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18 October 1983

Policy Unit

MR TURNBULL

GAS PRICES

Copy of record of meeting at Flag A.

A rise of 6 per cent in domestic gas prices in January 1984, as proposed by the Chancellor, would be consistent with the decisions reached at the Prime Minister's meeting of 13 September 1983 to maintain gas prices in real terms. Acceptance of Peter Walker's proposal of 5 per cent would result in real price reductions during the 15 month period between October 1982 and January 1984. This would erode the position achieved by the three successive 10 per cent real price increases during the last Parliament. We have no need to compromise on this point in the face of BGC and public resistance, as the maintenance of prices in real terms is a sensible and defensible policy for the short term.

For future years, recent papers by the Treasury and the Department of Energy have indicated that there is no agreement about the basis for setting economic pricing levels. We suggest that the Prime Minister should request that an agreed set of economic pricing criteria be prepared. The implications and timescale of moving towards economic pricing during this Parliament could then be considered further.

As the immediate need is to settle only the price rises for January 1984 and the planning assumptions for the IFR, we do not consider that any decisions on the Financial Target should be settled in advance of agreement on pricing principles. Similarly, any decisions on extending the industrial gas price freeze beyond the current financial year should also be based upon further consideration of pricing principles and objectives.

DLP.

DAVID PASCALL

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10 DOWNING STREET

Prime Minister (1)

Agree

(i) A 6 per cent increase in domestic gas prices on 1 January (equals increase in prices since last increase in October 1982)?

(ii) Freeze in industrial prices only to March 1984?

(iii) Agreed set of economic pricing principles to be reported back to you?

(iv) No decisions on Financial Target for BGC until pricing principles settled for longer term.

AT 18/10

Yes MT.

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cc D.P.

HL

10 DOWNING STREET

From the Private Secretary

19 October 1983

Gas prices

The Prime Minister has seen your Secretary of State's letter of 21 September and the Chancellor's reply of 17 October. She has commented that a 6% increase in gas prices on 1 January 1984 most closely reflects the outcome of the meeting she held on 13 September. Such an increase would be roughly equal to the increase in prices since the last occasion prices were set and thus would achieve the objective of maintaining gas prices in real terms at the level achieved by the three successive 10% real price increases.

On industrial prices she thinks the freeze should not be extended beyond the end of this financial year. The increases thereafter should be settled after further consideration of the pricing principles to be adopted in the longer term.

On pricing principles themselves, the Prime Minister has noted that there is as yet no agreement. She hopes that agreed criteria can be put back to her on what would be implied by the adoption of economic pricing. The implications of moving towards economic pricing during the course of this Parliament and the timescale to be adopted can then be considered.

She considers that there is no point in setting BGC a financial target until the longer term pricing policy has been settled.

I am copying this letter to John Kerr (H.M. Treasury), John Graham (Scottish Office), Callum McCarthy (Department of Trade and Industry), John Gieve (Chief Secretary's Office) and Richard Hatfield (Cabinet Office).

Andrew Turnbull

Michael Reidy, Esq.,
Department of Energy.

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Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

The Rt Hon Peter Walker MP
Secretary of State for Energy

17 October 1983

Dear Peter

GAS PRICES

Thank you for your letter of 21 September. I have also seen your letter of 14 October to Peter Rees and deal with the BGC pricing points in it in this reply because the Gas Board will, I understand, be meeting shortly to consider pricing and will clearly need to have our considered views.

My reactions to your proposals are as follows.

(a) Tariffs for domestic and small non-domestic consumers

I am sure that you are quite right not to agree to Sir Denis Rooke's suggestion that the price increase on 1 January should be only 4 per cent. At our meeting on 13 September, the Prime Minister said that it "should be such as to maintain gas prices in real terms at the level achieved by three successive 10 per cent real price increases" (Mr Scholar's letter of 14 September).

The current forecast of the increase in the RPI between October 1982 and January 1984 is 6 per cent. Accordingly, the price increase on 1 January 1984 should be 6 per cent. As well as being consistent with the outcome of the 13 September discussion, this is crucial in public expenditure terms. I have no strong views on the way it is split between the commodity charge and the standing charge. (Incidentally, it has been separately agreed that there should be a 5½ per cent price increase for British Rail on the grounds that it would be in line with inflation over the shorter period from January 1983 to January 1984.)

