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SCOTTISH OFFICE
WHITEHALL, LONDON SW1A 2AU

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

12 May 1983

Dear Chief Secretary

FINANCIAL TARGET AND PERFORMANCE AIMS FOR THE SCOTTISH ELECTRICITY BOARDS

As you know, I have for some time hoped to be able to set a financial target and performance aims for the two Scottish Electricity Boards. In my letter of 4 August 1980 to your predecessor, I described some of the problems which had to be overcome before this could be done satisfactorily. Since then my officials and yours have been in discussion both bilaterally and with the industry, and I believe we have now reached a broad basis of agreement upon which we can settle a target and aims for the electricity supply industry in Scotland.

As for the format of the financial target, I have always believed that a joint target should be set for both Boards because of the close integration of their generating activities which includes the sharing of costs through their joint generating agreement. The consequences of this is that the performance of one Board can have a marked effect on the finances of the other. I recognise that you may have some concern about accountability but in my view the new monitoring arrangements which we have recently introduced will enable us to ensure that each Board is held accountable for its own activities, and we will be able to identify which, if any, is responsible for a failure to meet the financial target. For similar reasons I propose to set a joint performance aim for generation and transmission, but separate aims for distribution since each Board's performance in this area can be separately identified.

I would propose that the financial target should be defined as the average return on net assets valued at current costs. In keeping with the definition used for the ESI, I would propose that capital work in progress be included within the asset base, but MWCA should be excluded from the calculation of profit. This latter point is of little importance, but the inclusion of capital work in progress will have an increasingly significant effect on the Board's rate of return as expenditure on Torness continues. The bulk of capital work in progress will in fact be expenditure on this one project which looms proportionally far larger in the finances of the Scottish Boards than any corresponding expenditure for the CEGB. The implications of this, which I believe your officials accept, is that the Board's rate of return will decrease in future years until such time as the operation of Torness can make a positive contribution to their finances.

Before we can agree on actual figure for the financial target, it is necessary to consider the questions of pricing policy and the relationship between tariffs and economic costs. We are all agreed that tariffs in the energy industries should be based on economic pricing principles and that the financial targets for the industries should also take account of these principles. There remains the problem, however, of determining what the economic or marginal costs are at a time of excess capacity which is likely to continue for the foreseeable future. I am now convinced that electricity tariffs in Scotland are significantly above the level necessary to meet marginal costs and this will continue even after the freeze this year. On economic grounds therefore there is scope for a further real reduction in electricity prices.

The pricing policy of the Scottish Boards has in the past been determined by the requirement to break even on operating costs, taking one year with another. As a result of the standstill this year they cannot reduce prices much further in real terms without risking a breach of this statutory obligation. This is in part due to the need to service debt accumulated on past capital expenditure, a position which will be further aggravated by the funding of interest charges on current capital expenditure associated with the construction of Torness AGR. This station is expected to produce significant operating cost savings after it is commissioned in 1987, but meantime SSEB is having to increase its borrowing in order to fund construction and is thereby incurring growing interest charges. The Board's financial position is not such that a failure to break even would require a subsidy, but it might mean that SSEB would have to borrow more to complete Torness.

Both Boards regard it as their responsibility to find ways of meeting this statutory obligation. They have indicated that in their view a loss in one or more years could be offset against a surplus in the subsequent or preceding period without involving a breach of statute, that is they are taking "one year with another". On this basis they would be willing to restrict tariff increases even although it might result in a loss. In practice they would make every effort to reduce any loss by improvements in performance during the year. What does concern the Boards, however, is that they will be precluded from achieving a real reduction in electricity prices by our setting a financial target at a level which would require a higher tariff regime. Their position would be made even more difficult if the Scottish target was greater than that applied to the industry in England and Wales, and that industry was able to reduce prices in real terms in 1984-85 whilst the Scottish Boards could not.

