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

PRIME MINISTER

GAS PRICES

I have seen Peter Walker's minute of 20 October.

2. As I said in my letter of 21 October to him, I really do find it hard to believe that the difference between 5 per cent and 6 per cent could cause the problems he foresees. All we would be doing is compensating for inflation since the last price increase. As far as BGC's profits are concerned, I understand that, with a 6 per cent increase, these would be of a similar order to those in 1982-83.

3. Peter refers to the way in which BGC have in the past calculated price increases in line with inflation. This is not the issue. The question is how we give effect to the policy decision we took at our meeting on 13 September. I agree with the view recorded in your Private Secretary's letter of 19 October; namely that this points to a 6 per cent increase in line with our forecast of inflation between October 1982 and January 1984.

4. Peter also argues that there has been a 57 per cent real increase since 1979-80. During the period of the three 10 per cent real increases we had two gas price increases a year; one each April to compensate for inflation in the previous year, and a 10 per cent increase each October. I am not sure how Peter has produced his figures, but I suspect that he may be comparing movements in the RPI between April 1980 and April 1983 against price increases in the same period. But that is not the correct comparison, for the increase in April 1980 was intended to compensate for inflation in 1979.

5. Indeed, if we were to pick up the old arrangements for compensating for inflation where we left them in April 1982, and were to make good the position since then, using BGC's method as described by Peter, I gather that we would now be talking about an increase of 10 per cent, not 6 per cent.



6. The letter of 19 October from your office also records your decision that the freeze on industrial prices should be extended to the end of 1983-84. In order to set BGC's EFL for 1984-85, we need to take a view now on what happens to prices when the freeze ends.

7. There are two possible approaches. First, we could keep industrial prices throughout the next three years below the level they would have reached without the extension of the freeze. As I understand it, this is the approach underlying Peter's proposal on BGC's public expenditure. Alternatively, we could in the April 1984 quarter move prices back to the levels at which they would have stood, but for the freeze. This would produce savings of £30 million a year in each of the next three years. I favour the second approach, but I would not wish to insist on it, and would settle for the first, provided that the £30 million were recouped in each year by slightly higher domestic prices. (The effect on domestic prices would be only an additional 1 per cent increase in January 1984 - ie to 7 per cent rather than 6 per cent).

8. I am copying this minute to the other recipients of Peter's, and to him.

John Kew.

PP. (N.L.)

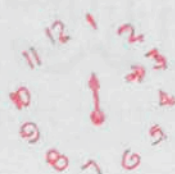
24 October 1983

[*Approved by the Chancellor, now in Luxembourg.*]

NAT IND : Gas + Electricity
H 8



24 OCT 1983





Prime Minister ⁽²⁾

PRIME MINISTER

To note and await Treasury reaction. Choice is 6 per cent which represents forecast inflation between October 1982 and Jan 1984 or 5.1% which is increase over latest known 15 month period.

GAS PRICES

I have seen Andrew Turnbull's letter of 19 October recording your views on gas prices.

I believe it is vital that further careful consideration is given to this issue. As I explained in my letter of yesterday to the Chancellor, the Gas Corporation are adamant that a 4% increase would be more than adequate. Both part-time and full-time Board members are resisting strongly the 5% increase I have proposed, and I am quite clear that there is no question of their being ready to contemplate a 6% increase or accept any responsibility for it. They could see no basis for it in the needs of the business or the profit position. To force a higher increase would require either an increase in the gas levy or special legislation to force the Corporation to raise prices against their will. I have already drawn attention to the considerable opposition that such an approach would trigger from the public at large, industry, Members of Parliament as well as the Corporation itself.

I would see a 5% increase, if that can indeed be achieved, as meeting the objective of maintaining gas prices in real terms at the level achieved by the three successive 10% real price increases. In fact, gas price increases have not followed RPI movement in a precise way: that is why there has been an increase over 1979/80, not of 3 x 10%, but of 57% in real terms. But when increases have been related to the RPI, the practice has been to base the increases on the RPI change in a period ended with the last published figure before a decision was reached. The last figure we have is for September 1983 and the increase on 1 January 1984 will be 15 months after the last one. The increase of the September 1983 RPI over 15 months earlier is 5.1%. In any event, the January 1984 price increase will be seen by consumers, as by BGC,



as this winter's increase at a time of 5% inflation; postponed a little because of BGC's good results. A higher figure would produce quite the wrong impression about inflation and damage the Government's counter inflation policy.

On all these grounds 5% is the maximum figure we can possibly justify.

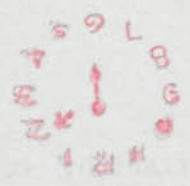
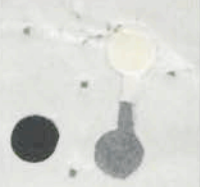
I am copying this letter to the Lord President of the Council, the Chancellor of the Exchequer, the Secretaries of State for Scotland, and Trade and Industry, the Chief Secretary, and Robert Armstrong.

A handwritten signature in blue ink, which appears to be 'R. Armstrong', is written over a faint, embossed watermark of the Royal Coat of Arms. The signature is fluid and cursive.

Secretary of State for Energy

20 October 1983

nat Ind,
Gas & Elect,
p78



20 OCT 1985

COMMUNIST

CONFIDENTIAL

cc J.P.

HU



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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10 DOWNING STREET

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c. LPO
SO
LPS
DTI
CDL
CS, HMT
CO
Chief Whips Office

From the Private Secretary

26 October 1983

Gas Prices

The Prime Minister has seen your Secretary of State's minute of 20 October and also the Chancellor's minute of 24 October. She feels that the issue of the increases in domestic and industrial gas prices should be considered by MISC 99. She feels it would be helpful for the Group to see the past exchanges between your Secretary of State and the Chancellor, the record of the 13 September meeting and my Private Secretary letter recording her view that the increase in domestic gas prices in January should be 6% and that the freeze on industrial prices should not be extended beyond March 1984.

