F

cc Prof Walters

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

9 October 1980

I Ellison Esq
Private Secretary
Department of Industry

Dear Ian

NATIONALISED INDUSTRIES: PRICES

The Chancellor has asked me to circulate a paper on nationalised industry prices recently prepared by Treasury economists. This analyses the reasons why the increase in nationalised industry prices during the current year has been so much faster than the movement of the retail prices index and attempts a forward look at 1981-82. Sections III, IV and particularly VI of the paper are directly relevant to the meeting on nationalised industry pay on 13 October (on which I wrote on 7 October).

However the paper as a whole goes wider than pay and it would be helpful to know whether Departments agree with the analysis in the paper (in particular the weight given to the different factors which have caused the rapid price increases) and also what is suggested about the outlook for 1981-82. However these wider matters are best pursued between officials in the Treasury and sponsor Departments; the Chancellor will not be looking for a response on these points at his meeting on 13 October.

Yours ever,

Peter

P S JENKINS
Private Secretary

cc PS/Energy
PS/Environment
PS/Scotland
PS/Wales
PS/Trade
PS/Transport
PS/Employment
PS/No.10

NATIONALISED INDUSTRY PRICE INCREASES

The object of this note is to quantify the main factors which are causing nationalised industry prices to rise faster than the RPI in 1980-81 and to give an early indication of the likely outcome in 1981-82.

I Nationalised Industry Prices

The component of the RPI which measures nationalised industry prices is currently showing increases on a year ago of 26%, which compares with an increase in the rest of the RPI of some 15% to 16%. This comparison, however, overstates the pressure which the nationalised industries are putting on the rest of the economy through higher prices.

The RPI covers only about two-thirds of the gross revenues of the nationalised industries. The other one-third includes, besides small industries such as Scottish Electricity and the British Transport Docks Board, three industries, namely steel, airways and shipbuilding, which face intense international competition and which, in common with much of UK manufacturing industry, are unable to increase their prices as fast as the RPI is rising. These three industries are putting pressure on the rest of the economy by higher borrowing rather than through higher prices.

The RPI covers prices to domestic users but not the prices charged to industry for bulk supplies. From Table 1, however, it will be seen that domestic and other prices are moving more or less together.

/Table 1

Table 1

Percentage price increases in the 12 months to 31 March 1981

	Domestic	Industrial
Coal	18	20
Electricity	29	28
Gas	29	32
Posts	18	18
Telecomms	22	18
Rail	19	-
Bus	20	-
All NIs listed above	25	-
All items RPI	14/15	

II The contribution of moves towards the economic pricing of energy

The largest increases are in Gas and Electricity and reflect a deliberate move towards economic pricing, taking account of the changes in world energy supply and demand during the 1970s, especially the rise in the price of oil. This latter affects other energy prices both directly (as a cost in electricity) and indirectly (by raising the demand for other fuels and hence their costs and prices).

The moves towards economic pricing are being implemented through the financial targets. Thus in the case of gas, the target to 1982-83 provides for an increase in domestic prices of 10% a year above the rate of inflation (there was a 17% 'inflation' increase in April 1980 and there will be in addition a 10% 'economic pricing' increase in October). The target for electricity (England and Wales) to 1982-83 provides for price increases of some 1½% a year over and above the increase in the industry's own costs as a move towards prices which will yield an adequate return on capital (ie to meet the RRR on investment). The driving force here, however, is fuel costs, which are estimated to rise by about a third during 1980-81; this accounts for well over half the 28% price increase. The higher coal prices shown were made possible by higher oil prices and reduce the NCB's losses and cash requirements.

III Pay and labour costs in the nationalised industries in 1980-81

As Table 2 indicates, labour costs per head have shown some tendency to rise faster in the nationalised industries than in the rest of the economy between 1970-71 and 1978-79. The rise was more or less continuous in coal and gas, the industries with the biggest relative increases. In the other industries the pattern was more mixed; but in all the nationalised industries labour costs per head were higher in 1978-79 than in 1971-72 relative to the rest of the economy (ie all the numbers in the last column are above 100).

Table 2

Ratio of labour costs per head in NIs to labour costs in the whole economy (mid-financial year 1970-71 = 100)

	1972-73	1975-76	1978-79
Coal	105	126	154
Gas	96	114	136
Electricity	105	106	105
Rail	102	108	102
Telecomms	113	120	109
Posts	111	119	105
All NIs listed above	105	108	108

Based on NI's accounts

The increase in labour costs the nationalised industries are expecting between 1979-80 and 1980-81 is faster than that which is likely to occur in the private sector and thus represents a continuation of the trend:-

/Table 3

Table 3

Percentage increase in labour costs between 1979-80 and 1980-81

Coal	17
Gas	26
Electricity	26
Posts	25
Telecomms	27
Rail	23
Bus	22
All private sector industries	about 18

The relatively small increase in labour costs in the NCB has to be set in the context of the big increase in these costs in the period up to 1978-79. For gas, electricity, posts and telecomms the increases shown above include staged payments from the previous year's pay settlements.

