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CABINET

MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

GAS PRICING POLICY AND THE FINANCIAL TARGET FOR THE
BRITISH GAS CORPORATION

Memorandum by the Secretary of State for Energy

1. We have agreed that gas prices should be raised over a period of 4 years to the oil-related level (E(79)12th) and that next year the domestic tariff should be increased by 10% in real terms by means of two instalments, one by the increase in the RPI in April and one of 10% real in October (C(79)18th). I was invited (E(79)14th) to circulate a paper showing the effects of two price increases a year, from April 1981 onwards, on public expenditure; on the Retail Price Index (RPI); and on customers' bills. I was also invited to display how twice yearly price increases might be maintained at the levels proposed in E(79)61 so that there was no rise in public expenditure. This paper has been agreed with the Chief Secretary.

GAS BILLS

2. Raising gas prices in real terms over and above the rate of inflation will necessarily mean a substantial increase in gas bills (see Annex A). Even assuming a declining rate of inflation, the typical bill will have increased by about half in cash terms by 1981/82, and will have doubled by 1983/84. But half or more of these increases will have been due to inflation. On the assumption that increases in pay would roughly keep in line with inflation, consumers would in fact find their gas bills over 40%

greater in 1983/84 than now, in terms of their ability to pay. But gas bills would still represent only a small proportion of average expenditure - some 2.4% compared with 1.6% at present.

3. Phasing price increases in two stages (April and October) would have only a small effect (up to 4%) on average gas bills - compared with a single increase in April - because the bulk of gas is consumed in the winter, after the autumn price rise.

PUBLIC EXPENDITURE

4. The latest financial forecasts from British Gas show a higher negative external financing requirement in comparison with the figures in my earlier paper (E(79)61) (which are also reflected in the Chief Secretary's paper (C(79)56)) on the basis of a single price increase in April each year (see Annex B). Phasing the price increase in two parts - an RPI increase in April and a further increase in October - could lose some £60m each year, in comparison with a single April increase. To recover this by a higher autumn price increase in the year in question would mean roughly doubling the October increase (e.g. from 10% to 20%) in part due to the lag in meter readings. Alternatively, one could have an April increase bigger than that in the RPI with a further similar increase in October (e.g. two increases of 15% depending on the rate of inflation; see Annex B).

RETAIL PRICE INDEX

5. The effect of a 10% real increase in any one year on the RPI is 0.16% over and above the effect of inflation. Because of the quarterly cycle of meter readings a tariff increase takes some 4 months to work its full way through into the RPI. The effect on the April RPI of a 10% real increase in tariffs on 1 April is in fact a rise of only about 0.025%. Phasing the price increase to the autumn could lessen this rise though it would not affect the rise over the 12-month period.

PRESENTATION

6. Although it is arguable that there may be some presentational advantage in having two gas price increases a year - as opposed to one - to attain our aim, the actual benefit to the consumer

not likely to be significant, particularly if the cost in public expenditure terms were to be recovered. BGC themselves feel that the presentational impact of a single annual increase would be less than that of two rises a year. I agree. We must avoid being seen to push up domestic prices every six months or so. On balance, April seems the best time to raise prices when gas consumption is lower, though if this was ruled out the cost of delaying the increase to July would be around £30m for each year ahead.

7. We should take a decision now to increase domestic gas prices by 10% p.a. in real terms for the years after 1980/81, in line with our decision to move towards oil-related prices. There is however no need for the moment to take final decisions on the phasing of each year's price increase in the later years. We should concentrate on getting our pricing strategy right, leaving the tactics to be settled later, in the light of the prevailing circumstances. I would nevertheless propose that for public expenditure and other planning purposes a single price rise in April of each year be assumed for the future.

CONCLUSION

8. We have agreed that domestic gas prices should be increased in real terms to an oil-related level over the next four years. We must now take firm decisions on the size of the annual price increases so that we can set British Gas a medium-term financial target, in line with our approach towards the electricity industry and to the nationalised industries generally. We must at the same time give the domestic consumer a clear signal now that gas is a depleting resource and should not continue to be sold at bargain prices.

9. I therefore recommend to my colleagues that we agree:

- (i) to increase domestic prices on average by 10% a year in real terms in 1981/82 and subsequent years;
- (ii) to assume for public expenditure and planning purposes single annual price increases each April;

- (iii) to open discussions with British Gas with a view to establishing and announcing a financial target to run for 3 years based on our decisions on prices.

D.A.R.H.

Department of Energy
8 November 1979

GAS BILLS

1. The figures below show the typical average size of quarterly gas bills corresponding to annual consumptions of:

80 therms	-	cooker
250 therms	-	cooker plus living room fire
400 therms	-	multi-point water heater plus fire
800 therms	-	boiler plus 7 radiators.

Domestic consumers average 550 therms a year and bills for this quantity are also shown.

2. The sums shown are at outturn prices and therefore include the effect of inflation (for which we have used BGC's own assumptions).* The price increases assumed an RPI increase in April 1980 (some 17%, depending on the rate of inflation) and 10% in October 1980, as already agreed; and 10% on top of the rate of inflation in April of subsequent years.

Annual consumption (therms)	Average quarterly bill (£ at outturn prices)				
	1979/80	1980/81	1981/82	1982/83	1983/84
80	7.10	8.70	10.90	13.00	15.50
250	16.10	20.10	24.90	29.70	35.30
400	22.90	28.50	35.30	42.10	50.00
800	39.40	49.00	60.70	72.40	86.00
550	29.00	36.20	44.00	54.40	63.50
Price Index	100	113	124	135	148

3. Over the period to 1983/84, average bills for a given consumption of gas would approximately double, on the stated assumptions. About half of this effect would be due to general inflation. To the extent that raising prices encourages conservation, bills could be rather lower than the figures shown.

4. Phasing the annual price increase between April and October of each year would have little effect on the size of the average bill because the bulk of gas is consumed in the winter, after the autumn increase (the average figures quoted allow for this weighting). The savings would amount to 30-60p a quarter for 80 therms p.a. and £1.00 to £2.00 at 800 therms p.a. - no more than 4% of the total bill.

	80/81	81/82	82/83	83/84
* increase over previous year	13	10	9	9 %



PUBLIC EXPENDITURE: EFFECTS OF GAS PRICE INCREASES

1. The figures in the Chief Secretary's paper (C (79)56) for total external finance from British Gas are as follows:

	<u>£m at 1979 Survey Prices</u>		
	81/82	82/83	83/84
Total external finance	- 200	- 380	- 630

2. On the basis of real price increases of 10% in April of each year, BGC's latest forecast is:

	- 223	- 426	- 674
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3. If each year's price increases were phased with an increase equivalent to that in the RPI in April and a further 10% (money) increase in October, there would be a loss of about £60m each year:

	- 160	- 360	- 610
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4. This £60m could in principle be recovered by means of price increases in October bigger than 10%. For instance, in 1981/82 a 20% increase in the autumn would recover £60m, while to get back to the figures of - £200m (para 1) a rise of about 17% would be needed. Such increases, amounting to some 17-20% in real terms in that year, would mean that a real increase of less than 10% would be needed in the following year to keep to the required external financing figures. In effect, one would be bringing forward part of one year's real increase into the previous year.

5. Another possible way of recovering this £60m would be by having an April increase bigger than that in the RPI, with a similar further increase in October; for instance if the rate of inflation is 10% p.a., two increases of 13% would suffice.