of these contracts tend to take place at times of high demand (i.e. usually in winter). The likely effect of industrial action on "interruptible" customers would thus depend, among other factors, on the time of year and the severity of the weather. Where gas is used industrially only for space heating, the effect would depend on the willingness of employees to continue at work in the absence of heating.

3.14 The largest industrial consumer of gas by far is the chemical industry (about 40 per cent of industrial sales). The steel industry is the second largest consumer. A summary of the information available about the industries most dependent on natural gas is provided in the Annex. It should be borne in mind however that if there is no shortfall in supply offshore and the terminals, national transmission system and distribution up to the customer's meter are kept in operation, the industrial customer is vulnerable only to the risk of leaks on his side of the meter which might require repair. Many industrial consumers might be able to undertake the necessary repairs without help from BGC employees. The larger industrial consumers draw gas direct from the higher-pressure parts of the distribution system, and are unlikely to be affected by the sort of leaks and closures of parts of the system discussed in paragraph 3.8 above.

Effect on commercial and other users

3.15 In the commercial and public service sectors gas is used extensively in hospitals, schools and a variety of public sector institutions as well as in shops and offices, mainly for space heating and catering. There are also some specialised users (notably crematoria) which are almost wholly dependent on gas. Without gas about 50 per cent of hospitals containing some 30 per cent of hospital beds in England and Wales (and a somewhat lower proportion in Scotland) would probably have to close and many others would face severe difficulties. Many other commercial and public sector establishments would have to close, except where they were able to switch to alternative sources of energy. It should however be kept in mind, as in the case of industrial consumers, that the effect of industrial action on such major consumers will be limited if it is confined to the non-repair of leaks on the customer's side of the meter and that it might prove possible for large consumers to have such leaks repaired without assistance from BGC employees. However, many such consumers draw their gas from low-pressure distribution systems and are accordingly at risk of having their supplies cut off by closure of parts of the system as described in paragraph 3.8 above.

Supplies to isolated communities

3.16 There are 18 small, isolated communities, mainly in Scotland and Wales, whose gas supplies are dependent on road-borne supplies of LPG or LNG. The risks of local industrial action are considered to be low since the local BGC personnel responsible for the day to day operations on site would be unlikely to support industrial action to the point of discontinuing gas supplies to their own small communities. However the same consideration might not apply to the drivers of the vehicles required to deliver gas supplies and industrial action by them could prevent BGC replenishing local stocks. Although the private sector could provide alternative supplies of LPG it is unlikely that they would be willing to jeopardise their own industrial relations by asking their employers to take part in strike breaking operations. Local trouble spots would then arise whose controversiality and news value might be out of proportion to the fairly low numbers affected.

IV. THE SCOPE FOR MITIGATING THE EFFECTS OF INDUSTRIAL ACTION

4.1 As explained in the preceding section the effects of industrial action would depend crucially on the functions affected, ie:

- action affecting the production and landing of natural gas would result in a reduction in supply to the country as a whole

- action leading to the failure of parts of the national transmission system could mean a loss of supply entirely to areas of the country

- while for technical and safety reasons every effort would be made to prevent action affecting the district distribution system or the local distribution system from resulting in loss of supplies to whole districts or localities, circumstances could arise where shutting off supplies locally would be seen as the lesser of two evils

- action affecting distribution and service on the customer's side of the meter would result in a withdrawal of labour for repair and maintenance leading to the shutdown of the supply to individual customers, as well as the postponement of non-essential work.

4.2 The form of mitigating action would depend on the situation arising, ie:

- reduction in supply to the country as a whole or part of the country would be countered so far as practicable by use of stocks, or reductions in consumption

- loss of supply to particular consumers would be mitigated to the extent that they had access to alternative sources of energy

- withdrawal of labour required for the safe operation and maintenance of the system would be countered, so far as practicable and desirable, by the provision of substitute labour.

Stocks

4.3 A quantity of natural gas is stored as a refrigerated liquid (LNG) and in a severe winter this can be evaporated and used to help to meet the peak demand. There is also gas stored in salt cavities at Hornsea, Humberside, which can be similarly available at times of peak demand. These stores are additional to the supplies of gas from the North Sea, and on a severe winter peak day could constitute about 15 per cent of the total supply. A proportion of this LNG is also set aside to cover mechanical failures in the system.

4.4 Peak gas supplies are available from plants which use oil (naphtha) and light petroleum gases as a feedstock, eg. substitute natural gas and butane/propane air plants. In total these plants constitute about 1.5 per cent of the total supply. In addition to these onshore peak supply plants, the Rough field, which supplies gas into the Easington terminal, is now fully owned by BGC and is to be used as a seasonal store producing gas only as required at times of peak demand in the winter.

4.5 Total storage capacity is equivalent to about two days of peak supplies, although a proportion of this is necessary for security purposes to ensure a safe shutdown of the entire system in an emergency. This would, in combination with reductions in consumption, enable the loss of the largest UKCS field (Leman, contributing 20 per cent of peak supplies) to be withstood for a short period. BGC's LNG and other on-shore storage capacity is closely geared to meeting short-term peak demand and an increase in storage capacity on a scale that would be of significance in a prolonged strike would not be economically justified. The Rough and Morcambe projects will provide, from the winter of 1984/85, greater flexibility in meeting seasonal peak demand. However, these additional peak supplies available from offshore would do little or nothing to increase resilience against disruption of the onshore transmission or distribution system.

Reductions in consumption

4.6 The need to maintain adequate pressure in the system for technical and safety reasons means that there is little scope for reducing gas consumption without cutting off supply to particular consumers. Pressure reduction would achieve only a very small saving especially at times of peak demand. Rota cuts, of the kind used to reduce electricity consumption, are ruled out on technical and safety grounds. An appeal to consumers to economise in the use of gas would probably have only a small effect.

4.7 The first significant measure to reduce gas consumption would therefore be to cut off interruptible supplies within the terms of consumers' contracts. The savings would depend on the number of days of interruptibility remaining from the usual period of 90 days provided in the contracts but the total supply of interruptible gas is only some 20 per cent of gas consumption.

4.8 The next step would be to use the emergency powers under the Energy Act 1976 to enable statutory restrictions on the use of gas to be imposed and for contraventions to be penalised. Orders made under these powers can apply to groups or classes of consumers or to all consumers within some specified area. They may prohibit the use of gas altogether or at certain times or for certain purposes. Directions could be given to individual consumers requiring them to stop using gas. These powers are only available while an Order in Council under Section 3.1 of the Act is in force.

4.9 When supplies fall short BGC need to reduce demand rapidly to match available supply, first by ceasing to supply interruptible customers and then by requesting selected major customers to reduce their demand. Once the situation has been brought under control it is open to them, within the limits set by available supplies and by the need to maintain minimum safe pressures in local distribution mains, and subject to the necessary statutory powers having been taken, to seek to give preference to priority consumers as determined by Government. It is not at present clear to us how effective are the arrangements for giving guidance to BGC on the priorities to be observed. The Group recommends that the Department of Energy, in consultation with DTI and other interested Departments and with BGC, should re-examine these arrangements and should report the outcome to the Civil Contingencies Unit.

Alternative energy sources

4.10 It is compulsory for industrial users supplied on interruptible terms to have an alternative source of energy - in most cases heavy fuel oil. The effect of loss of supply on their customers, and any other customers with the capacity for switching to oil, would be mitigated by any arrangements which the oil companies were able to make to ensure that increased supplies of heavy fuel oil were available to such customers.

4.11 Some consumers in the industrial and commercial sector, and many domestic consumers, will be able to meet some of their needs by switching to electricity. It is conceivable that electricity demand at peak times of the day in the winter might, as a result, rise above the ability of the electricity industry to supply. For example, if a third of domestic gas consumption at the evening peak on an average winter day were to be replaced by switching to electricity, there would be a shortfall in generating capacity of some 13 per cent. Such a shortfall would (even without taking into account constraints on transmission and distribution capacity) require rota power cuts of the order of those experienced during the winter of 1973/74, during which most consumers were liable to suffer about one three-hour power cut a day on average.

Substitute labour

4.12 As the analysis in Section III showed, the areas in which substitute labour might be required are as follows:

i. the terminals can be kept in operation by higher management with the help of a handful of workers (it would be surprising if BGC were unable to command the resources needed to do this, though it has not been thought desirable to consult them on the point specifically);

ii. the national transmission system can be kept in operation by higher management with the help of some of the 2,500 skilled maintenance workers or failing that assistance from the manufacturers of the engines (Rolls Royce) or possibly the armed services (see 4.17 below);

iii. distribution and service work essential for safety purposes ought to be carried out by BGC employees under the National Agreement. Where work is regarded as essential by management but not by the unions it would be open to management to seek to get it done by private contractors (who might, however, be unwilling to engage in "strike breaking") or by service assistance. In either case, however, there would be some risk to existing safety cover by BGC employees.

Existing plan for Service assistance

4.13 The current plan for Service assistance in the event of industrial action in the gas industry is known as VIBRATE. It provides Service manpower to assist the industry to maintain safety measures during industrial action by manual workers. It involves a total of 5430 servicemen (200 LV electricians, 50 HV electricians, 1485 mechanics, 885 drivers and 2810 unskilled/semi-skilled).

4.14 The plan envisages that the servicemen should be divided between the British Gas regions. Gas industry staffs would then allocate them to tasks and supervise their "on the job" training. The tasks they would be given are:

a. support for tasks for regional gas distribution (eg. monitoring pressure flow conditions and carrying out essential safety measures in gas holder stations);

b. maintenance of emergency services (eg. detection and temporary repair of gas leaks and initiation of shutdown procedures at gas supply sites).

As usual in operations of this sort, although tasking is a matter for gas industry management, the servicemen would remain under Service command throughout.

4.15 Successful implementation of the plan depends upon:

a. the continued operation, by gas industry staff, of the main high pressure transmission system;

b. the continued presence at work of sufficient supervisors to task and train the servicemen;

c. unrestricted access to specialised equipment.

The importance of the continued working of staff grades is therefore evident. If they are not prepared to work the Services lack the expertise to replace them.

4.16 Even if these requirements are met, the capacity provided by the Services is small in relation to the industry's normal manpower (around 42,000 manual workers). The servicemen can therefore do no more than provide limited safety cover. There is no prospect of expanding the plan, because the Services lack the skills needed in the industry.

4.17 As indicated earlier in this paper (paragraph 3.4) the need to keep in operation the compressor stations driven by gas turbines is critical to the maintenance of BGC's transmission system. Although recourse to the manufacturers might prove feasible in the event of a breakdown it would be desirable to have available a source of expertise which is not so susceptible to industrial relations pressures. At first sight the maintenance of gas turbines seems likely to be an area in which Service expertise will be relevant but the full feasibility of a Service plan to cover this task cannot be established without more detailed study, which will require consultation with BGC. It is therefore recommended that CCU should be charged with investigating the possibility of preparing a plan for Service assistance with the task of maintaining the compressor stations in operation.

General considerations affecting the use of substitute labour

4.18 In considering whether to use substitute labour, whether from private contractors or from the Services, the BGC would have to assess the existing level of emergency cover provided under the National Agreement and the risks that the existing cover might be withdrawn. It would also be necessary to ensure that work already being done by higher management, beyond their normal duties, would not be affected, and that their co-operation with any substitute labour would be forthcoming.

Overall assessment

4.19 The scope for mitigating action to counter a reduction in gas supply, by use of stocks or by reduction in consumption is limited. Further work is desirable to ensure that adequate guidance is given to the BGC on the priorities to be observed among consumers in a situation of reduced supply. The length of time that a substantial shortfall in gas supply could be withstood will depend on the nature and scope of the shortfall and on the time of year. A severe shortfall in overall supplies, which would be more likely to arise from action by workers in the Norwegian Frigg field than from action by the BGC's employees, is however not thought to have a high probability.

4.20 The main scope for mitigating action is in the use of substitute labour. The small number of key BGC personnel necessary to keep the terminals and national transmission system in operation could not be substituted with people from outside BGC. However, it should be possible in certain circumstances for BGC management to use substitute labour (either private contractors or servicemen under the existing plan VIBRATE) to maintain the district and local distribution system in a safe condition, should this not be achieved through union co-operation under the National Agreement on emergency cover. Industrial consumers affected by a leak on their side of the meter will lose supply unless they are willing and able to have the leak repaired either by their own staff or by a private contractor.

4.21 The co-operation of higher management is however essential for keeping the system in operation in all its functions, from landing to the consumer.

V. SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS

Industrial relations background (Section II)

5.1 The industrial relations risks can be summarised as follows:

i. there has been a low propensity to take industrial action by BGC's employees, because they are relatively well paid, are concerned about safety, are represented by traditionally moderate unions and, in the case of managerial grades, have a culture which is antipathetic to industrial action;

ii. there appears to be little risk of industrial action over pay;

iii. there is a somewhat greater risk of action over job losses although this is more likely to be local than national;

iv. the issue most likely to provoke industrial action is privatisation, depending to some extent on how far the existing structure is likely to be broken up, on the lead given by top management, and on the perceived implications for job security and work practices;

v. with the exception of workers in the Frigg Field, where it is hoped that any strike would be settled quickly under the Norwegian arbitration arrangements, the risks of industrial action outside BGC affecting gas supplies are low.

Nature and effects of industrial action (Section III)

5.2 The effect of industrial action by BGC's employees on the main functions of the system is assessed as follows:

i. it ought to be possible to keep the terminals in operation given the cooperation of higher management, and assistance from a small number of key workers (probably less than ten); this should be forthcoming bearing in mind the small numbers involved and the likely reluctance of the unions to precipitate a closure of the entire gas supply system;

ii. the centralised and automated national transmission system is unlikely to be shut down, given cooperation from higher management; it would become progressively vulnerable to breakdown through loss of essential maintenance, but only a small number of skilled men would be required for this and, if need be, assistance might be sought from the equipment supplier (Rolls Royce) or possibly from the armed services.

iii. the distribution system is vulnerable to the loss of labour for the repair of leaks and essential maintenance; the 90 per cent of leaks on the customers' side of the meter would be dealt with by shutting off supply at the meter, unless the customer could get the leak repaired without BGC assistance; this might cause progressive loss of supply at the rate of 20,000 to 40,000 customers a week; leaks in the distribution system on the supply side of the meter might be repaired, perhaps only temporarily, with cooperation from the unions under the National Agreement relating to emergency cover; if BGC did not regard such repairs as adequate they would need to decide whether it was practicable to effect permanent repairs by management action, perhaps with the help of contractors' labour; if these repairs proved impracticable BGC would have to adopt the "last resort" course of cutting off supplies to whole districts.

5.3 The consumers vulnerable to industrial action affecting gas are mainly:

i. the 50 per cent of domestic households using gas for heating and cooking;

ii. some major industrial users, and particularly the chemical industry;

iii. a large part of the commercial and public service sectors (including hospitals) who use gas for space heating and catering.

5.4 It should be borne in mind however that, if there is no shortfall in supplies from offshore, and provided that there is continued working by the relatively small number of key staff necessary to keep gas flowing through the national and regional systems, the effects of industrial action would be limited. Only a small percentage of domestic households would progressively have supply cut off at the meter because of leaks on their side of the meter. Some of these might be able to have repairs done by the private sector or to switch to electricity for some at least of their needs, though larger local concentrations of consumers would lose supplies if it became necessary for safety reasons to cut off some supplies at the district level. Those industrial consumers (responsible for about 45-50 per cent of industrial consumption) who are on interruptible contracts would have alternative standby arrangements and might in any event be able to use their own qualified labour to repair leaks on their side of the meter. Major commercial and public service sector consumers may also be able to get their leaks repaired without BGC assistance. Larger industrial consumers are unlikely for technical reasons to be affected by leaks and closures in the district distribution system, though the same is not true of larger commercial and public sector consumers.

<u>Scope for mitigating the effects of industrial action</u> (Section IV)

5.5 The scope for mitigating action to counter a reduction in gas supply by use of stocks or by reduction in consumption is limited. Further work is desirable by the Department of Energy and other Departments concerned to establish with BGC how far in a situation of reduced supply preference could be given to priority consumers as determined by Government. The length of time for which a substantial shortfall in gas supply could be withstood would depend on the nature and scope of the shortfall and on the time of year. Such a contingency, which would be more likely to arise from action in the Norwegian Frigg Field than from action by the BGC's employees, is however not thought to have a high probability.

5.6 The main scope for mitigating action is in the use of substitute labour. The small number of key BGC personnel necessary to keep the terminals and national transmission system in operation could not be substituted with people from outside BGC. However, it should be possible in certain circumstances for BGC management to use substitute labour (either private contractors or servicemen under the existing plan VIBRATE) to maintain the district and local distribution system in a safe condition, should this not be achieved through union cooperation under the National Agreement on emergency cover. Industrial consumers affected by a leak on their side of the meter will lose supply unless they are willing and able to have the leak repaired either by their own staff or by a private contractor.

5.7 The cooperation of higher management is however essential for keeping the system in operation in all its functions, from landing to the consumer.

Possible strategies

5.8 In considering possible strategies the Group confined itself to considering the scope for reducing the risk of, or improving the ability to withstand, industrial action by the BGC's own employees. Action affecting gas supply by others is either very unlikely or (as in the case of disputes affecting workers in the Norwegian Frigg Field) is normally outside the influence of the BGC or the United Kingdom Government. The Department of Energy is in close touch with the Inland Revenue and the Treasury about the proposed new tax protocol affecting these workers and would ensure that the risks to gas supply would be carefully weighed and brought to the attention of Ministers before a decision was taken to bring the new protocol into force.

5.9 It was also outside the Group's remit to consider how far industrial action in the gas industry might be deterred by existing or proposed legislation on industrial relations, either of general application or of application particularly to essential services, since these matters are under separate consideration.

5.10 The Group concluded that the following points which emerged from the study were of particular significance:

i. the risk of industrial action is most likely to arise in relation to proposals to privatise the gas industry, depending on the extent to which the existing structure is likely to be broken up, the lead given by top management, and the perceived implications for job security and work practices;

ii. the cooperation of higher management is crucial; as the recent formation of the Gas Higher Management Association has shown many of them are opposed to industrial action; if they continue to cooperate, any industrial action will be significantly less effective; per contra some extreme forms of action by higher management in association with some key staff could bring about the total and immediate cessation of gas supply;

iii. it is difficult for technical and safety reasons to cut off gas supply short of the customer's meter, although some parts of the district distribution system could be cut off as a last resort; the BGC's employees will probably be reluctant to place the safety of the community in jeopardy and thus forfeit public sympathy; therefore, depending on the workers' perception of the safety risks involved there is some prospect that disruption of supply short of the customer's meter might be limited or, at worst patchy; if, as is not thought probable, the workers did take an irresponsible attitude to safety the consequences would be severe;

iv. if industrial action were to be largely confined to the non-repair of leaks on the customer's side of the meter (which could be remedied by cutting off supply at the meter or by the customer's getting the leak repaired by a private contractor) only a small percentage of domestic consumers would be affected and it should be possible to withstand industrial action for many weeks.

5.11 The Group's main recommendations are therefore as follows:

i. in considering possible forms of privatisation for the gas industry, it will be desirable to weigh, alongside all the other relevant factors, the extent to which some forms of privatisation may substantially increase the risks of industrial action;

ii. the attitudes of higher management and their key staff will be crucial and it will clearly be important to make every effort to win their support for, or acquiescence in, whatever proposed form of privatisation Ministers may decide on;

iii. in the event of industrial action both the Government and the top management of the BGC would need to exploit fully the likely reluctance of the workforce to be seen to be endangering the safety of the community, as this could limit industrial action to a scale and type which could be endured for many weeks.

5.12 The Group also makes the following detailed recommendations:

iv. the Department of Energy, in consultation with the Department of Trade and Industry and other interested Departments and with BGC, should re-examine the arrangements for giving guidance to BGC on the priorities to be given, if possible, to essential gas consumers in the event of a significant reduction in gas supplies and report to the Civil Contingencies Unit;

v. the Civil Contingencies Unit should be asked to examine the possibility of contingency arrangements to facilitate the provision of Service assistance with the maintenance of the compressor stations in the national transmission system.

Cabinet Office
15 December 1983

INDUSTRIES MOST DEPENDENT ON GAS SUPPLIES

Iron and Steel

The iron and steel industry is the main consumer of non-natural gas. 20% of BSC's production involves the use of electric arc furnaces in which coke-oven gases are an important source of heat. Nevertheless, the iron and steel industry overall is still the second largest consumer of natural gas supplied by the British Gas Corporation. Over 36% of the gas used by the industry is natural gas.

In the event of a cessation of natural gas supplies, every private sector steel company's production would be badly hit, although there would be no inherent damage to plant. BSC would also be severely affected.

British Telecom

Some sophisticated electronic equipment now coming into use in BT requires uninterrupted temperature control. This may be gas dependent.

Aerospace

A reduction in gas supplies would cause serious problems even though as an energy source it is secondary to electricity.

Computers, Communications and Electronics

The IT industry is an assembly industry. However the components and other peripheral industries will be affected because gas is essential to certain processes. In particular gas is used in furnace processes, for coating printed circuit boards, in tape production and in disc coating. If there were to be a complete cessation of supplies there would be no damage to plant, and the industry could probably survive for a short while on stocks. However, eventually the industry would grind to a halt. Gas may also be important for clean air systems.

Clothing and Knitwear Industries

Gas is critical for certain steam using processes such as pressing, finishing and dying.

Mechanical and Electrical Engineering - General

A fair proportion of these industries are dependent on gas for ovens and furnaces for the heat treatment of materials, of which forging, metal cutting, annealing, soldering and brazing are just a few. The cessation of the supply of gas would have an immediate and disastrous effect on these industries. Some establishments might be able to keep going for a time using bottled gas.

Many other industries which rely on the use of components produced by these processes, would cease production when their stocks ran out.

Manufacturing Machinery and Machine Tools

Gas is important in the heat treatment of components but subsidiary in importance to electricity and oil.

Construction and Materials Handling Equipment

Loss of gas supplies would probably affect only the smaller companies, and smaller contractors, particularly those who are carrying out heat treatment processes. Disruption would be severe within three weeks.

Electrical Engineering

The effect would be felt mainly in those sectors of the industry using gas for process heating, eg glass working in the manufacture of electric lamps, where production would cease.

Metallurgical Plant Including Furnaces, Foundry Equipment and Die Casting Machines

If a disruption in gas supplies was sufficient to bring the heat treatment processes to a halt, overall production would cease soon afterwards.

Manufacture of Process Plant

Gas is used in some processes, including heat treatment processes, and loss of supplies would have repercussive effects on total output.

Newspapers, Printing etc

Gas is used not only for space heating but for process heating and process drying plus solvent recovery.

Paper and Board Industry

The whole industry is totally dependent on uninterrupted supplies of primary fuels, including gas, uses of which vary between mills.

Glass Industry

Glass container manufacture is a continuous process. It depends on a consistent supply of energy, including gas, to fire the furnaces and to keep the plant fully operational. Any interruption in energy supplies could result in furnace damage and shut down for 12 months for re-building (stand-by generators are inadequate for maintaining production). One-third of glass container manufacture is for the food and agricultural industry, and 9% for the chemical and pharmaceuticals industry. Any interruption in the supply of glass containers for more than two/three weeks would affect users' ability to supply essential public needs.

Gas is particularly used for the following processes:

Heating of furnaces

Heating of molten glass emerging from furnaces

Heating moulds

New furnaces are now normally dual-fired - gas or oil.

Industrial Sands

The industry is a heavy user of gas, mainly in its drying process.

Ball and China Clay

The industry is partially dependent on gas for processing raw materials.

Non-Ferrous Metals and Refractories

Some plants and processes (eg the continuous casting of copper) are dependent on gas. Withdrawal of supplies may result in closure. Many processes must carry through a 10/14 day cycle at a constant high temperature.

Motor Manufacture and Internal Combustion Engines

The industry is highly vulnerable to withdrawal of any form of energy supply. Gas is essential for paint processes.

Crematoria

Gas is almost universally used in crematoria.

Chemicals

The UK chemical industry employs 366,000. Turnover is over £16bn and the industry maintains a positive balance of trade of around £1.8bn. It produces some 30,000 chemical compounds. Most recent figures available (1980) show that about 40% of the chemical industry's energy is derived from natural gas. The chemicals and allied industries consume over one-third of total industrial sales of gas. Gas is used both for power and as a feed stock.

Disruption of production can have severe effects on the rest of industry, because most chemicals are sold for downstream uses. In addition, there is a public health requirement for goods such as detergents, soaps and pesticides.

Companies on interruptible contracts will have standby arrangements to use other fuels, but the extent of this capability is not known. Our information about 14 chemical plants in the North West is that 10 have firm contracts and 4 interruptible contracts. This suggests that the proportion of plants with standby arrangements may be as low as one third.

DC. B/F
5/1/84

10 DOWNING STREET

Prime Minister

To note the work of the Audit Commission. Mr Letwin's note explains the purpose of this manual and illustrates some of the horrors the AC has uncovered. You might like to look at the introduction and glance at the profile for Barnet.

I have written to Mr Read acknowledging receipt of the manual but will, if you agree, write again when you have looked at the manual, encouraging the AC in its work.

AT
21/12

~~TOP~~ SECRET

15A

Prime Minister

It looks as though you did not have time to look all the way through this.

AT 22/12

PRIME MINISTER

This report reaches the unexpected conclusion that the effects of a gas workers strike are likely to be limited. This is explained in the conclusions beginning on page 26.

A privatisation involving restructuring is thought to be the most likely cause of a strike. Mr. Walker may use this as an argument for doing it without restructuring. The Policy Unit draw the opposite conclusion. If the gas industry is not very vulnerable to a strike then we should not shrink from desirable measures to increase competition.

For the time being you are simply invited to take note though consent is sought for the two detailed recommendations in paragraph 5.12.

Agree?

Yes md

Duty Clerk

p.p. A.T.

21 December 1983

(i)

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

01-211-6402

Prime Minister

Content with the revised timing for this announcement?

DMB
21/12

David Barclay Esq
Private Secretary to the
Prime Minister
10 Downing Street
LONDON SW1

19 December 1983

Yes MT

Dear David

Thank you for your letter of 16 December confirming the Prime Minister's agreement to the transfer of my Secretary of State's gas safety responsibilities to the Secretary of State for Employment.

When Mr Walker minuted the Prime Minister on 28 November he said that he had in mind 1 January for transfer. Given the short time that now remains this is no longer practical. We therefore propose to make the transfer effective from 1 February and to make an announcement by way of an arranged Question immediately after the Christmas Recess.

I would be grateful for your confirmation that the Prime Minister is content with these arrangements.

Copies of this letter go to Richard Stoate (Lord Chancellor's Office), Tony Rawsthorne (Home Office), Barnaby Shaw (Employment) and Richard Hatfield (Cabinet Office).

Yours ever
Michael

M F REIDY
Private Secretary

DRAFT QUESTION AND ANSWER

Q. To ask the Secretary of State for Energy what steps he proposes to take to remove the present overlap in gas safety responsibilities between himself and the Secretary of State for Employment.

A. It is intended that, as from 1 February 1984, the gas safety responsibilities which I now exercise should be transferred to the Secretary of State for Employment. Broadly, these responsibilities involve the power to make gas safety regulations under S 31 of the Gas Act 1972 and the associated powers on penalties and prosecutions under S's 42 and 43; and the enforcement of the Gas Safety Regulations 1972 and the Gas Safety (Rights of Entry) Regulations 1983. The Secretary of State for Employment will also become responsible for making gas appliance safety orders under the Energy Conservation Act 1981 and for associated questions relating to gas appliance safety, including European Community activities in this area.

