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Prime Minister ②

AT 19/10

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ

01 211 6402

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer

19 October 1983

Dear Chancellor,

Thank you for your letter of 17 October.

I am becoming increasingly concerned at the Treasury's attitude towards the nationalised energy industries.

I thought the responsibility of my Department was to endeavour to see that these industries had proper financial targets set and were well managed so that they could achieve them. Increasingly I am gaining the impression that they are being looked upon as an area in which taxation can be raised in order to assist in meeting any adverse variations in the public sector borrowing requirement.

If the Government decided that this is an area of fine flexibility for tax purposes, then I think that should be clearly stated as being Treasury policy, and Treasury taxes should be imposed upon the fuels accordingly.

What I find particularly disconcerting is that the case to get more from gas is presented as an argument about economic pricing; but because this argument does not produce the required result on coal or electricity, different arguments have to be used as far as they are concerned, including the latest argument that we should actually ignore a financial target that you as my predecessor formally set.

I believe we will have immense difficulty in persuading the Gas Corporation to go for a 5% increase let alone the 6% which you are suggesting. They are adamant that a 4% increase would be adequate and would give them financial returns beyond those that the Government had set for previous years. It may be that, even with a 5% increase, they would refuse to do what we want. It could then only be done by massive increases in the gas levy or by Government directives backed by special legislation imposed on the Gas Corporation in the face of strong opposition from the BGC Board, all gas consumers, both industrial and domestic, and probably

Members of Parliament. I still judge, therefore, that the Government's best attainable position would be if I could persuade the Corporation to accept a 5% increase.

As for electricity, detailed financial targets have already been given to the industry, targets that are known publicly, of course, by electricity consumers. These targets are going to be exceeded substantially both this year and next. Currently the Electricity Council are discussing whether or not to give a substantial rebate to consumers this year with a freeze next or, alternatively, giving no rebate this year but reducing the tariff next year. There is no way the Electricity Council would agree to increases in price next year since these would result in massive profits and massive additional income beyond the target set for them by the Government. Here again in all probability we would face having to issue directives and perhaps legislate through Parliament to impose the increases that you have in mind.

On coal, I would simply repeat my view that we have appointed Ian MacGregor to do a job and we must let him do it. He is not prepared to lower figures on investment until he has had time to assess what is practicable.

I must say, looking at your paper on the cuts in general, for this Department to have already offered you savings of £1.75 billion compared with the baseline is a very remarkable performance and I am staggered that looking at the range of savings elsewhere compared with this, you now continue to press for increases in prices which will of course be highly inflationary, will not be good for industry and will cause, in my judgement, very severe Parliamentary difficulties.

I am copying this letter to the Prime Minister, George Younger, Norman Tebbit, Peter Rees and Sir Robert Armstrong.

John Neilson

p.p. PETER WALKER

(approved by the Secretary of State and signed in his absence)

19 OCT 1983

10 DOWNING STREET

(2)

Prime Minister

To note deteriorating relations between Treasury and Energy. On gas prices I have already minuted out your view as being that a 6 per cent increase for domestic prices from 1 January 1984 is needed if ground gained by 3 x 10% increases is not to be lost.

The other contentious items, in particular whether a price freeze or something less can be afforded for electricity; and whether NCB investment should be cut back, will have to be adjudicated by the MISC group.

AT 19/10

CC NO

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Prime Minister

AT 19/10

CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SWIP 3AG

Rt Hon Peter Walker MBE MP
Secretary of State for Energy
Thames House South
Millbank
LONDON
SW1P 4QJ

19 October 1983

CST to PM 18/10/83.

Dear Secretary of State

will repeat if required

Thank you for your letter of 14 October following up the points which we discussed at our bilateral on 27 September. I am grateful to you for setting out your position in detail. You will now have seen my minute to the Prime Minister summarising my position but I thought I should set out my views to you in more detail.

2. Unfortunately you are still a long way from the contribution that I need to achieve our target for the nationalised industries. Indeed the position is worse than we reached at the end of our bilateral. I explained in my letter to you of 23 September that I needed at least £600m a year from your industries [bids] towards the £1 billion a year target we agreed in E(A) Committee in July. At our meeting you offered specific savings of:

				£m cash
	1984-85	1985-86	1986-87	Total
Savings offered (27 September)	-350	-235	-435	1020

The savings now proposed are:

Savings offered (14 October)	-139	-354	-532	1025

This is still below the total of £1200m you said you would offer, let alone the £1800m I need. It is over £200m less in the crucial first year, where you are still well over baseline.

3. As you must have expected, I cannot accept your position. Overall I still need from your industries:

Further saving	400	300	75	775

National Coal Board

4. I must confess to some surprise that in just over two weeks since we met, the NCB have suddenly revealed a reduction in sales next year of over 2 per cent. This eliminates the savings in operational costs you identified. Are we sure this is a realistic assessment?

5. The major area of disagreement between us is investment where you have withdrawn £125m of the savings you offered, which themselves fell far short of the figures I thought reasonable. It seems to me tha the case for reductions is unassailable:

(a) The Monopolies and Mergers Commission severely criticised the NCB's investment programme in their report published in June. They revealed in particular that "over one third of the Board's expenditure on large major projects has gone into collieries which are either unprofitable or of doubtful profitability". They specifically recommended a "much more cautious approach to investment intended to increase or maintain production capacity, at least until such time as it is fully satisfied that it will be able to eliminate high-cost excess capacity".

