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cc R.T. [unclear]

From the Principal Private Secretary

5 February 1988

Dear Stephen,

PRIVATISATION OF THE ELECTRICITY SUPPLY INDUSTRY

The Prime Minister and your Secretary of State had a discussion of almost two hours yesterday evening with the Chairman of the Central Electricity Generating Board (CEGB), Lord Marshall, about the privatisation of the Electricity Supply Industry.

Lord Marshall said that the Secretary of State's proposals were neither good for the consumer nor for the nation; electricity supplies would be both insecure and more expensive; and they would lead to the end of nuclear power in this country. Lord Marshall then proceeded to elaborate these points.

The Secretary of State's proposals gave the obligation to supply to the Area Boards; and thus put them in the driving seat in the industry. Divorcing transmission from generation would separate the industry's brain from its body. The proposals amounted to an unprecedented experiment of staggering size. The structure suggested operated nowhere else in the world, precisely because other electricity supply industries had recognised that it would not work. The separation of responsibility for the grid from responsibility for managing the industry's main resources was a classic error of management. It was fundamental for there to be a large generator within the industry with the obligation to supply. That large generator had to be given as many obligations as possible if it was to maintain electricity supplies.

Lord Marshall's second argument concerned people. He recalled that during the coal strike, he had pleaded with the Prime Minister never to emphasise the CEGB's role. That reflected his policy of keeping politics out of the CEGB. For the last five years he had drummed into his staff their fundamental obligation of maintaining electricity supplies. He hoped that he could now say that as a result industrial action to disrupt power supplies was inconceivable. But if the obligation to supply was removed from the Generating Board, the Board's only obligation to maintain electricity supplies would be the need to meet commercial contracts. That would be a weak restraint on the CEGB unions. He

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feared if the industry lost its obligation to supply, it would lose its sense of responsibility.

His third argument concerned the nuclear power programme. By providing leadership, the CEGB had preserved the nuclear programme through Chernobyl, the Sizewell inquiry and other vicissitudes at a time when it had disappeared in many countries abroad. But the privatisation proposals would transfer the leadership role for promoting nuclear power from the Generating Board either to the Area Boards or, under some scenarios, to the Government. He did not believe that in those circumstances a planning inquiry would ever again sanction a nuclear power station. The Generating Board would not be able to speak with authority at inquiries on such issues like the site and economics. It could only speak up on safety aspects. Moreover, the Board's shareholders would not want to expose themselves to the nuclear risk. Of course, the Government could stipulate that a certain proportion of power supplies had to come from nuclear generation; and that might help at planning inquiries. But it would signal that the Government had lost the political argument.

Lord Marshall emphasised that the CEGB were not asking for a monopoly. 10 per cent of power supplies were already provided from outside the Board; and this percentage could grow. The operation and finances of the grid could be made transparent and there could be proper regulation. The Board were ready to contract out the building of new power stations, such as the one at West Burton, to the supplier who would build it at the cheapest price.

Concluding his presentation, Lord Marshall said that he had spoken as a scientist. He emphasised that the electricity supply industry was a unique industry: if it failed to deliver its product, there would be catastrophic national consequences. He would do his best to make the Government's chosen system work. But he had to tell the Prime Minister and Ministers in advance that it would fail. He was speaking for his whole Board, including the outside members, Mr. Giordano, Mr. Walker, Sir Terence Beckett and probably Mr. Wilkinson(?). He would have to voice his doubts in public. He did not wish to frustrate the wishes of the Government. Indeed, he would carry them out but then he would see everything fall apart.

Following Lord Marshall's presentation, there was considerable discussion between the Prime Minister, the Secretary of State and Lord Marshall. During that discussion, the Prime Minister said that she was bound to take Lord Marshall's arguments very seriously. But she had to remind him that the Secretary of State and she had tried to devise a scheme which would meet as many as possible of the CEGB's objectives. Lord Marshall should know that some Ministers had argued for structures which would have introduced greater competition into the system. She had insisted that the new structure should give a large role to the Generating Board. She understood the CEGB's wish to keep ownership of the grid. But no-one would believe that

real competition had been introduced into the system if the CEGB continued to control the grid and thus to have a significant influence on new entrants into the system. She was as passionately pro nuclear as Lord Marshall. But she could not see why the arrangements which the Secretary of State had described to him would damage the nuclear programme. She could see no greater problems in securing approval for nuclear power stations than now. Nor could she accept that the proposals would introduce politics into the industry which, after all, was nationalised and subject to ultimate political control. The Prime Minister then recalled her understanding of the system in Switzerland and Austria where the grid was obliged to take power generated by private firms. She emphasised that the Government had to take a longer term view. Although she trusted Lord Marshall not to exploit monopolistic aspects of the system, she could not trust his successors. The structure suggested by Lord Marshall provided insufficient scope for competition.