I understand that my RHF intends to make an agency agreement with the Health and Safety Commission to carry out most of these functions on his behalf. In addition, I propose to make a separate agreement with the Health and Safety Commission to cover the issue of consents under S 29 of the Gas Act 1972, since currently safety is the only consideration.

NatInd
Gas + Elec
pricing policy
K.I.

21 DEC 1983

O+O

Prime Minister (2)
To note. I have acknowledged.
AT 16/12

The Association of
British Chambers of Commerce
Sovereign House, 212a Shaftesbury Avenue
London WC2H 8EW
Telephone: 01-240 5831/6

DIRECTOR-GENERAL: W.A. NEWSOME

The Prime Minister,
The Rt Hon Margaret Thatcher MP
10 Downing Street,
LONDON SW1

16 December 1983

MF

Dear Prime Minister,

I enclose a copy of a letter which the Director-General of this Association has today sent by hand to the Secretary of State for Energy, on the subject of elecricity prices.

Copies have also been sent to the Chancellor of the Exchequer and the Chairman of the Electricity Council.

Yours sincerely,

David Nicholson

David Nicholson
Director, Home Affairs

Enc

The Association of
British Chambers of Commerce
Sovereign House, 212a Shaftesbury Avenue
London WC2H 8EW
Telephone: 01-240 5831/6

DIRECTOR-GENERAL: W.A. NEWSOME

The Rt Hon Peter Walker MBE MP
Secretary of State for Energy,
Department of Energy,
Thames House South,
Millbank
LONDON SW1P 4QJ

16 December 1983

Dear Secretary of State.

Thank you for your letter of 8 December about gas and electricity prices, in reply to mine of 16 November.

As you might imagine, we can hardly be satisfied with the outcome on gas prices, but the purpose of this letter is to say that we very much take on board the statement in your second paragraph that "pricing decisions are a matter for the industries concerned". Our members this morning are naturally concerned at the reports that the Cabinet yesterday agreed to apply some form of indirect pressure on the Electricity Council to oblige it to raise its prices, without recourse to legislation, which would clearly be the proper constitutional approach. We have noted that those reports indicate that prices to industry may remain frozen over the next year.

In view of the Electricity Council's belief that it can meet the Government's financial targets without raising its prices at all, this letter is to assure you of this Association's vigorous support for all you can do to ensure that the Electricity Council does not increase its prices to industry. I need hardly add that if the reports in this morning's papers prove to be ill-founded, and electricity prices to industry do rise next year, the members of the Chambers affiliated to this Association will be very displeased indeed.

I am copying this letter to the Prime Minister, the Chancellor of the Exchequer and the Chairman of the Electricity Council.

Yours Sincerely,

Tony Newsome

W A Newsome
Director-General

MJ
cc CO
DM
LCO
HO

10 DOWNING STREET

From the Private Secretary 16 December 1983

Ministerial Responsibility for Gas Safety

The Prime Minister was grateful for your Secretary of State's minute of 28 February.

The Prime Minister agrees that the Ministerial responsibilities for gas safety which currently lie with your Secretary of State should be transferred to the Secretary of State for Employment, on the understanding that both Mr. Walker and Mr. King agree that the Secretary of State for Employment has the lead interest.

The Prime Minister agrees that the transfer should take effect on 1 January, and that it should be announced in advance.

I am sending copies of this letter to the Private Secretaries to the recipients of your Secretary of State's minute.

Michael Reidy Esq
Department of Energy.

DSG

S/O

LC.NO

14

SCOTTISH OFFICE
WHITEHALL, LONDON SW1A 2AU

NBPM

AT 15/12

SECRET

The Rt Hon Peter Rees QC MP
Chief Secretary to the Treasury
HM Treasury
Parliament Street
LONDON SW1

14 December 1983

Dear Peter,

SCOTTISH ELECTRICITY BOARDS: EXTERNAL FINANCING LIMITS AND PRICES

I have seen the paper which Peter Walker has circulated for tomorrow's Cabinet about electricity prices.

The EFLs which I agreed with you for the Scottish Electricity Boards in October involved substantial reductions in my proposals, particularly in the case of the SSEB. As I made clear to you at the time my agreement was on the understanding that financial restrictions would not delay progress of SSEB's major capital investment at Torness and that I could not contemplate a situation where the EFL led to a substantial price increase in Scotland when there was a freeze in England and Wales.

It is now clear that the present level of EFLs will lead to price increases of at least 5% in Scotland: in a recent informal discussion the Chairman of SSEB mentioned the possibility of 7% and some of the Board's internal estimates point to figures even higher than that. I think it is essential that we should be able to restrict these increases to something less than the rate of inflation, a point to which the Prime Minister clearly attaches importance, as indicated in her Private Secretary's letter of 8 December. To allow sizeable increase which would be attributed to the construction of Torness, which represents such a major financial burden on SSEB, would attract severe criticism of our nuclear programme. I would also remind you that the long-run marginal cost in Scotland is substantially below that in England and Wales so that the principles of economic pricing mean that an increase in Scotland which would very largely close the gap with England and Wales (and would probably make industrial prices higher) would be particularly unjustifiable.

I cannot yet quantify the precise implications for the EFL's of keeping increases in Scotland below the rate of inflation, because the Scottish Boards still have to complete their estimates for 1984-85, but I hope it will be possible to agree the policy objective at this stage.

I am copying this letter to the Prime Minister, Cabinet Colleagues and Sir Robert Armstrong.

Yours ever,

George.

MR. TURNBULL

ELECTRICITY PRICES

The central question for Cabinet tomorrow is whether the industry can deliver the agreed EFL of £740 millions in 1984-85 without a price increase. All other arguments are secondary.

Even if this is possible, there is still a strong case for accepting the savings and insisting on a price rise. Cabinet on 10 November concluded that "any additional savings which the industries were able to offer would be welcome but that Cabinet was not ready at this stage to regard them as a substitute for desirable price increases".

Efficiency Savings

We have no indication of the source of the additional £210 million of savings. The Electricity Council have merely stated that they will do their best to achieve the EFL and that they have always delivered in the past.

This is not good enough. MISC 99 had understood that there was no further scope for efficiency savings. Although there is undoubtedly more fat in the industry, we must have a clearer indication of whether further savings are appropriate and realistic.

The option of raising prices later in the year if the savings are not being achieved is unattractive. It will be both difficult and politically damaging, particularly if, as well might be the case, the necessary rise is higher than 3%.

Presentation

A 3% rise will still be below the rate of inflation. It can be presented as the direct consequence of Government pressure on the industry to improve efficiency and reduce costs.

Economic Pricing

Any settlement below the rate of inflation will be consistent with a move towards economic pricing.

/There is no

There is no difference of opinion among Treasury, Energy and the Policy Unit about the direction in which prices should move but only about the magnitude.

Our view that prices probably need to fall further than the levels given by a 3% increase is based on the figures produced when the current financial target was set. The Treasury have never been convinced about the validity of these figures. They consider that a 3% rise would be in the middle of a range of uncertainty about the proper level of economic prices.

A 3% rise, therefore, would not be inconsistent with economic pricing principles.

Financial Framework

A 3% price rise is not inconsistent with the financial framework and Government's desired relationship with the industry. Our pressure upon the industry has already produced significant efficiency savings which were not apparent when the financial target was set. As a result the target will be exceeded, irrespective of any decisions on pricing.

At the time the target was set, we anticipated that prices would rise by 1½% less than the rate of inflation in 1984/85. There is no reason, therefore, why we should not maintain the original pricing path and raise the EFL.

Industrial Consumers

We do not accept that the consequence of current decisions on pricing should be to disadvantage industrial consumers. Fuel adjustment clauses and tariffs are both part of the price which the consumer pays. It must be possible to ensure that all consumers receive equal benefit from falling real prices.

Next Steps

Whatever is agreed for 1984/85, the implications of introducing economic pricing principles from 1985/86 onwards should be established well ahead of the next IFR. There are difficult issues here which must be resolved before the next financial target is set.

Conclusions

The case for a price freeze rests upon the ability of the Electricity Council to deliver the EFL through efficiency savings.

We have no evidence and no confidence that this is possible.

We should insist on the 3% price rise.

We should ensure that all consumers receive equal benefit from falling real prices.

The full implications of economic pricing should be established well ahead of the next IFR.

DLP.

DAVID PASCALL
14 December 1983

PRIME MINISTER

ELECTRICITY PRICES

You discussed this with the Chancellor. You both felt that the Electricity Council's word on achieving the EFL was an insufficient basis for a commitment to freeze prices as far ahead as April 1985.

You agreed to suggest a 2% rise on domestic prices and no increase in industrial prices, other than operation of the fuel adjustment clause.

I disagree with the Policy Unit advice. In my view, you are right to think that, without the co-operation of the Departmental Minister, you would incur great political damage in trying to impose a 3% rise. If the Minister concerned had been more enthusiastic, it might be different, but then the problem might not have arisen in the first place.

AT

14 December 1983

13

Ref. A083/3456

PRIME MINISTER

Public Expenditure Survey 1983: Electricity Prices
(C(83) 36)

BACKGROUND

The Ministerial Group on Public Expenditure (MISC 99) agreed with the Secretary of State for Energy, and recommended to the Cabinet, a package of savings on the nationalised energy industries. In addition to a reduction in the NCB's investment programme, £128 million was to be found by efficiency savings from the gas and electricity industries (we understand that the bulk is, in fact, to come from the electricity industry); and a further £210 million was to come from an increase of 3 per cent in electricity prices in England and Wales. In the absence of his Secretary of State, the Minister of State, Department of Energy, pointed out that the electricity supply industry (ESI) might be unwilling to increase prices in this way, and that the Government had no statutory power to require it to do so. The Secretary of State therefore wished to have discretion to agree to alternative proposals providing equivalent savings. The Cabinet took the view that the proposed price increase was fully justified; in particular, it avoided the risk that subsequent price increases might have to be more severe than was desirable. The Cabinet were not ready at that stage to regard efficiency savings as a substitute for desirable price increases. The Secretary of State for Energy was invited to make strenuous efforts to persuade the ESI to accept the Government's views (CC(83) 33rd Conclusions, Minute 4).

2. Since then there have been exchanges with the Chairman of the Electricity Council, Mr Philip Jones (see in particular his
FLAG A letter of 21 November attached to the Secretary of State for
FLAG B Energy's letter to the Chancellor of the Exchequer of 24 November), and between Ministers (see in particular the Chancellor's letter
FLAG C+D of 29 November and the Secretary of State for Energy's reply of
FLAG E 8 December). Your Private Secretary's letter of 8 December asked

the Secretary of State for Energy to circulate a note to the Cabinet for discussion. This was to cover three points:

(i) What alternative savings have the ESI discovered, and are they acceptable?

(ii) Are the prices proposed by the ESI consistent with the principles of economic pricing?

(iii) Is the proposed balance between domestic and industrial electricity prices sensible?

3. In response to this the Secretary of State for Energy has circulated his memorandum C(83) 36. His proposal (paragraph 11) is "to leave the industry now to minimise price increases within the new and exigent EFL". This means in practice, as the rest of his paper indicates:

(a) that the industry would do its utmost to live within the already announced EFL for 1984-85 of minus £740 million (ie repayments to the National Loans Fund of that amount);

(b) that it would not do so by unacceptable devices such as running down coal stocks at the expense of power station endurance or "end-year switches of money"; and that the industry would be reviewing working capital requirements as urged by the Treasury;

(c) that it would be ready to propose price increases during the year if necessary to achieve the EFL.

The Secretary of State also argues that the resulting prices are reasonable in economic terms and that they hold a proper balance between domestic and industrial consumers, the small increase for industry in 1984-85 offsetting the small reduction for industry in 1983-84.

MAIN ISSUES

4. The main issues before the Cabinet are as follows:

(i) Should the proposals on electricity prices in C(83) 36 be accepted?

(ii) If so, should any conditions be attached to that acceptance?

(iii) If not, how should the ESI be made to increase prices in 1984-85?

Should the proposals be accepted and, if so, on what conditions?

5. In considering whether the Secretary of State for Energy's proposals should be accepted, the Cabinet will need to satisfy itself on the following points:

(i) Is the proposed path of price increases now satisfactory? One of the main reasons why MISC 99 favoured an increase of 3 per cent in 1984-85 was to ensure that the increase in 1985-86 could be 3 per cent rather than 6 per cent as envisaged earlier by the industry. The Electricity Council has now told Mr Walker that its latest forecast is for a price increse of only 3 per cent in 1985-86 even if there is little or no price increase in 1984-85. If this had emerged in time for the discussions of MISC 99 they might well have taken a different view. There may be some residual concern about the possibility of a price increase which the ESI is ready to contemplate later in 1984-85 should it prove necessary to meet the EFL. If there was any danger that this increase might, as a result of postponement, have to be higher than the 3 per cent originally proposed by the Government from 1 April 1984, this would not produce a satisfactory path. This is a point on which Mr Walker and the Electricity Council might be asked to give reassurance.

(ii) Are the pricing proposals reasonably consistent with the principles of economic pricing? In general the thrust of recent discussions about economic pricing of gas and electricity is that gas has been underpriced (because the price has not taken adequate account of the world market price of the new gas supplies on which we shall increasingly have to rely) whereas electricity has been overpriced (because inadequate account has been taken of spare capacity and the low present requirement for investment). It would be difficult to argue a strong case on economic pricing principles for insisting on a 3 per cent rather than a smaller or nil increase in 1984-85. It would of course be contrary to the Government's general policy to subsidise electricity prices, which Mr Walker has sometimes seemed inclined to favour. But Mr Walker and the ESI would argue that a subsidy is not at issue here. The Cabinet was concerned at the meeting on 10 November that the financial target for the industry for 1983-84 and 1984-85, 1.4 per cent on current (not historic) cost assets, may be too low. If the target were to be increased, higher prices would probably be required. But, whatever the merits of increasing the target might be, it is not in practice easy to justify putting the target up again so soon after reducing it (from 2 per cent) in March 1983.

(iii) Is the impact on industry of the pricing proposals satisfactory? It emerged from the Electricity Council's letter of 21 November (and this is referred to in paragraph 10 of C(83) 36) that even if prices are frozen overall in 1984-85 charges for industrial and larger commercial consumers would rise by nearly 2 per cent and the increases for industrial consumers in the Midlands would come out nearer to 4 per cent. The question is therefore whether it would be feasible and desirable to change the balance of the ESI's pricing proposals in favour of the industrial consumer. The difficulty is that such price increases as might affect the industrial consumer appear to result not from any conscious decision by the ESI to load price increases on the industrial consumer but from the operation of the fuel price adjustment and from the fact that prices set by different Area Boards vary around the overall average. It would be odd for the Government at one moment to be pressing the case for more realistic and higher prices and at the next moment to be urging the ESI to charge lower prices to industry on industrial policy rather than economic pricing grounds. But the Secretary of State for Energy is already in touch with the ESI (paragraph 10 of C(83) 36) about alleviating the effects on industry of inter-area price differences.

(iv) Are the alternative savings credible and acceptable? It is unlikely that the dispute over electricity prices would have arisen if the ESI and Mr Walker had come forward with the alternative savings in the bilateral discussions or in MISC 99. It suggests either that something was being held back or that financial control and forecasting were not previously as tight as they should have been. But whatever view may be taken about the past, the Cabinet now has to consider whether there is sufficient assurance that the savings will be found in an acceptable way. Some assurances have now been given that certain unacceptable devices will not be used and there is a suggestion that particular attention will be paid to working capital requirements. Should agreement to Mr Walker's proposals be made conditional on further information being supplied about the ways in which the savings will be found? Or has this line of enquiry now been taken far enough in view of the general policy that it is for a nationalised industry itself to work out how it lives within its EFL?

Securing price increases opposed by ESI

6. If the Cabinet are not disposed to agree to the proposals in C(83) 36 it will be necessary to consider how the Government's views on prices can be made to prevail. One possible course would be to invite the Secretary of State for Energy to negotiate further with the ESI, making it clear that the Government finds their alternative proposals unconvincing. The Cabinet will probably however take the view that this approach has now been exhausted. Failing that, there appear to be only two possibilities:

(a) to take statutory powers to control nationalised industry prices; or

(b) to impose a smaller EFL, or a higher financial target, or both. If it were decided to proceed by setting a higher financial target, it will be for consideration whether to give financial targets statutory force (which they already have in a few industries); the question probably does not arise with EFLs, since Ministers already have statutory powers over the borrowing of nationalised industries.

7. Any legislation would probably be of general application, and not restricted to the ESI. If the Cabinet should favour this possibility, it would therefore be appropriate to invite Treasury Ministers to bring forward proposals.

Premature disclosures

8. The Cabinet's task has been made more difficult by widespread rumours and speculations in the media about the Government's views on electricity prices. You will no doubt wish to impress on your colleagues the importance of trying to avoid giving them further currency.

HANDLING

9. You will wish to invite the Secretary of State for Energy to introduce his memorandum. The Chancellor of the Exchequer might then be invited to reply; the Chief Secretary, Treasury may also have comments from the standpoint of public expenditure. The Lord President of the Council may wish to comment on any points relating to the work of MISC 99. The Secretary of State for Scotland may have comments on any implications for the electricity industry in Scotland, and the Secretary of State for Trade and Industry on the implications for industrial consumers, particularly regarding the balance between industrial and domestic prices. Should any question of legislation arise, the Lord President and the Lord Privy Seal would wish to give their views.

CONCLUSIONS

10. You will wish the Cabinet to reach conclusions on the following:

(i) Do they approve the proposals in C(83) 36 regarding electricity prices and the electricity supply industry's external financing limit in 1984-85?

(ii) If so, do they wish to attach any conditions to that approval?

(iii) If not, how would they wish to bring the electricity supply industry to agree to the Government's views?

approved by ROBERT ARMSTRONG
and signed in his absence.

Lindsay Wilkinson

14 December 1983

PRIME MINISTER

Ministerial Responsibility for Gas Safety

Sir Robert Armstrong recommends in the attached minute that you should agree to the transfer of responsibility for gas safety regulations from the Secretary of State for Energy to the Secretary of State for Employment. Mr. King would also assume responsibility for the executive work of the HSE in this area.

This transfer raises a more general question about responsibility for safety. It is not logical, for example, that DTI should be responsible through the BEAB for the safety of electrical appliances whereas the Department of Employment and HSE will, if you agree to this transfer, be responsible for the safety of gas appliances. There may be a case therefore for a more general look at Ministerial responsibility in this area - though you may prefer to leave matters as they stand rather than run the risk that HSE would use a more general review to argue for an extension of their role.

Agree to the gas safety transfer on the basis set out in paragraph 4 of Sir Robert Armstrong's minute? Yes

Do you wish to suggest a more general review of Ministerial responsibilities in this area? No

MT

DMB

DAVID BARCLAY

14 December, 1983

CEN8

Ref. A083/3450

PRIME MINISTER

You agreed last January that gas safety work should be transferred from the Department of Energy's Gas Standards Branch to the Health and Safety Executive. You also agreed that the Health and Safety Executive should report on this work to the Secretary of State for Energy, who would continue to be responsible for making the necessary regulations for controlling gas installation and appliances under the Gas and Energy Conservation Acts. The Secretary of State for Energy, with the support of the Secretary of State for Employment, has now suggested (his minute of 28 November) that the regulation-making powers and the reporting lines should be transferred to the Secretary of State for Employment, who is the Health and Safety Executive's sponsoring Minister.

2. The main argument in favour of the transfer is that the Secretary of State for Employment's general responsibilities for health and safety at work already give him an important interest in gas safety regulations and that there would therefore by some blurring of responsibilities if the Secretary of State for Energy had the responsibility for making regulations. Mr Walker also mentions two other arguments. One is that a transfer to the Secretary of State for Employment would be more efficient because a single Minister would be responsible both for determining the resources devoted to gas safety regulation and for determining gas safety policy. The other is that a transfer would be welcomed by the public as another step towards a co-ordinated approach to health and safety matters. There has appartently also been some public and union objection to the situation in which the Department of Energy is responsible both for gas energy policy, which may have one set of objectives and constraints, and for gas safety policy which may have another.

3. If, as it appears, the two Secretaries of State are satisfied that the lead interest in gas safety regulations in practice belongs to the Secretary of State for Employment, and if

the Secretary of State for Energy is also satisfied that his interests and those of the industry he sponsors can be properly covered by consultation arrangements, then I see no particular difficulty in your agreeing to the transfer even though the regulations extend beyond the work place. But I think it is important that the transfer should not be seen as a precedent for switching to the Secretary of State for Employment responsibilities for health and safety in other fields on which the Health and Safety Executive now reports to other Secretaries of State. Examples are nuclear power installations where the responsibility rests with the Secretary of State for Energy and the transport of dangerous goods where it rests with the Secretary of State for Transport. There is certainly a case for co-ordination of Government policies on health and safety - indeed this co-ordination is one of the things achieved by the establishment of the Health and Safety Commission and Executive with its wide ranging responsibilities. But I am doubtful whether a co-ordinated approach necessarily means a single reporting line to one Secretary of State. In any event you would want, I think, to have a more thorough machinery of government review to determine the balance of advantage.

4. I would therefore recommend that you agree to this particular transfer on the understanding that the two Secretaries of State believe that the Secretary of State for Employment has the lead interest in these particular regulations. But, if you do agree, I do not think that that should be taken as a precedent for any subsequent proposals which may be made to change the Health and Safety Executive's reporting lines to other Secretaries of State on other matters. Any such proposals would require a more thorough analysis and review of health and safety responsibilities.

RtA

ROBERT ARMSTRONG

14 December 1983

NAT IND : Gas and electricity

pricing : Pt 8

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

12 December 1983

Andrew Turnbull Esq
No 10 Downing Street
London SW1

Dear Andrew,

COAL/ELECTRICITY PRICES

We spoke about the idea of obliging the CEGB to pay a higher price for coal, thus enabling us to reduce the subsidy to the NCB. I attach a note which convinces me that this would be a bad idea.

No copies made.

Yours ever,

John Kerr.

J O KERR

COAL PRICES

In a competitive market place private sector firms will aim to produce goods to meet extra demand as long as the price they receive will cover their costs and allow them to make a reasonable return on capital. Such firms cannot fix the price in the market place in the way a monopolist can. They have to take whatever price they can get.

2. The Government's policy of "economic pricing" is directed at nationalised industries which have monopoly power. The aim is to mirror what happens with private sector firms in a competitive market place - ie a price which enables these nationalised industries to cover costs and earn a reasonable return when meeting extra demand.

3. The market for coal is competitive and so automatically produces a market price which is consistent with "economic pricing". The competition to the National Coal Board (NCB) comes from imports. The market price is the price at which these imports are available. The Central Electricity Generating Board (CEGB) pays this price for the coal it buys from the NCB. This means it is paying the right price.

4. What is wrong is that, at this price, the NCB makes losses. In the private sector, a firm that made losses would have to cut its costs or go out of business. The NCB needs to cut its costs. The way to do this is to close loss making pits.

5. In brief, the real problem is not that coal prices are too low but that NCB costs are too high.

6. In economic terms the right way to handle this is to cut NCB costs. It would <u>not</u> be right to force the CEGB to pay an uneconomic high price for coal. This would put industries which used large quantities of electricity at a competitive disadvantage through no fault of their own.

7. In political terms, the aim is to focus attention on the need to close loss-making pits. This aim is best served by making the NCB's losses plain for all to see, and not by disguising the losses by forcing the CEGB to pay an unreasonable price for coal.

CONFIDENTIAL

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

9 December 1983

Michael Reidy Esq
Private Secretary to the Secretary of State
for Energy
Department of Energy
Thames House South
Millbank
LONDON SW1P 4QJ

Dear Michael,

ELECTRICITY PRICES

The Chancellor has asked me to say that he was grateful for your Secretary of State's letter of 8 December, but is concerned at the position it describes, and looks forward to seeing the paper for Cabinet which was requested in Andrew Turnbull's letter, also of 8 December, to you.

Copies of this letter go to Andrew Turnbull, and to Richard Hatfield.

Yours ever

J O Kerr

J O KERR

9 DEC 1983

(D).

CC NO.

Prime Minister

This crossed with my letter commissioning a note for Cabinet colleagues, to be taken next week. This is a small advance but no more. While X gives some reassurance, I don't think Y will cut much ice.

Agree await paper for Cabinet?

AT 9/12

Yes MT

01 211 6402

PERSONAL AND CONFIDENTIAL

Rt Hon Nigel Lawson Esq MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
London SW1

8 December 1983

Dear Chancellor

ELECTRICITY PRICES

Thank you for your letter of 29 November.

I fully understand your concern that the electricity industry should in fact achieve the EFL set them for 1984/85 and that the NCB should not add more than is necessary to your public expenditure difficulties, though it is fair to say that the electricity and gas industries between them contributed over £400m to savings in 1984/85 in the recent Investment and Financing Review.

But I think we have to be careful not to treat these industries in much the same way as we would treat cash limited Government Departments. As you know, these are commercial undertakings and their EFLs, like the PSBR itself, are cash flow differences between very large flows of expenditures and receipts. In the case of the electricity industry, we are talking of an aggregate of the separate budgets of 13 statutory Boards. These are figures of a very different type and quality from many programmes of Government Departments, especially when one tries to look two or three years ahead.

I think this bears on the question of the precise identification of savings. I do not think we can look at this mainly or wholly in terms of specific cuts. What the industry has to do, and has said it will seek to do, is to manage its affairs so as to produce the £740m payment to the Exchequer in 1984/85.

The Chairman of the Electricity Council is confident that with a special effort, the industry will achieve this. If the Council finds that it cannot see its way to achieving the EFL without a price increase, it will impose a small increase during 1984/85. I think that the balance of this should be a matter for the Council to decide.

only after the 1979-80 EFL was raised.

The Council have a good record in this respect. They have achieved their EFL in each of the past 5 years. They are on course for achieving their cost saving performance aim for the two years 1983/84 and 1984/85. Their latest view of their EFL overshoot in 1983/84 has risen from £170m to £184m, though the winter months, with their uncertainty for the industry's cash flow, lie mainly ahead. They propose to review the management of working capital, a point to which the Treasury has recently attached importance. Beyond this, they will now be looking at any and every area where some extraordinary savings can be made. As I have said, I shall be monitoring progress closely.

X There is no question of meeting the EFL by running down power station coal stocks. The figures to which you refer assumed a modest rundown of the CEGB's continental stock pile, which I know you would like to see, but which must in the end depend on our coal import policy. There is no impact here on endurance.

You also asked in your letter about the course of electricity prices to industry. Y The Council tell me that in 1983/4 industry will in fact fare better than domestic consumers as a result of the combined operation of the industrial tariff and the fuel price adjustment clauses. The operation of the fuel price adjustment clause in 1984/85 is expected to do no more than restore the balance between the two classes of consumer.

The Council is also well aware that, within an average price standstill, some Area Boards will need a small price increase anyway. I understand that they will be considering ways in which this might be alleviated and I shall certainly keep in touch with their thinking. But we are talking here of management at Area Board level and we have to bear in mind that it would be contrary to our general approach to efficiency to urge that the consequences of differences of financial performance between Areas be obscured by equalisation.

As regards the position of the NCB, my officials are in touch with yours about setting a revised EFL for 1983/84 which will impose a better financial discipline for the remainder of 1983/84. I think, however, that it would be quite wrong to require the electricity industry to achieve a higher EFL more than half way though a financial year simply in order to offset bad performance in another industry where anyway a large part of the trouble is attributable to a decision to carry over £130m of excess from the 1982/83 NCB EFL into 1983/84 in order to assist a PSBR outturn in 1982/83. I come back to the point that we are not here talking about two Departmental services within a single cash limit.