I too would find it difficult to defend the situation where Scottish electricity prices were seen to be increasing faster than in England and Wales for reasons which were not obviously connected with changes in the real costs of generating electricity and when there is a considerable excess capacity on the system. We would be in the position of moving even further away from marginal cost pricing. I therefore propose to set a joint financial target of a return on average net assets valued at current costs of 1.4% for the three years from 1983-84 to 1985-86. Whilst I recognise the areas of doubt which led Nigel Lawson to choose a two-year target period for the ESI, I would prefer a slightly longer period for what will be the Scottish Boards' first financial target. As we are already into the first year, a two-year target would not give the Boards much time to become acquainted with the disciplines of a financial target. A three year target on the other hand would have the advantage of giving them more time to plan their operations in such a way as to meet it without seeking substantial increases in tariffs. It also has the advantage of taking the Scottish Boards out of step with the ESI which may bring benefits in the future by reducing direct comparisons between the targets and tariffs of the industries north and south of the Border. The level of my proposed target is similar to that agreed for the ESI, but it will, I believe, be more onerous for the Scottish Boards to achieve because capital work in progress, upon which no return can yet be earned, is proportionately a greater part of the Boards' asset base.

Provided the Boards successfully hold down their costs, a joint target of 1.4% would be consistent with the standstill this year and would also give some scope for a real reduction in tariffs during the period of the target. The pricing assumptions underlying the target are of course different from these in the planned EFRs and the present standstill together with the future moderation in pricing may have the effect of putting pressure on the EFRs. The need to break even will, however, exert strong pressure to reduce costs and I would expect the Boards to do better than they are predicting. I would certainly make it clear to the Boards that a financial target of 1.4% does not imply acceptance of their bid for a higher EFL and that a final decision on tariffs for 1984-85 and 1985-86 will depend on the circumstances at the time, including the need for the Boards to meet any EFLs which we have agreed by then. This will place the onus on the Board to achieve sufficient cost savings to justify a reduction in real tariffs.

At the same time I would propose to set the Boards the joint performance aim of reducing their controllable generating cost per unit sold by 3.0% over the three year period of the target; and for SSEB the aim of reducing controllable distribution costs by 7.5% and for NSHEB a reduction of 4.0%. The method used for calculating controllable costs excludes the effect of fuel price changes, depreciation, rates and general inflation, but does take account of the efficiency with which the Boards utilise the mix of fuel available to them. Because of differences in the methodology it is not possible to compare these aims directly with that for the ESI but I believe they are at least as onerous. In fact the Boards' task will be made even harder because the base year of 1982-83 gives every appearance of having been an exceptional year in terms of both Boards' performances, and during the period of the target the Boards will lose the benefit of burning NGLs at Peterhead.

I believe that the financial target and performance aims which I have proposed will increase the pressure on industry to reduce costs and increase efficiency. I would like to be able to set and announce the target and aims before the discussion of the Boards' investment and financing review. I also think it would be helpful politically at this time for us to be seen to be applying these controls to the nationalised industries in Scotland. I hope therefore that you will be able to accept these proposals quickly.

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

Ever ...

A MacNamle

Approved by the Secretary of State
and signed in his absence

wh 26/5

NEW ST. ANDREWS HOUSE
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EDINBURGH EH1 3SX

Rt Hon Leon Brittan QC
Chief Secretary to the Treasury
Treasury Chambers
Parliament Street
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25 May 1983

Dear Leon,

FINANCIAL TARGET AND PERFORMANCE AIMS FOR THE SCOTTISH ELECTRICITY BOARDS

Thank you for your letter of 18 May in which you suggest some amendments to my proposals for financial targets and performance aims for the two Scottish Electricity Boards.

Although I do not necessarily accept all of your arguments I am anxious to reach agreement as quickly as possible and as I see political difficulties in setting a higher figure I propose to set the Boards a joint financial target of 1.4% after MWCA. I would also make clear to the Boards that bids for higher EFLs in 1984/85 and 1985/86 will not be accepted and that the SSEB bid is consequently withdrawn.

As far as performance aims are concerned, I agree that NSHEB should be asked to reduce its distribution costs by 4.5%, and SSEB should aim for an 8% reduction over the period. The joint generation and transmission aim is more complicated; whilst I agree that a 4% reduction by 1984/85 should be achievable, it will be difficult for the Boards to maintain this performance once gas supplies to Peterhead are terminated. I will therefore encourage the Boards to maintain their performance in 1985/86 but we must recognise that the Boards may be unable to do so through no fault of their own.

I agree that the question of trading between the Scottish Boards and CEGB deserves more study. Before agreeing to call in consultants, however, I think officials should give more detailed consideration to the issues involved.

I now intend to write to the two Boards with details of these proposals. I intend to leave the matter of appliance retailing and contracting to a separate letter so as not to confuse the issues.

I am copying this letter to the Prime Minister, Nigel Lawson, Patrick Jenkin, Sir Robert Armstrong and John Sparrow.