IV The link between pay and prices

How much of the price increases in excess of the RPI increase can be explained by pay? Table 4 shows:-

i. The additional revenue each industry might expect to receive from the actual and prospective 1980-81 price increases over and above the revenue it would have received from an increase in prices in line with general inflation (as measured by the increase in the GDP deflator) on the anniversary of its previous year's increase;

ii. The costs borne by each industry in 1980-81 as a result of the 1980 pay settlements and the carry-over from the 1979 staged pay settlements, over and above the increases they would have incurred if their labour costs had increased in line with the average in the private sector on the anniversary of their previous year's settlement.

/Table 4

Table 4 £m

'Excess' revenue and 'excess' labour costs in 1980-81

Industry	(1) Excess Revenue Domestic and Industrial (see definition in text)	(2) Excess Labour Costs (see definition in text)	(3) Column 1 less Column 2
Rail	+ 40	+ 50	- 10
Bus	+ 30	+ 10	+ 20
Telecomms.	+160	+100	+ 60
Posts	+ 45	+ 90	- 45
Electricity	+400	+ 70	+330
Gas	+350	+ 50	+300
Coal	+135	- 15	+150

(2) These cost increases may have been anticipated to some extent and an allowance made for them in the price increases of the previous FY 1979-80.

The table shows that, in the case of posts and rail, labour cost increases higher than in the private sector more than accounted for the 'excess' price increases. In telecommunications they accounted for £100m out of a net figure of £160m.

V Other factors making for nationalised industry price increases

There are a number of factors other than the 'economic' pricing of energy and 'excessive' increases in labour costs which have contributed to the pressure on nationalised industry prices.

a. Government policy. Energy prices are not the only nationalised industry prices to be raised as a matter of Government policy. In particular, the telecommunications industry now has to meet a target return of 6½% on assets compared with the 5% achieved in 1979-80; and reduced subsidies are putting upward pressure on rail and bus fares.

b. Fuel prices have risen considerably faster than inflation in the past 18 months following the increases in oil prices. They are a significant factor in the electricity and transport industries.

c. Some industries have reacted to the pressures of EFLs and financial targets in part by raising prices and not solely by cutting costs. The electricity, telecommunications and transport industries appear to be in this category.

In practice the pressure of increased profit requirements, lower subsidies, higher costs or higher capital requirements are met not only by price increases but by a variety of other means - reducing costs by increasing efficiency, cutting services and delaying maintenance, reducing investment and disposing of assets. Thus the third column in Table 4 is the net effect of a wide range of adjustments. It is not possible to separate out the effects of all the (interacting) factors within the net figure.

VI Prospects for 1981-82

The prospects for nationalised industries' pay and price increases in 1981-82 are by no means comforting. The gas industry is set to increase domestic prices by 10% above the rate of inflation, as in 1980-81. The electricity supply industry might need a price increase of at least 20% next April. The Post Office is talking about a further 17% increase in postal charges in January 1982. It is likely that rail and bus fares will also increase faster than the RPI again in 1981-82.

Most of the industries are assuming that pay increases in 1981-82 will be considerably above single figures. Gas, Electricity and Rail are assuming an increase in earnings in 1981-82 of about 15-16%, Posts about 12%, premised on a 10% pay settlement in January, Telecommunications an increase of about 15% in average earnings assuming an 11% pay settlement next July. On the other hand, the NBC are hoping to keep their settlement down to around 5%, since in their case a higher figure would prejudice their investment plans and increase the pressure for earlier (though probably not larger) price increases.

VII Prices and the PSBR

Prices which are below those needed to reflect marginal costs and ensure that the nationalised industries' investment earns a return comparable with that of the private sector not only lead to waste in terms of resource allocation but also generate additional pressure on the monetary, PSBR and public expenditure targets.

Nationalised industry prices have a direct impact on public expenditure and the PSBR through the industries' financing requirements. For example, the effect on the gas and electricity industries' cash flows of prices lower across-the-board than they otherwise might be is:-

	£m (outturn) effect in 1981-82
Electricity	
a. 10% price shortfall (all customers)	700
b. 10% price shortfall (industrial only)	200
Gas	
a. 10% price shortfall (domestic)	150
b. 10% price shortfall (industrial)	30* (60m following year)

* effect of staggered contract renewals.

Taking nationalised industries as a whole, reductions in prices or failure to increase prices to economic levels would have considerable consequences for public expenditure and the PSBR.

