7

POLICY UNIT

MR TURNBULL ✓ AS 26/10

26 October 1983 (Revision 2)

cc Mr Mount

PUBLIC EXPENDITURE: ENERGY INDUSTRIES

The Figures

In summary the differences between the Department of Energy and the Treasury are:

	1984/5 £m	1985/6 £m	1986/7 £m	
Energy	+130	-540	-1355	
Chief Secretary	-270	-840	-1430	
Total	400	300	75	775

The main items in dispute for particular industries total £1070m, ie the Treasury have potential scope for compromise on individual items provided that total savings of at least £775m are achieved.

The £1070m can be broken down:

	1984/5 £m	1985/6 £m	1986/7 £m	
NCB	100	100	100	
ESI	260	140	30	
BGC	120	110	110	
Total	480	350	240	1070

NCB

Treasury wish to reduce the annual investment programme of £850-900m by about £100m 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

The figures can be broken down:

	1984/5 £m	1985/6 £m	1986/7 £m
Pricing	210	90	30
Costs	50	50	-

The pricing argument depends upon whether the existing financial target (1.4% on current assets in 1983/4 and 1984/5) should set the basis for price reductions in 1984/5 or whether the original price expectations should be implemented. The latter would result in an overshoot on the financial target. At the time the target was set it was anticipated that the price freeze in 1983/4 would be followed by a price increase of about 1½-2% below the rate of inflation in 1984/85. Peter Walker now maintains that a price freeze in 1984/5 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 result from the Treasury view that cost reductions should be based on the full achievement of the ESI's Performance Aim of four and a quarter per cent; that investment could be trimmed by about 2 per cent over the period; and that coal stockpiled in Holland and Belgium should be sold. These savings seem reasonable and should be supported.

BGC

Domestic Pricing	40	30	30
Industrial Pricing	30	30	30
Cost Savings/Exchange Rate Assumption	50	50	50

The savings on domestic pricing depend upon whether prices rise by 6% or 5% in January 1984. A rise of 6% would be consistent with the decisions reached at the Prime Minister's meeting of 13 September 1983 to maintain gas prices in real terms. Peter Walker is arguing that the conclusion of the Prime Minister's meeting implies a 5% rise although this would result in real price reductions during the period in question - the 15 months between October 1982 and January 1984. Peter Walker's main argument against 6% is the degree of BGC opposition and political difficulty which would result. It is doubtful whether an additional 1% rise would create unacceptable problems particularly as the maintenance of prices in real terms is a sensible and defensible policy. This argument needs to be settled quickly in order for any price rise to be introduced on 1 January 1984. The Treasury's case should be supported unless Peter Walker really does consider that 6% is totally unacceptable.

On industrial pricing, the Prime Minister has expressed the view that the current industrial price freeze should not be extended beyond March 1984. The Treasury had argued for ending the freeze in December. They now argue that the loss of revenue resulting from a freeze in the first quarter of next year should be recouped in the future either by slightly higher industrial prices or by slightly higher domestic prices. As there is no agreement on the pricing principles which should apply after the freeze ends, it would appear reasonable for planning purposes that industrial prices should be assumed to rise at least in line with inflation. This approach is likely to justify some but not all of the Treasury's bid - perhaps £10-20m per year.

However, as with electricity, there is a need to agree the proper basis for prices in future years after the immediate decisions on pricing and planning assumptions have been agreed. A move towards economic pricing could yield significant public expenditure savings.

The cost as opposed to price savings in the above table result from corrections for BGC's assumptions on exchange rates and some marginal trimming of investment and working capital. These are reasonable and should be supported.

The Pricing Debate

A few comments are appropriate to put the current pricing dispute into context.

Economic pricing is in the interests of both economic and energy policy objectives. The adoption of economic pricing is likely to require prices rises for gas but price reductions for electricity. This is likely to cause the Department and the Treasury respectively some short term difficulties.

There is no agreement about the basis for setting economic prices for gas or electricity. The position on coal is broadly acceptable with prices set on an import related basis. An agreed set of economic pricing criteria on gas and electricity is required to enable the implications, desirability and timescale of moving towards economic pricing during this Parliament to be considered further. Such a programme is likely to produce net revenue savings.

There is also a need for a consistent approach on economic pricing and financial targets for all the energy industries. Pricing principles should be taken into account in setting the financial target. There is currently no financial target for gas which should be deferred until pricing principles are agreed. The existing financial target for electricity runs until 1984/5 and sets the framework for current pricing decisions. Any subsequent financial target should reflect an agreed position on pricing principles.

Energy Investment

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 £2.6 billion in gas, £5.1 billion in electricity, and £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? Do we need to invest heavily in all energy industries?

On gas, the consequence of continuing to price 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 and to reduce dependence on coal. But Sizewell is a £1.3 billion investment of which £300m is included in the figures for the next 3 years. Although it is vital to secure the go-ahead from the Sizewell inquiry, actual construction could follow at a leisurely pace thereafter. On coal, the MMC heavily criticised the NCB's investment programme.

Conclusions

Of the possible £1070m of potential savings identified by the Treasury, there appears to be a strong case for achieving:

	1984/5 £m	1985/6 £m	1986/7 £m
Coal			
Investment	100	100	100
Electricity			
Costs	50	50	
Gas			
Domestic Pricing	40	30	30
Industrial Pricing	ca 10-20	ca 10-20	ca 10-20
Cost Savings	50	50	50

TOTAL	250-260	240-250	190-200	680-710

This compares with the Treasury's minimum target of:

	400	300	75	775

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. This is likely to produce additional public expenditure savings.

The question of whether high levels of investment in all the energy industries is justified at the present time should be considered further.

DLP.

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JDK

10 DOWNING STREET

From the Private Secretary

26 October 1983

Public Expenditure Survey: Energy Prices

To help him in his work on MISC 99, the Chancellor of the Duchy might like to see the attached note from the Policy Unit which sets out the issues at stake on the energy nationalised industries.

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