

MEETING RECORD

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SUBJECT CC MASTER



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10 DOWNING STREET

LONDON SW1A 2AA

28 September 1989

From the Private Secretary

Dear Stephen,

ELECTRICITY PRIVATISATION

The Prime Minister held a meeting this morning with your Secretary of State and others to discuss the issues set out in his minute of 26 September. Others present were the Chancellor of the Exchequer, the Secretaries of State for Trade and Industry and Scotland, Sir Robin Butler and Richard Wilson (Cabinet Office), Sir Alan Walters and Greg Bourne (Policy Unit).

I should be grateful if you and copy recipients would ensure that this letter is given a restricted circulation.

Your Secretary of State said that there was an urgent need now to settle the legal regime under which the privatised electricity companies would operate. The latest timetable for flotation would only be met if the issues in his minute were resolved in a matter of days. Holding to the timetable would require full co-operation from all the parties in the industry; there was no prospect of sticking to it if positions were disagreed. Allowance had to be made for the various time lags in the run-up to flotation; for example finalisation of contracts would take some four months once the legal framework was settled, the development of the computer software for the unprecedented new trading arrangements would require six months, and prior to flotation the new companies would need to have been operating and have financial and profit records for a period of some five months.

It was now clear that the contracts approach agreed between Ministers in July could not be agreed with the industry. Equally the proposals the industry representatives had put forward earlier this month were totally unacceptable on competition grounds. Your Secretary of State had therefore told the industry a revised approach was needed and, after difficult negotiations, the revised package set out in his minute had been agreed. This package was not ideal on competition grounds, but he believed it was acceptable. It had to be borne in mind that any attempt further to change the package would have major side effects, particularly on the coal industry. There was a serious danger of the Government being faced with united opposition from all sections of the coal industry.

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Continuing, your Secretary of State said he had discussed the position with the Director General of Electricity Supply. The DGES would have preferred a shorter transition, but your Secretary of State thought he would accept the present proposals.

In discussion the following main points were raised:

- (i) Your Secretary of State was to be congratulated on what he had achieved in the latest re-negotiation with the various sections of the electricity industry. But concerns remained about whether this provided for an adequate degree of competition. Both small businesses and domestic consumers faced the danger of being squeezed by the continuing monopoly elements in the package, in particular the proposed 1MW restriction for the first four years and the 0.1MW restriction for the following four years. These arrangements for segmenting the market could also give rise to great scope for bureaucratic disputes as the system was implemented. Against this background, it was likely that the package would face challenges, either from the official regulators in the form of the DGES or the European Commission, or from aggrieved parties such as the independent electricity producers through the courts. Such challenges in turn could create major political problems during the implementation of the privatisation.
- (ii) On the other hand, it was argued that the package provided for substantial protection for domestic and other small consumers, for example via the RPI minus X formula and the provisions against cross-subsidisation which would be operated by the DGES. As regards the position of independent producers, your Secretary of State had powers under the Act to issue second tier licences to them and he had every intention of so doing. It would not be possible to widen the existing scope for independent producers during the transition, but the intention was to ensure that the DGES retained maximum flexibility and discretion in the implementation of the aggregation and other rules during the 1MW and 0.1MW transitional phases. As regards the European Commission, initial informal contacts suggested that they were unlikely to cause major difficulty over the proposed package, although the position was necessarily uncertain. Whether or not there were large scale attempts at litigation by aggrieved parties would depend crucially on the attitude adopted by the Commission and the DGES; if they indicated they were satisfied with the overall framework, the prospects for successful litigation would be much reduced.
- (iii) In assessing whether the competition aspects of the new regime were adequate, it had to be borne in mind that the industry was being moved from a present position of total monopoly. Against that background, the package proposed by your Secretary of State represented a major improvement. It would however be possible to

consider whether the various parties in the electricity industry could be persuaded to accept some further modest changes to the transitional arrangements. They were most unlikely to accept a reduction in the four year period for the first transitional stage; but it might be possible to reduce the second transitional phase from four years to two years.

- (iv) Given the complexities of the electricity industry any contracts-based approach was bound to be bureaucratic. A better approach might be to base the arrangements on maximum use of the price mechanism. The tax system could be used to raise the price of electricity produced from fossil fuel sources (for example, to reflect their full costs including the impact on the greenhouse effect) to a level equivalent to the full cost of nuclear production. It would then be possible to recycle the proceeds of such a tax back via price discounts to consumers. Such a radical change of approach would however require new primary legislation, and make it impossible to achieve the completion of privatisation during the lifetime of the present Parliament. It had also to be borne in mind that long-term contracts would play an important part in attracting investors to subscribe to the flotation of the electricity companies.
- (v) The major problem underlying the difficulties of negotiating an acceptable contracts package was the position of the coal industry. Satisfactory arrangements had to be reached to avoid disruption and to achieve an orderly run down in this sector. There could, for example, be no question of changing the independent review procedure for colliery closure proposals. It was also essential for endurance purposes to maintain fully adequate levels of coal stocks. It was therefore for consideration whether there were any measures which could simultaneously achieve these objectives for coal while easing the difficulties of securing a satisfactory electricity contracts package. One possibility might be for the Government to assume responsibility for financing a tranche of coal stocks which might be viewed as a strategic stockpile. Against that, however, the real difficulty in the contracts arose from the size of the continuing flows rather than the level of coal stocks. Moreover, there seemed no major difficulty in the various parties reaching agreement on the volume of coal being contracted between BC and the electricity companies at around some 60 million tonnes; rather the point of issue was the price at which that volume of coal would be contracted. In addition, if the Government financed coal stocks this would give wrong signals to the industry.

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(vi) Consideration had also to be given to the implications for Scotland of a contracts package which did not allow adequate competition. With the planned increase in the capacity of the inter-connector Scottish electricity production could be viewed as a residual source of supply for that market. A eight year transitional period could serve to freeze out Scottish production from that market and adversely affect the flotation prospects for the Scottish electricity companies. Alternatively it would be necessary to have arrangements which enabled the Scottish companies to be part of the managed market.

(vii) It was noted that your Secretary of State would shortly be coming forward with detailed arrangements for the Magnox nuclear stations. The key issue that had still to be resolved was who would hold the licence. It should however be possible to find ways through this difficulty.

Summing up the discussion, the Prime Minister said that the Group had had a thorough discussion of the position reached and the available options. It was agreed that the top priority was to achieve the successful completion of electricity privatisation within the lifetime of the present Parliament. Your Secretary of State had achieved a great deal in his discussions with the parties and it was recognised that the revised proposals he had persuaded them to accept would go a long way towards improving the arrangements for competition in the privatised industry. It was agreed that he would now seek to persuade the parties to accept a reduction in the total length of the transitional period from eight to six years; if this could be achieved it was likely to be in the second phase of the transition. It would however be for your Secretary of State to judge in the light of his further discussions with the parties whether such an improvement could be achieved consistent with keeping to the very tight timetable now required. Meantime the Chancellor of the Exchequer should discuss with your Secretary of State and the Secretary of State for Scotland the detailed schedule and timetable for the flotation of the various new electricity companies. Your Secretary of State would shortly be putting forward detailed proposals on the outstanding nuclear issues.

I am copying this letter to the Private Secretaries to the Ministers attending and to the others present.

Yan.
P.G.

PAUL GRAY

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Department of Energy.