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CABINET

Ministerial Committee on Economic Strategy

Electricity (England and Wales) EFL 1980-81

Memorandum by the Secretary of State for Energy

As I mentioned in my minute of 16 April to the Prime Minister the Electricity Council considered their second tariff increase at a meeting on 17 April. They decided that an increase of 10% in August (with effect on bills from November) would be necessary in view of large increases in their costs since their EFL of £187m was set last November, and that even so economies beyond those already identified would have to be produced if the EFL was to be met. This paper sets out the position which has been reached.

Increase in costs

2 The following are the major elements in the increase in costs since the EFL was set:

- fuel (+ £149 m): reflecting higher coal and oil prices
- salaries (+ £87 m): reflecting salary settlements of 17-19% (the November estimate was 12%)
- reduced sales estimate (net effect + £34 m): reflecting lower economic growth

Together with the £20m roll-forward of 1979/80 payments, agreed in March, these figures would have meant that, if no action were taken, and the tariff increase of 17% in April were followed by one of 5% in October - as envisaged before these cost increases became apparent - the EFL outturn would be £477m instead of the £187m which we set in November. As matters stand, with a 10% increase in August (yielding £150m) and capital cuts of £52m (see below) the industry have still to identify £88m of savings in order to meet the EFL. This they have undertaken to do.

Economies

3 The industry has sought to identify economies wherever possible. Specifically: CEGB have cut a further £42m from their capital programme (£45m was trimmed from their programme of £700m when the EFL was set). This reflects a later start on Heysham II; stopping work on two units at Grain; deleting expenditure on a coal import facility; deferring schemes for cooling tower reinforcement, nuclear fuel discharge facilities, computing equipment etc. The Area Boards have also cut capital programmes by over £10m by eg deferring office extensions, reducing expenditure on system reinforcement and transformer replacement programmes. The scope for further capital cuts of the kind which would materially affect 1980/81 appears to be small (see Annex A).

4 The industry has also been tightening its control procedures on revenue expenditure. The CEGB are limiting manpower to the level of March 1979; this will involve staff reductions. Area Boards are also seeking manpower economies. (The industry as a whole has already reduced its labour force by 22.5% over the past 10 years). The Boards have been reviewing their holdings of sites with a view to disposal where possible and credit arrangements are being tightened. The industry are also examining the scope for further economies on revenue account, not least in order to improve the target return (see below).

Stocks

5 One element in the further £88m savings which the industry has promised may be stocks - one mt of coal = £35m; 1 mt of fuel oil = £90m. In considering any proposal to reduce stock building I shall of course have

regard to the effect on (i) strategic aspects and (ii) any consequential effect on the NCB's financial position. The "right" level of stocks is not easily defined. Year-end coal stocks give no indication of the adequacy of stock levels to meet the winter peak. Currently coal and oil stocks taken together are at about the level achieved in spring 1976, 1977 and 1978 (spring 1979 stocks were unduly low). However the balance between coal and oil in stock has altered as CEGB oil storage capacity has increased. (Spring coal stocks alone are well below those of the earlier years.) It would be premature to suggest now that fuel stocks should be reduced. The Board normally aims for 5-6 weeks endurance in the peak winter months. Uncertainties (demand, industrial relations) are such that it would be dangerous to reduce stocks below the level to sustain this endurance, with some tolerance to meet for example more than the averagely cold weather or possible problems with Magnox stations. If stock levels were to be reduced we could live to regret such a decision; it is a fact of life that the requirements of the coming winter cannot be accurately forecast, and that stocks cannot be run up and down at short notice. Nevertheless I am conscious that stocks are likely to be a key element in relation to the present and any possible future breach of the EFL, and I shall be discussing stock holding policies further with the industry.

Second Tariff Increase

6 The industry have accepted the task of identifying £88 m to meet the EFL. But this is predicated on a 10% tariff increase in August yielding £150m. (A July increase would have produced another £40m.) They believe that such an increase is absolutely necessary to the achievement of the EFL and maintaining (albeit reduced) progress towards the financial target.

7 Any further postponement, or a lower tariff increase, could I believe put the EFL at risk. There are many uncertainties in current assumptions. Sales for instance may be below even the reduced levels now assumed: this would affect both revenue and working capital, through stock levels. Further outages at Magnox stations could lead to heavy replacement generation costs.

