CONFIDENTIAL

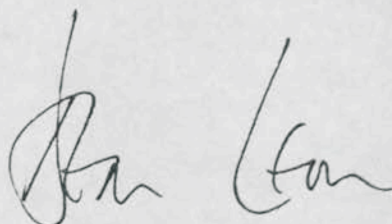
Prime Minister

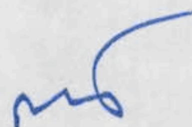
MES 21/2

01 211 6402

The Rt Hon Leon Brittan QC MP
Chief Secretary to the Treasury
Treasury Chambers
Parliament Street
LONDON SW1

21st February 1983





NEW FINANCIAL TARGET AND PERFORMANCE AIM FOR THE ELECTRICITY SUPPLY INDUSTRY (ENGLAND AND WALES)

In my announcement on 12 November last year of the electricity prices standstill in 1983/84, I said that I would announce as soon as possible a new financial target and performance aim for the industry, agreed with them, which would take full account of the conclusions the industry and I had reached on economic pricing.

Following further discussions with the industry and with your officials, I should now like to propose a financial target for the years 1983/84 and 1984/85 of an average return on average net assets of 1.3% (CEGB capital work in progress would be included within the asset base, but MWCA would continue to be excluded from the calculation of profit). This rate of return reflects the economic pricing principles which Ministers collectively agreed at the end of last year, together with further work on the application of those principles. As the note at the annex shows, this work has confirmed that a zero increase in prices in 1983/84 represents an adjustment which is at the lower end of what is required. There is strong evidence that the industry will over-recover its marginal costs in 1983/84 by at least £300 million even on the most conservative estimate. This implies that electricity prices still contain an element of tax on the user which cannot be justified in the circumstances of the present recession. I shall be examining this further, with the industry, on the basis of Coopers' investigation last year.

The target I am proposing implies a small further correction of over-pricing in 1984/85; prices are expected to increase in that year by approximately 1½ percentage points below the rate of general inflation. However, I should not wish to set a three year target, thus effectively determining the level of prices in 1985/86. In any case, in view of current uncertainties over, for example, the level of future coal prices to the CEGB, I very much doubt if we should be able to sustain a target for three years without amending it (as we have been under pressure to do for the present three year target). I should emphasise that my proposal fully conforms with the EFL we have already agreed

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for 1983/84 and with the agreed EFR for 1984/85. No additional calls on public expenditure are involved - although as you know we are under considerable pressure from the CBI to reduce electricity prices further for certain specific industries.

My proposals for a performance aim have also been thoroughly discussed between our officials and with the industry. I propose that the industry should aim to reduce its controllable costs by 4% over the period of the financial target (ie a 2% per annum reduction). I believe that, given the poor prospects for growth in sales of electricity, this is the most demanding aim which could be set while leaving the industry with some prospect of achieving it - a necessary condition if proper motivation and incentive to management is to be maintained. It will require cost savings beyond those already contained in the financial target assumptions. As it is, the projections on which it, and the financial target, are based include sales forecasts which are already beginning to look rather optimistic. Controllable costs for the purpose of the performance aim are defined as costs per unit sold (excluding the effect of fuel price changes, depreciation, rates and general inflation), so that a short-fall in sales will automatically increase costs per unit in the short term. We have agreed with the industry that the overall performance aim will be reflected by the Electricity Council in aims for each of the Area Boards and the CEGB. The Council and the Department will monitor performance against the aims and an account of progress will be included each year in the Annual Report.

A performance aim for the esi has not been set before and while I am satisfied that the present definition of controllable cost will provide an effective incentive to management, it is possible that in the light of experience we may be able to propose refinements. Taking this factor, together with the uncertainty in costs and sales movement over two years ahead into account, I do not think it would be right to set an aim for more than two years in the first instance. I do however attach considerable importance to the performance aim as a discipline on the industry and it would certainly be my intention that a new aim should be set to follow the first one.

I am under considerable pressure to set and announce a target quickly. I hope therefore that you will be able to accept these proposals.

I am copying this letter to the Prime Minister, the Chancellor, the Secretary of State for Industry, the Secretary of State for Scotland and John Sparrow.