VIII Conclusions

The increase in nationalised industry prices in excess of the RPI is the result of a number of factors. In the case of gas, and to a lesser extent electricity, the phased move towards economic prices has been the main element and will continue to be so in 1981-82. Pay settlements which exceeded average earnings in the private sector and included payments delayed from the previous pay round, were a significant factor in the big increases in prices for posts, rail and telecommunications in 1980-81. Increases in pay are expected to contribute to high price increases again in 1981-82. The other elements which are contributing to rapid price increases are diverse. They include big increases in fuel costs and the industries' response to the pressures exerted by external financing limits.

Restraining nationalised industry price increases arbitrarily would not only result in a waste of resources (because it would distort relative prices) but also put upward pressure on the PSBR and interest rates. The prospect then is of further increases in nationalised industry prices which it will be difficult to resist.

ANNEX

RAIL

Labour costs are about 60% of BR's operating costs. The large increase in labour costs has thus played a major role in the prospective increases in fares in November, only 10 months after the last increase. Other operating costs are expected to increase by 21% in 1980 - this higher than average increase mainly being due to large increases in fuel costs. The pressure which these cost factors has put upon BR are not entirely relieved by the November price increase, as Table shows. Moreover, falling demand has added to these pressures so that remedies other than fare increases have been sought - service withdrawals, frequency reductions, disposals and ultimately an increase of £40m in the EFL. But other things being equal, if BR had conceded a lower pay settlement this year the pressures for an early fares increase would have been considerably reduced.

BUS

Labour costs are over 2/3 of NBC's operating costs. The higher than average increases in labour costs have not arisen from the pay settlement which was in line with the private sector, but from the effects of the phased implementation of theEEC drivers hours regulations. Other cost increases are put at 18% in 1980-81.

NBC implemented fare increases above general inflation rate in 1979-80 and are expected to do so again this year. The problem has not been so much one of cost inflation as the need for NBC to maintain revenue in the face of falling demand and lower subsidies, which are being met in part by cutting services as well as above average fare increases.

TELECOMMS

Pay etc is only 40% of operating costs in telecomms. Nevertheless the combined effect of the staging of the 1979 settlement and the high (23% in a full year) settlement this year, on average earnings, is expected to be about 27%. This has clearly made a major contribution to theneed for an early and large price increase in November. Originally the Post Office were expecting that last year's price increase would be sufficient to see them through the whole of FY 1980-81; but that was premised

/on an

on an 11% pay settlement. Other factors which have been important include increases in working capital reflecting higher stocks "needed to maintain and improve service and launch much needed new customer apparatus" and non-pay cost pressures. Moreover the PO only made a 5% return on assets last year and are required to earn 6½% in the remainder of the target period.

POSTS

Pay etc is almost 80% of posts' operating costs. The large increase in labour costs in FY 1980-81 arises from the staging effect of the 1979 settlement and both the postal workers settlement this year and the repercussions of the telecomms settlement. The impact of the price increase is small relative to the pay increase since it comes so late in the financial year. But the PO are envisaging that they will fail to meet their financial target this year (£20m profit rather than £42m) but the EFL is pressing them to do so, since they are reducing their working capital needs from "careful cash flow management". It should also be noted that the £45m "additional revenue" is against a base which allows them a 15% increase in charges in February - whereas they were themselves assuming no further increase in the FY 1980-81. Against that base the additional revenue would be about £90m. It is clear then that price increases could have been avoided but for the excessive increases in labour costs.

ELECTRICITY

Since labour costs account for less than 20% of operating costs the effects of the high increase in labour costs is fairly small. The major factors behind the large real increase in electricity charges through this year has been the 36% increase in fuel costs (more than double the current inflation rate), although falling sales have played a small part. Price increases have only been a partial remedy - others have included cost savings and cuts in capital programmes.

GAS

Labour costs are about ¼ of operating costs so the effects of high wage cost inflation are muted. Increases in domestic charges have in any case been set by a formula of 10% plus the

/rate

rate of inflation at the beginning of the year and this is at present insensitive to cost increases. Cost inflation has put further pressure on industrial gas prices but it looks as though BGC will solve its EFL problems without recourse to pricing action. The additional revenue in the table arises almost exclusively therefore from government policy on gas pricing.

COAL

This year's miners' settlement was moderated by normal standards. Although NCB will be settling miners' pay in November they are currently forecasting only a 15% increase in their pay bill in 1980-81 and 1979-80. After allowing for some reduction in manshifts worked this implies only a 17% increase in labour costs per head. It is of course possible that a high settlement in the coming round above the going rate would present problems for NCB in 1981-82 aggravating the underlying losses.