Yours ever,

George.

Nat Ind MB
Gas & Elec Pricing

Secretary of State for Industry

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24 May 1983

CONFIDENTIAL

The Rt Hon Leon Brittan QC
Chief Secretary to the Treasury
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London SW1

24/5

Dear Leon,

FINANCIAL TARGET AND PERFORMANCE AIMS FOR THE SCOTTISH ELECTRICITY BOARDS

I was interested to see George Younger's letter to you of 12 May and your reply of 18 May.

2 I had also felt that a more demanding performance target should be set for Scotland and I therefore hope George will accept the specific suggestions you have made in your letter. As you say, a reduction in the industry's costs can make a major contribution to bringing down electricity prices. I am unhappy, however, with your comment that a 1.6% return on net assets would be a more appropriate financial target for the Scottish Boards than the 1.4% proposed by George. I note that you are prepared to agree to 1.4% so long as there is no increase in public expenditure by SSEB. My own view is that 1.4% is itself too high, bearing in mind the disproportionately higher level of work in progress in the capital employed by the Scottish Boards as compared with England and Wales, on which no return can be earned.

3 You agree that there are still issues to be resolved concerning the relationships between marginal cost pricing, statutory break-even obligations and rate of return objectives. We must return to these as a matter of urgency after the Election for they have a crucial bearing on the level of electricity prices. As you know, I am anxious that we should overlook no means of giving some comfort to the hard pressed energy intensive industries.

4 I am copying this letter to the Prime Minister, Nigel Lawson, George Younger and to Sir Robert Armstrong and John Sparrow.

Yours ever

Patrick

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Gas e Elect,
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CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon George Younger TD MP
Secretary of State
Scottish Office
Dover House
Whitehall
London SW1A 2AU

18 May 1983

Dear Secretary of State

FINANCIAL TARGET AND PERFORMANCE AIMS FOR THE SCOTTISH ELECTRICITY BOARDS

Thank you for your letter of 12 May suggesting a financial target and performance aims for the Scottish Electricity Boards. I welcome the considerable progress that has been made but the figures proposed give me some difficulty, particularly since they are associated with an additional public expenditure bid.

As far as format is concerned, I accept the practical arguments for setting a joint financial target for the two Boards combined, but we should be careful not to imply any overriding of the statutory duty of each Board, to break-even 'taking one year with another'. Accordingly, I suggest the target be set subject to each Board individually 'meeting its statutory financial duties'. I am glad that the target is to be set in current cost accounting terms. It is usual to take profit after the Monetary Working Capital Adjustment, in accordance with SSAP 16. There were special technical reasons why this could not sensibly be done for the Electricity Boards in England and Wales, but these do not apply to the Scottish Boards, particularly since a joint target is to be set. I should therefore prefer to set the target <u>after</u> MWCA.

Turning to the level of the target, I understand that it assumes electricity prices will fall in real terms by up to 2 per cent in 1984-85. There is an associated additional bid in IFR 1983 for SSEB totalling over £55 million in 1984-85 and 1985-86. I cannot accept this bid for higher expenditure, nor am I convinced that the price reduction would be justified.

(a) There seems to be a presumption that prices in Scotland should rise no faster than England and Wales. But if this was our starting position, surely prices in Scotland should first be brought up from their present level, significantly below that in England and Wales.

(b) The marginal cost figures given to Treasury do not appear to envisage any planned trading with England and Wales. Prima facie, if electricity generating assets in Great Britain as a whole are to be used most economically, then levels of output should be adjusted until the point is reached at which marginal costs of the systems in Scotland and in England and Wales are brought in line, except for transmission costs. This too implies a potential case for narrowing the price differential, as well as providing the Scottish Boards with profitable trade and using national resources optimally. Clearly there are technical issues involved too, but I think that we need to look much more closely at the potential economies to be achieved through planning trade between the two systems rather than relying on spot trading as at present. Subject to Nigel Lawson's views, I suggest that consultants might examine the economic and technical issues here, reporting to you both.

(c) A real price reduction would appear to be associated with SSEB making losses on its revenue account during all 3 years of the proposed financial target period. Unfortunately it does not appear that we shall have an opportunity to discuss your recent memorandum to E(NI), in the near future, but you raised the conflict that can arise between marginal cost principles, and the need to meet break-even duties and earn a reasonable return on assets. You pointed out that this conflict had yet to be resolved, and I agree that some deeper thought needs to be given to the problem. The Treasury will be making suggestions for further work between Departments.

