Ref. A0517

PRIME MINISTER

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

(E(79) 61)

BACKGROUND

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

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

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

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

HANDLING

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

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

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

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

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

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

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

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

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

CONCLUSIONS

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

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

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

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

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

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

RTA

ROBERT ARMSTRONG

29th October, 1979