PERSONAL AND CONFIDENTIAL

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10 DOWNING STREET

From the Private Secretary

2 September 1980

Dear Julian

ENERGY PRICING

As you know, your Secretary of State, with Sir Donald Maitland and Mr. MacIntyre, discussed energy pricing with the Prime Minister this morning. The Chancellor of the Exchequer, with Mr. Middleton and Mr. Wicks, was also present.

The discussion provided an opportunity for the Prime Minister to give a provisional reaction to your Secretary of State's minute of 21 August, so that he and the Chancellor of the Exchequer would be aware of the avenues which the Prime Minister will wish to see explored in the further papers now under preparation.

The Prime Minister's approach stems from her concern that industry is facing simultaneous problems as a result of a strong pound, high interest rates and high energy costs. She is not convinced that even the most efficient industry is capable of coping with all three problems at a time of recession. She therefore wishes to ensure that Ministers carefully examine our energy pricing strategy against this background.

The Prime Minister quoted her own experience of private industry where, for part of the trading year, companies will sell at minimal margins or even occasionally below cost in order to spread the year's overheads. She sees no parallel to this approach in our nationalised industries, and she believes that some reconsideration is necessary. High energy prices are apparently a significant factor in recent and threatened plant closures. But the result of these closures will simply be to reduce the revenue to the industry providing energy for each plant which is closed, which will simply compound the problem of spreading the energy producers' overheads. In present circumstances, the possibilities of differential pricing would need studying.

The Prime Minister also explained her current thinking on gas pricing. The artificial pricing of oil had allowed coal costs to rise to artificial levels. Current pricing strategy was intended to put gas on a par with the other fuels, rather than to force other fuels down to gas levels. The Government's approach on these matters had important consequences for other aspects of Government

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policy. Any change in the gas pricing strategy would have an effect on the PSBR contribution made by the gas industry, but this might be recovered by increased revenue generated elsewhere. Your Secretary of State emphasised the problems faced by the gas industry in meeting current demand, which made it important not to raise industrial demand. ICI's recent profits fall was due in part to the shortage of gas. He accepted the psychological importance of the Government's energy pricing strategy, and undertook to find a means of satisfying industry that energy costs in this country were rising no more than elsewhere. The paper he had in preparation would seek ways of taking the political heat out of the energy pricing issues.

The Prime Minister emphasised that she wanted to see the Government looking at the problem of industrial costs across the board. She feared that there still tended to be a compartmentalised approach within individual Ministries. It was particulary important to look at costs and efficiency within the nationalised industries. The Monopolies and Mergers Commission's report on the electricity industry, due at the end of the year, would be of particular interest.

The discussion ranged around the issues raised by the Prime Minister. I have not attempted to record this in detail as it was essentially background for the further discussion which will take place when your Secretary of State's paper is circulated.

I am sending copies of this letter to John Wiggins (HM Treasury), Ian Ellison (Department of Industry) and David Wright (Cabinet Office).

Yours ever

Mike Pattison

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Department of Energy.