Taken together, these points suggest it would be very unwise to base the financial target on the assumption of further real price reductions. I can, however, understand why you might not wish to make this explicit, and there would be no need to rule out entirely the possibility of further real price reductions in Scotland; but I think it is important to avoid becoming committed to make them or, indeed, to match whatever may happen in England and Wales.

Clearly cost reductions offer a very attractive route both to attaining a reasonable return on assets and keeping prices down. I therefore very much welcome your proposals to set the Boards some performance aims. The detailed figures which have been provided to the Treasury suggest, however, that more challenging targets should be within their grasp. In particular, the assumptions made about nuclear power station availability look unnecessarily pessimistic and targets for reducing manpower costs look unambitious, particularly in the light of the worrying increases revealed by the performance review you circulated. The picture is complicated for the joint generation and transmission performance aim by the expected loss during 1985-86 of cheap gas supplies at Peterhead. I should therefore like to suggest that you set a more demanding aim of 4% to be achieved by 1984-85 and then set the Boards the challenge of holding real controllable costs per unit to that level in 1985-86 too. On the distribution side, I believe that slightly more demanding figures of 4.5 per cent for NSHEB and 8 per cent for SSEB would also represent a worthwhile challenge. The objectives you recently set the Boards referred to the need to yield a proper return on their contracting and appliance retailing activities. Perhaps we could associate the performance aims with the target of at least breaking even on this business in 1983-84, and achieving a reasonable return by 1985-86 (which officials could settle).

This leaves the question of the precise level of target to be set. It follows from what I have said above on prices and costs that we think a higher level of, say, 1.6% would be both justified and attainable. Simple comparisons of figures with England and Wales are demonstrably misleading, but I do understand the difficulties you perceive over how a different figure might be interpreted. This needs to be balanced against the advantages of our being seen to run a tight financial regime for the Electricity industries. If you see insuperable political difficulties in setting the higher figure, then I should be prepared reluctantly to accept 1.4%, on the basis set out above, and on condition that the additional public expenditure bid for SSEB is withdrawn straight away. I ought also to say, that, since the IFR exercise for 1983 has only just got underway, I could not rule out having to seek further savings from the Scottish Electricity Boards later in the year.

I am copying this letter to the Prime Minister, Nigel Lawson and Patrick Jenkin, and to Sir Robert Armstrong and John Sparrow.

Yours sincerely

J.R. Grieve

f. LEON BRITTAN

[Approved by the Chief Secretary]

Nat Ind,
Geese Elect,
Pt 8

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Rt Hon Leon Brittan QC
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MLS 20/4

19 April 1983

Dear Leon,

OBJECTIVES FOR THE SCOTTISH ELECTRICITY BOARDS

Pt 7

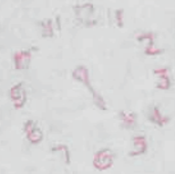
Thank you for your letter of 30 March accepting, with one change, the objectives which I intend to set for the Scottish Electricity Boards.

As I have received no objections from colleagues I am writing to the Chairmen setting their objectives which incorporate your change. In the covering letter I am also taking note of your suggestion that I might set a date for receipt of a report on the injection of private capital and have asked for a report before the end of March 1984.

I have considered John Sparrow's letter of 5 April, but feel that the point covered in item 10 is an important one, and should remain in the formal list of objectives. I am copying this letter to members of E(NI), to Sir Robert Armstrong and to John Sparrow.

Yours ever,

George.



CC/NO

Nat Ind

CABINET OFFICE

Central Policy Review Staff

70 Whitehall, London SW1A 2AS Telephone 01-233 7765

From: John Sparrow

CONFIDENTIAL

Qa 06316

The Rt Hon George Younger MP
Scottish Office
Dover House
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5 April 1983

Dear George,

Objectives for the Scottish Electricity Boards

I have seen your letter of 24 March 1983 enclosing proposed objectives for the two Scottish Electricity Boards.

The CPRS has been involved in the formulation of these objectives and we have made a couple of drafting points at official level. Otherwise I am happy to accept your proposals, although I feel that item 10 is not an objective and might best be put to the Boards separately.

I am sending a copy of this letter to the recipients of yours.

Yours sincerely,

John.

John Sparrow

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Pt. 7