

9/35



Prime Minister

(1)

Agree to take meetings

PRIME MINISTER

on defence and electricity prices?

Content with the agreements

PUBLIC EXPENDITURE SURVEY

reached so far - including on

social security and education?

At its meeting on 15 July, the Cabinet agreed that our aim in this year's Survey should be to hold to the planning totals in the 1982 White Paper. I was invited to hold bilateral meetings with colleagues with a view to securing this objective.

2. I have now held discussions with all our colleagues who have responsibility for major programmes of expenditure. There are still a few loose ends - and some major difficulties - but, after some tough and extensive negotiations, we have made good progress and I believe we can come close to meeting the Cabinet's objective. In this minute I seek to inform you of the present position and to consult you on the best way to resolve the remaining problems.

3. The position so far is:-

£ billion

(1) Baseline (after Budget changes) 120.3

(2) Bids at the time of the July Cabinet

Local authority current (reduced from an initial £1.6 billion)	1.1
Programmes	4.0
Nationalised industries	1.1
Total	<u>6.2</u>

(This does not cover the bids for the Falklands Garrison or electricity prices which had of course not crystallised by then)

(3) Outcome of discussions to date:

Additional Local authority current		1.1
Net Additional expenditure on programmes		0.7
Revised economic assumptions (tentative estimate)		0.3
		<hr/> 2.1
<u>Less:</u> Further special sales of assets	0.2	
Clawback for $3\frac{1}{2}$ per cent pay factor	0.1	
		<hr/> 0.3
		<hr/> 0.3
<u>Addition to baseline</u>		<hr/> 1.8

(4) Outstanding issues:

Programme bids unresolved (mainly Defence but excluding Falklands Garrison)		0.9
Falklands Garrison		0.5
<u>Nationalised Industries</u>		0.7

The nationalised industries figure following the bilaterals is now very close to the baseline, except for the major problem of the electricity EFL and electricity pricing proposals (see para 7b)

4. Thus, leaving aside the outstanding issues, the addition to the total allocated to programmes last year would be £1.8 billion. But the planning total in the 1982 White Paper includes a Contingency Reserve of £4 billion, a figure which was, of course, deliberately larger than we need for an operational reserve. Were there no outstanding issues, we could certainly hold to the White Paper total by reducing the Contingency Reserve by £1.8 billion leaving a reserve for the year of £2.2 billion.

5. To achieve this position, some decisions are assumed to which I should draw your attention. An important element of the

package would be the recovery of a $2\frac{1}{2}$ per cent overshoot in the 1982 social security uprating. This saving is worth about £250 million in 1983-84 and £750 million in a full year. There are obvious political difficulties about this, but Norman Fowler and I are agreed that it is the right course to take and that it can be made acceptable by certain other concessions. These would include restoration of the 5 per cent abatement of unemployment benefit and partial abolition of the earnings rule.

6. There are two other areas of possible political difficulty in the packages which I have so far agreed to recommend to Cabinet. Keith Joseph's offer of a saving of £10 million on student awards will involve a real reduction in student grants, which some colleagues may find it difficult to accept. On housing, Michael Heseltine and I have reached agreement on the public expenditure totals, but he will wish to seek Cabinet endorsement of his proposal to increase council house rents by an average of £1.50 a week.

7. There remain, then, a very limited number of outstanding but important difficulties:-

(a) On defence there are still a number of unresolved issues: the total bid, on which there is so far no agreement, is for an extra £1.3 billion (including the Falklands Garrison);

(b) the figure for the electricity supply industry is also not settled. There is a substantial bid to increase the industry's 'basic' EFL due to a number of pressures for increased expenditure or reduced revenue which the industry has been unable to offset by reducing costs elsewhere. In addition, there is a further bid for moderation of electricity prices over the years 1983-86 at a cost of £500 million or more a year (the details are summarised in the attached note);

(c) I have still to reach agreement with Francis Pym over bids of about £30 million and with David Howell and

Peter Walker over smaller amounts. Discussions of these bids are continuing and I am reasonably hopeful that we shall be able to reach agreement.

8. Our ability to adhere to the White Paper figures is, therefore, likely in the end to depend on our handling of the defence and electricity issues.

9. On defence, the problems undoubtedly remain difficult; but if we could settle on a modest increase to the programme provision and further adjust the Contingency Reserve, I am satisfied that our public expenditure aims could be met without impinging on the 3 per cent NATO commitment and without re-opening what has been agreed on handling the Falklands costs. I imagine that - as John Nott has suggested - you would yourself wish to chair a meeting on the defence programme, which Geoffrey Howe, John Nott and I would attend. I would naturally expand on these comments in a paper for that meeting.

10. This leaves the electricity supply industry - and its pricing policy - as probably the most awkward of our problems. The scale of the difficulty over pricing is such that it could make all the difference between our success and failure in meeting the Cabinet remit. On present plans electricity pricing is to be discussed in E next week, but I understand that Nigel Lawson is having some difficulty in obtaining the figures he needs from the industry. In any event, because of the importance of this issue to public expenditure, you may think it useful to have an early meeting on this with the Chancellor, Nigel Lawson and myself.