As regards subsequent price increases, BGC propose real increases of 1 per cent in January 1985, 1986 and, I believe, in 1987. I can accept these for planning purposes and for setting the 1984-85 EFL. As you say, this would not be a final decision on pricing. We clearly need to return to the issue of pricing policy and the figures may well require revision in the light of our eventual decision.

I have read with interest the paper enclosed with your letter of 21 September. It is surprising that BGC should suddenly come up with such a radically different view of long run marginal costs and I find the basis of their calculations far from clear. Prices based on such a view of costs would seem to recover less than half BGC's non-gas costs; an approach no commercial firm could afford. Clearly the first step is for your officials and mine to try to reach an understanding of BGC's new figures.

But I ought to make two points in the light of our discussion on 13 September. First, when the 30 per cent price increase was agreed back in 1979, there was no suggestion that this would be enough to correct in full the then prevailing

underpricing. The extent of underpricing was then put at 25-50 per cent, with much depending on real oil prices remaining constant. They have in fact risen. Secondly, even if we had got back to economic prices, it is most unlikely that this would have been the end of real price increases. All the signs are that real energy prices will rise. And when in early 1980 we announced the 30 per cent price increase, we did not claim that it would put the position right once and for all.

(b) Industrial contracts

I do not accept that our pricing policy should be based on keeping industrial prices within the European range. This was not agreed at our No 10 meeting. Our approach must be based on economic pricing. Anything else amounts to costly and selective subsidisation of industry.

In any case, on current views of exchange rates, BGC's price proposals for firm gas would only take our price to the top end of the European range, not above the top, and the price of interruptible gas would be well within the European range. I also note that your comparisons are based on consumers in the range 1 million - 10 million therms per annum. While this accounts for the bulk of industrial gas sold, it covers only a small minority of industrial consumers. I expect that a comparison based on the larger number of smaller industrial consumers would show our position in a more advantageous light.

You have proposed a freeze on industrial prices for the rest of this year and have raised the possibility of extending the freeze still further. I could agree to this only if the price rise in January 1984 for domestic and small non-domestic consumers were set correspondingly above 6 per cent, for we must offset the cost in each year of the coming three years of an industrial freeze after 31 December 1983. Otherwise I consider the freeze should end at that date. International comparisons suggest that it would not be unreasonable to load price increases in this way; our domestic prices are substantially below those in most of Europe.

(c) Financial Targets

You would like to set a target for the three years from 1983-84 to 1985-86. Frankly, I can see little purpose in doing this until we have an agreed pricing policy, for a return to economic pricing would make any target we now set pretty meaningless. Nor do I think we can take any long term view on the levy until we are in a position to settle prices and the financial target. This is unsatisfactory but seems unavoidable.

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

Yours
Nigel

NIGEL LAWSON

Nat Ind
Gase Elect,
p48

cc NO

(4)

Prime Minister

MCS 22/9

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
Treasury Chambers
Parliament Street
London
SW1P 3AG

21 September 1983

Dear Nigel.

GAS PRICES

See MCS to Energy 14.9.83

Following our meeting with the Prime Minister on 13 September, I am writing about the figure for the January 1984 price increase. I take this opportunity also to make proposals for the price assumptions for 1984/5 so that we can agree a two year Financial Target for BGC covering 1983/4 and 1984/5.

My proposals are as follows:

(i) a 5% tariff increase for domestic and small non-domestic consumers effective from 1 January 1984. This would broadly maintain gas prices in real terms at the level achieved by the three successive 10% real price increases, but I must warn my colleagues that it is an increase higher than the Gas Consumer Councils are expecting. We may face political pressure on it. If we went beyond 5% I am sure we would also meet resistance from the Gas Corporation, which has throughout proposed a 4% increase and is known to have done so. That would greatly increase our political difficulties.

(ii) No increase for industrial contract consumers for the remainder of this financial year. I believe there is a strong political and economic case for shifting away from the emphasis in BGC's original proposals on large increases in the industrial markets.

(iii) A two year Financial Target for BGC based on these increases for 1983/4, and on increases in all markets in line with inflation for 1984/5; as well as on foreseeable cost savings.