In fact, as I have said, the latest view of the electricity EFL overshoot in 1983/84 is £184m and, provided all goes well in the rest of the year, the 1983/84 PSBR will get the benefit of that. And the Chairman tells me that he has succeeded in convincing his Council that a rebate in 1983/84 would not be the right course; and that it would be better to minimise any tariff increase in 1984/85. So I have every hope that your point about 1983/84 will be largely met in substance, but without taking steps which would undermine the proper management and financial responsibility of the industries.

I think you may agree that there is here a satisfactory way forward on outstanding questions which could be reported as appropriate to colleagues.

I am copying this letter to the Prime Minister and to Sir Robert Armstrong.

Yours sincerely

Michael Reidy

for PETER WALKER
Approved by the Secretary of State and
signed in his absence.

Nat. Ind: Gas + Elect
Pt 8

SECRET

file

CC NO

10 DOWNING STREET

From the Private Secretary

8 December 1983

Dear Michael

Electricity Prices

The Prime Minister is concerned at the time it is taking to settle electricity prices following the recommendation made by MISC 99 to the Cabinet on 10 November. This uncertainty is regrettable since it is spoiling what should otherwise be a favourable story for the Government, as whatever is settled will still be considerably below the rate of inflation.

She would be grateful if your Secretary of State could circulate a note to colleagues in time for a discussion at next week's Cabinet.

B/F

This will need to answer three points. First where are the savings that the electricity industry now think are possible coming from? Colleagues will need assurance that they are not being achieved for example by running down stocks or pushing financing costs into later years. Secondly assurance is needed that the prices proposed are consistent with the principles of economic pricing. Thirdly assurance is needed that the balance between domestic and industrial prices is sensible.

I am copying this letter to Janet Lewis-Jones (Lord President's Office), John Kerr (HM Treasury), Alex Galloway (Chancellor of the Duchy of Lancaster's Office), Callum McCarthy (Department of Trade and Industry), John Graham (Scottish Office), David Heyhoe (Lord Privy Seal's Office) and John Gieve (Chief Secretary's Office), and to Richard Hatfield (Cabinet Office).

Yours sincerely
Andrew Turnbull

Andrew Turnbull

Michael Reidy, Esq.,
Department of Energy.

SECRET

SECRET

10

ELECTRICITY PRICES

Uncertainty about electricity prices has gone on too long. It is spoiling what should be a favourable story for the Government since whatever is settled will still be considerably below the rate of inflation.

Suggest that Secretary of State for Energy circulates a paper to colleagues in time for discussion at next week's Cabinet.

Will need to answer three points:

(i) Where are savings that Electricity Industry now think are possible coming from? Need assurance that not being achieved e.g. by running down stocks or pushing financing costs into later years.

(ii) Need assurance that the pricing path proposed is consistent with economic pricing.

(iii) Need assurance that the balance between domestic and industrial prices is sensible.

AT

8 December 1983

PERSONAL AND CONFIDENTIAL

Prime Minister (2)

To note

AT 5/12

Electricity prices file

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

5 December 1983

Andrew Turnbull Esq
10 Downing Street

Dear Andrew,

I understand that the Prime Minister recalled - during her talk with the Chancellor on 30 November - that the electricity supply industries were in trouble over their EFL in 1979-80, and that it had to be increased.

The Prime Minister was quite right. The EFL was raised by £300 million in March 1980 - see attached press release.

About two-thirds of the increase was linked to a build-up of stocks, which Ministers had encouraged, and which the public announcement welcomed. It follows that there is a limit to the extent to which we could now rub the industry's nose in the issue. But of course the episode did provide revealing evidence of the poor nature of their monitoring and control: in December 1979 they forecast an overshoot of £62 million; by mid-January 1980 it had risen to £254 million; and by mid-February to £325 million.

I believe the outturn was only £200 million higher. AT

I am not issuing copies of this letter.

Yours ever,

John Kerr.

J O KERR
Principal Private Secretary

13/384

Reference No 59

March 26, 1980

(Out of hours: 01-215 7877)

NEW EXTERNAL FINANCE LIMIT FOR ELECTRICITY SUPPLY INDUSTRY

Mr David Howell, Secretary of State for Energy, announced today (March 26) that the external finance limit for the electricity supply industry in England and Wales is to be raised by £300 million in the current financial year. But he said that the new limit would not add to the public expenditure planning total for the year.

Replying to a Parliamentary Question, Mr Howell said:

"The Electricity Council has sought an increase in its external financing limit to cover variations in the electricity industry's cash flow and its trading circumstances compared with the assumptions on which the limit was based. This is mainly due to the successful build up of fuel stocks which, in the increasingly uncertain world energy supply situation, the Government welcomes.

"In these exceptional circumstances, and having satisfied myself that the industry has taken all reasonable steps to absorb these unforeseen increases in its financing requirement, I have agreed to an increase in its external financing limit in the current year from (-) £68m to (+) £232m. This increase is partly met by prospective shortfalls in the financing requirements of other nationalised industries, and partly from the contingency reserve in the public expenditure plans; consequently it does not add to the public expenditure planning total".

BACKGROUND NOTE

The external finance limit for an industry is the limit on the amount of money that the industry may borrow, from all sources, in a given financial year.

Financial Times THURSDAY 1st DEC. 1983

file

Electricity prices 'could be cut by 7%'

By Ian Hargreaves

ELECTRICITY prices could be cut by as much as 7 per cent and then be held stable for a period without damage to the supply industry, according to an independent report circulating in Whitehall.

The report, by accountants Coopers and Lybrand, argues that the present formula used by the industry in setting electricity prices takes insufficient account of the gap in power station building caused by overcapacity.

But the report says that if allowance is made for the gap in power station building, it would trim the industry's annual requirement by between £500m and £700m — a saving which could be passed on as lower prices.

Government policy has been to ensure that electricity prices are set at an economic level, covering the costs of meeting additional demand and including a 5 per cent return on capital.

The report says that since overcapacity is likely to persist for up to 10 years, it might be possible for the industry to hold prices stable for several years after a price cut.

The report was commissioned by Mr Nigel Lawson, then Energy Secretary, following the 1981 Monopolies Commission report on the Central Electricity Generating Board.

It was intended to settle whether the tariff formula should be based on the hypothetical cost of new plant, the actual cost of existing plant or a mixture of both. Coopers decided on the cost of existing plant.

Although the report's findings have been challenged both the Energy Department and the industry, which considers the proposed formula to be improvident given need for nuclear stations such as the one proposed for Sizewell, it provides a sidelight on the controversy over electricity prices.

Mr Lawson, as Chancellor, has been pressing for higher prices and a larger payment by the industry to the Exchequer through its external financing limit. But he appears to have retreated from his initial demand for a price increase of 3 per cent next spring.

The line taken by Mr Peter Walker, the Energy Secretary, since Mr Lawson announced the tighter external financing limit in his autumn financial statement, is that it is up to the industry to make decisions about prices.

The Treasury had threatened to force prices up either by raising the Electricity Council's financial target from a 1.4 per cent return on net assets or by sending a letter specifically requesting the price increase.

Since criticism among Conservative backbenchers and in industry over the proposed price increases, Mr Lawson appears to have back-pedalled.

Unless he makes another move, the Electricity Council is likely next month to decide upon a zero average price change next April, which means some tariffs in certain unspecified areas could rise modestly, and to review the position later in the year.

UK Oil Ouput, Page 6

cc ~~IF~~

Energy prices
pt4

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

01 211 6402

Andrew Turnbull Esq
Private Secretary to the Prime Minister
10 Downing Street
London SW1

30 November 1983

Dear Andrew,

BRIEFING FOR PRIME MINISTER'S QUESTIONS

You asked Michael Reidy yesterday for a note on the different figures for the profits of the gas and electricity industries which had recently been quoted in Parliament. I hope that the note attached is helpful.

Yours

John Neilson

J S NEILSON
Private Secretary

Enc

GAS AND ELECTRICITY PROFITS 1982/83

In line with normal accounting practice, the gas and electricity industries report two profit figures : an operating profit and a net profit available for retention in reserves. The following table details the differences between these two figures and puts profits in context against assets and turnover.

1982/83 CURRENT COST RESULTS, £ MILLIONS

GAS			ELECTRICITY
663	Operating Profit		868
218	Net Interest		(536)
(208)	Taxation		-
(295)	Extraordinary item (provision for accounting loss on disposal of oil assets)		
188	Net Profit retained		332
	Return on average total net assets		
5.7%	i.	Operating Profit	3.2%
1.6%	ii.	Net Profit retained	1.0%
	Profit to Turnover:		
11.6%	i.	Operating Profit	9.4%
3.2%	ii.	Net Profit retained	3.6%

COMMENTARY

i. Gas Levy - this item (£524m in 1982/83) is treated as an operating cost in the British Gas Corporation's accounts, so is deducted prior to arriving at the £663m operating profit. It does not feature in the £208m charge for taxation, which consists mainly of current UK Corporation Tax.

ii. No Tax Charge for Electricity - no charge to taxation arises on the result for the year by reason of accelerated capital allowances, stock relief for the year and losses brought forward.

iii. BGC Extraordinary Item - this is an accounting mechanism to write out of BGC's books the Corporation's interests in offshore oilfields (£285m) and the Wytch Farm onshore oilfield (£10m) which are in the process of disposal as part of the privatisation programme. There is no reason to belive that this item will lead to an increase in gas prices: it is not in any real sense a "cost" borne by gas consumers, and is in any case marginal when set against BGC's accumulated retained profits of over £1.5 billion.

Department of Energy
30 November 1983

(B)

MR TURNBULL

Electricity Prices

The Electricity Council are now proposing to find additional savings of £210 million in 1984/85. These would meet the EFL of £740 million without the need for a general price increase. Peter Walker is prepared to accept subject to certain conditions. The Chancellor has requested a precise breakdown of those savings before the matter is brought back to Cabinet.

It is highly disturbing and a comment upon the efficiency of the industry that the threat of a price increase has now revealed significant additional savings which were not available to MISC 99. Indeed since we produced our proposals for electricity and gas price rises, the two industries have found further efficiency savings of over £700 million.

Furthermore, Cabinet concluded on 10 November that "any additional savings which the industries were able to offer through increased efficiency would be welcome but that Cabinet was not ready at this stage to regard them as a substitute for desirable price increases". There is therefore a strong argument for taking the further efficiency savings and insisting on the proposed price increases.

On the other hand, the current proposals could have the merit of achieving both the required public expenditure objectives and of bringing prices more quickly into line with economic principles. Although the full implications of economic pricing have yet to be established, we consider that prices do need to fall further than the real price decrease which would result from a 3 per cent increase in 1984/85.

A price freeze would also be popular and could be presented as the direct consequence of Government pressure on the industry to improve efficiency and reduce costs.

We do need, however, to be clear whether the implications of holding tariffs on average would benefit domestic more than industrial users, as the Electricity Council seems to be saying.

/Conclusions

Conclusions

Our conclusions are

- on balance the proposals to meet the industry's EFL by further savings could be acceptable providing that they are realistic and do not conflict with other objectives such as the need to extend power station endurance.

- the Electricity Council must undertake to increase prices if the EFL appears unlikely to be achieved.

- whatever is agreed for 1984/85, the implications of introducing economic pricing principles from 1985/86 onwards should be established ahead of the next IFR. As with gas, this will enable the next financial target to be based on clearly agreed pricing principles.

AT

29 November 1983 pp DAVID PASCALL

vc NO

F

CHANCELLOR OF THE EXCHEQUER

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

29 November 1983

The Rt. Hon. Peter Walker MBE MP
Secretary of State for Energy

Dear Peter

ELECTRICITY PRICES

Thank you for your letter of 24 November.

My approach throughout these discussions has been based on the Government's commitment to economic pricing. The Council have undertaken to use their best endeavours to live within the EFL and you say that they can already see their way to obtaining the bulk of the £210 million savings. As your people know, I think we need to see a precise breakdown of what they have in mind, and it would be helpful to have this before you take the matter back to Cabinet. It would be important, for example, to avoid action which would reduce power station endurance, or put additional pressure on later years, or cause increased problems for the NCB's EFL. As I understand it, the latest monitoring figures for the ESI suggest that the industry is planning on a level of stocks in 1984-85 below the estimate of outturn for 1983-84.

I am also a little unclear about the increase in charges the Council now envisage in 1984-85. Philip Jones' letter suggests that they expect an average increase of 0.9 per cent, which would be entirely loaded onto industrial and large commercial consumers. The overall increase for them would presumably thus be nearly 2 per cent, with the increases for industrial consumers in the Midlands coming out nearer to 4 per cent. You will no doubt wish to consider whether it might not be preferable to load the increase more onto the domestic consumer instead.

Philip Jones also refers to the prospective EFL savings in 1983-84 of some £170 million. He goes on to mention the possibilities of a rebate, of using the saving to help the position in 1984-85, and of seeking "some recognition" of this "contribution to the relief of the 1983-84 PSBR." I hope you will make clear to him that the saving is in fact needed to offset the excess on the NCB's EFL, and that his suggestions are therefore non-starters.

I am very worried about the position of the NCB, which is, I understand, deteriorating. As you know, the public expenditure position this year is very difficult. I must look to you to find whatever savings are necessary from the nationalised industries for which you are responsible to cover the NCB overshoot and the additional expenditure on RMPS. We must aim to settle this quickly, as the NCB must have a clear target to which to work; and I should be grateful if you could make some early proposals on this.

I am copying this letter to the Prime Minister and Sir Robert Armstrong.

Yours ever
Nigel

NIGEL LAWSON

2 MS

This is ridiculous
We are paying £1½ billion
to subsidise coal and
not getting the benefit
on electricity prices
Reduce the EFL
to coal
and make them
pick it up on the
electricity consumer
MT

PRIME MINISTER

The Electricity Council have put forward two propositions:-

(i) they can achieve 1984-85 EFL of -£740 million with a price freeze.

(ii) they now believe that the price rise required in 1985-86 is only 3 per cent, rather than the 6 per cent envisaged which MISC 99 considered.

They now propose continuing the freeze, but with an undertaking to raise prices if it looks as though the EFL will be overshot. Peter Walker endorses this.

The Chancellor is considering how to respond. He will discuss this at his bilateral on Wednesday. Even if he feels disposed to accept, he does not think he can do so without agreement of Cabinet colleagues, particularly Lord Whitelaw. The minutes of the 10 November meeting stated:

> "any additional savings which the industries were able to offer through increased efficiency would be welcome but that Cabinet was not ready at this stage to regard them as a substitute for desirable price increases".

While this does not rule out an arrangement of the kind suggested, it implies that it needs to be blessed by colleagues.

What is the difference between the average cost of a ton of coal produced and the price paid per ton by CEGB.

AT

28 November, 1983.

cc NIO

PRIME MINISTER

Your Private Secretary wrote on 31 January 1983 confirming your agreement to the proposal that the safety responsibilities exercised by this Department's Gas Standards Branch should be transferred to the Health and Safety Executive. At that stage it was envisaged that the Health and Safety Commission and its Executive would report to me on the discharge of these responsibilities.

on part 7

Since then officials have been working on the mechanics of the proposed transfer. Because of the complexities there has been some slippage in the timetable but we are now ready to put a transfer in place.

The work on the details has highlighted grey areas in the proposed arrangements on account of the separate responsibilities of the Secretaries of State for Energy and Employment. At its simplest it concerns my responsibility for the Gas Regulations and the Employment responsibility for Health and Safety at Work which impinges on areas of gas safety.

I therefore propose, and Tom King agrees, that the responsibilities for gas safety which currently lie with the Secretary of State for Energy should be transferred to the Secretary of State for Employment. Essentially this would mean transferring the power to make regulations under S 31 of the Gas Act 1972 and the associated powers under section 42 and 43 on penalties and prosecutions, and the enforcement of the Gas Safety Regulations 1972 and the Right of Entry Regulations 1983. The Secretary of State for Employment would also become responsible for the making of gas appliance safety orders under the Energy Conservation Act 1981. The legislation is framed in the general terms of 'the Secretary of State', and no changes in the legislation are required to effect a transfer. A Ministerial transfer would not only avoid blurred areas of responsibility which would not be resolved by an executive transfer, but would also avoid problems associated with the interface between responsibility for policy and responsibility for resources. More important it would be another step towards achieving the objective of a co-ordinated approach to health and safety matters. We believe that it would be welcomed by the public. Ministers in both Departments take the view that, subject to your agreement, the transfer should be effected at an early date. I have in mind 1 January. It would be administratively convenient yet allow sufficient time to consult BGC and make a public announcement by way of an arranged PQ. It would be helpful therefore if you and colleagues could give your early agreement to the proposal.

I am copying this to the Lord Chancellor, the Secretary of State for the Home Department, the Secretary of State for Employment and Sir Robert Armstrong.

PETER WALKER

28 November 1983

NAT IND

Gas + Elec Prices

PE 8

cc NO
I would welcome a policy unit note when Ch/Ex replies.
AT 24/11

9

01-211 6402

The Rt Hon Nigel Lawson MP
The Chancellor of the Exchequer
HM Treasury
Parliament Street
London SW1

24 November 1983

Following the Cabinet discussion on 10 November I put very firmly to the Chairman of the Electricity Council the Government's view that the Council should make a 3% price increase, contributing £210m to the EFL of the industry in 1984/85. I also told him that the Government was setting the EFL for the Electricity Council for 1984/85 at £740m, including £210m from this price increase.

Philip Jones undertook to convey to the Electricity Council the Government's view, and I know that he put the view firmly to them on 17 November. As a result of that I have now received the attached letter from him. On receipt of this letter I asked my officials to discuss with the Electricity Council what was meant by using their best endeavours to achieve the EFL of £740m set by the Government as from the Government's point of view it was essential that that figure was obtained. The Council can already see their way to obtaining the bulk of the £210m that will be required. They also pointed out that as an industry whenever they have promised to use their best endeavours to obtain a target they have always delivered.

I think, however, it is important that we carefully monitor the performance of the industry in the early part of next year in order to make quite certain that the EFL figure will be reached. I think we should also seek an undertaking from Philip Jones that if it became clear as the year proceeded the EFL would not be achieved, then a price increase would take place in order to secure the figures placed upon them by the Government.

I am copying this letter to the Prime Minister and Sir Robert Armstrong.

Peter,

PETER WALKER

SECRET AND PERSONAL

PS/PUS

PS/MOS
PS/PUSS
PS/PUSS
Mr Manley
Mr Morphet
Mr E. Price
Mr Wilson
Mr Brown
Mr Fullerton
Mr Thynne.

6/12/83

RICITY COUNCIL

(A)

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

21st November 1983.

The Rt. Hon. Peter Walker, MBE, MP,
Secretary of State for Energy,
Thames House South,
Millbank,
LONDON SW1P 4QJ.

SECRETARY OF STATE FOR ENERGY'S OFFICE
RECEIVED
22 NOV 1983

Dear Secretary of State,

When I saw you on 14th November you explained that the Government wished the Electricity Supply Industry to increase its tariffs by 3% in 1984/85 with the prospect of a further 3% increase in 1985/86. You urged very strongly that the Industry should accede to this request. I duly reported your request to the Electricity Council at its meeting on 17th November, making quite clear the importance the Government attached to it.

The Industry fully understands that the need to contain public expenditure is central to the Government's policies and is more than ready to play its part in contributing to this objective. The Industry is meeting the performance targets set for it and has already offered very large EFL repayments to assist the recent review of public expenditure; over £2.8 billion over the three years 1984/85 to 1986/87. It is therefore very concerned that it should be asked to increase its tariffs in addition, when it cannot defend the proposed increase either by reference to the needs of the Industry or by reference to the financial target agreed with the then Secretary of State as recently as March of this year.

The Industry's target of 1.4% return for the two years 1983/84 - 1984/85 on net assets on a CCA basis, and the associated individual targets for the twelve Area Boards and the CEGB, were set in March following several months of discussion. The Industry at that time suggested a target for a longer period and with a higher rate of return. The then Secretary of State however did not feel able to agree to this and our financial target was determined accordingly.

We have recently reviewed our progress towards meeting our EFL for 1983/84, and our financial target for the two years 1983/84 and 1984/85. Our EFL for this year requires us to make a repayment to the Government of £418M. Because of the favourable effect on our finances of a lower rate of inflation than we had assumed, lower fuel prices and our own efforts to control costs, we now expect to over-achieve that EFL by some £170M.

We had hoped that this excess could be rolled forward to help the position in 1984/85. We understand that the Treasury rules will not permit this. We would, nevertheless, hope that this is something that could be considered further. If it cannot, we would still hope that some recognition could be made of the further contribution we will be making to the relief of the PSBR in 1983/84.

Our present assessment is that in addition to exceeding this year's EFL we will exceed the financial target set last March for two years, even if we hold the current tariffs on average for a further year. Against this background Board Chairmen considered that they would come under considerable pressure from their Boards, which, as you know, include influential external non-executive Members, and from the Consultative Councils to agree to a rebate for this year and a price reduction in 1984/85. The Council agreed at the October meeting that it would try to hold off pressure for a rebate in 1983/84 by announcing its intention because of improved results to hold the average level of tariffs unchanged for another year. This seemed to the Council a defensible position, notwithstanding that it would mean over-achievement of the EFL and of the financial target.

I should explain that holding tariffs on average in 1984/85 does not mean that no consumer would suffer price increases. The fuel price adjustment clause which applies to industrial and larger commercial consumers would continue to operate, and would increase charges for them by nearly 2%, or the equivalent of 0.9% across the Industry. In addition to this, some Area Boards would need to raise tariffs within the average, while others, mainly in the south, would be able to reduce them. In the Midlands, for example, this could mean an increase of 2% to industrial consumers in addition to the operation of the fuel price adjustment clause. If the Council had to impose a further increase on top of that, this would be bound to attract the sharpest criticism from industry which is still complaining that electricity prices are too high in comparison with those of their international competitors and is constantly pressing for reduction.

Any imposed increase, apart from the criticism it will draw from British industry, would also make much more difficult management's task of securing further improvements in this Industry's efficiency and our ability to negotiate a reasonable wage settlement with our unions next year. We have impressed upon our staff the need to control and reduce costs as a means of keeping electricity prices as low as possible in order to achieve our profit targets, and to increase our competitiveness. We are making good progress towards achieving the performance aims set us by the Government. The CEGB has negotiated with the NCB a favourable coal price agreement and this was only secured because it was seen as a means of stimulating electricity demand and hence coal sales. The tariff increase now proposed would more than absorb the benefit of the prices agreed with the NCB.

We had intended to approach the forthcoming wage round on the need to avoid any increase in costs which would threaten the prospects of holding electricity prices unchanged on average next year. Any proposed tariff increase is bound seriously to weaken the stance we take in pay negotiations. The electricity unions have, as you know, the power well short of strike action to cause considerable disruption to electricity supplies and to the merit-order running of power stations which would cost the Industry dear. The Council has asked me to stress to you the serious, demotivating effect on staff in general and on the pay situation in particular if the Industry is forced to increase tariffs beyond what is necessary to meet its needs.

We recognise that the Government had in mind the advantages of a smooth progression in electricity prices in urging a tariff increase of 3% in 1984/85 and a further 3% in 1985/86. You will however appreciate that it is simply not possible to predict with any certainty the level of tariff increases likely to be required for more than a year ahead. Many assumptions have to be built into such forecasts. In September we were expecting that a 6% increase would be needed in 1985/86. At the time this was a reasonable indication but no more than that. Our re-examination of the position now indicates that an increase of 3% in 1985/86 would be sufficient to enable us to meet the EFL requirement for that year. As far as we can see at present therefore the problem of a sharp increase in 1985/86, following no increase in 1984/85, seems unlikely to arise. Our preferred course would be that average prices in 1984/85 should be held level, with the possibility of a 3% increase in 1985/86, (plus about 0.9% for FPA).

The Chancellor announced in his statement in the House last Thursday afternoon that he had set an EFL for the Industry for 1984/85 of £740M. This is considerably higher than we had anticipated or would have wished. Although it is not an agreed EFL we will now give urgent consideration to the action the Industry needs to take to reach this EFL and we will do our best to achieve it. We would however ask that the Industry should be allowed, as is customary, to decide for itself what action is necessary to meet the Government's financial requirements.

The EFL and the financial target on which it is based should be consistent. We have heard suggestions that our present target of 1.4% return on net assets is too low. But our return was agreed with the Government, and is related to net assets on a CCA basis. Many British companies, as you know, are still on an historic cost accounting basis.

We are however at any time ready to discuss with you the pricing principles which should be followed for this Industry and to agree a financial target with you for the period beyond 1984/85. Such a target would, we hope, last for at least three years and would not be changed in mid stream. We do recognise at the same time the right of the Government to change such a target should there be a radical change of circumstances.

I have written at some length which reflects the deep concern which Council has asked me to express to you about the Government's request. We have always been as an Industry co-operative with the Government and I can assure you we wish to remain so. We do however hope that the points made in this letter will be carefully considered by you and your colleagues.

Yours sincerely

Philip Jones

2

10 DOWNING STREET

Prime Minister

I was surprised to hear the Lord President say that the Cabinet minutes gave Mr. Walker a let-out on energy prices. It seems to me that they are quite

CC (83) 33rd Concl Min 4 (LCM)

clear (copy below) and that Mr. Walker could not fail to secure the price increases without bringing the matter back to Cabinet.

FERB

15.11.83

CONFIDENTIAL

√C

10 DOWNING STREET

c. LPO
SO
LPS
DTI
CDL
CS, HMT
CO
Chief Whip's Office

From the Private Secretary

26 October 1983

Gas Prices

The Prime Minister has seen your Secretary of State's minute of 20 October and also the Chancellor's minute of 24 October. She feels that the issue of the increases in domestic and industrial gas prices should be considered by MISC 99. She feels it would be helpful for the Group to see the past exchanges between your Secretary of State and the Chancellor, the record of the 13 September meeting and my Private Secretary letter recording her view that the increase in domestic gas prices in January should be 6% and that the freeze on industrial prices should not be extended beyond March 1984.

I am copying this letter, together with these papers, to the Private Secretaries to members of the MISC 99 Group and to Sir Robert Armstrong.

ANDREW TURNBULL

Michael Reidy, Esq.,
Department of Energy.

CONFIDENTIAL

√C

CONFIDENTIAL

Jak

10 DOWNING STREET

From the Private Secretary

26 October 1983

Public Expenditure Survey: Energy Prices

To help him in his work on MISC 99, the Chancellor of the Duchy might like to see the attached note from the Policy Unit which sets out the issues at stake on the energy nationalised industries.

ANDREW TURNBULL

Alex Galloway, Esq.,
Office of the Chancellor of the Duchy of Lancaster

CONFIDENTIAL

7

POLICY UNIT

MR TURNBULL ✓ AT 26/10

26 October 1983 (Revision 2)

cc Mr Mount

PUBLIC EXPENDITURE: ENERGY INDUSTRIES

The Figures

In summary the differences between the Department of Energy and the Treasury are:

	1984/5 £m	1985/6 £m	1986/7 £m	
Energy	+130	-540	-1355	
Chief Secretary	-270	-840	-1430	
Total	400	300	75	775

The main items in dispute for particular industries total £1070m, ie the Treasury have potential scope for compromise on individual items provided that total savings of at least £775m are achieved.