(b) They also cast major doubts on the outcome of investment intended to increase efficiency, reporting that "NCB has tended to under-estimate ... the prospective costs which a colliery will experience following investment". This is confirmed by the fact that, despite over £6000m of investment in NCB over the last decade (at today's prices), productivity has increased by less than 10 per cent.

(c) NCB's investment programme is already huge (representing (17 per cent of turnover) compared with industry generally (5-6 per cent)).

Against this background it is extraordinary that the NCB can simultaneously report a further down-turn in sales and argue that the level of investment must be sustained unchanged.

Electricity

6. I must make it unequivocally clear that I have not agreed to a freeze in electricity prices next year, contrary to what you say in your letter. Indeed since we met it seems that the case has weakened. The ESI are now forecasting the following pattern of real price changes:

	1984-85	1985-86	1986-87
Real change in electricity prices year-on-year	-5*	+1	-2

Economic pricing is supposed to give consumers a clear signal on which to base their decisions. They will hardly get that if the ESI reduce prices in real terms in one year only to increase them by more than the rate of inflation the next. We think there is a strong case for a smoother path, with a real price reduction of, say, 2 per cent in April 1984.

7. Although they have come through well in the later years I am disappointed that the ESI have not offered any further saving in 1984-85. It appears that they are not even reckoning to achieve fully the efficiency aim for that year which was agreed this Spring. Such independent evidence as there is suggests that aim is not arduous. In their report on the Yorkshire Electricity Board published last month, the MMC recommended that it "should be treated as a minimum requirement".

8. Last year the Electricity Council overstated their future costs leading to a forecast £170m undershoot at this year's EFR and an unnecessarily low financial target. Are we convinced that they are not being similarly cautious this year?

9. You mentioned two avenues for savings. As I indicated in my letter of 23 September, we shall need to use the ESI's undershoot this year to offset the comparable overshoot by the NCB, so as to avoid a net increase in public expenditure this year. This is not therefore of any help to the problem for 1984-85. It is useful to have identified possible receipts from sales of CEGB's coal stockpile on the Continent, but unfortunately I need a firm figure for the present purpose.

British Gas Corporation

10. The Chancellor has written to you separately on the pricing proposals in your letters of 21 September and 14 October. On the basis of a domestic price increase in January 1984 in line with the conclusions of the meeting at No.10 on 13 September ie. 6 per cent, there would be an additional benefit to BGC's external finance of:

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* gives no average increase if inflation is 5 per cent.

	1984-85	1985-86	1986-87
			(£m)
	-48	-23	-31

Ending the industrial gas price freeze in January 1984 is more difficult to cost. But from discussions between our officials the benefit should be at least:

-60	-30	-30

11. I accept that BGC have identified some cost savings. But a significant proportion of these come from changes to economic assumptions and flow-through effects from changes to the revenues assumptions. We did not discuss in any detail further scope for cost savings at our bilateral. Given the evidence in the Deloittes report for potential annual savings of up to £100m from improving working practices, I am convinced that, from some combination of cost savings and reductions in capital expenditure and working capital, it is possible to find further savings of:

-50	-50	-50

12. Taking these areas of savings into account would provide a contribution of £450m towards the targets agreed in E(A) rather than the £85m you are offering.

13. Taken together, there is clearly substantial scope for bridging the gap that remains between us on the nationalised industries.

Departmental Programme

14. I am grateful for the very positive approach you have taken to finding savings on your Departmental programme. Overall I can accept the figure you are now offering for the UKAEA, although I hope that we can firm up on the £2m increased funding by BNFL when we come to the Estimates for 1984-85. When BNFL comes up for privatisation, we shall need to clarify and codify its financial relationship with UKAEA very clearly. Obviously the presumption must be that the Company would pay the full cost of work done for its benefit.

15. You are, of course, perfectly entitled to bring forward additional bids next year. I have two immediate reactions to those you mentioned. First, I share your scepticism about whether it is appropriate for the Government to fund these High Security Fences at all. Second, it is important that the UKAEA should have to absorb the costs of dealing with nuclear wastes within an agreed programme. Otherwise we shall be perpetually at risk of surprises of the pre-1971 kind.

16. Finally, I very much welcome the broader review of the UKAEA that you are planning to undertake before next year's PES. This seems entirely consistent with our approach to long-term

public expenditure and more satisfactory for the Authority too. It was also good of you to invite Treasury officials to be associated with your review.

17. Copies of this letter go to the Prime Minister, George Younger, Norman Tebbit and Sir Robert Armstrong

Yours sincerely

J.G. Grieve

for PETER REES

[Approved by the Chief Secretary]

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PRIME MINISTER

Some progress with Mr. Walker but a long way from agreement on gas and electricity prices. On NCB investment a deal is possible to cut the EFL but not to show it as reduced investment.

I have warned Mr. Walker's Office that you are anxious to settle the public expenditure survey at the 10 November Cabinet; and that if he does not settle with the MSC Group next Monday or Tuesday you are unlikely to try and settle with him before Cabinet.

I warned that he might therefore need to reconsider his China trip. He could come home direct from China around 8 November rather than spending the last two days in Hong Kong. But this might look unfortunate diplomatically. He might therefore want to cancel the whole thing. In any case, if he is forced to go to Cabinet he may prefer to stay at home in order to prepare his case.

Agree this line? — I very much hope he will be able to agree and carry out his full China trip (& Hong Kong)

MT

AT

28 October 1983

SECRET