Your Secretary of State emphasised the importance of transferring the obligation to supply to the distribution companies. The contracts between the distribution companies, generating companies and the grid would be a key element in ensuring security of supply. The workforce, who would be the shareholders in the business, would recognise the importance of fulfilling contracts. The Government would be exposed to great criticism if it adopted the solution favoured by Lord Marshall, especially following the criticism of BGC and BT privatisations. Retention by the CEGB of the obligation to supply would place an effective limit on the number of outside generators. The distribution companies would in those circumstances be the captive of a monopolist generating company. The Secretary of State thought that it was common ground that it was technically possible to operate a separate grid and generating company. The respected consultants, Merz, McClellan had advised that his approach was viable. The argument was about costs. He believed that the the structure he had suggested would lower costs through competitive pressures.

The following points were made in general discussion.

- (i) The Prime Minister asked whether the transfer of the obligation to supply to the distribution boards would create extra costs for the system. Would the distribution companies budget for more spare capacity than they really needed in order to over-insure against failure to meet their obligation to supply? Would a greater margin of spare capacity be required in those circumstances compared to the existing arrangement where the single generating board had the obligation? The Secretary of State pointed out that the distribution boards and the grid company would contract with each other so as to keep the costs of extra spare capacity to the minimum;
- (ii) Lord Marshall said, in reference to the Prime Minister's comments about foreign generating

systems, that the system in England and Wales was unique in that it was based on a national transmission grid. It had substantial cost and operational advantages. Abroad, generating stations tended to cluster round their markets with only tenuous links with other generating systems. There was always a generator who had responsibility in his local area for supply. If he broke his contract and failed to supply his customers, he would lose his licence;

- (iii) Lord Marshall maintained that in an industry where 80 per cent of the costs came from the generating side, there would not be sufficient spare capacity available to allow proper competition. Competition required spare capacity which could be called in when the market so demanded. But the costs of maintaining spare capacity were so expensive as to make it unlikely that such spare capacity would be available. The system would degenerate into a cost plus arrangement. The generators would run plants to maximise their commercial returns, not to maintain supplies. The Secretary of State pointed out that the existing system was effectively cost plus. The arrangement he proposed would put pressure on the generators to reduce costs. Moreover, the generators would only receive payment if they maintained supplies;
- (iv) The Prime Minister noted that the private generators argued that the 1983 electricity legislation had not achieved its objective of stimulating private generation because they had never been given a reasonable deal by the CEBG. Lord Marshall replied that the 1983 legislation had not worked because in order to reduce prices the CEBG had been persuaded by the Department to lower the capacity charge element in their tariffs. The Board had now raised that element and private generators were showing much more interest;
- (v) Lord Marshall said that in the structure he envisaged, there was nothing to prevent the distribution companies buying power directly from private generating companies. The CEBG would take account of such power supplies when judging how to implement their obligation to supply. In discussion with your Secretary of State after the Prime Minister had left the meeting, Lord Marshall emphasised this point, arguing that the Department's diagrammatic representation of the CEBG's preferred structure, showing private generation feeding power into the CEBG, was misleading. Your Secretary of State replied that the private generator would not be well placed to offer back up facilities if his supplies failed. It therefore would be most unlikely for private generators to make satisfactory arrangements to provide power direct to Area Boards

on any substantial scale under the CEGB's preferred structure.

Concluding the discussion, the Prime Minister said that she would need to consider further Lord Marshall's arguments with the Secretary of State and the other interested Ministers. It was essential to create a structure which provided genuine competition. The Government could not put itself in a position where it could be said that they had created a private monopoly from a public monopoly. Lord Marshall should reflect on the discussion too, and see how he could meet the Government's objectives.

Yours truly
Nigel Wicks

N. L. Wicks

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