11. I would of course be happy to provide details of the provisional agreements which I have made with the majority of our colleagues, and any further information that you may require.

12. I am sending copies of this minute to Geoffrey Howe and to Sir Robert Armstrong only.

L.B.

LEON BRITTAN

5 October 1982

The Chief Secretary would have in mind a meeting before E, and even if the detailed figures are not yet available.

ELECTRICITY SUPPLY INDUSTRY (ENGLAND AND WALES)

The Secretary of State for Energy has indicated that he will be putting forward a substantial additional bid, above the White Paper baseline, totalling more than £ $\frac{1}{2}$ billion for additional external finance in 1983-84 for the electricity supply industry in England and Wales (ESI).

2. The reasons for this bid are complex. One element is due to several pressures for increased expenditure or reduced revenues which the industry has been unable to offset fully by lower costs elsewhere.

3. The largest element in the additional bid is due to the Secretary of State's wish for price moderation, perhaps even a price freeze for the ESI in 1983-84. Every one per cent off electricity prices adds £70-£80 million to public expenditure. A price freeze compared to the assumption of a 7 per cent inflation rate in 1983-84 would cost some £500 - £550 million.

4. The Secretary of State's suggestion for price moderation next year follows a review of the industry's price structure by Coopers & Lybrand. It has been the policy since the 1960s to aim to set electricity prices equal to marginal costs (ie. to charge the customer for the consequences of a change in his demand for electricity). One element in these costs - representing about 20 per cent of them - has been the cost of the additional plant needed to meet an increase in demand. But because the industry will continue to have substantial over-capacity, it is not planning to build new power stations for the foreseeable future (other than nuclear stations which are justified on cost-saving rather than capacity grounds). Coopers' argument is that the plant element in marginal costs should reflect, not a new station, but the much lower cost of deferring the retirement of an existing station. The precise effect of this approach on marginal costs (and hence prices) has not yet been determined, but it is thought that they might be up to some 10 per cent lower in real terms than at present.

5. The Treasury accepts that Coopers' arguments point to some

moderation in electricity prices over the next few years. But the phasing of the moderation should depend on, besides the technical marginal cost arguments, the requirements of the Government's public expenditure/PSBR policies. The degree of price moderation sought by Mr Lawson should therefore be phased over a few years. In political terms too, the credibility of a once and for all change of the order proposed, based on a technical study of pricing policy, is questionable. It would seem to imply that for some time now we have allowed electricity prices to be far too high.

Beneficiaries

6. The precise beneficiaries of the price moderation are still unclear. But since the intention is to moderate the general level of prices a large proportion of the benefits would probably go to domestic and commercial consumers (shops and offices etc) (roughly 60 per cent). The rest would go to industry. The intensive electricity users would benefit proportionately least. They already receive many of the benefits of the arrangements recommended by Coopers through the scheme announced in the last Budget.

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overpaying*



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DRAFT PRESS NOTICE

PUBLIC EXPENDITURE PLANNING AND PAY

As is usual at this time of year the Government is reviewing its plans for public expenditure. As part of the process of reaching final decisions on the cash total for each programme for 1983-84, it is necessary to decide what provision should be made for wages and salaries. Such provision is determined principally by the numbers employed and the rates at which they are paid.

A decision has now been taken to budget for sufficient additional cash in 1983/84 to provide for average increases in wage and salaries bills by 3½% from due settlement dates.

This decision concerns the cash provision to be made in public expenditure. It is not a pay norm. Each Department has its own specific budget, within which expenditure on wages and salaries must be accommodated.

This decision relates to those groups for which provision is made in monies voted by Parliament, save that a decision about the provision for the wage and salaries element in health service expenditure is not being taken for the present. It does not directly cover the local authorities or the nationalised industries,

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which are not within the Government's direct control, but they will be constrained respectively by the rate support grant proposal and by External Financing Limits.

NOTE FOR EDITORS

A similar announcement about the provision for pay in 1982/83 was made on 15 September last year. The rate of inflation is already much lower than at this time last year, when the corresponding figure for 1982/83 was fixed at 4%.

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10 DOWNING STREET

From the Private Secretary

11 October 1982

PUBLIC EXPENDITURE SURVEY

The Prime Minister was grateful for the Chief Secretary's note of 5 October.

She endorses the approach he has been following in his recent discussions with colleagues, and will herself be taking meetings on defence and electricity prices during the coming week.

The Prime Minister notes the areas of possible political difficulty singled out by the Chief Secretary in his report on the agreements he has so far reached. She has commented that she is content with what has been agreed - so long as these decisions can be got through the House of Commons.

I am sending a copy of this letter to John Kerr (HM Treasury) and Richard Hatfield (Cabinet Office).

M. C. SCHOLAR

John Gieve, Esq.,
HM Treasury.

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