The £1070m can be broken down:

	1984/5 £m	1985/6 £m	1986/7 £m	
NCB	100	100	100	
ESI	260	140	30	
BGC	120	110	110	
Total	480	350	240	1070

NCB

Treasury wish to reduce the annual investment programme of £850-900m by about £100m per year. These cuts can be achieved without affecting investment in the modern economic pits and need not be perceived as questioning the Government's long-term commitment to the coal industry. They should be supported despite Peter Walker's arguments that cutting investment would stiffen NUM resolve against pit closures, and that MacGregor needs time to produce his own proposals.

Investment is anyway high for a bankrupt industry, and the recent MMC report considered that the NCB should be more cautious generally on investment plans.

ESI

The figures can be broken down:

	1984/5 £m	1985/6 £m	1986/7 £m
Pricing	210	90	30
Costs	50	50	-

The pricing argument depends upon whether the existing financial target (1.4% on current assets in 1983/4 and 1984/5) should set the basis for price reductions in 1984/5 or whether the original price expectations should be implemented. The latter would result in an overshoot on the financial target. At the time the target was set it was anticipated that the price freeze in 1983/4 would be followed by a price increase of about 1½-2% below the rate of inflation in 1984/85. Peter Walker now maintains that a price freeze in 1984/5 is consistent with the financial target. As a price freeze would also appear to be consistent with a move towards economic pricing principles, there is a strong economic and commercial case for retaining the original financial target which runs until 1984/5, and accepting the pricing implications.

However, there is a need to agree on pricing principles for future years in conjunction with the financial target from 1985/6 and to adjust the public expenditure figures accordingly. For the present, there is little difference between the Treasury and the Department for planning assumptions in the later years.

The cost savings result from the Treasury view that cost reductions should be based on the full achievement of the ESI's Performance Aim of four and a quarter per cent; that investment could be trimmed by about 2 per cent over the period; and that coal stockpiled in Holland and Belgium should be sold. These savings seem reasonable and should be supported.

<u>BGC</u>

Domestic Pricing	40	30	30
Industrial Pricing	30	30	30
Cost Savings/Exchange Rate Assumption	50	50	50

The savings on <u>domestic pricing</u> depend upon whether prices rise by 6% or 5% in January 1984. A rise of 6% would be consistent with the decisions reached at the Prime Minister's meeting of 13 September 1983 to maintain gas prices in real terms. Peter Walker is arguing that the conclusion of the Prime Minister's meeting implies a 5% rise although this would result in real price reductions during the period in question - the 15 months between October 1982 and January 1984. Peter Walker's main argument against 6% is the degree of BGC opposition and political difficulty which would result. It is doubtful whether an additional 1% rise would create unacceptable problems particularly as the maintenance of prices in real terms is a sensible and defensible policy. This argument needs to be settled quickly in order for any price rise to be introduced on 1 January 1984. The Treasury's case should be supported unless Peter Walker really does consider that 6% is totally unacceptable.

On <u>industrial pricing</u>, the Prime Minister has expressed the view that the current industrial price freeze should not be extended beyond March 1984. The Treasury had argued for ending the freeze in December. They now argue that the loss of revenue resulting from a freeze in the first quarter of next year should be recouped in the future either by slightly higher industrial prices or by slightly higher domestic prices. As there is no agreement on the pricing principles which should apply after the freeze ends, it would appear reasonable for planning purposes that industrial prices should be assumed to rise at least in line with inflation. This approach is likely to justify some but not all of the Treasury's bid - perhaps £10-20m per year.

However, as with electricity, there is a need to agree the proper basis for prices in future years after the immediate decisions on pricing and planning assumptions have been agreed. A move towards economic pricing could yield significant public expenditure savings.

The cost as opposed to price savings in the above table result from corrections for BGC's assumptions on exchange rates and some marginal trimming of investment and working capital. These are reasonable and should be supported.

The Pricing Debate

A few comments are appropriate to put the current pricing dispute into context.

Economic pricing is in the interests of both economic and energy policy objectives. The adoption of economic pricing is likely to require prices rises for gas but price reductions for electricity. This is likely to cause the Department and the Treasury respectively some short term difficulties.

There is no agreement about the basis for setting economic prices for gas or electricity. The position on coal is broadly acceptable with prices set on an import related basis. An agreed set of economic pricing criteria on gas and electricity is required to enable the implications, desirability and timescale of moving towards economic pricing during this Parliament to be considered further. Such a programme is likely to produce net revenue savings.

There is also a need for a consistent approach on economic pricing and financial targets for all the energy industries. Pricing principles should be taken into account in setting the financial target. There is currently no financial target for gas which should be deferred until pricing principles are agreed. The existing financial target for electricity runs until 1984/5 and sets the framework for current pricing decisions. Any subsequent financial target should reflect an agreed position on pricing principles.

Energy Investment

Although there are convincing arguments for individual investment decisions and for the general size of the investment programme in each of the energy industries, more fundamental questions should now be posed about energy investment. Is it appropriate to be investing £2.6 billion in gas, £5.1 billion in electricity, and £2.6 billion in coal over the next 3 years? Is this a sensible allocation of resources given the essential need to reduce public expenditure generally? What priority should we give to energy compared with the NHS etc? Do we need to invest heavily in all energy industries?

On gas, the consequence of continuing to price below economic levels will be to stimulate demand leading to yet more investment. On electricity, we don't need Sizewell on capacity grounds, although there is a strong case on economic grounds for nuclear investment in order to reduce electricity prices and to reduce dependence on coal. But Sizewell is a £1.3 billion investment of which £300m is included in the figures for the next 3 years. Although it is vital to secure the go-ahead from the Sizewell inquiry, actual construction could follow at a leisurely pace thereafter. On coal, the MMC heavily criticised the NCB's investment programme.

Conclusions

Of the possible £1070m of potential savings identified by the Treasury, there appears to be a strong case for achieving:

	1984/5 £m	1985/6 £m	1986/7 £m
Coal			
Investment	100	100	100
Electricity			
Costs	50	50	
Gas			
Domestic Pricing	40	30	30
Industrial Pricing	ca 10-20	ca 10-20	ca 10-20
Cost Savings	50	50	50

TOTAL	250-260	240-250	190-200	680-710

This compares with the Treasury's minimum target of:

400	300	75	775

Of the other items, the question of an electricity price freeze in 1984/5 is the most significant. In this case, the importance of public expenditure savings will need to be balanced against a strong argument for maintaining the existing financial target and moving closer towards economic pricing in 1984/5. For future years, there is an urgent need to agree the basis and desirability of moving to economic pricing for all fuels. This is likely to produce additional public expenditure savings.

The question of whether high levels of investment in all the energy industries is justified at the present time should be considered further.

DLP.

DAVID PASCALL

10 DOWNING STREET

(2)

Prime Minister

This is a useful piece of contingency planning. A decision to sign for Sleipner gas will have two consequences

(i) signing at say 26p per therm against 22-23p paid in the North Sea will weaken case for holding down domestic gas prices

(ii) it would make no sense to pay more for imported gas than for ~~[illegible]~~ North Sea gas. UK producers should be allowed to export. This will maximise UK development.

No action at this stage

AT

26/10

[illegible]

SECRETARY OF STATE FOR ...
... STREET
... LONDON SW1
01-211 6402

CONFIDENTIAL

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
H M Treasury
Parliament Street
London SW1

25 October 19..

26 p.

Dear Nigel.

BGC'S NEGOTIATIONS FOR SLEIPNER GAS

I have delayed my reply to your letter of 1 August until I was able to report progress. I told BGC at the beginning of August to proceed with the Sleipner negotiations on the ad referendum basis we had agreed, and I understand that the Norwegians accepted the position. There have been several rounds of negotiation since then and at the last, on 12 October, BGC tabled an offer which a joint working group is now examining in detail. When negotiations resume on 9 November, it is expected that they will progress rapidly towards a conclusion.

With the prospect, assuming an ad referendum agreement has been reached, that we will then have to make up our minds fairly promptly whether or not the deal should go ahead, I think it would be as well for our officials to discuss in some detail, so that they can advise us in due course, the likely balance between supply and demand for Continental Shelf gas which you rightly identify in your letter as a key issue. I will ask my officials to get in touch with yours accordingly.

Peter

PETER WALKER

Nat. Ind: Car Prices Pt 8.

10 DOWNING STREET

Prime Minister

The Chancellor has now written arguing (again) for a 6 per cent increase in domestic gas prices.

(i) Agree we send this to MISC 99 for resolution?

(ii) Agree I circulate past correspondence to group, starting with Michael's record of 13 September meeting, followed by the first Walker/Lawson exchange, my Private Secretary letter recording your view in favour of 6 per cent, and concluding with the second Walker/Lawson exchange?

In addition we could, if you wish, get Policy Unit to prepare some background briefing for Lord Cockfield.

Yes no

~~Do I chair Misc 99~~? AT 24/10

3.39

CONFIDENTIAL

cc D.P.

~~cc NO~~

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

PRIME MINISTER

GAS PRICES

I have seen Peter Walker's minute of 20 October.

with AT

2. As I said in my letter of 21 October to him, I really do find it hard to believe that the difference between 5 per cent and 6 per cent could cause the problems he foresees. All we would be doing is compensating for inflation since the last price increase. As far as BGC's profits are concerned, I understand that, with a 6 per cent increase, these would be of a similar order to those in 1982-83.

3. Peter refers to the way in which BGC have in the past calculated price increases in line with inflation. This is not the issue. The question is how we give effect to the policy decision we took at our meeting on 13 September. I agree with the view recorded in your Private Secretary's letter of 19 October; namely that this points to a 6 per cent increase in line with our forecast of inflation between October 1982 and January 1984.

4. Peter also argues that there has been a 57 per cent real increase since 1979-80. During the period of the three 10 per cent real increases we had two gas price increases a year; one each April to compensate for inflation in the previous year, and a 10 per cent increase each October. I am not sure how Peter has produced his figures, but I suspect that he may be comparing movements in the RPI between April 1980 and April 1983 against price increases in the same period. But that is not the correct comparison, for the increase in April 1980 was intended to compensate for inflation in 1979.

5. Indeed, if we were to pick up the old arrangements for compensating for inflation where we left them in April 1982, and were to make good the position since then, using BGC's method as described by Peter, I gather that we would now be talking about an increase of 10 per cent, not 6 per cent.

6. The letter of 19 October from your office also records your decision that the freeze on industrial prices should be extended to the end of 1983-84. In order to set BGC's EFL for 1984-85, we need to take a view now on what happens to prices when the freeze ends.

7. There are two possible approaches. First, we could keep industrial prices throughout the next three years below the level they would have reached without the extension of the freeze. As I understand it, this is the approach underlying Peter's proposal on BGC's public expenditure. Alternatively, we could in the April 1984 quarter move prices back to the levels at which they would have stood, but for the freeze. This would produce savings of £30 million a year in each of the next three years. I favour the second approach, but I would not wish to insist on it, and would settle for the first, provided that the £30 million were recouped in each year by slightly higher domestic prices. (The effect on domestic prices would be only an additional 1 per cent increase in January 1984 - ie to 7 per cent rather than 6 per cent).

8. I am copying this minute to the other recipients of Peter's, and to him.

John Kerr.

PP. (N.L.)

24 October 1983

[Approved by the Chancellor, now in Luxembourg.]

NAT IND: Gas + Electricity
Pt 8

24 OCT 1983

Prime Minister ②

To note and await Treasury reaction. Choice is 6 per cent which represents forecast inflation between October 1982 and Jan 1984 or 5.1% which is increase over latest known 15 month period.

AT 20/10

PRIME MINISTER

GAS PRICES

I have seen Andrew Turnbull's letter of 19 October recording your views on gas prices.

I believe it is vital that further careful consideration is given to this issue. As I explained in my letter of yesterday to the Chancellor, the Gas Corporation are adamant that a 4% increase would be more than adequate. Both part-time and full-time Board members are resisting strongly the 5% increase I have proposed, and I am quite clear that there is no question of their being ready to contemplate a 6% increase or accept any responsibility for it. They could see no basis for it in the needs of the business or the profit position. To force a higher increase would require either an increase in the gas levy or special legislation to force the Corporation to raise prices against their will. I have already drawn attention to the considerable opposition that such an approach would trigger from the public at large, industry, Members of Parliament as well as the Corporation itself.

I would see a 5% increase, if that can indeed be achieved, as meeting the objective of maintaining gas prices in real terms at the level achieved by the three successive 10% real price increases. In fact, gas price increases have not followed RPI movement in a precise way: that is why there has been an increase over 1979/80, not of 3 x 10%, but of 57% in real terms. But when increases have been related to the RPI, the practice has been to base the increases on the RPI change in a period ended with the last published figure before a decision was reached. The last figure we have is for September 1983 and the increase on 1 January 1984 will be 15 months after the last one. The increase of the September 1983 RPI over 15 months earlier is 5.1%. In any event, the January 1984 price increase will be seen by consumers, as by BGC, as this winter's increase at a time of 5% inflation; postponed a little because of BGC's good results. A higher figure would produce quite the wrong impression about inflation and damage the Government's counter inflation policy.

On all these grounds 5% is the maximum figure we can possibly justify.

I am copying this letter to the Lord President of the Council, the Chancellor of the Exchequer, the Secretaries of State for Scotland, and Trade and Industry, the Chief Secretary, and Robert Armstrong.

Secretary of State for Energy

20 October 1983

Nat Ind,
Gas & Elect,
Pt 8

SECRET

20 October 1983 6

MR TURNBULL cc Mr Mount

PUBLIC EXPENDITUE: ENERGY INDUSTRIES

The Figures

The Treasury are seeking total savings on top of the savings offered by Peter Walker of:

1984/5 £m	1985/6 £m	1986/7 £m	Total £m
400	300	75	775

The main items in dispute for particular industries total £1,130m, ie the Treasury have potential scope for compromise on individual items provided that total savings of at least £775 million are achieved.

The £1,130 million can be broken down:

	1984/5 £m	1985/6 £m	1986/7 £m	
NCB	100	100	100	
ESI	260	140	60	
BGC	160	100	110	
Total	520	340	270	1130

NCB

Treasury wish to reduce the annual investment programme of £850-900 million by about £100 million per year. These cuts can be achieved without affecting investment in the modern economic pits and need not be perceived as questioning the Government's long-term commitment to the coal industry. They should be supported despite Peter Walker's arguments that cutting investment would stiffen NUM resolve against pit closures, and that MacGregor needs time to produce his own proposals.

Investment is anyway high for a bankrupt industry, and the recent MMC report considered that the NCB should be more cautious generally on investment plans.

SECRET

ESI

Pricing	210	90	60
Costs	50	50	-

The pricing argument depends upon whether prices are reduced in line with the current financial target or whether the financial target should be tightened to reflect the original price expectations. Peter Walker maintains that a price freeze in can be accomodated with 1984/5 is consistent with the financial target. As a price freeze would also appear to be consistent with a move towards economic pricing principles, there is a strong economic and commercial case for retaining the original financial target which runs until 1984/5, and accepting the pricing implications.

However, thereis a need to agree on pricing principles for future years in conjunction with the financial target from 1985/6 and to adjust the public expenditure figures accordingly. For the present, there is little difference between the Treasury and the Department for planning assumptions in the later years.

The cost savings reflect the Treasury view that cost reductions should be based on the ESI's Performance Aim of four and a quarter per cent rather than a planning assumption of three per cent; and that working capital and investment could be trimmed by about 10 per cent and 2 per cent respectively over the period. These savings seem reasonable, and should be supported.

One new sensible suggestion is that the CEGB should sell its continental Dutch coal stocks and thereby raise perhaps £70 million.

BGC

Domestic Pricing	50	20	30
Industrial Pricing	60	30	30
Cost Savings/Exchange Rate Assumption	50	50	50

Acceptance of a 6 per cent domestic price rise in January 1984 which the Prime Minister has effectively endorsed will achieve the above savings on domestic prices. On the other hand, extension of the industrial price freeze until March 1984 which the Prime Minister has also endorsed/effectively eliminates possible industrial gas savings, at least in the first year. However, as with electricity there is a need to consider the proper basis for prices in future years. A move towards economic pricing could yield significant savings and the planning assumptions used for the IFR could be adjusted accordingly.

The cost savings result from corrections for BGC's assumptions on exchange rates and some marginal trimming of investment and working capital, and should be supported.

Energy Investment in the Wider Context

Although there are convincing arguments for individual investment decisions and for the general size of the investment programme in each of the energy industries, more fundamental questions should now be posed about energy investment. Is it appropriate to be investing £2.6 billion in gas, £5.1 billion in electricity, and £2.6 billion in coal over the next 3 years? Is this a sensible allocation of resources given the essential need to reduce public expenditure generally? What priority should we give to energy compared with the NHS etc? I think there is an important point here because we do not need to invest heavily in all energy industries.

?

We have the natural resources and in the context of public expenditure constraints, could give different priorities to investment in the different energy industries.

On gas, the consequence of pricing below economic levels will be to stimulate demand leading to yet more investment.

On electricity, we don't need Sizewell on capacity grounds, although there is a strong case on economic grounds for nuclear investment in order to reduce electricity prices. But Sizewell is a £1.3 billion investment of which £300 million is included in the figures for thenext 3 years. Should we continue to invest heavily in both electricity and coal?

want decision but no construction ?

Conclusions

Of the possible £1,130 of potential savings identified by the Treasury, there appears to be a clear case for achieving:

	1984/5 £m	1985/6 £m	1986/7 £m	Total £m
made up?	250	220	180	650

This compares with the Treasury's minimum target of:

	400	300	75	775

Of the other items, the question of an electricity price freeze in 1984/5 is the most significant. In this case, the importance of public expenditure savings will need to be balanced against a strong argument for maintaining the existing financial target and moving closer towards economic pricing in 1984/5. For future years, there is an urgent need to agree the basis and desirability of moving to economic pricing for all fuels which is likely to produce additional revenue.

The question of whether high levels of investment in all the energy industries at the present time should also be addressed.

DLP.

DAVID PASCALL

CONFIDENTIAL

cc D.P.

HL

10 DOWNING STREET

From the Private Secretary

19 October 1983

Gas prices

The Prime Minister has seen your Secretary of State's letter of 21 September and the Chancellor's reply of 17 October. She has commented that a 6% increase in gas prices on 1 January 1984 most closely reflects the outcome of the meeting she held on 13 September. Such an increase would be roughly equal to the increase in prices since the last occasion prices were set and thus would achieve the objective of maintaining gas prices in real terms at the level achieved by the three successive 10% real price increases.

On industrial prices she thinks the freeze should not be extended beyond the end of this financial year. The increases thereafter should be settled after further consideration of the pricing principles to be adopted in the longer term.

On pricing principles themselves, the Prime Minister has noted that there is as yet no agreement. She hopes that agreed criteria can be put back to her on what would be implied by the adoption of economic pricing. The implications of moving towards economic pricing during the course of this Parliament and the timescale to be adopted can then be considered.

She considers that there is no point in setting BGC a financial target until the longer term pricing policy has been settled.

I am copying this letter to John Kerr (H.M. Treasury), John Graham (Scottish Office), Callum McCarthy (Department of Trade and Industry), John Gieve (Chief Secretary's Office) and Richard Hatfield (Cabinet Office).

Andrew Turnbull

Michael Reidy, Esq.,
Department of Energy.

CONFIDENTIAL

10 DOWNING STREET

Prime Minister (1)

Agree

(i) A 6 per cent increase in domestic gas prices on 1 January (equals increase in prices since last increase in October 1982)?

(ii) Freeze in industrial prices only to March 1984?

(iii) Agreed set of economic pricing principles to be reported back to you?

(iv) No decisions on Financial Target for BGC until pricing principles settled for longer term.

AT 18/10

Yes [illegible]

CONFIDENTIAL

18 October 1983
Policy Unit

MR TURNBULL

GAS PRICES

Copy of record of meeting at Flag A.

A rise of 6 per cent in domestic gas prices in January 1984, as proposed by the Chancellor, would be consistent with the decisions reached at the Prime Minister's meeting of 13 September 1983 to maintain gas prices in real terms. Acceptance of Peter Walker's proposal of 5 per cent would result in real price reductions during the 15 month period between October 1982 and January 1984. This would erode the position achieved by the three successive 10 per cent real price increases during the last Parliament. We have no need to compromise on this point in the face of BGC and public resistance, as the maintenance of prices in real terms is a sensible and defensible policy for the short term.

For future years, recent papers by the Treasury and the Department of Energy have indicated that there is no agreement about the basis for setting economic pricing levels. We suggest that the Prime Minister should request that an agreed set of economic pricing criteria be prepared. The implications and timescale of moving towards economic pricing during this Parliament could then be considered further.

As the immediate need is to settle only the price rises for January 1984 and the planning assumptions for the IFR, we do not consider that any decisions on the Financial Target should be settled in advance of agreement on pricing principles. Similarly, any decisions on extending the industrial gas price freeze beyond the current financial year should also be based upon further consideration of pricing principles and objectives.

DLP.

DAVID PASCALL

CONFIDENTIAL

4.63

CONFIDENTIAL

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

The Rt Hon Peter Walker MP
Secretary of State for Energy

17 October 1983

Dear Peter

GAS PRICES

Thank you for your letter of 21 September. I have also seen your letter of 14 October to Peter Rees and deal with the BGC pricing points in it in this reply because the Gas Board will, I understand, be meeting shortly to consider pricing and will clearly need to have our considered views.

My reactions to your proposals are as follows.

(a) Tariffs for domestic and small non-domestic consumers

I am sure that you are quite right not to agree to Sir Denis Rooke's suggestion that the price increase on 1 January should be only 4 per cent. At our meeting on 13 September, the Prime Minister said that it "should be such as to maintain gas prices in real terms at the level achieved by three successive 10 per cent real price increases" (Mr Scholar's letter of 14 September).

The current forecast of the increase in the RPI between October 1982 and January 1984 is 6 per cent. Accordingly, the price increase on 1 January 1984 should be 6 per cent. As well as being consistent with the outcome of the 13 September discussion, this is crucial in public expenditure terms. I have no strong views on the way it is split between the commodity charge and the standing charge. (Incidentally, it has been separately agreed that there should be a 5½ per cent price increase for British Rail on the grounds that it would be in line with inflation over the shorter period from January 1983 to January 1984.)

As regards subsequent price increases, BGC propose real increases of 1 per cent in January 1985, 1986 and, I believe, in 1987. I can accept these for planning purposes and for setting the 1984-85 EFL. As you say, this would not be a final decision on pricing. We clearly need to return to the issue of pricing policy and the figures may well require revision in the light of our eventual decision.

I have read with interest the paper enclosed with your letter of 21 September. It is surprising that BGC should suddenly come up with such a radically different view of long run marginal costs and I find the basis of their calculations far from clear. Prices based on such a view of costs would seem to recover less than half BGC's non-gas costs; an approach no commercial firm could afford. Clearly the first step is for your officials and mine to try to reach an understanding of BGC's new figures.

But I ought to make two points in the light of our discussion on 13 September. First, when the 30 per cent price increase was agreed back in 1979, there was no suggestion that this would be enough to correct in full the then prevailing

18 OCT 1983

underpricing. The extent of underpricing was then put at 25-50 per cent, with much depending on real oil prices remaining constant. They have in fact risen. Secondly, even if we had got back to economic prices, it is most unlikely that this would have been the end of real price increases. All the signs are that real energy prices will rise. And when in early 1980 we announced the 30 per cent price increase, we did not claim that it would put the position right once and for all.

(b) Industrial contracts

I do not accept that our pricing policy should be based on keeping industrial prices within the European range. This was not agreed at our No 10 meeting. Our approach must be based on economic pricing. Anything else amounts to costly and selective subsidisation of industry.

In any case, on current views of exchange rates, BGC's price proposals for firm gas would only take our price to the top end of the European range, not above the top, and the price of interruptible gas would be well within the European range. I also note that your comparisons are based on consumers in the range 1 million - 10 million therms per annum. While this accounts for the bulk of industrial gas sold, it covers only a small minority of industrial consumers. I expect that a comparison based on the larger number of smaller industrial consumers would show our position in a more advantageous light.

You have proposed a freeze on industrial prices for the rest of this year and have raised the possibility of extending the freeze still further. I could agree to this only if the price rise in January 1984 for domestic and small non-domestic consumers were set correspondingly above 6 per cent, for we must offset the cost in each year of the coming three years of an industrial freeze after 31 December 1983. Otherwise I consider the freeze should end at that date. International comparisons suggest that it would not be unreasonable to load price increases in this way; our domestic prices are substantially below those in most of Europe.

(c) Financial Targets

You would like to set a target for the three years from 1983-84 to 1985-86. Frankly, I can see little purpose in doing this until we have an agreed pricing policy, for a return to economic pricing would make any target we now set pretty meaningless. Nor do I think we can take any long term view on the levy until we are in a position to settle prices and the financial target. This is unsatisfactory but seems unavoidable.

I am copying this letter to the Prime Minister, George Younger, Norman Tebbit, Peter Rees, and Sir Robert Armstrong.

Yours
Nigel

NIGEL LAWSON

Nat Ind
Gas e Elect.
p48

SIR ROBIN BUTLER

with compliments

P E Middleton

Permanent Secretary

H M TREASURY

SECRET & PERSONAL

NBPM

5

H M Treasury

Parliament Street London SW1P 3AG

Switchboard 01-233 3000

Direct Dialling 01-233 ....

P E Middleton
Permanent Secretary

Sir Robert Armstrong GCB CVO
Cabinet Office
70 Whitehall
LONDON
SW1A 2AS

10 October 1983

Dear Robert,

WITHSTANDING A STRIKE IN THE GAS INDUSTRY

Thank you for sending me a copy of your letter of 5 October to Ken Couzens.

2. I should like Tom Burgner, the Under-Secretary in charge of the Public Enterprise Group, to be the Treasury representative on MISC 98, with Steve Robson, the Assistant Secretary in charge of the Energy Division as his alternate.

3. I am copying this letter to the recipients of yours.

Yours ever,

Peter

P E MIDDLETON

CNO

SCOTTISH OFFICE
WHITEHALL, LONDON SW1A 2AU

Prime Minister (2)
Secretary of State for Scotland very close to settling, though he could reopen if an electricity price freeze is agreed in England and Wales. As a member of MISC 99, he ought not to be in dispute.
AT 25/10

CONFIDENTIAL

The Rt Hon Peter Rees QC MP
Chief Secretary to the Treasury
HM Treasury
Parliament Street
LONDON
SW1P 3AG

7 October 1983

Dear Peter

EXTERNAL FINANCING LIMITS: SCOTTISH NATIONALISED INDUSTRIES

At our meeting on 29 September you requested a number of cuts in the external financing requirements of the Scottish Electricity Boards. My officials have since been in contact with the Chairmen of the Boards about your proposals.

These cuts will undoubtedly cause difficulties for the Boards since their budgets are already tight. The Chairmen are particularly concerned about the effect on the financial target and performance aims which we have only recently negotiated and there is a danger that imposed cuts will bring the system into disrepute.

Nevertheless I am prepared to accept your proposals for reductions for NSHEB in the three years 1984/85-1986/87. In light of these reductions the Board will clearly have to reconsider its planned refurbishment programme and its run of river schemes.

In the case of SSEB, I can accept the reductions in 1984/85 and 1985/86. Officials have agreed that the baseline figure for 1986/87 should be £160m but that further discussions will be necessary in the context of next year's IFR. We also agreed that these decisions should not be allowed to cause the Torness project to be delayed, and it may be that I shall need to seek an additional bid if there is a danger of this happening.

