COVERING CONFIDENTIAL

SECRETARY OF STATE FOR ENERGY
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N Sanders Esq
Private Secretary to the
Prime Minister
No 10 Downing Street

19 February 1980

Dear Nick,

ELECTRICITY EXTERNAL FINANCING LIMIT 1979/80 AND 1980/81

I am attaching a minute from my Secretary of State to the Prime Minister about the external financing limit of the electricity industry.

My Secretary of State has asked me to apologise for the length of this minute. He felt however it was important to set out the whole picture of this complex issue before any discussion.

Yours ever,

Denis

Denis ~~Walker~~
Private Secretary

PRIME MINISTER

ELECTRICITY EXTERNAL FINANCING LIMIT 1979/80 AND 1980/81

I refer to your Private Secretary's letter of 11 February, asking for a report with a view to a meeting. Before dealing with the specific points you raise, it may be helpful if I explain the background.

In late November and early December the industry notified me that their then best estimates showed a possible breach of their EFL by £62m. I wrote to John Biffen about this on 3 December. The main reason for the breach at that time was that fuel prices had risen faster than the industry anticipated when, in July 1979, they decided on their tariff increase for September 1979. Fuel stocks had been building up during the autumn, with our encouragement, against the possibility of industrial action in the mines. In response to my expression of concern about the £62m, the Electricity Council demanded their latest and best estimates from all the Boards. They told me on 11 January of the outcome, which was an estimate of a possible breach of £254m. They accepted that we should have been notified of this earlier and I have been assured that arrangements for better reporting to the Council are in hand. Fuel stock increases (both coal and oil) were the main reason for the possible breach, accounting for £161m, and the effect of the higher fuel prices mentioned above accounted for a further £73m. At that time the industry were still expecting sales to be higher than those forecast when the EFL for 1979/80 was fixed in June 1979. They have now revised their sales forecast down in line with revised assumptions of economic growth. The latest estimate of the breach, which takes account of the effects of the steel strike so far, is £325m. The main factors underlying the breach are thus;

a) fuel prices, both coal and oil, have risen more rapidly than was expected when the September 1979 tariff increases were decided on in July 1979. Oil prices have risen particularly rapidly.

b) the industry have recently revised downwards their forecast of electricity sales for this year by 3 twh from 230 twh to 227 twh. This is because of the combined effects of 3 factors - the BSC strike, milder than average weather, and a lower general level of industrial activity.

c) wage and salary settlements were higher than expected when the EFL was set in July. Settlements accepted by union negotiators were twice rejected by ballots of the workforce. An arbitration award a few weeks ago was the final part of last year's settlement.

d) at the start of last summer the CEGB's coal stocks stood at 11.4m tonnes, lower than they had been for some years, and the Board were forecasting an end winter stock position of some 10m tonnes. Colder weather in the early part of the summer and the CEGB's response to the oil supply situation kept stocks low. The action taken by the Board, British Rail and the National Coal Board (encouraged by us) succeeded in building up coal stocks of 16m tonnes before Christmas, equivalent to 5 weeks' endurance at peak winter demand. Under the threat of a miners' strike we were grateful for these efforts. End year stocks are now forecast at 13½ mt - 3½ mt more than the original forecast.

e) oil stocks were built up in the autumn with a view to providing flexibility and increased endurance. The CEGB was able to obtain additional oil from BNOC sources (I wrote to you at the time about this) and filled its storage capacity of 1.8m tonnes by November. Thus the Board emerged from the Christmas holiday period with good stocks of coal and of oil.

My discussions with the industry have also looked ahead to 1980-81. In November 1979 we agreed an EFL for that year of £187m, based *inter alia* on assumed tariff increases of about 17% in April (corresponding to the expected general increase in the RPI) and 5% in October, consistent with the achievement of a financial target of an average of 1.8% return on assets on a CCA basis over a period of 3 years. Since that EFL was set, there have been adverse movements in several major underlying assumptions:

a) The EFL took into account expected coal price increases of 17% in March this year and 7% later in the year. The CEGB and NCB have just agreed on an increase of 19.25% for March, and the CEGB now assume a further increase of 20% in January 1981, the miners' new settlement date.

b) Electricity sales forecasts have been revised downwards in line with new GDP assumptions.

c) The industry no longer believe they can achieve a salary settlement of 12%.

