010 cc Duguid

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cc Mr Hoskyns

Prime Minister [2]

Nat Ind

To note that the Treasury are now suggesting (see x below) that the energy industries could offer lower prices to selected customers.

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

17 September 1980

The Rt. Hon. David Howell MP
Secretary of State for Energy

Dear David

Good! At last! MT.

TL. 17/9

ENERGY PRICING

.... I attach a note on energy pricing by my officials which you might like to bear in mind when you are preparing your paper for E Committee on this subject. It is not intended to deal with the equally important question of the control of nationalised industry costs. I am not necessarily committed to all the arguments in the note, but it does seem to me to summarise our existing approach to these matters.

Could I ask that your Department should consider two particular points which arise from the note.

x (i) It suggests that there might be a case for permitting the electricity supply industry to reduce its prices to certain firms provided the revenues generated from those firms still covered the marginal costs of generation and supply and the industry could hold its (higher) prices to its other customers. I recognise that this might require some amendment to the industry's statutory duties but that apart, I wonder whether you see any advantage in the proposal. I would need to be convinced that it would not lead to an increase in public expenditure. We simply cannot afford this particularly in view of the enormous problems posed for public expenditure by the loss-makers and other nationalised industries.

(ii) We will need to see the results of studies by your Department and the CBI on international energy comparison, but quite apart from these studies I wonder whether, as the note suggests, there might be scope for some international action by the UK to try to ensure that energy prices in other countries are set by market principles and subsidisation is avoided. You will remember that this subject was discussed at the Venice Summit and that the recent change in the Canadian

/Government required

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Government required some departure from the more virtuous Tokyo formula. I should be interested to know what you think of the chances of making any useful progress in this direction.

I should also be interested to have your views on the possibility of encouraging the Generating Boards to increase the facilities available for coal imports. I recognise that this would not provide any competitive stimulus to the NCB in the short term, though the knowledge that the facilities were planned might have some helpful effect in restraining the industry's costs. It would be important for the new import facilities to be owned by the private sector so that their cost would not add to public expenditure. And we would need to be assured that the NCB could cut its own output if it looked as if it would be faced with unsold surpluses because of competition from imported coal. Without such cuts in its own output, the cost of financing unsold NCB stocks would place a heavy burden on public expenditure. I suspect that this could be a real stumbling block since, as your paper E(80)96 shows, there is already a strong prospect that the NCB will have a problem with excess stocks over the next few years. The CEGB are also planning for coal import facilities some way above their current forecasts of imports.

I am sending a copy of this letter to the Prime Minister.

GEOFFREY HOWE

ENERGY PRICES

(Note by Treasury Officials)

Pricing Principles for the Nationalised Energy Industries

In market economies prices are the principal mechanism for ensuring that national resources are used efficiently; ie that consumers' demands are met in the most economical (ie least cost) way given the technology and resources available. Sensible resource use implies that if consumers wish to use say more electricity, they should be prepared to pay the (extra) costs involved in providing it - marginal costs. Supplying at a price below marginal costs would mean that the value to users (measured by the price) was less than the value of resources used to provide the additional supply. A clear waste from the national point of view. It also would be bad business for the supplier since some of the supply would be sold at a price which did not cover costs. Thus in efficient markets the use of national resources will be steered in the right direction in response to financial gains and losses faced by individual buyers and sellers.

2. In competitive markets prices would be pushed towards marginal costs* by the normal trade pressures. Businesses which persistently charged below marginal costs would go out of business and prices above marginal costs would lead to excessive profits which would attract new and less greedy firms.

3. Where supply is in the hands of monopoly suppliers - like the nationalised energy industries - marginal cost prices have to be implemented as a deliberate matter of policy. Marginal cost pricing is well established in the electricity industry and the financial target announced earlier this year reflects a move towards it. But in gas and coal the idea has not caught on. The measurement of marginal costs, never easy, raises particular problems for those industries.