Yours
Nigel

NIGEL LAWSON

ANNEX

MARGINAL COST PRICING OF ELECTRICITY

The Secretary of State for Energy's minute tothe Prime Minister of 18 October 1982 advised that, in the light of studies carried out by the consultants Coopers and Lybrand and by Government, current electricity prices were found to be higher than would result from a proper application of economic principles. Criticism focussed particularly on the capacity charge (representing about 20% of the esi's revenue recovery). it was generally agreed that in present circumstances of over-capacity in the industry, this should not contain cost elements related to construction of new capacity but should be based on the cost of retaining existing capacity. It was also proposed that prices should only reflect those overhead cost elements which are marginal, ie those which increase in porportion to increases in demand.

2. In subsequent discussions with theCEGB officials established that the 1983/84 Bulk Supply Tariff (BST) has in fact been constructed in the following way:

(i) The unit rates (which recover some 80% of the esi's revenue), calculated on a marginal cost basis, will recover some £5600 million;

(ii) The capacity charge related to the cost of retaining existing plant will recovery some £890 million, comprising some £470 million of plant related costs and some £520 million of overheads;

(iii) CEGB overheads amount in total to £810 million. To recover these in full, the balance of £390 million has been added into the capacity charge. An additional £480 million has been included, to bring the CEGB's profit up to about £300 million giving total revenue recovery of £7260 million which is consistent with a price standstill.

3. A marginal cost based tariff would raise £5600 million through unit rates and £890 million through the capacity charge. To this could be added whatever proportion of the £390 million balance of overheads was judged to be marginal in future. The Coopers Report, with which the Department agree, expressed strong doubts about this. However, even if the whole of this item were judged to be marginal, prices next year will be pitched almost £500 million above the level which could be justified by marginal cost pricing; even if it were thought necessary for accounting reasons for the CEGB to break even before interest this would still put 1983/84 prices some £300 million above economically justifiable levels.

COAL

4. AsCoopers and Lybrand, and the CPRS in their report on electricity pricing recognised, correct coal pricing must be an important part of correct electricity pricing. The 18 October 1982 minute to the Prime Minister indicated that

desirable changes in coal pricing policy could also lead to further reductions in electricity prices. Coal pricing policy is currently under review; in the meantime the CEGB are in 1983/84 continuing their past practice by assuming for electricity pricing purposes that the resource cost of coal at the margin is 95% of its average actual cost. In fact, under the agreement with the NCB concluded in November the discount offered by the NCB for the marginal tonne of coal is not 5% but 11%. Given present low world market prices for coal, it would be hard tojustify an electricity pricing policy which assumed that the marginal tonne of coal had the same resource cost as the average price charged by the NCB. If however the CEGB's energy rates were to be based on 100% of the financial costs of coal (rather than 95%), this would raise at most an additional £200 million in revenue. This would still leave 1983/84 prices substantially above those indicated by marginal cost calculations.

1984/85

5. Marginal costs and average costs are expected to move broadly in step. It follows that unless prices rise more slowly than unit costs, they are likely to remain significantly above the levels indicated by marginal cost pricing. The financial target proposals in fact envisage a small additional correction of under-pricing in 1984/85, equivalent to revenue of less than £100 million.

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FROM: JOHN CAINES CB, DEPUTY HEAD, CENTRAL POLICY REVIEW STAFF

c/NO
Nat Ind

CABINET OFFICE
Central Policy Review Staff
70 Whitehall, London SW1A 2AS Telephone 01-233 7798

NBPM
MCS 18/3

Qc 080 18 March 1983

The Rt Hon Nigel Lawson MP
Department of Energy
Thames House South
Millbank
SW1P 4QJ

Dear Nigel

FINANCIAL TARGET AND PERFORMANCE AIM FOR THE ESI

In John Sparrow's absence I am writing to comment on the recent exchanges on this subject between you and the Chief Secretary. In the CPRS's view these raise some important issues. The two most immediate are the implications of the degree of overpricing revealed by the latest estimates and the appropriate division of the financial consequences between the Exchequer on the one hand and the industry and consumers on the other.

It seems to us that if a judgement can now be made on these points, it should be reflected in the new financial target. If not, the Government should set a financial target which does not compromise future decisions, whatever they may be, and which applies over the shortest practicable period. We suggest that this implies an unchanged real price in 1984/85 and a two year target. This should be accompanied by the maximum pressure on the industry to reduce costs.

It seems to us that there are four relevant considerations: marginal cost principles, accountancy results, the statutory break even obligations and a financial target assessed in terms of a return on net assets. The situation is not helped by the changing numbers from the industry and the difficulties in interpreting what constitutes marginal costs.

