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Nat Inds

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PRIME MINISTER

Electricity (England and Wales) EFL, 1980-81

(E(80) 34)

BACKGROUND

The External Financing Limit (EFL) for 1980-81 is £187 million. When this was set last November it was thought that it would involve domestic tariff increases of 17 per cent in April and 5 per cent in October. Since then costs have risen substantially, and the possibility was floated of making the second price rise larger than 5 per cent and earlier than October - 10 per cent in July. You said that before agreeing to this increase you wished Mr. Howell to prepare a paper on all the options, including the possibility of reducing working capital requirements for stock-building.

2. On 17th April the Electricity Council decided that there should be an increase of 10 per cent in August together with capital investment cuts and other cost savings. This increase would first affect bills in November. The full RPI effects of 0.29 per cent would be reached in December.

3. The increases in costs since last November total £290 million - mainly higher fuel costs, higher salary settlements, and less sales revenue. This sum will be met by:

(i) £150 million yield from the 10 per cent tariff increase;

(ii) £52 million capital investment cuts; and

(iii) £88 million savings yet to be identified.

One element in the £88 million savings may be stocks (paragraph 5 of the paper). But Mr. Howell warns against significant reductions here. It would be risky to reduce stocks substantially. Any significant reduction could have an adverse effect on the NCB's financial position, as well as affecting endurance in times of difficulty.

4. Although this package should mean that the EFL can be held, it is not entirely satisfactory in terms of the financial target or, therefore, of public expenditure plans in later years. The financial target is to achieve a return on net assets, in current cost accounting terms, of an average of 1.8 per cent a year over the next three years. Achievement of this is assumed in the public expenditure projections to 1983-84; and any failure to meet it would, therefore, be a major setback in the effort to turn round the finances of the nationalised industries as a whole. As it is, even with the proposed increases, the CCA return in 1980-81 will be about 0.5 per cent compared with the 0.9 per cent desirable if the target is to be met over the period. Further substantial price increases, and cost savings, are likely to prove inevitable in later years.

5. If approved, the August increases will first become public knowledge in June. That is when the Electricity Council will be obliged to go to their Consumer Consultative Council.

HANDLING

6. You will wish to ask Mr. Howell to introduce his paper. Mr. Biffen could then comment on the public expenditure implications for the current and later years. I understand that he may wish to argue for advancing the increase to July (so getting another £40 million) with the objective of getting nearer to course for the financial target. The points to establish in subsequent discussion are:

(i) Are there any further practical options for 1980-81?

Because of the uncertainties of costs to, and sales by, the industry, an increase smaller than 10 per cent could well risk failure to meet the EFL. This would be a setback to public expenditure plans. Looking at the alternatives, you will wish to satisfy yourself on the proposed approach to stocks. This is, however, being examined further and may well contribute to the £88 million savings proposed. Little is said in the paper on disposals and this may be worth questioning. But in practice there may not be much in it. The industry owns spare land but needs to retain some of it as sites for future power stations. Sale of showrooms has often been considered. It could be looked at again if the Committee thought it worthwhile; but if changes were to be made they would probably not have effect this year. Capital investment has already been cut by £52 million. Anything more could lead to substantial nugatory expenditure, put the financial target at risk in later years, and also be damaging to the plant industry.

(ii) If the 10 per cent increase is approved can the £187 million EFL be held?

The Electricity Council have undertaken to make the necessary savings. However, they have yet to identify £88 million of them. You may wish to ask Mr. Howell to satisfy himself in, say, two months' time that they have produced firm proposals for these savings. Otherwise there is a risk that the package could burst too late in the year to do anything about it.

(iii) Should the 10 per cent increase be brought forward to July?

This would yield £40 million more and so make achievement of the EFL more certain. It would get the industry nearer to the path for their 3 year financial target, and so reinforce public expenditure objectives. But the Electricity Council themselves now favour August.

(iv) Should there be an inquiry into the efficiency of the industry?

The Committee may feel that, while there may be little option but to agree to the proposed price increase if the EFL for 1980-81 is to be held, they would like to see an in depth inquiry into the efficiency of this industry. One possibility would be a reference to the Monopolies and Mergers Commission. I suggest you do not take a firm decision on this at the meeting. Mr. Nott is considering the possible candidates for references to the Commission. If the Committee so wished, the electricity industry could be put on the list which, at a later stage, Mr. Nott could put to the Committee for consideration. It would then be possible to judge what priority should be given to an inquiry into electricity.

(v) Are there other longer-term measures to be considered?

One possibility might be to reintroduce the fuel cost adjustment clauses for domestic tariffs which were withdrawn in January 1979, but which still apply to industrial tariffs. These allowed for increases in coal and oil costs to be passed on automatically in quarterly bills. The advantage was that they were a flexible instrument for dealing with the major uncertain element in the costs to the industry (fuel accounts for over half of the industry's running costs); brought in extra revenue quickly and, because they were automatic, small and obscurely represented on customer's bills, did not attract the same odium as main tariff increases. On the other hand they were controversial and open to criticism as a means of passing on inflationary costs automatically. With two increases already scheduled for this year they probably offer little increased revenue in the short term, but they could be a helpful device for later years.

(vi) Are there any implications for the EFL regime generally?

The discussion may well lead to questions and proposals on the operation of EFLs for nationalised industries generally, and on financial targets. You will recall that you recently set up a Committee under the Chancellor to look at the financing of the nationalised industries (E(NF)). This Committee will be meeting shortly to discuss papers on the EFL system by the Treasury and the CPRS. You could, therefore, ask the Chancellor to ensure that E(NF) considers any new points raised in the present discussion. But any such points are likely to take time to resolve and should not be a reason for delaying decision on the electricity increase.

(vii) What are the implications for Scotland?

I understand that Mr. Younger now expects that an increase in the order of 10 per cent will be necessary for the Scottish industry in August. Because of this Mr. Howell's proposals are unlikely to be embarrassing to him. You will wish to ask him to report further when he has firm proposals for his industries. This will probably be in May.

CONCLUSIONS

7. Subject to the discussion, the Committee might be guided -

(i) either to approve now the proposed 10 per cent increase in August; or to invite Mr. Howell to raise any further proposals either on timing levels or other options with the Electricity Council urgently and to report back in sufficient time not to jeopardise the EFL, should a 10 per cent price increase in August prove to be an essential element in the package.

(ii) If the increases are approved, to invite Mr. Howell to satisfy himself in two months' time that the Electricity Council has formulated firm proposals for their proposed £88 million of additional cost savings.

(iii) If the Committee wants a longer-term investigation into the efficiency of the industry, to invite Mr. Nott to consider it as one of the candidates for a reference to the Monopolies Commission and to make further recommendations to the Committee.

(iv) To invite Sir Geoffrey Howe to take account, in the further work of the new Committee on the Financing of the Nationalised Industries (E(NF)), of any general points raised on the EFL system; and

(v) To invite Mr. Younger to report further when he has firm proposals for tariff increases by the Scottish industries.

RA

(Robert Armstrong)

23rd April, 1980