The final point I should like to make in connection with the Electricity Boards concerns the possibility of a freeze on electricity prices in 1984/85. Cecil Parkinson's letter of 22 September to Peter Walker refers to the fact that in England and Wales there might be no worsening of the public expenditure position. This is not the case in Scotland: my officials estimate that the external financing requirements would be increased in each of the three years by about £30m-£40m for SSEB and by £10m-£15m for NSHEB. There would be great public criticism if electricity prices were increased only in Scotland. We have argued consistently for a number of years that electricity prices are higher in Scotland than in justified by economic principles. In these circumstances, I would need to seek a relaxation of the EFLs in order to allow the Scottish Boards also to freeze their tariffs.

As for STG, I have some revised proposals for the EFL. The figures are:

	1984/85	1985/86	1986/87
		£m	
29 September			
My bid	17.8	15.8	17.5
Treasury target	14.3	12.3	15.5
Further reduction sought by Treasury	3.5	3.5	2.0
Present bid	15.8	14.3	15.5
Further reduction now offered on earlier bid	2.0	1.5	2.0

My current bid for STG, comes very close to your target, and indeed achieves it in 1986/87. I cannot, however, meet you in full for each year. Our officials have discussed the reasons for this, namely that my bid at the bilateral already took account of future efficiency gains and that allowance for the Group's repaying debt ahead of schedule was not appropriate.

But after further consideration of the Group's investment proposals I now offer the following:-

	1984/85	1985/86	1986/87
		£m	
29 September bid	21.7	19.9	19.7
Present bid	20.2	19.4	19.2
Reduction	1.5	0.5	0.5

I trust these reconsidered STG bids can now be agreed between us.

Yours ever,

George

Nat Ind
Gas & Elect
Pt 8

NBPM

4

MINISTRY OF DEFENCE
MAIN BUILDING WHITEHALL LONDON SW1A 2HB
Telephone 01-218 2193 (Direct Dialling)
01-218 9000 (Switchboard)

PERMANENT UNDER-SECRETARY OF STATE
SIR CLIVE WHITMORE KCB CVO

7th October, 1983.

PUS/83/921
(39/1)

Dear Robert,

WITHSTANDING A STRIKE IN THE GAS INDUSTRY

Thank you for sending me a copy of your letter of 5th October to Ken Couzens about the establishment of MISC 98.

I should like to nominate Barry Miller, the Head of Defence Secretariat 6, as the Ministry of Defence member of the Group.

I am sending copies of this letter to Peter Middleton (Treasury), Kenneth Couzens (Energy), Kerr Fraser (Scottish Office), Michael Quinlan (Employment), Brian Hayes (Trade and Industry) and Robin Butler (10 Downing Street).

Yours ever,

Clive.

Sir Robert Armstrong, GCB, CVO,
Cabinet Office,
70 Whitehall,
London, SW1A 2AS.

NBPM

cc HO

DEPARTMENT OF ENERGY
THAMES HOUSE SOUTH
MILLBANK
LONDON SW1P 4QJ

01-211 5444

J.R.S. Guinness
DEPUTY SECRETARY

7th October 1983

Sir Robert Armstrong GCB CVO
Cabinet Office
70 Whitehall
London SW1A 2AS

Dear Robert,

Withstanding a Strike in the Gas Industry

In Ken Couzens's absence I am replying to your letter of 5th October about the setting up of the Official Group on the Gas Industry (MISC 98) which will have the remit to study withstanding a strike in the gas industry.

I would like to nominate Graham Campbell, the Under Secretary in charge of Gas Division, as the Department's member on this Group. I should be grateful if the Secretariat could arrange for a second copy of MISC 98 papers to be sent to Ivor Manley in view of his co-ordinating role in the Department for handling such strikes.

I am sending copies of this letter to the other recipients of your letter.

Yours sincerely,

John Guinness

J.R.S. Guinness

NBPM

3

Department of Employment
Caxton House Tothill Street
London SW1H 9NF
Telephone 01-213 3000

M E Quinlan CB
Permanent Secretary

SECRET & PERSONAL

Sir Robert Armstrong GCB CVO
Cabinet Office
Whitehall
London SW1

7 October 1983

Dear Sir Robert

WITHSTANDING A STRIKE IN THE GAS INDUSTRY

Thank you for sending me a copy of your letter of 5 October to Ken Couzens.

I should like this Department to be represented on MISC 98 by Matt Wake, the Under Secretary responsible for the relevant industrial relations division here.

I am copying this letter to the recipients of yours.

Yours sincerely

pp EM van Schagen

MICHAEL QUINLAN

SECRET & PERSONAL

SECRET AND PERSONAL

file SH

bcc: Mr Mount

10 DOWNING STREET

2

From the Principal Private Secretary

SIR ROBERT ARMSTRONG

Withstanding a Strike in the Gas Industry

Thank you for sending me a copy of your letter of 5 October to Ken Couzens (A083/2780). I would like to nominate David Pascall of the No. 10 Policy Unit for Peter Gregson's Official Group.

B.E.R. BUTLER

7 October, 1983

SECRET AND PERSONAL

F E R Butler Esq

Mr. Mount
Do you want to nominate someone
FERB
6.10

CABINET OFFICE

I'd like to nominate David Pascall
fm
6/10

With the compliments of

Sir Robert Armstrong GCB CVO

Secretary of the Cabinet

and Head of the

Home Civil Service

70 Whitehall, London SW1A 2AS

Telephone 01-233 8319

70 WHITEHALL, LONDON SW1A 2AS

01-233 8319

From the Secretary of the Cabinet and Head of the Home Civil Service

Sir Robert Armstrong GCB CVO

Ref. A083/2780 5 October 1983

Withstanding a Strike in the Gas Industry

The Prime Minister agreed some time ago that, as part of the series of studies of withstanding strikes in key industries, there should be a study of the gas industry. An Official Group on the Gas Industry (MISC 98) is therefore being established under Peter Gregson's chairmanship with representatives from the following Departments:

Treasury
Department of Energy
Ministry of Defence
Scottish Office
Department of Employment
Department of Trade and Industry
No 10 Policy Unit

I am writing to seek nominations for the Group at about Under Secretary level to reach me by the end of this week (7 October).

I am sending copies of this letter to Peter Middleton (Treasury), Clive Whitmore (Defence), Kerr Fraser (Scottish Office), Michael Quinlan (Employment), Brian Hayes (Trade and Industry) and Robin Butler (10 Downing Street).

ROBERT ARMSTRONG

Sir Kenneth Couzens KCB

CONFIDENTIAL

PA

cc DP

PRIME MINISTER

23 September 1983

GAS PRICES

Your meeting on 13 September 1983 agreed that the gas price increase at the beginning of January 1984 should maintain gas prices in real terms but that no decision on future years should be taken immediately. The Secretary of State for Energy has submitted proposals for a 5% increase for domestic and small non-domestic consumers from 1 January 1984; a freeze on industrial contracts consumers for the remainder of the 1983/84 financial year; and a two year financial target for BGC, incorporating increases in line with inflation for all markets in 1984/85. Your meeting reached no conclusions on this last point.

Given the dispute about the basis which should be used for future economic prices, as illustrated in recent papers by both the Treasury and the Department of Energy, the immediate need is to settle the price rises for January 1984 and the planning assumptions for the IFR. We do not consider that the Financial Target should be settled in advance of agreement on pricing principles. The announcement of a Financial Target which incorporates prices rises for 1984/85 in line with inflation would significantly reduce the options for achieving economic pricing in this Parliament.

In order to resolve the present unsatisfactory dispute about economic pricing principles for both gas and electricity as soon as possible, we suggest that you should set up a small Interdepartmental Group which would include the No 10 Policy Unit.

DLP.

DAVID PASCALL

Prime Minister (4)

mcs 22/9

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET
TELEPHONE DIRECT LINE 01-215 5422
SWITCHBOARD 01-215 7877

ECNO.

JU555

Secretary of State for Trade and Industry

22 September 1983

CONFIDENTIAL

The Rt Hon Peter Walker MP
Secretary of State for Energy
The Department of Energy
Thames House South
Millbank SW1

Dear Peter,

ENERGY PRICES

I see from your more recent minute to the Prime Minister on this subject that it now seems possible that the electricity price 'freeze' could be extended to 1984/5 within the present financial target and with no worsening of the public expenditure position. If this is so I am sure it would be the right course to take. There can be little justification for extracting a higher rate of return than planned for by overcharging the customers of an industry which is suffering from over-capacity. While an overall price freeze would not solve the problems of the large industrial users which we are studying, the continued freeze would make some contribution to alleviating their competitive disadvantage and would of course be welcome to industry as a whole.

2 On gas prices, I hope that the figures which you have been asked to prepare comparing the position of domestic tariff customers and industrial contract customers will bring out the different rates of return which BGC is earning on these two businesses. In the past we have been concerned that industrial customers were subsidising domestic customers and I do not think an industrial price increase would be appropriate until the Corporation is earning a similar return on both sides.

3 I am copying this letter to the Prime Minister, Nigel Lawson, George Younger and Sir Robert Armstrong.

Yours Ever,

Cecil

Nat Fuel : Gas + elec Pricing Pt 8

cc NO

Prime Minister

(4)

MCS 22/9

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

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
London
SW1P 3AG

21 September 1983

Dear Nigel.

GAS PRICES

See MCS to Energy 14.9.83

Following our meeting with the Prime Minister on 13 September, I am writing about the figure for the January 1984 price increase. I take this opportunity also to make proposals for the price assumptions for 1984/5 so that we can agree a two year Financial Target for BGC covering 1983/4 and 1984/5.

My proposals are as follows:

(i) a 5% tariff increase for domestic and small non-domestic consumers effective from 1 January 1984. This would broadly maintain gas prices in real terms at the level achieved by the three successive 10% real price increases, but I must warn my colleagues that it is an increase higher than the Gas Consumer Councils are expecting. We may face political pressure on it. If we went beyond 5% I am sure we would also meet resistance from the Gas Corporation, which has throughout proposed a 4% increase and is known to have done so. That would greatly increase our political difficulties.

(ii) No increase for industrial contract consumers for the remainder of this financial year. I believe there is a strong political and economic case for shifting away from the emphasis in BGC's original proposals on large increases in the industrial markets.

? MCS (iii) A two year Financial Target for BGC based on these increases for 1983/4, and on increases in all markets in line with inflation for 1984/5; as well as on foreseeable cost savings.

(iv) The price increase for industrial contract consumers for 1984/5 would need to be spread over the year in order to keep within the European range. The domestic tariff increase might be on 1 October 1984.

(v) We will need now to obtain revised financial forecasts from BGC on the basis described above; but I believe these proposals are consistent with the present EFL for 1983/4 and are likely to involve no addition to public expenditure costs in 1984/5.

I should stress that what I am proposing for prices in 1984/5 is a planning assumption to enable us to set a two year Financial Target for British Gas, and to settle the EFL for 1984/5. It is not a final decision on pricing. If BGC are able to achieve lower prices within their Financial Target and EFL for 1984/5, then I believe that the consumer, and especially the industrial consumer, should benefit. This may be all the more necessary if we are to keep our industrial gas prices competitive with those in Europe.

I think you will agree that these proposals are consistent with the conclusions reached at the Prime Minister's meeting. I attach a note which expands on the background to my proposals.

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

Yo ee

PETER WALKER

ec FM.

CONFIDENTIAL

GAS PRICING

1. This note sets out the background to the decisions which are needed on gas prices in 1983/4 and 1984/5, and relates these decisions to the July IFR, to BGC's Corporate Plan and to the need for a Financial Target for BGC.

BGC Cost and Price Calculations

2. Table 1 attached to this note sets out the pricing proposals for each of four markets used in the July IFR and in BGC's Corporate Plan. It then compares these figures with the estimates in their Corporate Plan of long run marginal costs, which are based on their estimates of the cost of contracted imports (mainly from the Norwegian Frigg field) and of marginal onshore costs. Taken at face value, this comparison suggests that BGC's original proposals would have produced prices falling further behind marginal costs. However, it would be wrong to accord these long run marginal cost figures a status which they cannot bear. As the Treasury paper enclosed with the Chancellor's minute of 9 September points out, lrmc figures are notoriously difficult to calculate, let alone forecast. This is particularly so in the case of gas, given that BGC operate an integrated system while drawing on very varied sources of supply - different load factors, different beach terminals and seasonally different rates of gas flow.

3. In addition, a number of major uncertainties surround the BGC mid-year estimates:-

(i) BGC have said that they have based their estimates of marginal onshore costs on the assumption that their network was fully

... utilised

utilised to meet existing demand, and that the system would have to be expanded to take on additional sales. This is in fact not the case, and these estimates are therefore based on unrealistic assumptions. The contribution to costs from this "capacity charge" is substantial;

(ii) BGC have recently produced figures on an alternative <u>avoidable costs</u> basis, on principles similar to those arising in the recent re-examination of long run marginal costs in electricity. These avoidable costs figures are much lower than the lrmc figures hitherto used in their Corporate Plan. The results are set out in Table 2 which shows BGC making a <u>profit</u>, though a declining one, on new supplies from the Frigg field in all markets. The BGC calculation requires further examination but their avoidable costs figures are further evidence that the lrmc figures they have hitherto used may not be soundly based;

(iii) The figures make no allowance for cost savings such as those identified in the Deloittes Report;

(iv) The <u>gas costs</u> element of the lrmc figures includes supplies from the Odin field in the later years. Taking figures solely for Frigg would reduce the estimate of marginal cost by 1 to 2p a therm (1982/3 prices);

(v) BGC's gas cost forecasts rest crucially on their forecasts of oil prices, because of the link between the two in the escalation clauses of their gas supply contracts with the producers. These forecasts were

... produced

produced some time ago, and there is increasing evidence to show that they are on the high side. If the rapid real rise in oil prices which BGC expect in the late 80's and 1990s does not take place, then the marginal cost could be much lower;

(vi) Exchange rates have a significant effect on the gas costs used in the lrmc figures because the Norwegian Frigg price varies with the exchange rate between sterling and a basket of European currencies. The movement in exchange rates since BGC put forward their proposals has had the effect of lowering their gas costs by about 1p/therm as compared with their original forecast;

(vii) The price of Norwegian Frigg has been taken as a proxy for lrmc gas costs. Although the Frigg contract contains escalator clauses, it was concluded nearly ten years ago. If, ultimately, BGC contract to buy Sleipner gas, it could be argued that the base price for that gas would then become a more appropriate indicator, although BGC would not in fact be using Sleipner gas until the 1990's.

4. Some of these uncertainties, such as the relevance and level of the Sleipner price and the level of marginal onshore costs, should be resolved in the coming year. The question of marginal onshore costs in particular, which is now under discussion with BGC, is very relevant to the consideration of longer term

price issues which Ministers decided to undertake on 13 September. Other uncertainties, especially about the oil price and the exchange rate, will remain .

Domestic and Industrial Prices 1983/4 and 1984/5

5. Ministers have made it clear in public statements over the past year that the domestic gas price rise in the autumn of 1983 would not be "more than about the rate of inflation". it is widely known that BGC proposed an increase of 4% from 1 October 1983, and the Consumer Council in particular know this and have objected to it. Since the October increase was delayed, BGC have proposed a 4% increase from 1 January 1984 in the light of their improved results in 1983. Ministers decided on 13 September that the price increase at the beginning of January 1984 should be such as to maintain gas prices in real terms at the level achieved by the three successive 10% real price increases.

6. It seems difficult to contemplate a much higher increase than the 4% BGC have proposed first, for October 1983 and then for January 1984. 4% was the rate of inflation when BGC proposed the October 1983 increase. A further three months without an increase would perhaps make it possible to justify a 5% increase from 1 January 1984. A 5% tariff increase already involves an increase in charges per therm greater than 5%, given the need to avoid increasing standing charges.

7. The scope for manoeuvre in the industrial contract markets is limited by continuing weakness in the industrial sector and the fact that UK prices for firm gas are still near the top end of the European range. Table 3 shows that, without some moderation, BGC's present plans could take the UK to the top of the European pricing range by mid 1984. These figures are of course crucially dependent on the exchange rates assumed. Those used in Table 3 are derived from the Treasury's most recent National Income Forecast (NIF), but this was made some weeks ago.

... If

If the September pattern of exchange rates were to continue, the sterling equivalent of the gas price in other European countries would be lower than shown in Table 3. If the dollar were to depreciate less in 1984 than assumed in the NIF, then the sterling equivalent of European gas prices, particularly in the interruptible market, would be a little higher than forecast.

8. The earliest date at which BGC could now implement a domestic tariff increase is 1 January 1984, because of the legal requirement for consulting their Consumer Councils and informing their customers. An increase of 5% on that date, rather than the 4% which BGC are proposing, coupled with the improved profitability which BGC are now reporting for this year, should enable them to hold industrial contract prices at their current level for a further three months and still remain within their present EFL.

9. BGC are at present without a Financial Target and are pressing to have it settled. There is also a need to agree BGC's 1984/5 EFL. This points to the need to settle a planning assumption for prices in 1984/5 which, together with the decisions for 1983/4, could form the basis of a two year Financial Target. Increases for all markets in line with inflation next year would hold the position without having any material impact on BGC's external financing position as hitherto forecast; although this would need to be examined closely in the light of revised forecasts from BGC and in the case of the industrial markets, revised forecasts of the position vis a vis our European competitors.

Department of Energy

19 September 1983

COMPARISON OF BGC'S JULY IFR AND CORPORATE PLAN PRICING PLANS WITH COST OF NEW SALES ON LRMC BASIS

P/THERM, 1982/83 PRICES

	82/83	83/84	84/85	85/86	86/87	87/88
Domestic						
Cost of New Sales	42.5	44.6	45.3	46.5	47.4	48.3
BGC Plan Price	38.0	37.8	37.6	38.1	38.4	39.0
Loss (%)	4.5 (12)	6.8(18)	7.7(20)	8.4(22)	9.0(23)	9.3(24)
Non Domestic Tariff						
Cost of New Sales	37.5	39.6	40.3	41.5	42.4	43.3
BGC Plan Price	33.5	33.3	32.9	33.1	33.5	34.0
Loss (%)	4.0(12)	6.3(19)	7.4(22)	8.4(25)	8.9(27)	9.3(27)
Firm Contract (Regions)						
Cost of New Sales	32.5	34.6	35.3	36.5	37.4	38.3
BGC Plan Price	30.5	29.7	29.4	29.0	29.1	29.3
Loss (%)	2.0(7)	4.9(16)	5.9(20)	7.5(26)	8.3(29)	9.0(31)
Interruptible (Regions)						
Cost of New Sales	25.5	27.6	28.3	29.5	30.4	31.3
BGC Plan Price	25.5	24.6	24.6	24.5	24.5	24.9
Loss (%)	- (-)	3.0(12)	3.7(15)	5.0(20)	5.9(24)	6.4(26)

Notes

Cost of new sales is based on BGC estimates of the average cost of contracted imports in each year plus marginal onshore costs, assumed by BGC to remain constant in real terms over the period.

TABLE 2

COMPARISON OF BGC'S JULY IFR AND CORPORATE PLAN PRICING PLANS WITH THE COST OF NEW SALES ON AN AVOIDABLE COST BASIS

P/THERM, 1982/83 PRICES

	82/83 p/th	83/84 p/th	84/85 p/th	85/86 p/th	86/87 p/th	87/88 p/th
Domestic Tariff						
Cost of Sales	34.3	35.4	34.2	34.7	36.1	37.0
BGC Plan Price	38.0	37.8	37.6	38.1	38.4	39.0
Profit (%)	3.7 (9.7)	2.4 (6.3)	3.4 (9.0)	3.4 (8.9)	2.3 (6.0)	2.0 (5.1)
Non-Domestic Tariff						
Cost of New Sales	25.6	26.8	25.7	26.3	27.8	28.8
BGC Plan Price	33.5	33.3	32.9	33.1	33.5	34.0
Profit (%)	7.9 (23.6)	6.5 (19.5)	7.2 (21.9)	6.8 (20.5)	5.7 (17.0)	5.2 (15.3)
Firm Contract (Regions)						
Cost of New Sales	25.3	26.5	25.4	26.0	27.5	28.5
BGC Plan Price	30.5	29.7	29.4	29.0	29.1	29.3
Profit (%)	5.2 (17.0)	3.2 (10.8)	4.0 (13.6)	3.0 (10.6)	1.6 (5.5)	0.8 (2.7)
Interruptible (Regions)						
Cost of New Sales	21.5	22.7	21.6	22.2	23.7	24.7
BGC Plan Price	25.5	24.6	24.6	24.5	24.5	24.9
Profit (%)	4.0 (15.7)	1.9 (7.7)	3.0 (12.2)	2.3 (9.4)	0.8 (3.3)	0.2 (0.8)

Note: Cost of New Sales in each year is calculated from the average cost of gas from the Frigg Field (UK and Norwegian), together with an analysis of the additional costs of extending the industry to distribute Frigg and other Northern Basin gas.

TABLE 3

DEPARTMENT OF ENERGY PROJECTIONS OF INDUSTRIAL GAS PRICES IN THE EC TO MID 1984

LOADS OF 1-10 M THERMS P.A.

Pence per Therm

	Oct 1 1982 (a)	Oct 1 1983 (b)	Jan 1 1984 (b)	July 1 1984 (b)
FIRM GAS				
Great Britain (c)	30.3	30.3	31:3	32.7
Belgium	27.7 -29.6	30.-32	30-32	31-33
France	23.7 - 27.1	28 -32 (d)	28-32	29-33
Germany (e)	26.3 -30.4(37)	28 -32(37)	28-32(36)	29-33(36)
Netherlands	25.3 - 26.5	27 - 28	28-29	28-29
Italy	26.5 - 28.1	29 - 31	28-30	28-30
INTERRUPTIBLE GAS				
Great Britain	24.5 - 26.5	24.5 - 26.5	25.5 - 27.5	26.9 - 28.9
Belgium	26.7	28	27	27
France	24	28	27	27
Germany	25.3	27	26	26
Netherlands (f)	N/A	N/A	N/A	N/A
Italy	25.1	28	27	27

Notes:
(a) Figures in CBI report, Feb 1983.
(b) It is assumed that dollar fuel oil prices in Europe do not rise either as a result of inflation or in real terms, and that some sterling depreciation takes place against the French Franc and Deutschemark from October 1983 (in line with NIF).
(c) BGC's July IFR proposals, as moderated by the extension of the present freeze until 1 January 1984.
(d) Assuming a 4% increase in French firm gas prices in September 1983.
(e) Includes gas oil related prices paid by some small industrial consumers (bracketed figures)
(f) N/A = not applicable.

CONFIDENTIAL

~~NO~~

(4)

Prime Minister

MCS 22/9

(Seen by PM)

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

21 September 1983

Michael Reidy Esq
Private Secretary to the Secretary of State
for Energy
Department of Energy
Thames House South
Millbank
LONDON SW1P 4QJ

Dear Michael,

ENERGY PRICES

/A 8 with MCS?

The Chancellor has seen your Secretary of State's minute to the Prime Minister of 16 September, amplifying Michael Scholar's record of the Prime Minister's meeting on 13 September. However, the Chancellor found Mr Walker's minute slightly ambiguous.

If by settling gas prices, your Secretary of State means first establishing what economic pricing implies for gas and then implementing the result, the Chancellor is happy to accept his proposition that economic pricing should be applied to the other fuels. However, if by settling gas prices, Mr Walker means holding real prices constant, while Ministers continue to debate the future path of gas prices, then the Chancellor cannot accept Mr Walker's conclusion. He notes first that the benefits in terms of resource allocation would be negated if two fuels were correctly priced but the third was not, since it would not be possible to achieve the correct level of demand and supply for the first two fuels. Second, the Chancellor points out that the Government cannot ignore the public expenditure consequences of conceding full economic prices for electricity and coal, where this principle points to lower prices, but of failing to act where economic pricing points to higher prices for gas.

I am copying this letter to Michael Scholar at No. 10.

Yours sincerely,

Margaret O'Mara

MISS M O'MARA
Private Secretary

NAT. IND GAS + ELEC PRICES Pt8

CONFIDENTIAL

Nat Ind
Gas + Elect Prices
with NR?

CC NO

(2)

Prime Minister

!

MES 16/9

PRIME MINISTER

ENERGY PRICES

I have seen your office's record of our discussion on 13 September and, whilst broadly it strikes me as an accurate and helpful record, there is one point I should like to add for the sake of completeness. I was grateful to the Chancellor of the Exchequer for agreeing to my proposal that, having settled gas prices, we should go on to establish what would be involved in the full application of economic pricing to the electricity and coal industries. This is a point of some importance on which the record should be explicit.

I am copying this minute to the Chancellor of the Exchequer, the Secretary of State for Scotland, the Minister of State at the Department of Trade and Industry and Sir Robert Armstrong.

16 September 1983

pp SECRETARY OF STATE FOR ENERGY

(Dictated by the Secretary of State and signed in his absence)

CONFIDENTIAL

Nat. Ind:
E Gas + Elec
Pt 8

SUBJECT

(A)

file

bcc: Nick Owen
a master

10 DOWNING STREET

From the Private Secretary

14 September 1983

Dear Michael,

ENERGY PRICES

The Prime Minister took a meeting on energy prices yesterday evening. The Chancellor of the Exchequer, your Secretary of State, the Secretary of State for Scotland, Mr. Lamont (Minister of State, Department of Trade and Industry), Sir Robert Armstrong and Mr. Gregson were present.

It was argued that the high profits in the gas industry, and the fact that gas prices were considerably higher than the average costs of the industry had produced a public perception that gas prices were too high, and would generate severe political difficulty over future price increases. It would not be sufficient to appeal to a principle of economic pricing, reflecting long-run marginal costs in the industry, given that application of the same principle in the electricity and coal industry would point to price reductions, which would be unacceptable on PSBR and other grounds. Against this it was argued that these principles of economic pricing ought to be followed throughout the energy industries: this, indeed, had been the justification for the recent standstill in electricity prices. It would be unfortunate, in view of the higher cost of new gas supplies, to maintain a price structure which encouraged consumers to switch ~~to~~ from electricity, thus compounding the industry's over-capacity difficulties. The high profits of the gas industry were a direct consequence of the low-price contracts they had secured in the past. This windfall gain ought to benefit the whole economy, not just gas-users.

Done

In further discussion it was argued that, to bring gas prices to their international level it would be necessary to increase them in real terms by between 6% and 7% a year over the next three years. The importance of bringing prices to the international market level could be seen in the substantial, and growing, proportion of imported gas. Every 1% subsidy on the gas price cost £50 million. In the present public expenditure climate it was essential not to impose any additional burden from this source.

/ Summing up

DS

Summing up the discussion, the Prime Minister said that the price increase at the beginning of January 1984 should be such as to maintain gas prices in real terms at the level achieved by the three successive 10% real price increases. As to future years, no decision should be taken immediately. Your Secretary of State would provide further figures, illustrating our position relative to other countries as regards industrial gas prices (both for gas as a fuel and as a feedstock), and showing the relationship between domestic and industrial prices in the United Kingdom. There might be a case for making the timing of future price increases towards the international price reflect the changing proportion of old and new supply contracts within the totality of British Gas's cost structure. There would, however, be great political difficulty in a future series of real price increases, given that the three successive 10% increases in the last Parliament had been presented as a necessary step, now completed, to put gas prices on a proper economic footing. Your Secretary of State and the Chancellor of the Exchequer should consider the precise figure for the January 1984 price increase; and further consideration would be given to the longer term price issues when the further information she had requested was available.

I am sending copies of this letter to John Kerr (HM Treasury), Muir Russell (Scottish Office), John Alty (Mr. Lamont's Office, Department of Trade and Industry), Peter Gregson and Richard Hatfield (Cabinet Office).

Yours sincerely,

Michael Scholar

Michael Reidy, Esq.,
Department of Energy.