The case for marginal cost pricing is based on economic arguments. The CPRS report on Electricity Prices argues in favour of relating electricity prices to marginal costs. This ensures correct allocation of resources within the economy and, by implication, enables consumers to be the beneficiaries from improved performance by the industry in controlling its marginal costs. The Chief Secretary has, of course, to watch the public expenditure implications, through the industry's EFL, of pricing policies related to marginal costs especially if these produce loss on the Profit and Loss Account.

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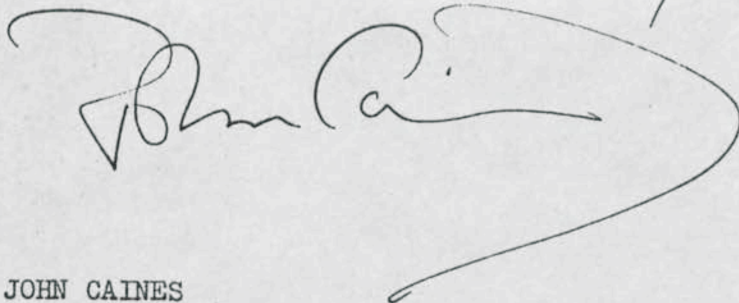
The fact that loss on the Profit and Loss Account can arise with economic pricing poses questions for Ministers to settle. First: is the industry's current asset base correctly valued in a period of over capacity (ie when a sizeable proportion of the assets has no earning potential)? Secondly, should any loss (which results in part from the burden of past mistakes by the industry) be borne by the taxpayer through a higher EFL rather than by the industry (eg through smaller wage increases) and its customer (through "excess" pricing)? Thirdly, is it acceptable to interpret the statutory obligations as being fulfilled when the industry has a positive cash flow even if it has a loss on P & L account. This has particular significance at a time - like now - when investment expenditure is relatively low, and the industry can reduce its indebtedness.

Whatever decisions are made on the new financial target, we would like to stress the importance of using the period before the next financial target is to be set to resolve the various issues described in this letter and to press the industry to produce reliable data to enable this to be done.

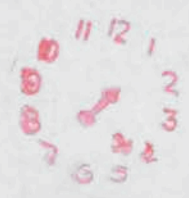
I am sending a copy of this letter to the Prime Minister, the Chancellor of the Exchequer, the Chief Secretary, the Secretary of State for Industry, the Secretary of State for Scotland and to Sir Robert Armstrong.



JOHN CAINES

Nat Ind, Gas e Elect, pt 7

18 MAR 1983



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Prime Minister 2

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SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
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01-211 6402

The Rt Hon Leon Brittan QC MP
Chief Secretary to the Treasury
Treasury Chambers
Parliament Street
London SW1

15th March 1983

Dear Leon

Your letter of 11 March gives me some difficulties. Since I made my proposals to you three weeks ago in my letter of 21 February, there has been mounting protest from the industry about the absence of a new target to underpin their current tariff proposals, due for implementation on 1 April and announcement this Thursday following the last meeting of the Electricity Council in this financial year. They are already complaining vehemently about the delay and are bound to react very unfavourably to new proposals at this late stage.

I cannot accept your proposition that the new target should be equivalent, allowing for the changes in asset base, to the old one. You say twice that there is room for debate on the right level of electricity prices but the Treasury, and the Government as a whole, have already accepted that electricity prices should not be increased in the year which begins in a fortnight's time. The old target produced price increases which we all accept should not occur in 1983/84, and there can be no question of going back on the price "freeze" for that year. Since that is presumably common ground, your proposals would require us to decide now that prices in 1984/85 should rise by 6%, or 2% more than under my proposal.

In this very difficult situation, I will do what I can to help. I must see the outgoing Chairman of the Council tomorrow. In the circumstances, the most I can do is to propose to him that the target should be 1.4% and the performance aim 4¼%, although I cannot believe that this will necessarily result in any further reduction in costs. I shall also have to say that progress towards achieving the performance aim in 1983/84 will to some extent mitigate the higher prices in 1984/85 implied by the new target.

I am copying this letter to the recipients of yours.

Yours ever
Nigel

NIGEL LAWSON

NAT. IND: Electricity Pricing policy : Pt 7

Prime Minister

Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon Nigel Lawson MP
Secretary of State
Department of Energy
Thames House South
Millbank
London SW1P 4QJ

11 March 1983

Dear Nigel,

Thank you for your letter of 21 February proposing a new financial target and performance aim for the electricity supply industry.