Investment, Spare Capacity and Discriminatory Pricing

4. Investment is an important element of marginal costs; eg if higher demand for electricity means that new power stations are

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* marginal costs are defined here as all the extra costs to the firm in provided extra output.

required earlier, this is a real economic cost which should be reflected in prices if they are to do their job of guiding investment plans and ensuring that energy demands are met in the most economic way. But because lead times in energy are long, investment decisions have to be taken well in advance and in practice it is not possible to plan so far ahead with perfect accuracy. As a result in any particular short period we may find ourselves with too much or too little capacity to meet demand at "long run" marginal cost prices. Where there is significant excess capacity which is likely to persist, it will theoretically make sense, subject to other considerations (which may in practice prove overriding), to shade prices down towards "short run" marginal costs*; ie the additional current outgoings associated with the extra output. Whether this will benefit the industry's finances depends on what happens to receipts in total. If for instance selling more output requires price cuts across the board because price discrimination is unfair (or even illegal), the likely result is that receipts will fall and the cash flow be reduced.

5. A private firm would not price down this far unless it saw some compelling longer term advantage eg survival. A nationalised industry would survive but there would be a cost either to the PSBR or, if the PSBR was to remain constant in terms of additional cuts in public expenditure, increases in taxes etc. It is hardly sensible to adopt pricing policies which increase the PSBR, if this runs directly counter to the Government's overall policy which is designed to secure the best economic outcome in the longer term. Further expenditure cuts and tax increases may be extremely costly in terms of the sacrifices entailed and these would have to be balanced against the advantage to the nation of cheaper electricity etc. But it would make sense both for private firms and nationalised industries to exploit any opportunities for discriminatory pricing down as a temporary expedient if this increased short-term cash flow. The opportunities will depend on the industry's cost structure and market position (and perhaps on its statutory obligations - though these could be changed if necessary).

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* There may be other options eg stockbuilding, which may in some circumstances make better sense.

6. Pricing down would have to be limited say to contracts over a specified time period and the temporary nature of the arrangement made clear. (How easy in practice it would be to resist demands for continued cut price supplies when the circumstances had changed is another matter.)

7. At present we have too much capacity in electricity and too little in gas. To the extent that short run marginal cost arguments justify (temporarily) lower electricity prices the same arguments would lead to (temporarily) higher prices for gas.

Relationship with Oil Prices

6. It is not possible to generalise further about pricing opportunities in the short run. But it is worth noting the implications of marginal cost pricing for fuel price relativities over the longer term. As oil gets dearer, people will switch to other fuels and it will make sense to meet these demands provided users are willing to pay (marginal) costs. It is unlikely that over the rest of the century, supplies of other fuels can be increased without incurring higher costs, so that rising oil prices will tend to raise the price of other fuels. This however is not monopolistic greed or "parity pricing" but common sense. We cannot do much about rising oil prices, but we can adapt our fuel policy to minimise the costs. Keeping other fuels' price artificially low would simply make things worse because there would be reduced encouragement to expand their supply and because incentives for energy conservation would be reduced.

Public Expenditure and the PSBR

7. The overriding need to contain public expenditure and the PSBR during the next few years gives added reason for charging economic prices for the products of the nationalised energy industries since their prices have a direct impact on public expenditure through the industries' external financing requirements. For example, the effect on the gas and electricity industries' cash flows of prices lower across the board than they otherwise might have been is:

	£m (outturn) Effect in 1981-82
Electricity	
a) 10% price shortfall (all customers)	700
b) 10% price shortfall (industrial only)	200
c) 20% price shortfall (large users only)	240
Gas	
a) 10% price shortfall (domestic)	150
b) 10% price shortfall (industrial)	30* (£60m following year)

* Effect of staggered contract renewals.

The increase in public expenditure and the PSBR will be somewhat smaller to the extent of, for example, the reduced energy costs borne by the public sector and the increased tax revenues from higher company profits. Even so, it is clear that reductions in gas and particularly electricity prices have considerable consequences for both PSBR and public expenditure.

8. To the extent that increases in energy prices reduce the PSBR, they also tend to ease the pressure on the money supply. This effect would not be as large in the short term as that produced by an increase in direct taxes with comparable revenue implications because the temporary increase in the general price level would itself tend to increase the demand for money. Nonetheless, interest rates could be slightly lower for a given rate of monetary growth.