MT

PRIME MINISTER

ENERGY PRICES

Nigel Lawson minuted you on 23 August, commenting on my minute of 15 August. You are arranging for us to discuss this, but it may simplify our discussion if I record some points on the more theoretical aspects of Nigel's minute.

I think his minute takes too simplistic a view of "economic levels" of energy pricing. As he well knows, there is enormous room for argument about what is an economic level of pricing for electricity or gas, and about how to give effect to it in commercial practice.

As an example, we found it possible last autumn to take a radically new view of what was an economic level of pricing for electricity and, as Nigel says, to go for a price freeze in 1983/4 on the basis of it. I think the new view was right, but the change illustrates that views on economic pricing can alter.

In the case of gas there simply is no agreement worldwide that long-run marginal costs are the sole basis for commercial pricing, in the sense that the consumer should immediately be charged the full price of the most recently purchased tranche of gas supplies. It is common experience with gas utilities in Europe and North America that they practice some form of averaging. Provided they remain profitable overall, such utilities may accept initially a small profit or even a loss on new high priced gas supplies, perhaps against an expectation of better returns on that tranche of supplies later.

Nigel says that no private sector business would do this. But the nature of the gas supply business means that gas utilities, whether public or private, need to recognise long term supply obligations to consumers, and very often also to buy new supplies in large tranches. That is the position of BGC. If it were possible to have competing gas utilities in the UK private sector now, I do not believe they either could or would price solely by reference to the cost of their last purchase of gas, so long as some of them still had gas supplies contracted at lower rates. Competition would prevent this.

I do not think however that there need be all that much between the Chancellor and myself on the immediate course of action. On electricity prices for 1984/5 it now seems possible that an extension of the freeze to the whole of that year could be achieved within the present financial target, and with no worsening of the public expenditure position. Lower inflation is improving the prospect for electricity profits. Nigel will recall that at the time the present target was set he expressed some misgivings that electricity prices would be too high, given the present level of overcapacity in the system. But I expect that a satisfactory conclusion on electricity prices can emerge from the autumn review of nationalised industry finances.

We will however need to discuss gas prices at your meeting. BGC now tell me that profitability in the current financial year has been better than expected. They say they are content to defer any increase until 1 January 1984. It remains for us to decide the quantum of the increase from that date.

I am sending copies of this minute to Nigel Lawson, Cecil Parkinson and George Younger.

SECRETARY OF STATE FOR ENERGY

Sept '83

CONFIDENTIAL

CONFIDENTIAL

9 September 1983
Policy Unit

PRIME MINISTER

ENERGY PRICES

Peter Walker is really attempting to undermine the whole idea of pricing energy at economic levels. We should oppose this because:

1. Uneconomic pricing ~~subsidises~~ encourages energy users to be wasteful.

2. The subsidy raises the PSBR and hence helps to push up interest rates and inflation.

3. In the end, energy prices do have to be painfully readjusted to cover future costs of supply.

4. Economic energy pricing would not worsen inflation because during this Parliament, electricity prices and - to a lesser extent - coal prices, are likely to fall, even if gas prices ought to rise.

5. This Government is committed to economic pricing throughout the public sector. To exclude energy would be to erode the logic of our policy.

6. Even if Government does wish to subsidise energy-intensive industries, the way to do it is through direct help from the Exchequer, not by sending the wrong signals to the whole of industry.

7. The real rates of return on investment in gas and electricity are only 1.6 per cent and 1 per cent respectively (1982/3: current cost basis, after interest, tax and extraordinary items).

Domestic Gas

Despite the three price increases of 10 per cent in real terms for domestic gas since 1979, on current forecasts domestic gas is still underpriced. Unless prices are progressively moved to economic levels, demand will increase. More imports of gas would then be needed. They would have to be sold at a loss.

CONFIDENTIAL

Domestic prices are only now at 1970 levels in real terms, and are significantly below European levels. The effect of the series of 10 per cent rises has been to transfer perhaps about a quarter of the available economic rent to the Exchequer since 1980.

The extent of current underpricing depends upon the definition of economic prices. Based on the Frigg field contract which is usually taken as a reasonable indicator of marginal cost, domestic gas was probably underpriced in 1982/83 by about 4½p per therm, or about 12 per cent. The extra revenue foregone which would otherwise have been available to the Exchequer on this basis, is about £500 million - on top of the combined actual total of gas levy and BGC's profits of about £1,200 million, of which only about £700 million passed to the Exchequer in the form of the levy and tax. As gas costs are increasing in real terms, the degree of underpricing is likely to increase in 1983/84 - and any freeze decision would make the "pricing gap" wider still.

Moreover, if the price at which the gas could be sold into Europe is used as a basis for economic prices, the degree of underpricing is probably much higher.

As there is no clear agreement about the correct basis for economic gas prices, the proposal for BGC to raise domestic prices in line with inflation in October is intended to maintain real prices until the most appropriate interpretation of economic prices is agreed.

Industrial Gas

As far as industrial gas prices are concerned, comparison with Frigg does not indicate any significant underpricing. There is therefore a similar need for industrial prices to rise at least in line with inflation, although higher increases would be indicated by the rise in real gas costs.

If BGC are selling gas at prices below the current marginal costs of supply, new entrants into the market under the Oil and Gas Enterprise Act are likely to be few and far between.

Electricity

By contrast, electricity is at present overpriced.

Even with the 1983/84 price freeze, electricity prices are probably about 6 per cent, equivalent to about £500 million revenue, above economic levels. If the CEGB is required to break even before interest, prices are still probably about 3 per cent, or £300 million in revenue, above economic levels. The purpose of the current price freeze, and the proposed increase of 1½ per cent below the rate of inflation in 1984/85, is to give the Government an opportunity to agree the detailed basis for future prices.

We consider that electricity prices should move as quickly as possible towards economic levels, even if this implies going further towards a price freeze in 1984/85 than has already been agreed. This would involve some recognition that current prices are too high, but that embarrassment would be confined to political circles. It would be a pity to miss an opportunity to implement proposals which are both rational and likely to be widely welcomed by electricity consumers.

It is possible that economic prices could lead to accounting losses - which would be borne by the taxpayer rather than by the electricity consumer. This would be in conflict with the industry's statutory duty to break even and would also mean that the industry would not earn a positive return on investment.

But you can argue that if the industry is still able to repay debt despite accounting losses, the financial health of the industry is still being maintained.

Coal

Although coal prices have been raised above economic levels, with implications for electricity prices, the new NCB/CEGB pricing agreement will lead to a fall in real coal prices. Prices will be raised by only 2.5-2.9 per cent in November, in order to align NCB prices more closely with import prices, and thus begin to eliminate overcharging. Coal prices should not therefore be significantly out of line with economic price levels in the future, although further discussion on import price alignment may be needed.

B

Large industrial users of electricity

Your meeting last December, which considered the CPRS Report on Electricity Prices for Industry, concluded that electricity prices should be properly based on economic prices, without any subsidy from the taxpayer or cross-subsidy from other consumers. This conclusion related primarily to the question of whether the tariff system should be tilted to favour large industrial users of electricity. Arising from this meeting, new proposals on direct contracts, sophisticated tariffs and load management schemes are being considered by DTI and Department of Energy. These proposals have yet to be agreed between the two Departments and brought back to E(NI).

Conclusions

We recommend that your meeting on Tuesday should agree:

1. That energy prices should be set by economic pricing principles and that the Department of Energy should produce proposals on the most appropriate interpretation of economic prices for gas, electricity and coal.

2. That domestic gas is underpriced and that prices should be raised in line with inflation from October. Thereafter, the Department of Energy should produce proposals for eliminating the underpricing of domestic gas within 5 years. Industrial gas prices should be raised in line with real gas costs after the expiry of the current industrial price freeze at the end of the year.

3. That electricity is overpriced and that consideration should be given to moving closer towards a price freeze in 1984/85.

FM

FERDINAND MOUNT

4.47 cc AW

CONFIDENTIAL

Prime Minister

MCS 9/9

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

PRIME MINISTER

ENERGY PRICES

We are due to meet next Tuesday to discuss energy prices. In my minute to you of 23 August, I argued against Peter Walker's proposal that there should be no increase in the price of domestic gas after October and that the freeze on electricity prices should be extended to 1984-85. On the latter, I do not believe decisions need to be taken now but officials should be asked to examine the finances of the electricity industry and the way marginal costs are developing, taking into account the recent agreement on coal prices between the NCB and the CEGB.

2. I stated in my minute that there is a strong case for gas prices to rise in real terms and I offered to develop the arguments further. I attach a paper which considers the general principles we should be following - indeed have been following - on the prices of different fuels and why these point to higher real gas prices. Against this background we should certainly not be allowing real gas prices to fall in the short term, thereby yielding some of the ground won at great cost in the last Parliament.

3. I am copying this to Peter Walker, Cecil Parkinson and George Younger.

Margaret O'Mara

(N.L.)

9 September 1983

(approved by the Chancellor and signed in his absence)

GAS PRICING POLICY

Note by the Treasury

Introduction

This note provides the background to decisions which are needed on BGC's domestic gas price increase this autumn and on the direction gas prices should follow over the medium term.

General principles

2. The approach which this administration have adopted on energy prices is that they should be set at economic levels. When a fuel eg oil, is traded internationally the price set in the world market provides a clear guide. When the oil price rose, it was accepted that domestic prices should rise and that this was equally true when the UK was an importer, as in 1973-74, or a net exporter, as after 1979. In this way, consumers are given the right signals about their use of energy, paying for each extra unit of oil what it costs to import or what is forgone in exports. Likewise, producers make their development plans on the basis of the prices they will earn in the open market.

3. Both coal and gas are also traded internationally though less freely than oil. Nevertheless, international prices can provide a guide to domestic pricing. In the case of gas, imports now account for a substantial proportion (about 25 per cent) of UK supply and so the price of those imports provides a clear marker for what it costs to acquire additional (marginal) supplies. In the case of coal, imports are limited and it is more difficult to establish representative prices. Nevertheless, the recent agreement reached between the NCB and the CEGB does seek to align the price of coal for power stations more closely to import parity.

4. In the case of electricity, there is only limited trading and so efforts have been made to establish a system for setting prices which would mirror the results of competitive forces. It has been recognised that this is best done if prices reflect marginal costs.

5. A benefit of relating the price of fuels to marginal costs (whether these are derived from looking at the costs of acquiring new supplies on the world market or, as in the case of electricity, by looking at the structure of costs in the industry itself), is that consumers base their decisions to consume an extra unit of fuel on the price which reflects what that extra unit costs to produce. If consumers and producers of energy are to behave as in a free

market, all fuels need to be correctly priced (a significant divergence from economic levels of even one will distort decisions across the whole sector).

6. Defining marginal costs is not easy, partly because the costs are difficult to identify, and partly because there is frequently dispute about the precise concept. Successive White Papers have argued that prices should cover long-run marginal costs, ie not just those costs that vary in the short run as output fluctuates but also the capital cost of meeting expanding demand. The latter should include the 5 per cent required rate of return on that capital.

7. Since 1979, significant adjustments have been made to the prices of different fuels. Gas prices, particularly to the domestic consumer, had been held down while the prices of competing fuels rose, and no longer reflected the full cost of acquiring new supplies. A painful but necessary adjustment was undertaken. Also last year, adjustments were made to the Bulk Supply Tariff for electricity so that it reflected the true cost structures more accurately. A standstill in average electricity prices was instituted to last until next spring. Despite recent adjustments, however, a major imbalance in the price of gas remains.

Gas Pricing

8. Economic principles suggest that the most sensible policy to follow for gas prices is one where customers are charged the cost of acquiring new supplies. This is presently given by the price BGC has to pay for imports on the open market, and in current circumstances is best represented by the price being paid for Frigg gas of around 22p per therm. The negotiations for gas from the Sleipner field indicate that the price of gas to replace Frigg in the 1990s will be even higher. The price at which domestic gas has been acquired has been depressed by the ban on exports and the fact that until recently BGC was a monopoly buyer, but it too is rising and would rise to the same level as imports if the ban on exports were lifted. (One of the effects of offering less for domestic gas than for imports is that the development of UK resources is delayed in favour of imports.)

9. Figures supplied by BGC in the course of examination of its Corporate Plan indicate that at current selling prices, BGC is not covering the full costs of acquiring and marketing Frigg gas. They show that BGC is selling Frigg gas at a loss (though BGC does not accept this interpretation of the figures, as it argues that in addition to covering the cost of the gas itself, the selling price needs to cover only those costs which are immediately variable in the short run). Furthermore, the gap between the planned selling prices and the cost of new supplies is expected to increase over the next five years. The figures are set out in Annex A. As part of the programme of external investigations into the nationalised industries, Deloittes were asked to examine the efficiency of BGC. Their study, which has just been

published, reached very similar conclusions. Annex B reproduces their analysis. They concluded in paragraph 3.29 that

> "In 1982-83 sales of gas in all markets, apart from the interruptible market, were taking place at prices which were insufficient to meet marginal costs and thus the costs of maintaining supply."

In 1982-83, the shortfall in the domestic market was about 4½p per term and with the current freeze on gas, this can be expected to have increased.

10. When, in the case of oil, the price rose, the surplus earned by UK producers was syphoned off by PRT to the benefit to the community as a whole. In the case of gas, the price of earlier contracts has risen under indexation arrangements, but much more slowly than the cost of acquiring new gas. This means that there is a potential surplus or economic rent which arises from the difference between the old and the new contracts. Part of the benefit of this rent has come to the Exchequer through the gas levy but by far the larger part has gone to BGC and its customers. What is happening in effect is that BGC takes the view that it should charge only enough to cover average costs plus what it needs to earn the target return which has been set by Government.

11. This policy has several harmful effects:-

(i) It encourages excessive use of gas which must be met by high cost imports;

(ii) The expansion of the gas market has contributed to excess capacity in electricity generation and coal.

(iii) If continued, it would build up demand so that large and expensive synthetic gas plants - dependent on coal - would eventually be required to meet it.

(iv) It runs the risk of a painful adjustment of prices later on.

(v) The economic rent arising on earlier contracts subsidises BGC's customers through low prices rather than being distributed to the community as a whole through lower taxes. (This is particularly unfair to those in rural areas who are not connected to the gas network. One in four families is unable to obtain gas.)

12. Deloittes also noted the adverse consequences of current pricing policies:

"As current prices fail to reflect the replacement cost of gas plus marginal non-gas costs of supply, there is a danger that the gas reserves are being depleted too quickly and that excessive capacity will be provided." (paragraph 15.20)

"This in turn may lead to over investment in capacity and it may also have an adverse effect on the allocation of resources in energy markets as a whole."

13. There is thus a strong economic and financial case for higher gas prices. To bring prices charged to consumers up to the cost of new supplies by 1987-88 implies real increases from now on of 6-7 per cent a year. To prevent the gap which existed in 1982-83 getting larger implies increases of 4-6 per cent a year. With inflation forecast at 5 per cent, this implies nominal increases of around 10 per cent a year. Compared with BGC's plans for constant real prices, increases of 5 per cent a year in real terms, starting in January 1984, would generate the following increased cash flow for BGC:

£ million 1983-84 prices

	1984-85	1985-86	1986-87	1987-88
Increased cash flow	250	500	750	1000

14. BGC's Corporate Plan projects CCA profits of £500 million rising to £750 million a year, a rate of return of around 4 per cent. If the levy were unchanged, profits would thus be more than doubled. BGC has already repaid all its debts and, in the absence of an increase in the levy, would become an even greater net lender to the NLF. The policy followed hitherto has been to raise the levy so that the surplus on earlier contracts comes back to the taxpayer, as it does in the case of oil through PRT. However, the choice between a higher levy or higher profits is a difficult one (not least from a political point of view) and needs to be considered carefully.

15. It can be seen that either way the benefits to the Exchequer are substantial. If BGC's profits were allowed to increase, public expenditure would be reduced. If the levy were raised, there would be no reduction in public expenditure but receipts would increase. But the case for adjusted gas prices is not made primarily on public finance grounds but on the need to adjust the prices of different fuels to reflect their changing cost structures. At the

same time as gas prices would be rising, coal prices should be falling in real terms. The principles of economic pricing which point to higher prices for gas mean matching lower import prices for coal. The agreement recently reached between the NCB and the CEGB seeks to align the price of coal for power stations more closely on the price of imports. In turn, electricity prices should be either constant or falling slightly in real terms.

16. Our success in reducing inflation has been based on attacking the root cause of the disease not on artificially holding down nationalised industry prices. Indeed, as recent history shows, when such prices were held down, inflation rose, whereas our efforts to bring prices to economic levels have not prevented inflation from falling. It is doubtful if keeping gas prices lower would have any significant impact on the RPI. Even on a mechanical calculation, a 20 per cent real increase in domestic gas prices over four years could add only about 0.1 per cent a year to the RPI.

17. Higher gas prices will undoubtedly be unpopular as the recent outcry over BGC's profits indicates. This emphasises the importance of tackling this problem early in the life of the Parliament.

Conclusions

18. (i) Energy prices should be set in a way which reflects the different costs of supply of each fuel. This is best done by relating prices to marginal costs. In this way consumers pay for additional units what those units cost to supply;

(ii) There is a major imbalance in fuel prices which distorts the whole energy sector, leading to excess demand for gas and underutilisation of existing capacity in electricity generation;

(iii) To prevent the gap between prices charged for gas and the economic price getting larger, increases of 4-6 per cent real (say 10 per cent nominal) are needed each year starting in January 1984;

(iv) The same principles point to lower real coal and in turn lower real electricity prices.

H M TREASURY

9 September 1983

TABLE A

BGC'S GAS PRICES
(as in Corporate Plan)

p per therm
(1982/83 prices)

		1982-83	1983-84	1987-88
(A)	Domestic			
	Cost of new supplies[1]	22.0	24.1	27.8
	Onshore marginal costs	20.5	20.5	20.5
	Total marginal cost	42.5	44.6	48.3
	Planned price	38.0	37.8	39.0
	Gap	4.5	6.8	9.3
(B)	Non-Domestic Tariff			
	Cost of new supplies	22.0	24.1	27.8
	Onshore marginal costs	15.5	15.5	15.5
	Total marginal cost	37.5	39.6	43.3
	Planned price	33.5	33.3	34.0
	Gap	4.0	6.3	9.3
(C)	Firm Contract			
	Cost of new supplies	22.0	24.1	27.8
	Onshore marginal costs	10.5	10.5	10.5
	Total marginal cost	32.5	34.6	38.3
	Planned price	30.5	29.7	29.3
	Gap	2.0	4.9	9.0
(D)	Interruptible Contract			
	Cost of new supplies	22.0	24.1	27.8
	Onshore marginal costs	3.5	3.5	3.5
	Total marginal cost	25.5	27.6	31.3
	Planned price	25.5	24.6	24.9
	Gap	-	3.0	6.4

[1] currently Frigg

Profit based on Marginal Costs

3.21 The second column in Table 3.12 shows sector margins computed from average revenue less the marginal costs of supplying gas in each sector. The marginal costs are made up of two components:-

(a) marginal gas costs which relate to the purchase of new gas supplies; and

(b) marginal non-gas costs which take into account the additional storage, transmission and distribution costs involved in bringing new supplies from the terminal to the final consumer.

3.22 Average gas costs take into account historic costs and are therefore influenced by the original lower price contracts, whereas marginal gas costs reflect the current replacement cost of gas. Average gas costs will of course lag behind marginal costs. Marginal gas costs used in Table 3.12 are based on the actual cost to BGC of importing gas from the Norwegian Frigg Field. This is amongst the most expensive gas purchased by BGC and hence provides an estimate of the current replacement cost of gas to BGC. [Future supplies of gas are likely to be contracted at prices per therm which are at least equal to this amount].

3.23 Estimated marginal non-gas cost per therm includes the revenue expenditure associated with taking on additional demand in each market sector, together with capital depreciation, the cost of additional working capital requirements and the cost of unaccounted for gas (each attributed to market sectors on a cost per therm basis). Marginal revenue expenditure is estimated by BGC to be equivalent to approximately two thirds of average revenue expenditure for each market. This estimate is based partly on analysis of the relationship between changes in sales volume and total costs and partly on cross-sectional analysis of Regional costs in relation to Regional sales.

3.24 A further item is included in the marginal cost calculations to cover the cost of matching the load factor of demand in each sector to the higher load factor of gas as supplied. The figures in Table 3.12 are based on an 80% load factor of supply, which is approximately equal to the actual load factor of gas drawn from the Norwegian Frigg Field. This is taken by BGC to be the best option in terms of minimising overall cost of supply, based on its assessment of the additional offer price of lower load factor gas set against the incremental cost of achieving lower load factors of supply to the final consumer through additional investment in storage facilities.

3.25 For the purpose of this analysis, it has been assumed that the marginal load relates to an increase in customer numbers with current average levels of consumption rather than to an increase in overall average gas consumption by existing gas customers. This assumption is likely to have only a small effect in terms of marginal profitability, since in our calculations marginal costs are compared with average revenue, which includes the standing charge element of gas pricing.

	ESTIMATED AVERAGE PROFIT(1)		ESTIMATED PROFIT USING MARGINAL COSTS(2)	
	p/therm (current prices)	As % of Costs	p/therm (current prices)	As % of Costs
1980/81				
DOMESTIC MARKET	(0.5)	(2)	(5.0)	(17)
NON-DOMESTIC MARKET				
Tariff	6.0	29		
Firm Contract	7.7	43		
Interruptible	7.0	49		
Total non-domestic	6.9	40	3.3	16
TOTAL REGIONAL SALES	2.6	12	(1.5)	(6)
[HQ Contracts	(0.7)	(8)	n/a	n/a
TOTAL SALES	2.3	11	n/a	n/a]
1981/82				
DOMESTIC MARKET	0.1	0	(4.6)	(13)
NON-DOMESTIC MARKET				
Tariff	2.1	8		
Firm Contract	5.8	25		
Interruptible	6.0	32		
Total non-domestic	4.9	22	0.9	3
TOTAL REGIONAL SALES	2.1	8	(2.3)	(7)
[HQ Contracts	0	0	n/a	n/a
TOTAL SALES	1.9	8	n/a	n/a]
1982/83				
DOMESTIC MARKET	4.0	12	(1.8)	(5)
NON-DOMESTIC MARKET				
Tariff	3.4	12		
Firm Contract	4.5	17		
Interruptible	4.1	19		
Total non-domestic	4.1	16	(0.7)	(2)
TOTAL REGIONAL SALES	4.1	14	(1.3)	(4)
[HQ Contracts	1.8	15	n/a	n/a
TOTAL SALES	3.8	13	n/a	n/a]

Notes:

(1) The gas levy is included as a cost and is fully allocated to Regional sales pro rata to therms sold.

(2) This column is computed from average revenue less marginal non-gas costs (excluding a return on capital) and less the cost of gas imported from the Norwegian Frigg Field at an 80% load factor of supply; [n/a denotes "not applicable"].

(3) This analysis includes Regional sales only. HQ contracts have been excluded on the grounds of commercial confidentiality. [This note applies only to the published version].

Source: Information provided by BGC

3.26 The marginal cost figures shown in Table 3.12 suggest that average revenue across all Regional sales has been insufficient to meet marginal cost in each of the last three years. In 1980/81 and 1981/82, however, the non-domestic market, taken as a whole, has been profitable. The marginal shortfall in the domestic sector has diminished over the period, while a marginal shortfall occurred in the non-domestic sector for the first time in 1982/83. This relative shift largely reflects the programme of 10% real domestic price increases and industrial price restraint adopted by BGC in line with Government policy.

3.27 The marginal figures in Table 3.12 do not contain any element to cover a return on capital. In our view it is appropriate that BGC should not only break even on marginal sales but should also generate a return on assets employed at the margin. Table 3.13 shows a detailed breakdown of marginal profitability for 1982/83 when a 5% rate of return on capital assets is included as a further element of costs.

Table 3.13
Marginal Profitability including a return on capital employed
(1982/83)

	Estimated Profit using Marginal Costs, p/therm	
	Excluding Return on Capital	Including Return on Capital
Domestic	(1.8)	(4.8)
Non-Domestic Market		
Tariff	(2.5)	(4.6)
Firm Contract	(0.5)	(1.7)
Interruptible	0.5	0.1
Total non-domestic	(0.7)	(1.9)
Total Regional Sales	(1.3)	(3.5)

3.28 The firm and interruptible contract sectors employ less capital per therm sold than the domestic and non-domestic tariff sectors. Table 3.13 shows that the profitability of the firm and interruptible contract sectors is thus relatively less affected by including a return on capital. The interruptible sector not only covers marginal expenditure but also generates the 5% required rate of return on capital.

3.29 Table 3.13 suggests that in 1982/83 sales of gas in all markets apart from the interruptible market were taking place at prices which were insufficient to meet marginal costs and thus the costs of maintaining supply. This is most marked in the tariff sectors. If gas were priced to cover these estimates of marginal costs including a 5% return on capital, it would still at present cost less than competing U.K. fuels. The amount of additional revenue generated would of course depend on the extent to which volume was retained. Our analysis suggests that if all gas had been priced to cover marginal costs including a 5% return on assets, and if 1982/83 volumes had been maintained, over £500m of additional revenue would have been generated in the year. Changes in cost-efficiency or gas costs would affect the estimate of marginal costs in future. These changes would have to be taken into account in future decisions on prices.

Prime Minister

There is also a note from Alan Walters (flag A) and from Ferdie Mount (flag B)

MCS 9/9

P.01090

PRIME MINISTER

Energy Prices

BACKGROUND

You are holding an informal meeting of Ministers on Tuesday 13 September to discuss energy prices. The papers are those circulated with Mr Rickett's letter of 26 August: an undated minute from the Secretary of State for Energy, and the minute of 23 August from the Chancellor of the Exchequer.

2. The Secretary of State for Energy proposes:

a. To extend the existing freeze on electricity prices to 1984-85; and

b. to hold the increase in gas prices in 1983-84 and 1984-85 "to a level which would be well below the rate of inflation".

3. The Chancellor of the Exchequer objects strongly to these proposals. He argues that gas prices should rise in real terms; and that electricity prices should be kept in line with economic costs. He suggests that it is not necessary to take a specific decision on electricity prices now. But it is public knowledge that the British Gas Corporation (BGC) intends to increase

domestic gas prices in October by 4 per cent; the Chancellor proposes that the increase should be 5 per cent, in line with current forecasts of inflation.

4. Ministers collectively last considered gas prices in December 1982 (E(NI)(82)9th Meeting, Item 1). At that time the BGC's corporate plan was based on an assumption that domestic gas prices would decline by 2 per cent in real terms over three years. E(NI) agreed that the industry's financial target should be set on the basis of maintaining domestic gas prices in real terms over that period, but on the clear understanding that the target could be revised to achieve a real increase in domestic gas prices in 1985-86, should Ministers eventually decide that this was appropriate.

MAIN ISSUES

5. You will wish the meeting to address the following questions.

i. What should the Government's general policy be towards energy prices?

ii. What views should it take of the BGC's proposal to raise domestic gas prices by 4 per cent from October 1983?

General Policy

6. The opposing points of view are clearly set out in the papers. The Secretary of State for Energy argues that:

a. energy prices generate excess profits, because

b. they incorporate an element of taxation to reduce the public sector borrowing requirement; therefore

c. they should be held down in the interests of reducing inflation and industrial costs.

7. The Chancellor of the Exchequer disagrees on all points. He argues that:

a. in relation to the size of the industries and the capital they employ profits are rather low;

b. if prices are related to costs they include no element of taxation; and

c. artificially holding down nationalised industry prices is not the way permanently to reduce inflation.