I am disappointed at your suggestion for a lower financial target of only 1.3 per cent return on net assets on the new definition (ie 1.5 per cent on the old). This compares with the existing target of 1.7 per cent and the forecast outturn against it of 2.2 per cent. Some £10 billion has been invested in the industry over the last 15 years, which was supposed to earn at least a 5 per cent real rate of return. It is therefore somewhat surprising that we should be budgeting for a falling return on assets. I also find it difficult to understand why you pressed me for a 3-year target for British Gas but want a 2-year one for electricity. There are always uncertainties, but the immediate future for electricity must surely be as predictable as that for BGC.

We are, however, entirely agreed upon the need to put more pressure on the industry to make real reductions in its costs. It is helpful that your Department has persuaded the ESI to increase the aim from the 3 per cent reduction in real controllable costs between 1982-83 and 1984-85 originally proposed to 4 per cent. But I hope that we can go further. I am advised, for example, that the industry's cost forecasts assume a real increase in salaries and associated costs per head, which has not been adequately explained. This was, of course, an area criticised by the Monopolies and Mergers Commission in their Report on the CEGB, which referred to "... labour costs rising more rapidly than the national average" (Para 10.68 of HC315). Given the ESI's leading position in public sector pay, it would be wrong to endorse an aim based on increasing real labour costs per head. Indeed, our assumption would be the reverse. On that basis, I suggest that the aim should be, say, 4½ per cent.

Turning to the financial target, you say that the rate of return proposed of 1.3 per cent would reflect economic pricing principles and that the industry's recovery of marginal costs in 1983-84

would imply an element of tax on the user. There is a great deal to debate here and I do not accept all you say. Financial targets should not be fixed mechanically, but should reflect a wide range of factors, which were listed in Paragraph 73 of Cmnd 7131. I also understand that the return suggested would drive the CEGB into a post interest loss rising to over £300m in 1984-85, which it seems difficult to reconcile with the Board's statutory breakeven obligation. Furthermore, on the details of your marginal cost calculation, it is unclear whether it is correct to exclude from the capacity charge any element for the capital cost of the national grid system. Nor is it self-evidently right for the industry's prices to reflect a discount to the NCB coal price simply because that is a feature of the somewhat artificial agreement reached between two state monopolies.

As I say, there is a lot to debate here. But I am conscious that you wish to settle the target quickly. I therefore suggest that we might proceed as follows. There should be a $4\frac{1}{2}$ per cent performance aim and the financial target should be 1.5 per cent on the new definition, (ie the same as the existing 1.7 per cent on the old definition). As long as the agreed External Financing Requirement figures are safeguarded as you suggested and it is justified on economic pricing principles, I would be prepared for cost savings secured through achievement of the performance aim to be reflected in real reduction of prices up to that referred to in your letter. If you could agree to proceed in this way, I would be prepared to accept a 2 year target and aim.

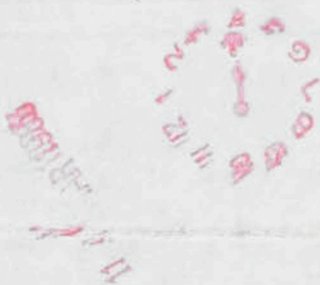
This approach would, I think, give the Industry a real challenge and put it (rather than the Government) under maximum pressure to deliver the cost savings and lower prices.

On subsidiary points, I very much welcome your proposals for monitoring and publication of performance aims and financial targets. This seems to me entirely consistent with our drive for greater efficiency, and I hope that the new Chairman of the Electricity Council will be able to take a leading role here.

A copy of this letter goes to the Prime Minister; the Chancellor, the Secretary of State for Industry, the Secretary of State for Scotland, Sir Robert Armstrong and John Sparrow.

LEON BRITTAN

Nat Ind, Gas & Elect, Pt. 7



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DEPARTMENT OF INDUSTRY
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Secretary of State for Industry

9 March 1983

Copies to:

PS/Ministers
PS/Secretary
Mr Gill
Mr Manzie, Mr Wright
Mr Sumner - MM
Mr Bryant - CTP
Mr Shepherd - EC1
Mr Duguid - PPU
Mr Hunt - CTP
Mr Avery - CTP
Mr Owen - ICA2 (with papers

The Rt Hon Nigel Lawson MP
Secretary of State for Energy
Thames House South
Millbank
London SW1

Dear Nigel,

ELECTRICITY PRICES

I have been giving some consideration to the representations made by the CBI to us at our meeting on 17 February and I would like to put to you some proposals which would add up to a convincing response to the CBI points.