Industry and Energy Prices

9. It is understandable that industry should seek reductions in energy prices as one of a number of possible forms of relief during

the current recession and severe liquidity squeeze. However, there are some strong reasons, apart from energy pricing policy, for resisting any general move in this direction.

a) A financial squeeze is the necessary consequence of the Government's monetary policy, and is one of the main means by which inflation is being reduced. Substantial and widespread assistance to the corporate sector, via lower energy prices, would be inconsistent with the Government's economic policy.

b) General reductions in the price of particular fuels would probably not be a very cost-effective way of helping to maintain the long-term viability of the generality of firms which are particularly seriously affected by the recession.

c) Subsidised energy prices are not in the long-run interests of industry because they would tend to reduce the incentive to adopt more energy efficient technology and would thus leave industry in a less competitive situation than otherwise when the subsidies were eventually withdrawn.

10. However, the general considerations are not inconsistent with the possibility of more flexible industrial energy pricing at the margin. The recession is reducing the demand for energy for industrial purposes so helping to create excess capacity in some energy industries. As suggested in paragraph 4 it may well be, in this situation, in the (revenue maximising) interest of some supplying industries (eg electricity) to shade energy prices, or at least price increases, or to make selective cuts in prices to customers who might otherwise go out of business. These decisions are essentially a matter for the commercial judgement of the energy industries concerned.

11. It is doubtful however whether more flexible industrial energy pricing (stopping short of pricing which was totally uncommercial) would make a significant difference to the decisions by particular

companies on whether to continue in business or to close. On average industrial energy represents only around 3 per cent of total costs of manufacturing industry. In those sectors where energy costs represent a much larger proportion of total costs, the scale of price reductions likely to be feasible would probably not make a great difference to the overall financial position of companies.

12. Bowater's plant at Ellesmere Port is a case in point. It suffers cost disadvantages compared with average costs in Canada and Scandinavia of about £6m-£7m, split equally between wood pulp, coal and electricity. The Electricity Board would have to halve the price of electricity supplied to Ellesmere Port to bring it into line with Canadian/Scandinavian levels and would almost certainly have been subsidising Bowater at that level. The Forestry Commission were prepared to reduce the price they charged for wood if Bowater would accept a change in specification which would have reduced harvesting costs, but this would have saved no more than £¾m. To have halved wood prices, which would have required a subsidy to the Forestry Commission and to the private wood owners because the reduced price would not have covered harvesting and transport costs, would have saved only £2m. Moreover, the problems of UK newsprint producers are not confined to higher input costs, but include severe pressure on selling prices due to the fact that world newsprint prices are set by the price of Canadian newsprint which, due to a combination of depreciation of the Canadian dollar and appreciation of the pound, has nowhere nearly moved in line with rising UK production costs.

<u>International Energy Prices</u>

13. The Government is studying with the CBI comparisons of international energy prices. Whatever conclusions are reached in that study on levels of energy prices here and abroad, it will be in the UK's interest to ensure that energy in other countries is priced according to market principles. Otherwise British industry, whatever its position now, would certainly have cause for complaint about competitors' "unfair" use of cheap energy inputs. International efforts to conserve energy would also be hindered if energy prices in other countries were artifically restrained.

14. Against this background it is worth considering whether the UK should mount an initiative eg in the International Energy Agency. A low key initiative might simply be to raise in the Agency's Standing Group on Long Term Co-operation the case for charging for energy at market prices with the aim of persuading the Ministerial Governing Board to promulgate a recommendation on these lines together with proposals for monitoring its implementation. A more radical proposal would be to try to gain wide international acceptance that trade in products which embodied unreasonably cheap use of energy inputs was "unfair". For example, the Community and/or other international bodies dealing with energy might over a period of time evolve a GATT-like character whereby trade in certain goods subject to extreme kinds of subsidisation by cheap energy inputs could be restrained.

15. Our ample supplies of indigenous energy (coal, oil and gas) would provide us with a firm platform for such an initiative. We could argue that despite our plentiful supplies we are adopting market pricing principles in the interests of conservation and are eschewing subsidisation. Properly handled an initiative ought not to raise the thorny questions of Community competence over North Sea oil.

16. An initiative by the UK on these lines could be justified on its merits. Ministers might also find it politically helpful in this country to be able to demonstrate that the Government is trying to take action internationally to try to prevent unfair competition in energy products.