He adds the further points that:

d. failure to relate ~~to~~ energy prices to costs gives the wrong signals to consumers and leads to economic distortion; and

e. BGC is selling gas at a loss: more precisely, the price for domestic gas does not cover the cost of supplies from fields outside the Southern Basin of the North Sea; and the proportion of gas from such fields in the total supplied is rising.

8. The points made by the Chancellor of the Exchequer have so far commanded the support of Ministers collectively. You will

also note that the Secretary of State for Energy's point about industrial costs is not relevant to the main specific question before the meeting: the rise in domestic gas prices in October.

9. The conclusions of the meeting on these general questions will be relevant to impending consideration of the BGC's corporate plan and discussions of the finances of both the gas and electricity industries in the current nationalised industries' Investment and Financing Review. You will wish to invite the Ministers concerned to take account of them as appropriate.

Domestic gas price increase

10. Even if Ministers continue to take the view that energy prices should be related to economic costs, they will wish to consider whether the BGC should be asked to impose an increase in domestic gas prices in October of 5 per cent rather than the 4 per cent which has become public knowledge. Certainly it would be consistent with the general policy to do so; and failure to keep domestic gas prices moving as fast as inflation would be likely to store up trouble for the future. On the other hand, the BGC would be only too likely to let it be known that any higher price increase than already proposed resulted from Government pressure: as mentioned in paragraph 4 above it was only through Government pressure that the Corporation was persuaded to avoid planning for a fall in domestic gas prices in real terms.

HANDLING

11. You will wish to invite the Secretary of State for Energy to open the discussion and the Chancellor of the Exchequer to respond. All Ministers present at the meeting are likely to wish to contribute.

CONCLUSIONS

12. You will wish the meeting to reach conclusions on:

i. general policy towards energy prices;

ii. the size of the proposed increase in October 1983 in domestic gas prices.

PG

P L GREGSON

8 September 1983

CONFIDENTIAL

A

PRIME MINISTER

ENERGY PRICES

Peter Walker's minute to you is in effect a plea to abandon the very basis of our policy. The argument betrays a remarkable innocence of the basic commonsense of economics, a state of mind not unusual among our political opponents, but now mercifully rare among Ministers. But even more important, I believe it would be a serious mistake politically to depart from the principles to which we have adhered through the most difficult periods over the past two or three years.

The economic principles of pricing are simple. Where there is an international market for an energy source, we should charge the international price. This we do with great success in oil.

Where there are no sales to overseas customers, because of past political decisions, then it is argued we should charge the total unit production costs of the most expensive source. Thus in the case of gas, the price it is said should be the cost in the Frigg field. But in an expanding industry this will be too low - and probably far too low. Indeed it is easy to see that we should charge more than the Frigg cost since it is certain that it would be profitable for the general energy consumer, and producer, to develop more gas fields which have a higher cost than Frigg. Charging a price equal to Frigg will preclude that profitable development.

So in principle our gas prices should conform to international prices (that is to say European import prices less any additional transport cost) even though we have been so far precluded from selling our piped gas to European customers. That is the real export opportunity foregone and that should be the basis of our pricing system. We should ensure additional fields exploited provided that their cost is less than this international price.

If we keep our energy prices at the level of the international market, then we shall be pursuing the best possible pricing policy and we shall maximise both the benefits from our energy sources and all our other resources.

The only significant area where I suspect our energy prices may be a little too high is in the generation component (the non-tradeable

/component)

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(A) CONFIDENTIAL

component) of electricity prices. Due to the vast errors that have been made in investment in generating stations we have an over-supply of them. There are good arguments for charging rather low prices for the generating component of electricity so that some stations do not stand wastefully under-utilized. Nigel Lawson had this well in hand as a consequence of the Cooper Lybrand Report and the debate which ensued. There is certainly a case for some readjustment of electricity prices. But there is no case at all for not pursuing our policy on gas prices. They should be raised.

Peter Walker's paper has all the elements of a plea for protection. We have seen the disastrous consequences of protection in many fields, not least in agriculture, coal mining and shipbuilding. He commits an elementary but common error in interpreting the normal profits, rent and royalties of the energy industries as a tax.

It is one of the great triumphs of the last government to have successfully imposed the efficient prices for energy. Your reputation for firmness, consistency and honesty in policy has been much admired. It would be a great tragedy if we deviated into the paths of subsidy and protection.

[I have not discussed the alleged effects of subsidies on inflation. I have put the arguments so often before that I cannot conceive that the absurdity of the propositions is not widely recognised.]

AW

ALAN WALTERS
8 September 1983

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BGC COST STRUCTURE 1982/83

	Total £m	p/therm
Gas Costs	1916	11.6
Operating Costs	2142	13.0
Total BGC Costs	4058	24.6
Gas Levy and PRT (£4m)	527	3.2
Taxation	208	1.3
Cash contribution (negative EFR)	230	1.4
Total Govt Take	965	5.9
Total Costs	5023	30.5

Average price for gas sold and used 32.1

Source: Report and Accounts

Revised Table A

BGC'S GAS PRICES

(as in Corporate Plan)

p per therm
(1982/83 prices)

		1982-83	1983-84	1987-88
(A)	**Domestic**			
	Current average cost of gas	11.7	12.6	16.0
	Onshore marginal costs	20.5	20.5	20.5
	Total cost	32.2	33.1	36.5
	Planned price	38.0	37.8	39.0
	Profit	5.8	4.7	2.5
(B)	**Non-Domestic Tariff**			
	Current average cost of gas	11.7	12.6	16.0
	Onshore marginal costs	15.5	15.5	15.5
	Total cost	27.2	28.1	31.5
	Planned price	33.5	33.3	34.0
	Profit	6.3	5.2	2.5
(C)	**Firm Contract**			
	Current average cost of gas	11.7	12.6	16.0
	Onshore marginal costs	10.5	10.5	10.5
	Total cost	22.2	23.1	26.5
	Planned price	30.5	29.7	29.3
	Profit	8.3	6.6	2.8
(D)	**Interruptible Contract**			
	Current average cost of gas	11.7	12.6	16.0
	Onshore marginal costs	3.5	3.5	3.5
	Total cost	15.2	16.1	19.5
	Planned price	25.5	24.6	24.9
	Profit	10.3	8.5	5.4
	Excludes gas levy	3.2	2.9	1.8

File

10 DOWNING STREET

From the Private Secretary

31 August 1983

Dear Julian,

This is just to confirm that I have arranged for a meeting to discuss your Secretary of State's minute on energy prices together with that of the Chancellor of the Exchequer at 1700 on 13 September.

I am sending a copy of this to Margaret O'Mara (HM Treasury), Jonathan Spencer (Department of Trade and Industry), Muir Russell (Scottish Office) and Richard Hatfield (Cabinet Office).

Yours ever
Tim Flesher

TIM FLESHER

Julian West Esq
Department of Energy.

CONFIDENTIAL

bcc: MR. FLESHER
to arrange
early meeting

10 DOWNING STREET

From the Private Secretary

26 August, 1983

BF for Meeting
13/9
[illegible]

Energy Prices

The Prime Minister has seen your Secretary of State's recent minute. She has also seen the Chancellor of the Exchequer's minute of 23 August. She would like to discuss the issues raised in these minutes with your Secretary of State, the Chancellor of the Exchequer and the other Ministers to whom your Secretary of State's minute was copied. We will be in touch to fix an early meeting.

I am coping this to Margaret O'Mara (H.M. Treasury), Jonathan Spencer (Department of Trade and Industry), Muir Russell (Scottish Office) and Richard Hatfield (Cabinet Office).

W. F. S. RICKETT

J. D. West, Esq.,
Department of Energy

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PRIME MINISTER

ENERGY PRICES

The minute at Flag A from Peter Walker suggests that gas price increases in 1983/84 and 1984/85 should be held well below the rate of inflation and that the freeze on electricity prices should be extended to 1984/85. He argues this on two grounds: first, that the profits of the gas and electricity industries will otherwise cause political controversy; second, that keeping nationalised industry price increases to a minimum is necessary at this stage of the Government's "counter-inflation programme".

The minute at Flag B from the Chancellor of the Exchequer argues that the Government should continue to allow energy prices to move towards economic levels, and that they should be set either by reference to the prevailing world price or to reflect the cost of supplying an additional unit of fuel. The Chancellor argues that this means in practice:

(a) that the freeze on electricity prices should not be extended into 1984/85, but that electricity prices and external finance should be considered together later in the autumn after further studies by officials; and

(b) that gas prices should be allowed to rise by at least 5 per cent in October (rather than the 4 per cent proposed by BGC), although he feels that there is in fact a strong case for allowing gas prices to rise in real terms.

It seems clear that we will need a meeting on energy prices to resolve this disagreement. Normally the Gas Corporation would have announced their proposed price rise following the Board Meeting on 17 August, but they have been asked to defer

/ an announcement

an announcement; in view of this, an early meeting seems desirable. Would you like to make this a meeting of E(NI), or would you prefer a smaller ad hoc meeting?

I think an ad hoc meeting would be better.

M

WBR

24 August 1983

(B) CC DP

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

PRIME MINISTER

ENERGY PRICES

Peter Walker has written to you suggesting gas price increases in 1983-84 and 1984-85 should be held to a level well below the rate of inflation and that the freeze on electricity prices should be extended to 1984-85. I am sure this would be quite wrong. Rather than helping our economic policies as he suggests, it would make our job of reducing the PSBR much more difficult and we should be giving the wrong signals to energy users.

2. Peter argues that public criticism over the level of profits recently announced by the gas and electricity industries and the need to keep down the rate of inflation mean that energy price increases need to be restrained, even at the expense of increases in the PSBR. In fact, taking account of its size, the electricity industry's profits have been low generally compared with the private sector. And BGC's profits, while far from excessive, are due to the fact that over half BGC's gas supplies come from cheap long-term contracts negotiated in the 1960s. On its most recent purchases of gas, it is actually making a loss at current selling prices. Clearly we have an argument to win in public over nationalised industry profits but the answer is not to restrain prices to an uneconomic level.

3. Nor do I consider constraining energy prices in the short term an effective way of permanently reducing inflation. Previous Administrations of both Parties have discovered to their cost that subsidising prices below economic levels only stores up trouble for the future when they have, inevitably, to rise to their correct levels. This is precisely why we have had to increase domestic gas prices so much since 1979.

/4. The key to

4. The key to our approach to energy prices has been to move towards economic levels. Where fuels are marketed internationally, the world price provides a clear guide. In other cases, prices need to be set to reflect the cost of supplying an additional unit of fuel. If consumers and producers of energy are to behave as in a free market, all fuels need to be priced at economic levels if distortions across the whole energy sector are to be avoided.

5. We agreed last autumn to continue with economic pricing for electricity, based on revised forecasts of costs of supply. The price freeze in 1983-84 and the planned real reductions of 1½ per cent in 1984-85 followed. Peter Walker bases his argument for a freeze not on costs but on past profits. With the freeze, this year's profits will be much lower anyway. The effect of his suggestion would be to plunge the ESI into substantial losses.

6. We do not have to take decisions on electricity now. I suggest that officials examine with the industries precisely how marginal costs will be affected by efficiency gains and real reductions in average coal prices. We can then look at prices and external finance together in the autumn.

7. So far as gas is concerned, economic principles clearly point to higher prices. There is a world market price for gas, which is what BGC has to pay for new supplies. By selling below this price (as BGC is currently doing), BGC is selling gas not merely uneconomically but actually at a loss. No private sector business would do this. If continued, it would lead to excessive consumption of expensive imported gas at the expense of electricity at a time of massive surplus capacity in electricity generation. And, since world market prices for gas are rising, it makes the adjustment later on more painful.

8. Higher energy prices are never easy to defend publicly, but I believe there is a strong case, both economically and financially,

/for gas prices

for gas prices to rise in real terms. I should be happy to develop this. The issue is important, not least because the view we take on future gas prices must underlie our consideration of BGC's Corporate Plan (which is now overdue). Until it is resolved, it would be advisable, as I told Peter Walker, to use the neutral assumption of maintaining doemstic prices in real terms for the purpose of the October price increase. Since we are forecasting an annual rate of inflation of around 5 per cent in the autumn, we need a 5 per cent increase in domestic gas prices.

9. Finally, I think it is important to be clear that setting prices at economic levels does not represent a tax on energy consumers, as Peter suggests. It is neutral in economic terms, since it reflects the cost of production. On the other hand, restraining gas prices below economic levels would represent a subsidy to the gas consumer from the general taxpayer. We should not forget that one in four families is unable to obtain gas.

10. I am copying this to Peter Walker, Cecil Parkinson and George Younger.

Margaret O'Mara

N.L.
23 August 1983

(approved by the Chancellor and signed in his absence) rec DP (A)

cc NO

Prime Minister

I think I ought to draw your attention to the problems we face on gas and electricity prices, in the light of the profits reported by these two industries. As you will have seen, in the case of the gas industry the controversy about profits and prices has centred on BGC's proposed 4% increase for domestic consumers from 1 October, and on industry's concern that the price freeze for industry may not be extended beyond the 3 months already announced by BGC. In the case of the electricity industry the argument has been about whether there should be a rebate on account of 1982/3 profits, and an extension of the present price freeze to cover 1984/5.

I believe we are at a stage in the counter-inflation programme where we badly need to see nationalised industry price increases kept to a minimum in order to help keep down the general rate of inflation. In 1979 - 1982 nationalised industry prices were a strong upward influence on inflation. We need as much relief as we can get from that now in order to reduce wage pressures, help competitiveness and assist employment.

The way in which inflation has been taken into account in implementing the programme of three price increases of 10% in real terms for domestic gas has led, in a period of falling inflation, to gas tariffs being as much as 57% higher in real terms (100% in money terms) than they were in 1979/80. In spite of the effect of recession on demand, and of the use of very conservative accounting practices, the gas and electricity industries are now beginning to make big accounting profits.

In 1982/3 the electricity industry declared profits of £868m before, and £332m after interest. These profits are at present forecast to be lower in later years, mainly because of the 1983/4 price freeze; but that is on rather pessimistic assumptions about GDP growth, electricity demand, inflation and coal prices. Repayments of debt to the Exchequer over the next three years are put at nearly £2bn. The gas industry, which has no long term debt, reported profits for 1982/3 of £663m before tax and interest; and of £188m after tax, adjustments for short term interest and a once-for-all £300m write off against profits for the oil assets we are privatising. The gas levy for 1982/3 was £523m. Forecast gas profits before tax and interest rise from about £500m in 1983/4 and 1984/5 to over £850m in 1986/7; and, after tax and interest adjustments, are in the £350m to £400m area.

Thus we risk exposure politically year by year to successive large profit declarations, accompanied by announcements of further price increases. In the case of the electricity industry the controversy now would have been much greater had not my predecessor, with the agreement of Geoffrey Howe, decided to freeze electricity prices in 1983/4 and to say that in 1984/5 any increase would be below the rate of inflation.

All these considerations could be said to point to holding gas price increases in 1983/4 and 1984/5 to a level which would be well below the rate of inflation; and in the case of electricity to extending the freeze to 1984/5. That would represent some movement from last year's E(NI) decision that domestic gas prices should rise in line with inflation, but the large accounting profits had not been declared when that decision was taken. This course would minimise political controversy. It would be consistent with the long term case for gas prices to rise relative to electricity prices. But it would of course mean that the Chancellor could not look to the gas and electricity industries for so much of a contribution to the reduction of the PSBR.

Each 1% change in the October domestic gas price increase (which also applies to small businesses) affects the PSBR by about £16m in 1983/4 and about £50m in 1984/5. A three month's extension of the industrial contract price freeze would, on present forecasts, reduce BGC's profits by about £25m and avoid a 6½% increase on firm and a 10% increase on interruptible supplies for that period; while adding, on plausible assumptions, about £17m to the PSBR in 1983/4 and about £60m in 1984/5. The present assumption about electricity prices in 1984/5 is that there will be an increase in the range of 4% to 5% (1½% below the rate of inflation); or perhaps somewhat less according to the price the CEGB finally pays the NCB for coal. Each 1% reduction in this price increase in England and Wales would cost the PSBR £70m in 1984/5.

My concern is that it would be contrary to the best interests of our policies if we were to fall into a position where we were looking to gas and electricity profits as a source of tax revenue. If we want a low inflation economy which endures and is consistent with a recovery in employment, we shall have to keep down the costs of inputs to industry, and certainly not to tax them. As I understand it, that has been the policy behind successive reductions of the national insurance surcharge.

Of course, increased efficiency in these nationalised industries is essential to keep down prices. Both the gas and electricity industries have made contributions to profits through increased efficiency and have exceeded their financial/performance targets. I shall maintain the pressure. But increased efficiency alone cannot remove the need for price increases if the underlying policy is to make such increases in the interests of the PSBR.

On broad political and economic grounds I would prefer an approach on the lines of paragraph 6 above. I think it would be asking for trouble politically to do as the Chancellor has now proposed and seek to increase the 4% proposed (and known to be proposed) by British Gas to 5%. But I seek your guidance on whether it is right to use this particular route for PSBR reduction by going even as far as the 4%.

Although the Gas Corporation's proposals have been widely anticipated, they are due to make a formal board decision on them on 17 August, and would normally make an immediate announcement. I have asked them to defer any announcement however.

I am copying this minute to the Chancellor of the Exchequer and to the Secretaries of State for Trade and Industry and Scotland.

CBrooks

Approved by the Secretary of State for Energy
and signed in his absence.

Aug 83

cc N/O

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

BF

1 August 1983

The Rt Hon Peter Walker MBE MP
Secretary of State for Energy

NBPM at this stage
Await response from P Walker.
2/8

Dear Peter

BGC'S NEGOTIATIONS FOR SLEIPNER GAS

Thank you for your letter of 26 July.

The decision whether to purchase Sleipner is clearly one of major importance; and I agree with you that it is essential that BGC be told not to commit themselves until all the details, most importantly price, have been established, and discussed with Government. BGC should make it clear to the Norwegians that their negotiations this week are without commitment and ad referendum to Government. And I hope you can also ensure that we are allowed adequate time to consider the possible package as finally identified.

The following three issues seem particularly relevant.

First, it would be most helpful if, before final decisions are required, we could have available your Department's assessment of the likely balance between supply and demand for Continental Shelf gas if Sleipner is not purchased by BGC. That is a key piece of evidence, which would go rather further than major companies' refusal to guarantee UKCS supplies, significant though that may be.

Secondly, it is crucial that BGC should accept that if they buy Sleipner they will have to sell the gas at a commercial price. It would be wrong for them to buy it, at a substantial resource cost to the UK, if they can only sell it by cross-subsidising its purchase from the profits on lower-cost contracts. To sell Sleipner gas at less than the true cost of acquiring it would mean that the wrong signals were given to consumers. The consequence would be that we would find ourselves importing more gas than could be justified at a resource cost to the nation. We would have to be clear that this would not happen.

NAT IND. Gov Pt 8

Finally, the issue of exports is no less crucial, and before we take a decision on Sleipner we shall have to consider the study on the possibility of gas exports, which will I hope be ready very soon. Our Sleipner decision may well hang on the answers to the - legal and political as well as economic - questions it raises: it would be wholly wrong if a Sleipner purchase were in practice to inhibit UKCS development.

Copies of this letter go to the Prime Minister, to Geoffrey Howe and to Sir Robert Armstrong.

Yours
Nigel

NIGEL LAWSON

CONFIDENTIAL

NO

4

I have spoken to J. Kerr PERB 1.8.

Prime Minister

The Chancellor would like domestic gas prices to go up 5% not 4%.

A very unwise letter to have written - and even more unwise to have given circulation

MCS 28/7

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

26 July 1983

The Rt. Hon. Peter Walker MBE MP
Secretary of State for Energy

Dear Peter

BGC OCTOBER GAS PRICING PROPOSALS

with MCS or n folder 2

Your letter of 25 July - informing me that BGC would today be announcing an extension of the current freeze on industrial prices - reached my office at noon today. Although on this occasion I would not have wished to object to the specific proposal, I hope that more notice can be given on future occasions.

As you know, one way and another I have had occasion to study very carefully the vexed question of gas prices. I am satisfied that there is a strong case for an increase in gas prices in real terms. However, we are not able to come to a definitive view on this until the basis of the figuring has been completed. I understand your officials are currently working on this with BGC. I hope it can soon be settled, as decisions will be needed in the context of the IFR exercise.

While the figuring is being settled I think the neutral assumption to make for domestic gas prices is that they should be maintained in real terms. I assume this is what BGC are trying to achieve with their proposal for a 4 per cent increase from 1 October. While the 12 month rate of inflation is currently just below 4 per cent, this is partly the result of temporary factors. As the Government has made clear on a number of occasions some rise in the rate of inflation is expected in the autumn. From August onwards I would expect the 12 month rate to be around 5 per cent. This indicates that to hold domestic prices constant in real terms, you should be steering BGC towards 5 rather than 4 per cent.

As the increases in the industrial and domestic sectors will be interim ones while we review policy, it is important that no commitments should be given about how long the new prices will be held.

I am copying this to members of E(A) Committee and to Sir Robert Armstrong.

Yours ever
Nigel

NIGEL LAWSON

Nat Grid: Gas & Elect
Privacy Act P[illegible]

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c.c. N.O.

(2)

Prime Minister

BGC to purchase some Norwegian gas

MCS 27/7

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

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
LONDON SW1

26 July 1983

Dear Chancellor

The volume of gas under contract to the British Gas Corporation will decline rapidly over the next decade. They consequently need to place contracts for large volumes of new gas to meet requirements in the 1990's.

As you will know, since last Autumn, in competition with continental utilities, BGC have been negotiating for the purchase of gas from the Sleipner Field on the Norwegian Continental Shelf.

The gas would come on stream in about 1991 and from 1996 would be producing at 400 bcf per year for 10 to 15 years.

That level of production would meet one quarter of our expected requirements and would, in fact, be a replacement for Norwegian Frigg gas which runs out by the end of this decade.

I have carefully studied the implications of this negotiation and I am convinced that both for the mid-term and long-term we need to retain a Norwegian connection. There will be Norwegian gas available after our own gas supplies run out and I am anxious that this should not be fully contracted to the continent.

A number of oil companies have suggested the possibility that new gas supplies from the UKCS would be able to meet the major part of the Gas Corporation's requirements in the 1990's. I have, however, confronted a number of the major companies as to the possibility of their being able to, in any way, guarantee such supplies and they are unable to give any such guarantees of delivery during that period. I gained the impression that the majority of them accept the need to buy Sleipner, although naturally there are some that would benefit from an improved gas price should supplies prove to be inadequate in the 1990's due to Norwegian gas being unavailable.

Of course, if UKCS gas supplies in the 1990's proved to be beyond our present expectations, then we should consider allowing exports to take place. I am pressing ahead with a study on the possibility of gas exports. But in the period immediately ahead UKCS producers will have every incentive to search for and develop any gas found in order to meet the large gap between expected supply and demand even if BGC purchase Sleipner.

The main factor in the Gas Corporation's negotiations will, of course, be the price at which Sleipner gas can be bought and I intend to authorise them by the end of this week to proceed with the negotiations scheduled to begin on 2 August. As you know I had previously postponed these negotiations in order that I could study the position in depth.

Providing the price is right, I believe we should proceed with this purchase. But, naturally, I shall make it clear to BGC that no final settlement can be reached until we have the opportunity of measuring the cost. We will be in a position to do this more accurately after the negotiations next week.

I am copying this letter to the Prime Minister, Geoffrey Howe and Robert Armstrong.

Yours sincerely

pp PETER WALKER
(Approved by the Secretary of State
and signed in his absence)

010

Prime Minister

MES 26/7

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

CONFIDENTIAL

Rt Hon Nigel Lawson Esq MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
London SW1P 3AG

25 July 1983

Dear Nigel.

BGC OCTOBER GAS PRICING PROPOSALS

British Gas will be announcing tomorrow, Tuesday 26, an extension of the current freeze on industrial contract prices for a further quarter, until the end of the year. This is obviously welcome news. They have not yet decided what, if any, increase to introduce in January.

On domestic prices, the Corporation are proposing an overall increase in the tariffs of 4% from 1 October. This will be loaded on to the commodity rate, which will rise by about 4½%, with the standing charge being frozen for a further year. These decisions will not be announced formally for some weeks, since the Corporation need to consult the National Gas Consumers Council. They are consistent with E(NI)'s decision last year that domestic gas prices should rise broadly in line with inflation following the large increases of the last three years.

I am copying this letter to the members of E(A) Committee and to Sir Robert Armstrong.

Yours ever

PETER WALKER

26 JUL

cf NC

NEW ST. ANDREWS HOUSE
ST. JAMES CENTRE
EDINBURGH EH1 3SX

CONFIDENTIAL

NBPM

MCS 5/7

The Rt Hon Peter Walker MBE MP
Secretary of State for Energy
Thames House South
Millbank
LONDON
SW1P 4QJ

5 July 1983

Dear Peter,

OBJECTIVES FOR THE CHAIRMAN OF THE ELECTRICITY COUNCIL

I refer to your letter of 21 June to Nigel Lawson enclosing a draft letter to Philip Jones setting out his objectives as Chairman of the Electricity Council. I have also seen John Sparrow's letter of 27 June.

I am content that the letter should be issued and published. However, in considering John Sparrow's reference to encouraging schemes for the production of combined heat and power, you may wish to bear in mind that I set an objective along these lines for the two Scottish Boards earlier this year.

I am copying this letter to the Prime Minister, other members of E(NI) and Sir Robert Armstrong.

Yours ever,

George

Nat Ind: Gas & Elect, Pt 8

NBRM

CABINET OFFICE

Central Policy Review Staff

MCS 4/7

With the compliments of

the Head of the CPRS

70 Whitehall, London SW1A 2AS

Telephone 01-233 7765

fe NO

CABINET OFFICE

Central Policy Review Staff

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

From: John Sparrow

Qa 06403

CONFIDENTIAL

27 June 1983

The Rt Hon Peter Walker MBE MP
Department of Energy
Thames House South
Millbank S W 1

Dear Peter,

Objectives for the Chairman of the Electricity Council

I have seen a copy of your letter of 21 June to the Chancellor of the Exchequer enclosing a draft policy letter to Philip Jones setting out his objectives as Chairman of the Electricity Council.

The CPRS has been involved in the formulation of these objectives but there are two points which you might wish to consider when finalising the letter.

First, the Energy Act 1983 places a new and specific requirement upon the Boards to adopt and support schemes for the combined production of heat and power (CHP) subject to normal financial criteria. In view of this, I suggest that a reference to CHP should be made in paragraph 2 of the letter. Perhaps the last two sentences could read: "You should also encourage the Boards to adopt and support commercially viable schemes for the combined production of heat and power in line with the new requirements in the Energy Act 1983. I would like you to take a special interest in these areas." The emphasis on commercial viability would not commit the Government to take the lead in district heating schemes but support for CHP would provide a welcome boost to industrial schemes.

My second point concerns the discussion of strategic and corporate planning in paragraph 4. There is increasing agreement on the need to distinguish clearly between the strategic planning options which need to be assessed at the beginning of the planning cycle and the results of this cycle contained in the Corporate Plan. The proposed strategic plans for the ESI will reflect this point, but the draft objectives could reinforce the distinction if the second, third and fourth sentences of paragraph 4 were re-ordered as follows:

"This plan should set out clearly, in the context of the objectives agreed with Government, the strategic options and issues facing the industry together with the industry's preferred planning objectives. Decisions on these options, taken together with agreed financial and performance targets and the industry's external financing limits, should provide the basis on which the Board's detailed plans for efficient operation and cost reducing investment are to be developed. The strategic plan should also include a summary of the main conclusions of the current Corporate Plan including up-to-date financial and sales forecasts."