2 I am inclined to discount some of the complaints - those which have been largely met by the joint effects of your efforts on prices and of sterling's recent depreciation. But we have to recognise that there remain a group of high load factor users which are disadvantaged, by as much as 20%, in relation to their Continental competitors, which benefit from discounts or special tariffs. I well understand that we are constrained, or more accurately, we have chosen to constrain ourselves by not amending the ESI's statutory obligations with regard to undue preference and by deciding to adhere pretty closely to economic pricing, in contrast to our partners in Europe. This limits our room for manoeuvre but within those limits I think that it is absolutely vital that we do all we can. It would be a pity to lose this particular argument with industry, as we are in danger of doing, after the considerable efforts which have been made on electricity prices over the last two years. I have four proposals to make. They concern:

i) eliminating the existing overcharging element in the electricity industry's tariffs in 1984/85;

ii) intensified pressure to reduce the industry's costs;

iii) extension of load management terms to more users;

iv) direct dealing with the CEGB.

3 I have seen your letter of 21 February to Leon Brittan in which you draw attention to the degree of over-charging of at least £300m in 1983/84, in relation to economic pricing. I find it disappointing, to say the least, that after biting the bullet and accepting the principle of economic pricing for energy, we

have departed from this approach in the wrong direction, using electricity prices as a means of general taxation. It also seems odd, incidentally, to describe the average return on net assets of 1.3% as a reflection of economic pricing principles, if it results in the over-recovery of properly accounted marginal costs of electricity by as much as this - equivalent to approximately 4% on prices. The correction which you propose is equivalent to a 1½% real reduction in prices in 1984/85. I see no justification for not adjusting fully to economic pricing by 1984/85 and reducing prices relative to costs by 4% in real terms.

4 The performance aims which you propose for the industry are most welcome. I understand that the ESI's financial targets allow for increases in revenue expenditure cost per unit of electricity of 12.9% over the next two years and for increases in salary costs per employee of 16%. There would seem to be a strong case for setting the industry more ambitious targets than it has set itself. I would also urge you to use your best endeavours to secure a coal deal between the CEGB and the NCB next November which results in increases in coal prices well below the general rate of inflation. The removal of restrictions in the CEGB imports could be a material factor in securing this.

5 I think that it is important that we should begin thinking now how these three factors - the removal of the existing element of overcharging, improved performance by the industry, and better terms on coal - will translate into prices. The broad magnitude of these opportunities to reduce real electricity prices suggest to me that the price freeze could be extended through 1984/85, on a basis which would be economically justified. I consider that this is feasible and should be understood as an objective of energy policy.

6 Turning now to direct dealing with the CEGB, I would suggest that the CEGB be pressed to begin discussions with twenty or so large users, following the recent ICI precedent. Direct dealing would have a number of advantages, some economic, others presentational. Major users in particular resent being separated from their supplier by the Area Boards. As became clear at the CBI meeting, this arrangement leads to suspicions that major users are cross-subsidising domestic users' much higher unit distribution costs. It is also at odds with the general business practice for smaller buyers to use the distribution chain but for larger buyers to deal direct. Direct dealing would allow a fuller consideration of users' load characteristics and would remove the inevitable averaging process by which Area Boards translate the BST into tariffs. Direct dealing would, I appreciate, take the CEGB into what is for them new territory: it would have staffing implications and could at times involve the CEGB in difficult negotiations when confronted

by large customers in commercial difficulties. But this is an aspect of normal commercial life which confronts any large supplier and there is no reason to my mind why the CEGB should not have to face up to commercial realities.

7 Lastly, I hope that you will consider seriously my proposal for halving the qualifying threshold for the Consumer Contracted Loan from its present 6MW average winter load to 3MW. The CCL terms have been most useful to intensive users, but intensive users are not necessarily large users. According to the paper industry, there are an additional 17 paper producers which would qualify with the lower threshold and several would probably take advantage of CCL if they did: 6 out of 9 paper producers which already qualify have done so. I understand that there are some steel and chemical producers which might also apply. I am informed, however, that a 4MW threshold, which you mentioned at our meeting, would not attract any chemical producers.

8 I am copying this to Leon Brittan and George Younger.

Yours ever

Patrick

11 APR 1985