It is against this background that I consider the points you have raised. I await confirmation, but it looks as if it will be possible for the industry to defer payments of about £100m from this year to next, and that they could make savings of the order of £25-£30m. This would leave a remaining excess of about £200m to be added to this year's EFL, making it £132m (- 68m + £200m). As regards next year, after taking into account the need to cope with £100m of deferred payments, the industry estimate that to hold the EFL back to the original £187m, taking account of all the adverse factors mentioned above, could necessitate tariff increases of around 21% in October, or around 15% if the increases were brought forward to July. Much depends on the timing and extent of any coal price increase in connection with the new NUM settlement date of 1 January 1981. A larger than expected increase could still leave the electricity industry in trouble with its EFL.

However, the Chief Secretary's proposal, about which you have asked, would involve reducing next year's EFL by the net amount of the breach in this year's (ie by £200m). The October tariff increase could then reach even worse levels - around 30%, or around 18% if the increase were brought forward to July.

Clearly all this is unacceptable - we are reviewing urgently the possibilities for remedial action with the industry. You have asked what scope there is for a cutback in the industry's capital investment programme, with particular reference to new power stations. The industry is reviewing at top speed its capital programmes in the light of the new, lower, load forecasts. However, particularly in respect of power stations, a very high proportion of expenditure in any year is determined by commitments entered into in previous years.

Possible fields for action include;

a) oil-fired power stations under construction (Ince, Grain and Littlebrook). Grain and Littlebrook were slowed down to make savings required by the Government for EFL purposes in the summer of 1979. The Board have been taking a tough line with the workforce on these sites; that at Ince has been substantially reduced, and the laggers' strike at Grain has brought the possibility of the closure of the site.

b) curtailment of work on the completion of Drax, where construction began on site in the autumn of 1978. Contractual commitments would probably make the cancellation of the work too expensive. The project was brought forward with Government financial aid to help the plant industry. To stop it would hit them hard.

c) the new AGR station at Heysham II. This is a course which could have great dangers for the whole of our nuclear programme. Work has not started on construction of the station, and no major hardware contracts (boilers, turbine generators) have yet been placed. The effect of serious delay or cancellation on the plant industry would be severe, and there would be repercussions for the Scottish station at Torness. As I say a setback to this project would certainly call in question our commitment to the nuclear programme I announced in the House on 18 December. I do not believe this is a price worth paying.

We could consider easing the pressure on the EFL by asking the CEGB to reduce fuel stocks. Their current forecast is that coal stocks will reach 13m tonnes by the end of 1980/81, ½m tonnes below this year's expected spring stock. Taking action to reduce coal stocks by 3m tonnes to 10m tonnes next spring would reduce working capital needs by £100m. But of course there are considerable risks in planning to reduce coal stocks. The CEGB normally build up their stocks steadily from spring to November when the peak usually occurs. However, this year the NUM settlement date has been advanced (a point the Secretary of State for Scotland has made). In the new circumstances I would hope stock levels could reach their peak earlier compared with last winter. The effect of running down coal stocks on the NCB and on the course of NUM negotiations must also be considered.

Summing up, the main features of the situation we face are;

a) rising fuel (particularly coal) costs and other factors have, in the industry's view, made it impossible for them to achieve the EFL next year on the basis of the previously contemplated tariff in crease of 17% in April and 5% in October. We shall almost certainly need a higher tariff increase in the autumn;

b) the suggestion that any excess borrowing over this year's EFL should be absorbed next year would lead to very grave difficulties and should not in my view be further pursued;

c) some reduction of financing requirements could be achieved by reducing fuel stocks, but this would be very risky in the face of the earlier NUM settlement date next year and world energy supply uncertainties.

d) the industry is reappraising its capital programmes in the light of the reduced load forecast, but there is little room for manoeuvre, and the implications for the plant industry and the nuclear programme will need extremely careful consideration and could be very dangerous.

I am sending copies of this minute to the Chancellor of the Exchequer, the Chief Secretary to the Treasury, the Secretary of State for Industry, the Secretary of State for Scotland, and to Sir Robert Armstrong.

DA

Secretary of State for Energy
19 February 1980