? MCS

(iv) The price increase for industrial contract consumers for 1984/5 would need to be spread over the year in order to keep within the European range. The domestic tariff increase might be on 1 October 1984.

(v) We will need now to obtain revised financial forecasts from BGC on the basis described above; but I believe these proposals are consistent with the present EFL for 1983/4 and are likely to involve no addition to public expenditure costs in 1984/5.

I should stress that what I am proposing for prices in 1984/5 is a planning assumption to enable us to set a two year Financial Target for British Gas, and to settle the EFL for 1984/5. It is not a final decision on pricing. If BGC are able to achieve lower prices within their Financial Target and EFL for 1984/5, then I believe that the consumer, and especially the industrial consumer, should benefit. This may be all the more necessary if we are to keep our industrial gas prices competitive with those in Europe.

I think you will agree that these proposals are consistent with the conclusions reached at the Prime Minister's meeting. I attach a note which expands on the background to my proposals.

I am copying this letter to the Prime Minister, George Younger, Cecil Parkinson and Sir Robert Armstrong.

PETER WALKER

21 SEP 1983

8/ ecFM.

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GAS PRICING

1. This note sets out the background to the decisions which are needed on gas prices in 1983/4 and 1984/5, and relates these decisions to the July IFR, to BGC's Corporate Plan and to the need for a Financial Target for BGC.

BGC Cost and Price Calculations

2. Table 1 attached to this note sets out the pricing proposals for each of four markets used in the July IFR and in BGC's Corporate Plan. It then compares these figures with the estimates in their Corporate Plan of long run marginal costs, which are based on their estimates of the cost of contracted imports (mainly from the Norwegian Frigg field) and of marginal onshore costs. Taken at face value, this comparison suggests that BGC's original proposals would have produced prices falling further behind marginal costs. However, it would be wrong to accord these long run marginal cost figures a status which they cannot bear. As the Treasury paper enclosed with the Chancellor's minute of 9 September points out, lrmc figures are notoriously difficult to calculate, let alone forecast. This is particularly so in the case of gas, given that BGC operate an integrated system while drawing on very varied sources of supply - different load factors, different beach terminals and seasonally different rates of gas flow.

3. In addition, a number of major uncertainties surround the BGC mid-year estimates:-

(i) BGC have said that they have based their estimates of marginal onshore costs on the assumption that their network was fully

... utilised

utilised to meet existing demand, and that the system would have to be expanded to take on additional sales. This is in fact not the case, and these estimates are therefore based on unrealistic assumptions. The contribution to costs from this "capacity charge" is substantial;

(ii) BGC have recently produced figures on an alternative avoidable costs basis, on principles similar to those arising in the recent re-examination of long run marginal costs in electricity. These avoidable costs figures are much lower than the lrmc figures hitherto used in their Corporate Plan. The results are set out in Table 2 which shows BGC making a profit, though a declining one, on new supplies from the Frigg field in all markets. The BGC calculation requires further examination but their avoidable costs figures are further evidence that the lrmc figures they have hitherto used may not be soundly based;

(iii) The figures make no allowance for cost savings such as those identified in the Deloittes Report;

(iv) The gas costs element of the lrmc figures includes supplies from the Odin field in the later years. Taking figures solely for Frigg would reduce the estimate of marginal cost by 1 to 2p a therm (1982/3 prices);

(v) BGC's gas cost forecasts rest crucially on their forecasts of oil prices, because of the link between the two in the escalation clauses of their gas supply contracts with the producers. These forecasts were

... produced

produced some time ago, and there is increasing evidence to show that they are on the high side. If the rapid real rise in oil prices which BGC expect in the late 80's and 1990s does not take place, then the marginal cost could be much lower;

(vi) Exchange rates have a significant effect on the gas costs used in the lrmc figures because the Norwegian Frigg price varies with the exchange rate between sterling and a basket of European currencies. The movement in exchange rates since BGC put forward their proposals has had the effect of lowering their gas costs by about 1p/therm as compared with their original forecast;

(vii) The price of Norwegian Frigg has been taken as a proxy for lrmc gas costs. Although the Frigg contract contains escalator clauses, it was concluded nearly ten years ago. If, ultimately, BGC contract to buy Sleipner gas, it could be argued that the base price for that gas would then become a more appropriate indicator, although BGC would not in fact be using Sleipner gas until the 1990's.