And the fuel cost assumptions are also subject to uncertainty - though they do provide cover against substantial increase (including a 20% coal price increase from 1.1.1981).

8 The full effect of the August tariff increase on the RPI of 0.29% should not be experienced till December.

Financial Target

9 The August increase is expected to yield a CCA return of about 0.5% - uncomfortably below the 0.9% 'path' which, before these cost increases, was envisaged as the first step towards the financial target of an average of 1.8% pa over the next three years. A lower or later tariff increase - in addition to putting the EFL at risk - would yield an even lower return, and almost certainly require a revision of the target.

Conclusion

10 Because of adverse movements in the industry's costs, there is a threat to the EFL in 1980/81. To meet this the industry are making further capital cuts of over £50m, are committed to seeking further economies totalling £88m (which will require the most vigorous efforts) and are planning a tariff increase of 10% in August.

11 I invite my colleagues to note the position which has been reached, and in particular the fact that the industry regard a tariff increase of 10% in August as essential to achieving their EFL over and above other cuts and economies.

D.A.R.H.

DEPARTMENT OF ENERGY
21st April 1980

Annex A

CEGB CAPITAL PROGRAMME 1980/81

Further to the cuts of £45m + £42m which have been made, the revised programme stands at £611m for 1980/81 at March 1980 prices. The bulk consists of projects close to completion, so that sunk costs outweigh costs yet to be incurred. Halting such projects now would mean that large past expenditures, on which interest would continue to be payable, would be rendered nugatory. The following comments relate to the attached table:

a) nuclear stations under construction. I am anxious that these stations should be completed as soon as possible in order to obtain substantial fossil fuel savings. The stations have been much delayed; further delay as a result of capital stringency would be counter-productive.

b) new nuclear stations; Heysham II. Following our decision I shall be pressing the Board to get ahead.

c) oil fired stations. Expenditure on Grain, Littlebrook and Ince B is expected to total £93m. Work has already been stopped on the last 2 units of the 5 unit station at Grain. A complete cessation of work there and at Littlebrook might save about £30-40m (after taking account of cancellation charges) but would mean that total expenditure of some £800m would be rendered nugatory. Industrial relations "ripple effects" could be expected at other sites, including nuclear sites. Cancellation of Ince B would save £10m, leaving over £200m of nugatory expenditure.

d) Drax completion. Cancellation would bring onerous charges in 1980/81 which might increase the electricity industry's financial difficulties. There would be a prospect of nugatory expenditure of up to £250m, for which the CEGB could be expected to seek compensation. The CEGB are trying out a new site strategy at Drax, the success of which could have an important effect on future nuclear power station construction. Cancellation would be a serious blow to the main contractors concerned, particularly to NEI/Parsons and Babcock and Wilcox. Drax makes sense both as an outlet for coal from the new Selby mines and also in view of the movement of the coal/oil price relativity in favour of coal since the project was begun in 1977-8, and oil supply uncertainties.

e) Dinorwic. Expenditure of £66m is planned. This major pumped storage scheme in an area of high unemployment is well on the way to completion; cancellation would mean nugatory expenditure of at least £270m.

f) Cross-Channel Link. Has not yet been finally approved by Ministers. Expected expenditure in 1980/81 is only £7m; the project should show an attractive rate of return, and would add to the diversity and security of electricity supply. I understand that the French Government has recently authorised Electricite de France to go ahead.

g) Miscellaneous generation and transmission projects. Reductions have already been made under each of the two recent cuts. The scope for further reduction appears to be very small, and could result in offsetting expenditure on revenue account (eg on repairs).

CEGB CAPITAL EXPENDITURE 1980-81

MAIN HEADINGS

	March 1980 prices £m
1 Nuclear stations under construction	
Dungeness B	37
Hartlepool	52
Heysham I	31
2 New nuclear station	
Heysham II	52
3 Oil-fired stations	
Grain	35
Littlebrook D	40
Ince B	18
4 Coal-fired station	
Drax completion	136
5 Pumped storage	
Dinorwic	66
6 Transmission Project	
Cross-Channel Link	7
7 Miscellaneous generation and transmission projects	137
TOTAL	611

It does not of course follow that savings of this order could be obtained by cutting or freezing these programmes .