I am copying this letter, together with these papers, to the Private Secretaries to members of the MISC 99 Group and to Sir Robert Armstrong.

ANDREW TURNBULL

Michael Reidy, Esq.,
Department of Energy.

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10 DOWNING STREET

Prime Minister

The Chancellor has now written arguing (again) for a 6 per cent increase in domestic gas prices.

(1) Agree we send this to MISC 99 for resolution?

(2) Agree I circulate past correspondence to group, starting with Michael's record of 13 September meeting, followed by the first Walter/Lawson exchange, my Private Secretary letter recording your view in favour of 6 per cent, and concluding with the second Walter/Lawson exchange?

In addition we could, if you wish, get Policy Unit to prepare some background briefing for Lord Cockfield.

Yes me
~~To I should Miss 99?~~ AT
24/10

20 October 1983

MR TURNBULL

cc Mr Mount

PUBLIC EXPENDITUE: ENERGY INDUSTRIESThe Figures

The Treasury are seeking total savings on top of the savings offered by Peter Walker of:

1984/5 £m	1985/6 £m	1986/7 £m	Total £m
400	300	75	775

The main items in dispute for particular industries total £1,130m, ie the Treasury have potential scope for compromise on individual items provided that total savings of at least £775 million are achieved.

The £1,130 million can be broken down:

	1984/5 £m	1985/6 £m	1986/7 £m	Total £m
NCB	100	100	100	300
ESI	260	140	60	460
BGC	160	100	110	370
Total	520	340	270	1130

NCB

Treasury wish to reduce the annual investment programme of £850-900 million by about £100 million per year. These cuts can be achieved without affecting investment in the modern economic pits and need not be perceived as questioning the Government's long-term commitment to the coal industry. They should be supported despite Peter Walker's arguments that cutting investment would stiffen NUM resolve against pit closures, and that MacGregor needs time to produce his own proposals.

Investment is anyway high for a bankrupt industry, and the recent MMC report considered that the NCB should be more cautious generally on investment plans.

ESI

Pricing	210	90	60
Costs	50	50	-

The pricing argument depends upon whether prices are reduced in line with the current financial target or whether the financial target should be tightened to reflect the original price expectations. Peter Walker maintains that a price freeze in 1984/5 ^{can be accommodated with} is consistent with the financial target. As a price freeze would also appear to be consistent with a move towards economic pricing principles, there is a strong economic and commercial case for retaining the original financial target which runs until 1984/5, and accepting the pricing implications.

However, there is a need to agree on pricing principles for future years in conjunction with the financial target from 1985/6 and to adjust the public expenditure figures accordingly. For the present, there is little difference between the Treasury and the Department for planning assumptions in the later years.

The cost savings reflect the Treasury view that cost reductions should be based on the ESI's Performance Aim of four and a quarter per cent rather than a planning assumption of three per cent; and that working capital and investment could be trimmed by about 10 per cent and 2 per cent respectively over the period. These savings seem reasonable, and should be supported.

One new sensible suggestion is that the CEGB should sell its ^{continental} Dutch coal stocks and thereby raise perhaps £70 million.

BGC

Domestic Pricing	50	20	30
Industrial Pricing	60	30	30
Cost Savings/Exchange Rate Assumption	50	50	50

Acceptance of a 6 per cent domestic price rise in January 1984 which the Prime Minister [REDACTED] has effectively endorsed will achieve the above savings on domestic prices. On the other hand, extension of the industrial price freeze until March 1984 which the Prime Minister has also endorsed ^{effectively} eliminates possible industrial

gas savings, at least in the first year. However, as with electricity there is a need to consider the proper basis for prices in future years. A move towards economic pricing could yield significant savings and the planning assumptions used for the IFR could be adjusted accordingly.

The cost savings result from corrections for BGC's assumptions on exchange rates and some marginal trimming of investment and working capital, and should be supported.

Energy Investment in the Wider Context

Although there are convincing arguments for individual investment decisions and for the general size of the investment programme in each of the energy industries, more fundamental questions should now be posed about energy investment. Is it appropriate to be investing ^{gas, £5.1 billion in electricity, and £2.6 billion in} £2.6 billion in coal over the next 3 years? Is this a sensible allocation of resources given the essential need to reduce public expenditure generally? What priority should we give to energy compared with the NHS etc? I think there is an important point here because we do not need to invest heavily in all energy industries.

We have the natural resources and in the context of public expenditure constraints, could give different priorities to investment in the different energy industries.

On gas, the consequence of pricing below economic levels will be to stimulate demand leading to yet more investment.

On electricity, we don't need Sizewell on capacity grounds, although there is a strong case on economic grounds for nuclear investment in order to reduce electricity prices. But Sizewell is a £1.3 billion investment of which £300 million is included in the figures for the next 3 years. Should we continue to invest heavily in both electricity and coal?

Conclusions

Of the possible £1,130 of potential savings identified by the Treasury, there appears to be a clear case for achieving:

1984/5	1985/6	1986/7	Total
£m	£m	£m	£m
250	220	180	650

made up?

This compares with the Treasury's minimum target of:

400	300	75	775
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Of the other items, the question of an electricity price freeze in 1984/5 is the most significant. In this case, the importance of public expenditure savings will need to be balanced against a strong argument for maintaining the existing financial target and moving closer towards economic pricing in 1984/5. For future years, there is an urgent need to agree the basis and desirability of moving to economic pricing for all fuels which is likely to produce additional revenue.

The question of whether high levels of investment in all the energy industries at the present time should also be addressed.

D.P.

DAVID PASCALL