4. Some of these uncertainties, such as the relevance and level of the Sleipner price and the level of marginal onshore costs, should be resolved in the coming year. The question of marginal onshore costs in particular, which is now under discussion with BGC, is very relevant to the consideration of longer term

price issues which Ministers decided to undertake on 13 September. Other uncertainties, especially about the oil price and the exchange rate, will remain .

Domestic and Industrial Prices 1983/4 and 1984/5

5. Ministers have made it clear in public statements over the past year that the domestic gas price rise in the autumn of 1983 would not be "more than about the rate of inflation". it is widely known that BGC proposed an increase of 4% from 1 October 1983, and the Consumer Council in particular know this and have objected to it. Since the October increase was delayed, BGC have proposed a 4% increase from 1 January 1984 in the light of their improved results in 1983. Ministers decided on 13 September that the price increase at the beginning of January 1984 should be such as to maintain gas prices in real terms at the level achieved by the three successive 10% real price increases.

6. It seems difficult to contemplate a much higher increase than the 4% BGC have proposed first, for October 1983 and then for January 1984. 4% was the rate of inflation when BGC proposed the October 1983 increase. A further three months without an increase would perhaps make it possible to justify a 5% increase from 1 January 1984. A 5% tariff increase already involves an increase in charges per therm greater than 5%, given the need to avoid increasing standing charges.

7. The scope for manoeuvre in the industrial contract markets is limited by continuing weakness in the industrial sector and the fact that UK prices for firm gas are still near the top end of the European range. Table 3 shows that, without some moderation, BGC's present plans could take the UK to the top of the European pricing range by mid 1984. These figures are of course crucially dependent on the exchange rates assumed. Those used in Table 3 are derived from the Treasury's most recent National Income Forecast (NIF), but this was made some weeks ago.

... If

If the September pattern of exchange rates were to continue, the sterling equivalent of the gas price in other European countries would be lower than shown in Table 3. If the dollar were to depreciate less in 1984 than assumed in the NIF, then the sterling equivalent of European gas prices, particularly in the interruptible market, would be a little higher than forecast.

8. The earliest date at which BGC could now implement a domestic tariff increase is 1 January 1984, because of the legal requirement for consulting their Consumer Councils and informing their customers. An increase of 5% on that date, rather than the 4% which BGC are proposing, coupled with the improved profitability which BGC are now reporting for this year, should enable them to hold industrial contract prices at their current level for a further three months and still remain within their present EFL.

9. BGC are at present without a Financial Target and are pressing to have it settled. There is also a need to agree BGC's 1984/5 EFL. This points to the need to settle a planning assumption for prices in 1984/5 which, together with the decisions for 1983/4, could form the basis of a two year Financial Target. Increases for all markets in line with inflation next year would hold the position without having any material impact on BGC's external financing position as hitherto forecast; although this would need to be examined closely in the light of revised forecasts from BGC and in the case of the industrial markets, revised forecasts of the position vis a vis our European competitors.

Department of Energy

19 September 1983

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COMPARISON OF BGC'S JULY IFR AND CORPORATE PLAN PRICING PLANS WITH COST OF NEW SALES ON LRMC BASIS

P/THERM, 1982/83 PRICES

	82/83	83/84	84/85	85/86	86/87	87/88
Domestic						
Cost of New Sales	42.5	44.6	45.3	46.5	47.4	48.3
BGC Plan Price	38.0	37.8	37.6	38.1	38.4	39.0
Loss (%)	4.5 (12)	6.8(18)	7.7(20)	8.4(22)	9.0(23)	9.3(24)
Non Domestic Tariff						
Cost of New Sales	37.5	39.6	40.3	41.5	42.4	43.3
BGC Plan Price	33.5	33.3	32.9	33.1	33.5	34.0
Loss (%)	4.0(12)	6.3(19)	7.4(22)	8.4(25)	8.9(27)	9.3(27)
Firm Contract (Regions)						
Cost of New Sales	32.5	34.6	35.3	36.5	37.4	38.3
BGC Plan Price	30.5	29.7	29.4	29.0	29.1	29.3
Loss (%)	2.0(7)	4.9(16)	5.9(20)	7.5(26)	8.3(29)	9.0(31)
Interruptible (Regions)						
Cost of New Sales	25.5	27.6	28.3	29.5	30.4	31.3
BGC Plan Price	25.5	24.6	24.6	24.5	24.5	24.9
Loss (%)	- (-)	3.0(12)	3.7(15)	5.0(20)	5.9(24)	6.4(26)

Notes

Cost of new sales is based on BGC estimates of the average cost of contracted imports in each year plus marginal onshore costs, assumed by BGC to remain constant in real terms over the period.

