Qa 04424

To: MR LANKESTER

From: SIR KENNETH BERRILL

The Electricity Council's External Financing Limits and the Increase in Electricity Prices

1. The Prime Minister has been sent copies of recent correspondence between the Secretary of State for Energy and the Chief Secretary on the expected breach in the Electricity Council's external financing limit (EFL) for 1979/80. In this minute we in the CPRS outline the possible serious implications for electricity prices in April 1980 and November 1980.

2. The Electricity Council have warned the Government of the prospective £300m. breach in their EFL for the current year 1979/80. This £300m. over-run is almost entirely due to a combination of the unexpectedly high price of fuels (oil and coal) and the rebuilding of fuel stocks at power stations largely at Government request. The £300m. figure takes no account of the steel strike which is estimated to be costing the Council some £4m. a week.

3. The proposal is that any over-run on the 1979/80 EFL should be carried over into 1980/81 and coped with inside an unchanged EFL for that year. The 'hard line' approach is that the Electricity Council should have to meet the whole of their 1979/80 over-run. The 'soft line' approach is that they should be compensated for their 'successful' efforts to rebuild stocks (a figure of up to £135m. was mentioned in the Chief Secretary's letter - an amount which we believe could just be accommodated within the contingency reserve for 1979/80).

4. As always in the electricity industry much will depend on whether the winter of 1980/81 is abnormally cold or warm and on what happens to the price of oil and coal inputs to power stations over the year. But the 1980/81 EFL was set very tight, i.e. based on mid-range assumptions which are now proving optimistic and contained no reserve for contingencies.

5. There will, of course, be limited opportunities in 1980/81 for improved efficiency and for deferment of payments into 1981/82 but generally speaking the Electricity Council would have to plan to meet its 1980 EFL by a mixture

of (i) price rises over and above the 'inflation plus 5 per cent' already assumed for April and October 1980; (ii) cut backs in capital spending, (the capital expenditure programme for 1980/81 is currently costed at over £1 bn.); and (iii) reduction in stocks of coal and oil at power stations (a move which the Government would presumably not wish to encourage given the annual pay negotiations with the miners).

6. Each one percentage point rise in electricity prices on top of 'inflation plus 5 per cent' is worth around £50m. in a full year. A one percentage additional rise left until October would raise only £25m. in 1980/81. We in the CPRS believe that under the 'hard line' approach the Electricity Council could be forced into raising tariffs in April by the rate of inflation and in October by over another 10 per cent. Indeed, they might feel it necessary to propose this even if the 'soft line' of allowing them £135m. for stocking costs were agreed. For if the EFLs are to be rigidly applied they may feel it necessary to provide some contingency margin in October 1980 against, for example, a warm winter or unexpected rises in oil prices.

7. The problem this presents for the Government is obvious. Further public sector price adjustments in the 30 per cent region in 1980/81 have obvious implications for the Government hopes of achieving a drop in the rate of inflation that year, and on energy pricing policy the Government has recently said that gas rises should rise at inflation plus 10 per cent in order to close the gap with other fuels. A subsequent decision to raise electricity prices at, at least, this rate would look peculiar.

8. All this suggests a careful look both at the case for giving the Electricity Council some relief on its successful stocking operation and at the Council's proposed capital spending programme - including, of course, the AGR at Heysham.

9. It also suggests that the cash limits system for nationalised industries needs discussion (as the Chairmen have suggested). The turnover of some of these industries is so large (£3bn./£4bn.) that small percentage changes in sales (perhaps due to the weather) can cause variations costing not just tens but hundreds of £m. They are only allowed to change their prices once or twice a year and at fixed times. Against this how should the EFL system be operated: (a) do they put in generous contingency margins -

which could mean public expenditure cuts elsewhere; (b) are they allowed to 'take one year with another' - if so, how many years; (c) are they given retrospective adjustments for certain events outside their control (steel strike, faster rate of inflation of their raw materials, a warm winter, etc.)? There are obvious difficulties in any of these courses but in the view of the CPRS the EFL system has not yet been adequately fitted into the Nationalised Industry Sector. This year we have prospective over-runs in the post office, steel, electricity, shipbuilding, and don't quite know what to do with them.

10. Against this background the Prime Minister may wish to ask Mr Howell -

(i) what effect the prospective breach of the Electricity Council's EFLs will have on electricity prices;

(ii) if the prospective increase in electricity prices is unacceptable, what scope there is for a cut back in the Council's capital expenditure programme with particular reference to new power stations?

11. She might also, at some time, like to ask the Chancellor if he is satisfied with the system of EFL as presently applied to the nationalied industries.

12. I am sending a copy of this minute to Sir Robert Armstrong.

KB

6 February 1980

-6 FEB 1980