Although I support paragraph 7 and its emphasis on the undoubted importance of British Electricity International, the ESI, through its approach to procurement, can also play a part in ensuring that the UK supply industry is internationally competitive. You might wish to raise this with Philip Jones as your predecessor did with Sir Walter Marshall.

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

Yours sincerely,

John.

John Sparrow

Nat Ind; Gas & Elect; pt 8

NBPM
MLS 24/6

Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon Peter Walker MP
Secretary of State for Energy
Thames House South
Millbank
London SW1P 4QJ

23 June 1983

Dear Peter

OBJECTIVES FOR THE CHAIRMAN OF THE ELECTRICITY COUNCIL

You wrote on 21 June seeking agreement to the draft letter to Philip Jones.

I am content that the letter should be issued and published.

I am copying this letter to the Prime Minister, other Members of E(NI) and Sir Robert Armstrong.

Yours ever
Peter

PETER REES

west Ind, Gas & Elect, Pt 8

CC NO

NBPM

MCS 22/6

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

01 211 6402

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
LONDON SW1

21 June 1983

Dear Nigel

OBJECTIVES FOR THE CHAIRMAN OF THE ELECTRICITY COUNCIL

I am enclosing the draft of a letter to Philip Jones setting out his objectives as Chairman of the Electricity Council. The objectives are similar at all relevant points to those set for the Chairman of the Central Electricity Generating Board and published on 18 March.

I am content with the letter as drafted, and as approved by you before the election. Subject to your agreement and that of our E(NI) colleagues I propose to publish the objectives, by means of a written answer, at an early date.

I am copying this letter to the Prime Minister, other members of E(NI) and Robert Armstrong.

Yours
Peter

PETER WALKER

T P Jones Esq CB

Chairman

Electricity Council

30 Millbank

London SW1

This letter sets out the objectives which the Government wish you to pursue as Chairman of the Electricity Council. The objectives elaborate the responsibilities and obligations placed by Statute on the Electricity Council, and in particular the duty to promote and assist the maintenance and development by Electricity Boards in England and Wales of an efficient, co-ordinated and economical system of electricity supply.

1 Your prime objective must be by all practicable means to promote and encourage maximum efficiency throughout the industry including sustained and detailed attention to cost control by the various Boards in England and Wales through all aspects of their activities. In this context:

(a) You should encourage Boards to set challenging cost control and efficiency targets wherever practicable, and monitor them carefully;

(b) You should advise me on the setting of financial and performance targets for the electricity supply industry in England and Wales and for each Board individually; you should keep me informed on progress towards their achievement;

(c) A wide range of performance indicators should be developed and published.

2. It must also be your objective to increase the scope for competition in electricity supply. In consultation with individual Boards as necessary, you should review the prospects for the injection of private risk capital into areas of the industry's operations and make positive recommendations to me wherever possible. You should encourage the Boards to develop co-operation with private generators of electricity, within the framework laid down in the Energy Act 1983, when enacted, and ensure that effective commercial and technical arrangements exist to take full economic advantage of their potential contribution to supply. I would like you to take a special interest in this area.

3. I shall require Boards to set out their capital investment proposals comprehensively for my approval, giving an account of the strategic framework against which they have been developed. I shall also require them to continue to pay close attention to the methodology used in capital investment appraisal.

In advising me on these proposals it should be your objective to promote the production and distribution of electricity at the lowest possible cost consistent with maintaining adequate standards eg of security of supply.

4. Each year, prior to submission to the Department of the Board's Capital Investment Memorandum and the Investment and Financing Review, the Electricity Council should prepare a strategic plan for the industry which will be reviewed with Government. This plan should set out up to date financial and sales forecasts, and the strategic options and issues facing the industry as

well as the industry's preferred planning objectives. I shall require the Board's detailed plans for the efficient operation and cost reducing investment to be developed within this framework. The Board's plans should also take full account of the objectives agreed with Government as well as the financial and performance targets agreed and the industry's external financial limits. Bearing in mind the requirements of S.8(5) of the Electricity Act 1957, you should ensure regular, timely, and effective information flows from the Boards to assist the Government and the Electricity Council to monitor performance in relation to those objectives, targets and limits.

5. You should, in consultation with the Boards, and as appropriate with Government, develop and promote a framework of electricity pricing principles, within which the Boards set their prices so as to reflect the costs at the margin of meeting demands on a continuing basis, and so as to be consistent with the financial framework set by Government.

6. Subject to objective 2 above, you should seek to ensure that both the contracting and sales of appliance activities of the Area Boards are carried out effectively and economically so as to yield a proper return on the assets employed.

7. Subject of course to European Community and other international obligations, you should encourage the Boards to assist UK manufacturing industry to secure orders in export markets, in particular through the provision of support services through British Electricity International.

8. You should ensure that the industry remains sensitive to the impact of its policies and prices on consumers, and that these are properly presented to the industry's consumer representative bodies and to the public at large.

9. You should seek by all practicable means to promote close working relationships within the industry. In this connection, I draw attention to David Howell's statement of July 1980 which I attach.

10. Finally, I should make clear that the Government may wish to give further guidance to you at a later date or to impose constraints from time to time, for wider reasons, on your ability to achieve one or other of these objectives.

PETER WALKER

Ch 26/5 CC No.

SECRETARY OF STATE FOR SCOTLAND

NEW ST. ANDREWS HOUSE
ST. JAMES CENTRE
EDINBURGH EH1 3SX

Rt Hon Leon Brittan QC
Chief Secretary to the Treasury
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

25 May 1983

Dear Leon,

FINANCIAL TARGET AND PERFORMANCE AIMS FOR THE SCOTTISH ELECTRICITY BOARDS

Thank you for your letter of 18 May in which you suggest some amendments to my proposals for financial targets and performance aims for the two Scottish Electricity Boards.

Although I do not necessarily accept all of your arguments I am anxious to reach agreement as quickly as possible and as I see political difficulties in setting a higher figure I propose to set the Boards a joint financial target of 1.4% after MWCA. I would also make clear to the Boards that bids for higher EFLs in 1984/85 and 1985/86 will not be accepted and that the SSEB bid is consequently withdrawn.

As far as performance aims are concerned, I agree that NSHEB should be asked to reduce its distribution costs by 4.5%, and SSEB should aim for an 8% reduction over the period. The joint generation and transmission aim is more complicated; whilst I agree that a 4% reduction by 1984/85 should be achievable, it will be difficult for the Boards to maintain this performance once gas supplies to Peterhead are terminated. I will therefore encourage the Boards to maintain their performance in 1985/86 but we must recognise that the Boards may be unable to do so through no fault of their own.

I agree that the question of trading between the Scottish Boards and CEGB deserves more study. Before agreeing to call in consultants, however, I think officials should give more detailed consideration to the issues involved.

I now intend to write to the two Boards with details of these proposals. I intend to leave the matter of appliance retailing and contracting to a separate letter so as not to confuse the issues.

I am copying this letter to the Prime Minister, Nigel Lawson, Patrick Jenkin, Sir Robert Armstrong and John Sparrow.

Yours ever,

George.

Nat Ind MB
Gas & Elec Pricing

~~CC~~ No

Prime Minister 2

CR
25/5

01 211 6402

MS

CONFIDENTIAL

J O Kerr Esq
Private Secretary to the
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
London
SW1

24 May 1983

Dear John,

PAY OF ESI CLERICALS

The Electricity Council have reported that on 17 May they concluded a pay settlement with their clerical, professional and administrative grades. The settlement is subject to ratification by NALGO but I understand that ratification is a formality and is expected on 7 June.

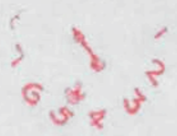
The settlement provides for an increase in clerical grades' salaries ranging from 3.5% at the bottom to 5.8% at the top. The Council have therefore secured lower increases for the more junior staff, in line with market considerations. The professional and administrative grades will receive 5.8%. The overall package represents an increase in average earnings of 5.6%, which is less than that for the industry's other three negotiating groups (5.7% for the manual and 5.8% for the engineers and managers).

I am copying this letter to the Private Secretaries to the Prime Minister, members of E Committee and the Secretary of State for Scotland, as well as to Richard Hatfield and Gerry Spence.

Yours ever

John

J D WEST
Private Secretary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Secretary of State for Industry

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB
TELEPHONE DIRECT LINE 01-212 3301
SWITCHBOARD 01-212 7676

c/NO

JU775

24 May 1983

CONFIDENTIAL

The Rt Hon Leon Brittan QC
Chief Secretary to the Treasury
Treasury Chambers
Parliament Street
London SW1

DJ

24/5

Dear Leon,

FINANCIAL TARGET AND PERFORMANCE AIMS FOR THE SCOTTISH ELECTRICITY BOARDS

I was interested to see George Younger's letter to you of 12 May and your reply of 18 May.

2 I had also felt that a more demanding performance target should be set for Scotland and I therefore hope George will accept the specific suggestions you have made in your letter. As you say, a reduction in the industry's costs can make a major contribution to bringing down electricity prices. I am unhappy, however, with your comment that a 1.6% return on net assets would be a more appropriate financial target for the Scottish Boards than the 1.4% proposed by George. I note that you are prepared to agree to 1.4% so long as there is no increase in public expenditure by SSEB. My own view is that 1.4% is itself too high, bearing in mind the disproportionately higher level of work in progress in the capital employed by the Scottish Boards as compared with England and Wales, on which no return can be earned.

3 You agree that there are still issues to be resolved concerning the relationships between marginal cost pricing, statutory break-even obligations and rate of return objectives. We must return to these as a matter of urgency after the Election for they have a crucial bearing on the level of electricity prices. As you know, I am anxious that we should overlook no means of giving some comfort to the hard pressed energy intensive industries.

4 I am copying this letter to the Prime Minister, Nigel Lawson, George Younger and to Sir Robert Armstrong and John Sparrow.

Yours ever

Patrick

Nat Ind,
Gas e Elect,
Pt 8

E(/NO

NBPM

MU328/5

Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon George Younger TD MP
Secretary of State
Scottish Office
Dover House
Whitehall
London SW1A 2AU

18 May 1983

Dear Secretary of State

FINANCIAL TARGET AND PERFORMANCE AIMS FOR THE SCOTTISH ELECTRICITY BOARDS

Thank you for your letter of 12 May suggesting a financial target and performance aims for the Scottish Electricity Boards. I welcome the considerable progress that has been made but the figures proposed give me some difficulty, particularly since they are associated with an additional public expenditure bid.

As far as format is concerned, I accept the practical arguments for setting a joint financial target for the two Boards combined, but we should be careful not to imply any overriding of the statutory duty of each Board, to break-even 'taking one year with another'. Accordingly, I suggest the target be set subject to each Board individually 'meeting its statutory financial duties'. I am glad that the target is to be set in current cost accounting terms. It is usual to take profit after the Monetary Working Capital Adjustment, in accordance with SSAP 16. There were special technical reasons why this could not sensibly be done for the Electricity Boards in England and Wales, but these do not apply to the Scottish Boards, particularly since a joint target is to be set. I should therefore prefer to set the target after MWCA.

Turning to the level of the target, I understand that it assumes electricity prices will fall in real terms by up to 2 per cent in 1984-85. There is an associated additional bid in IFR 1983 for SSEB totalling over £55 million in 1984-85 and 1985-86. I cannot accept this bid for higher expenditure, nor am I convinced that the price reduction would be justified.

(a) There seems to be a presumption that prices in Scotland should rise no faster than England and Wales. But if this was our starting position, surely prices in Scotland should first be brought up from their present level, significantly below that in England and Wales.

(b) The marginal cost figures given to Treasury do not appear to envisage any planned trading with England and Wales. Prima facie, if electricity generating assets in Great Britain as a whole are to be used most economically, then levels of output should be adjusted until the point is reached at which marginal costs of the systems in Scotland and in England and Wales are brought in line, except for transmission costs. This too implies a potential case for narrowing the price differential, as well as providing the Scottish Boards with profitable trade and using national resources optimally. Clearly there are technical issues involved too, but I think that we need to look much more closely at the potential economies to be achieved through planning trade between the two systems rather than relying on spot trading as at present. Subject to Nigel Lawson's views, I suggest that consultants might examine the economic and technical issues here, reporting to you both.

(c) A real price reduction would appear to be associated with SSEB making losses on its revenue account during all 3 years of the proposed financial target period. Unfortunately it does not appear that we shall have an opportunity to discuss your recent memorandum to E(NI), in the near future, but you raised the conflict that can arise between marginal cost principles, and the need to meet break-even duties and earn a reasonable return on assets. You pointed out that this conflict had yet to be resolved, and I agree that some deeper thought needs to be given to the problem. The Treasury will be making suggestions for further work between Departments.

Taken together, these points suggest it would be very unwise to base the financial target on the assumption of further real price reductions. I can, however, understand why you might not wish to make this explicit, and there would be no need to rule out entirely the possibility of further real price reductions in Scotland; but I think it is important to avoid becoming committed to make them or, indeed, to match whatever may happen in England and Wales.

Clearly cost reductions offer a very attractive route both to attaining a reasonable return on assets and keeping prices down. I therefore very much welcome your proposals to set the Boards some performance aims. The detailed figures which have been provided to the Treasury suggest, however, that more challenging targets should be within their grasp. In particular, the assumptions made about nuclear power station availability look unnecessarily pessimistic and targets for reducing manpower costs look unambitious, particularly in the light of the worrying increases revealed by the performance review you circulated. The picture is complicated for the joint generation and transmission performance aim by the expected loss during 1985-86 of cheap gas supplies at Peterhead. I should therefore like to suggest that you set a more demanding aim of 4% to be achieved by 1984-85 and then set the Boards the challenge of holding real controllable costs per unit to that level in 1985-86 too. On the distribution side, I believe that slightly more demanding figures of 4.5 per cent for NSHEB and 8 per cent for SSEB would also represent a worthwhile challenge. The objectives you recently set the Boards referred to the need to yield a proper return on their contracting and appliance retailing activities. Perhaps we could associate the performance aims with the target of at least breaking even on this business in 1983-84, and achieving a reasonable return by 1985-86 (which officials could settle).

This leaves the question of the precise level of target to be set. It follows from what I have said above on prices and costs that we think a higher level of, say, 1.6% would be both justified and attainable. Simple comparisons of figures with England and Wales are demonstrably misleading, but I do understand the difficulties you perceive over how a different figure might be interpreted. This needs to be balanced against the advantages of our being seen to run a tight financial regime for the Electricity industries. If you see insuperable political difficulties in setting the higher figure, then I should be prepared reluctantly to accept 1.4%, on the basis set out above, and on condition that the additional public expenditure bid for SSEB is withdrawn straight away. I ought also to say, that, since the IFR exercise for 1983 has only just got underway, I could not rule out having to seek further savings from the Scottish Electricity Boards later in the year.

I am copying this letter to the Prime Minister, Nigel Lawson and Patrick Jenkin, and to Sir Robert Armstrong and John Sparrow.

Yours sincerely

J.R. Grieve

f. LEON BRITTAN

[Approved by the Chief Secretary]

Nat Ind,
Geese Elect,
Pt 8

O/C

Nat-Ind
GNC

SCOTTISH OFFICE
WHITEHALL, LONDON SW1A 2AU

NBPM
MLS 12/5

The Rt Hon Leon Brittan QC MP
Chief Secretary to the Treasury
Treasury Chambers
Parliament Street
LONDON SW1

12 May 1983

Dear Chief Secretary

FINANCIAL TARGET AND PERFORMANCE AIMS FOR THE SCOTTISH ELECTRICITY BOARDS

As you know, I have for some time hoped to be able to set a financial target and performance aims for the two Scottish Electricity Boards. In my letter of 4 August 1980 to your predecessor, I described some of the problems which had to be overcome before this could be done satisfactorily. Since then my officials and yours have been in discussion both bilaterally and with the industry, and I believe we have now reached a broad basis of agreement upon which we can settle a target and aims for the electricity supply industry in Scotland.

As for the format of the financial target, I have always believed that a joint target should be set for both Boards because of the close integration of their generating activities which includes the sharing of costs through their joint generating agreement. The consequences of this is that the performance of one Board can have a marked effect on the finances of the other. I recognise that you may have some concern about accountability but in my view the new monitoring arrangements which we have recently introduced will enable us to ensure that each Board is held accountable for its own activities, and we will be able to identify which, if any, is responsible for a failure to meet the financial target. For similar reasons I propose to set a joint performance aim for generation and transmission, but separate aims for distribution since each Board's performance in this area can be separately identified.

I would propose that the financial target should be defined as the average return on net assets valued at current costs. In keeping with the definition used for the ESI, I would propose that capital work in progress be included within the asset base, but MWCA should be excluded from the calculation of profit. This latter point is of little importance, but the inclusion of capital work in progress will have an increasingly significant effect on the Board's rate of return as expenditure on Torness continues. The bulk of capital work in progress will in fact be expenditure on this one project which looms proportionally far larger in the finances of the Scottish Boards than any corresponding expenditure for the CEGB. The implications of this, which I believe your officials accept, is that the Board's rate of return will decrease in future years until such time as the operation of Torness can make a positive contribution to their finances.

Before we can agree on actual figure for the financial target, it is necessary to consider the questions of pricing policy and the relationship between tariffs and economic costs. We are all agreed that tariffs in the energy industries should be based on economic pricing principles and that the financial targets for the industries should also take account of these principles. There remains the problem, however, of determining what the economic or marginal costs are at a time of excess capacity which is likely to continue for the foreseeable future. I am now convinced that electricity tariffs in Scotland are significantly above the level necessary to meet marginal costs and this will continue even after the freeze this year. On economic grounds therefore there is scope for a further real reduction in electricity prices.

The pricing policy of the Scottish Boards has in the past been determined by the requirement to break even on operating costs, taking one year with another. As a result of the standstill this year they cannot reduce prices much further in real terms without risking a breach of this statutory obligation. This is in part due to the need to service debt accumulated on past capital expenditure, a position which will be further aggravated by the funding of interest charges on current capital expenditure associated with the construction of Torness AGR. This station is expected to produce significant operating cost savings after it is commissioned in 1987, but meantime SSEB is having to increase its borrowing in order to fund construction and is thereby incurring growing interest charges. The Board's financial position is not such that a failure to break even would require a subsidy, but it might mean that SSEB would have to borrow more to complete Torness.

Both Boards regard it as their responsibility to find ways of meeting this statutory obligation. They have indicated that in their view a loss in one or more years could be offset against a surplus in the subsequent or preceding period without involving a breach of statute, that is they are taking "one year with another". On this basis they would be willing to restrict tariff increases even although it might result in a loss. In practice they would make every effort to reduce any loss by improvements in performance during the year. What does concern the Boards, however, is that they will be precluded from achieving a real reduction in electricity prices by our setting a financial target at a level which would require a higher tariff regime. Their position would be made even more difficult if the Scottish target was greater than that applied to the industry in England and Wales, and that industry was able to reduce prices in real terms in 1984-85 whilst the Scottish Boards could not.

I too would find it difficult to defend the situation where Scottish electricity prices were seen to be increasing faster than in England and Wales for reasons which were not obviously connected with changes in the real costs of generating electricity and when there is a considerable excess capacity on the system. We would be in the position of moving even further away from marginal cost pricing. I therefore propose to set a joint financial target of a return on average net assets valued at current costs of 1.4% for the three years from 1983-84 to 1985-86. Whilst I recognise the areas of doubt which led Nigel Lawson to choose a two-year target period for the ESI, I would prefer a slightly longer period for what will be the Scottish Boards' first financial target. As we are already into the first year, a two-year target would not give the Boards much time to become acquainted with the disciplines of a financial target. A three year target on the other hand would have the advantage of giving them more time to plan their operations in such a way as to meet it without seeking substantial increases in tariffs. It also has the advantage of taking the Scottish Boards out of step with the ESI which may bring benefits in the future by reducing direct comparisons between the targets and tariffs of the industries north and south of the Border. The level of my proposed target is similar to that agreed for the ESI, but it will, I believe, be more onerous for the Scottish Boards to achieve because capital work in progress, upon which no return can yet be earned, is proportionately a greater part of the Boards' asset base.

Provided the Boards successfully hold down their costs, a joint target of 1.4% would be consistent with the standstill this year and would also give some scope for a real reduction in tariffs during the period of the target. The pricing assumptions underlying the target are of course different from these in the planned EFRs and the present standstill together with the future moderation in pricing may have the effect of putting pressure on the EFRs. The need to break even will, however, exert strong pressure to reduce costs and I would expect the Boards to do better than they are predicting. I would certainly make it clear to the Boards that a financial target of 1.4% does not imply acceptance of their bid for a higher EFL and that a final decision on tariffs for 1984-85 and 1985-86 will depend on the circumstances at the time, including the need for the Boards to meet any EFLs which we have agreed by then. This will place the onus on the Board to achieve sufficient cost savings to justify a reduction in real tariffs.

At the same time I would propose to set the Boards the joint performance aim of reducing their controllable generating cost per unit sold by 3.0% over the three year period of the target; and for SSEB the aim of reducing controllable distribution costs by 7.5% and for NSHEB a reduction of 4.0%. The method used for calculating controllable costs excludes the effect of fuel price changes, depreciation, rates and general inflation, but does take account of the efficiency with which the Boards utilise the mix of fuel available to them. Because of differences in the methodology it is not possible to compare these aims directly with that for the ESI but I believe they are at least as onerous. In fact the Boards' task will be made even harder because the base year of 1982-83 gives every appearance of having been an exceptional year in terms of both Boards' performances, and during the period of the target the Boards will lose the benefit of burning NGLs at Peterhead.

I believe that the financial target and performance aims which I have proposed will increase the pressure on industry to reduce costs and increase efficiency. I would like to be able to set and announce the target and aims before the discussion of the Boards' investment and financing review. I also think it would be helpful politically at this time for us to be seen to be applying these controls to the nationalised industries in Scotland. I hope therefore that you will be able to accept these proposals quickly.

I am copying this letter to the Prime Minister, the Chancellor, the Secretary of State for Energy, the Secretary of State for Industry and John Sparrow.

Ever yours,

A MacKenzie

Approved by the Secretary of State
and signed in his absence

12 MAY 1983

Nuet Bud

10 DOWNING STREET

Prime Minister

Is this the material on high energy costs you were referring to?

MCS 25/4

Yes

SS NO

SECRETARY OF STATE FOR SCOTLAND

NEW ST. ANDREWS HOUSE
ST. JAMES CENTRE
EDINBURGH EH1 3SX

Rt Hon Leon Brittan QC
Chief Secretary
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

NBPM

MLs 20/4

19 April 1983

Dear Leon,

OBJECTIVES FOR THE SCOTTISH ELECTRICITY BOARDS

Pt 7

Thank you for your letter of 30 March accepting, with one change, the objectives which I intend to set for the Scottish Electricity Boards.

As I have received no objections from colleagues I am writing to the Chairmen setting their objectives which incorporate your change. In the covering letter I am also taking note of your suggestion that I might set a date for receipt of a report on the injection of private capital and have asked for a report before the end of March 1984.

I have considered John Sparrow's letter of 5 April, but feel that the point covered in item 10 is an important one, and should remain in the formal list of objectives. I am copying this letter to members of E(NI), to Sir Robert Armstrong and to John Sparrow.

Yours ever,

George.

CC/NO

Nat Ind

CABINET OFFICE

Central Policy Review Staff

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

From: John Sparrow

CONFIDENTIAL

Qa 06316

The Rt Hon George Younger MP
Scottish Office
Dover House
Whitehall
SW1

5 April 1983

AR 6/4

p.a

Dear George,

Objectives for the Scottish Electricity Boards

I have seen your letter of 24 March 1983 enclosing proposed objectives for the two Scottish Electricity Boards.

The CPRS has been involved in the formulation of these objectives and we have made a couple of drafting points at official level. Otherwise I am happy to accept your proposals, although I feel that item 10 is not an objective and might best be put to the Boards separately.

I am sending a copy of this letter to the recipients of yours.

Yours sincerely,

John.

John Sparrow

CONFIDENTIAL

NAT IND
Elect. Pol.
Pt. 7

PART 7 ends:-

CST to S/S Scotland 30/3

PART 8 begins:-

Sparrow (CPRS) to S/S Scotland 5/4

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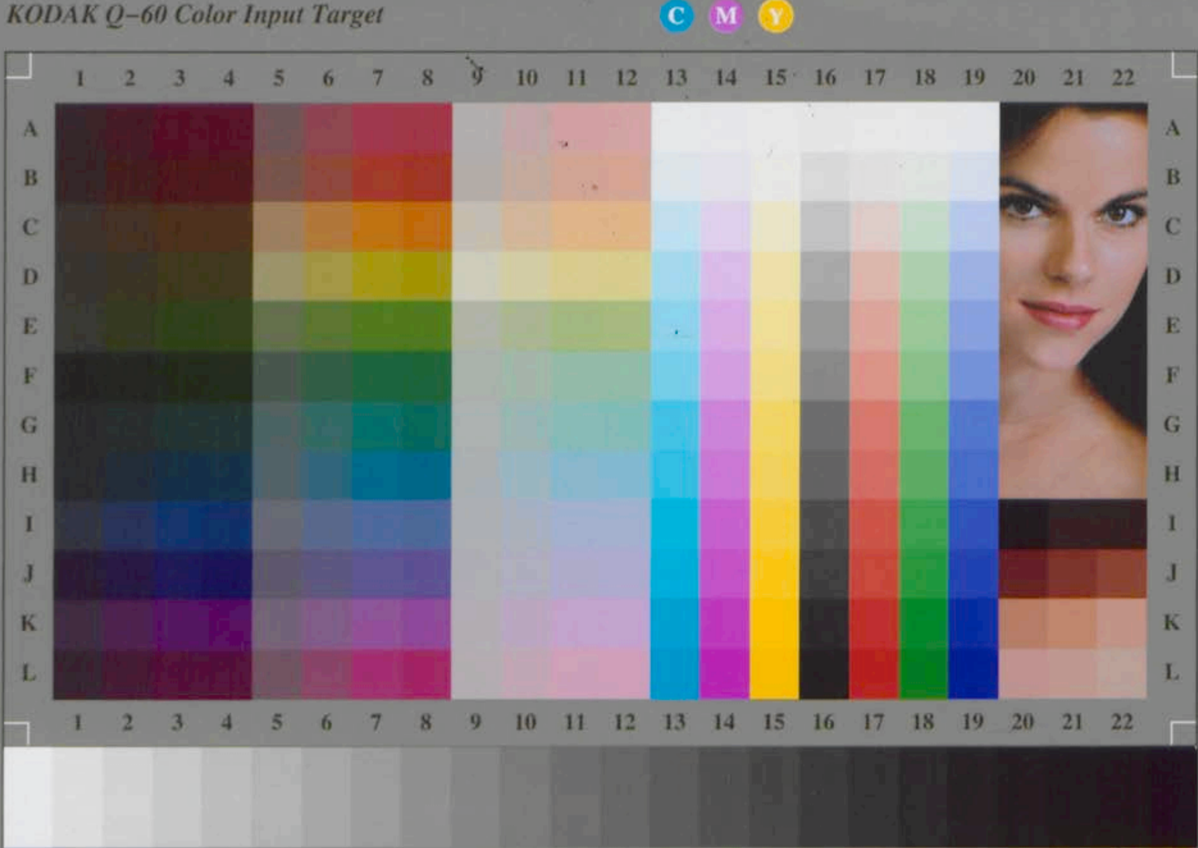

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