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TABLE 2

COMPARISON OF BGC'S JULY IFR AND CORPORATE PLAN PRICING PLANS WITH THE COST OF NEW SALES ON AN AVOIDABLE COST BASIS

P/THERM, 1982/83 PRICES

	82/83 p/th	83/84 p/th	84/85 p/th	85/86 p/th	86/87 p/th	87/88 p/th
Domestic Tariff						
Cost of Sales	34.3	35.4	34.2	34.7	36.1	37.0
BGC Plan Price	38.0	37.8	37.6	38.1	38.4	39.0
Profit (%)	3.7 (9.7)	2.4 (6.3)	3.4 (9.0)	3.4 (8.9)	2.3 (6.0)	2.0 (5.1)
Non-Domestic Tariff						
Cost of New Sales	25.6	26.8	25.7	26.3	27.8	28.8
BGC Plan Price	33.5	33.3	32.9	33.1	33.5	34.0
Profit (%)	7.9 (23.6)	6.5 (19.5)	7.2 (21.9)	6.8 (20.5)	5.7 (17.0)	5.2 (15.3)
Firm Contract (Regions)						
Cost of New Sales	25.3	26.5	25.4	26.0	27.5	28.5
BGC Plan Price	30.5	29.7	29.4	29.0	29.1	29.3
Profit (%)	5.2 (17.0)	3.2 (10.8)	4.0 (13.6)	3.0 (10.6)	1.6 (5.5)	0.8 (2.7)
Interruptible (Regions)						
Cost of New Sales	21.5	22.7	21.6	22.2	23.7	24.7
BGC Plan Price	25.5	24.6	24.6	24.5	24.5	24.9
Profit (%)	4.0 (15.7)	1.9 (7.7)	3.0 (12.2)	2.3 (9.4)	0.8 (3.3)	0.2 (0.8)

Note: Cost of New Sales in each year is calculated from the average cost of gas from the Frigg Field (UK and Norwegian), together with an analysis of the additional costs of extending the industry to distribute Frigg and other Northern Basin gas.

TABLE 3

DEPARTMENT OF ENERGY PROJECTIONS OF INDUSTRIAL GAS PRICES IN THE EC TO MID 1984

LOADS OF 1-10 M THERMS P.A.

Pence per Therm

	Oct 1 1982 (a)	Oct 1 1983 (b)	Jan 1 1984 (b)	July 1 1984 (b)
FIRM GAS				
Great Britain (c)	30.3	30.3	31:3	32.7
Belgium	27.7 - 29.6	30.-32	30-32	31-33
France	23.7 - 27.1	28 -32 (d)	28-32	29-33
Germany (e)	26.3 -30.4(37)	28 -32(37)	28-32(36)	29-33(36)
Netherlands	25.3 - 26.5	27 - 28	28-29	28-29
Italy	26.5 - 28.1	29 - 31	28-30	28-30
INTERRUPTIBLE GAS				
Great Britain	24.5 - 26.5	24.5 - 26.5	25.5 - 27.5	26.9 - 28.9
Belgium	26.7	28	27	27
France	24	28	27	27
Germany	25.3	27	26	26
Netherlands (f)	N/A	N/A	N/A	N/A
Italy	25.1	28	27	27

Notes:
(a) Figures in CBI report, Feb 1983.
(b) It is assumed that dollar fuel oil prices in Europe do not rise either as a result of inflation or in real terms, and that some sterling depreciation takes place against the French Franc and Deutschemark from October 1983 (in line with NIF).
(c) BGC's July IFR proposals, as moderated by the extension of the present freeze until 1 January 1984.
(d) Assuming a 4% increase in French firm gas prices in September 1983.
(e) Includes gas oil related prices paid by some small industrial consumers (bracketed figures)
(f) N/A = not applicable.