PERSONAL AND CONFIDENTIAL

Prime Minister (2)
To note
AT 5/12

Electricity prices file

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

5 December 1983

Andrew Turnbull Esq
10 Downing Street

Dear Andrew,

I understand that the Prime Minister recalled - during her talk with the Chancellor on 30 November - that the electricity supply industries were in trouble over their EFL in 1979-80, and that it had to be increased.

The Prime Minister was quite right. The EFL was raised by £300 million in March 1980 - see attached press release.

About two-thirds of the increase was linked to a build-up of stocks, which Ministers had encouraged, and which the public announcement welcomed. It follows that there is a limit to the extent to which we could now rub the industry's nose in the issue. But of course the episode did provide revealing evidence of the poor nature of their monitoring and control: in December 1979 they forecast an overshoot of £62 million; by mid-January 1980 it had risen to £254 million; and by mid-February to £325 million.

I believe the outturn was only £200 million higher. AT

I am not issuing copies of this letter.

Yours ever,

John Kerr.

J O KERR
Principal Private Secretary

Reference No 59

March 26, 1980

(Out of hours: 01-215 7877)

NEW EXTERNAL FINANCE LIMIT FOR ELECTRICITY SUPPLY INDUSTRY

Mr David Howell, Secretary of State for Energy, announced today (March 26) that the external finance limit for the electricity supply industry in England and Wales is to be raised by £300 million in the current financial year. But he said that the new limit would not add to the public expenditure planning total for the year.

Replying to a Parliamentary Question, Mr Howell said:

"The Electricity Council has sought an increase in its external financing limit to cover variations in the electricity industry's cash flow and its trading circumstances compared with the assumptions on which the limit was based. This is mainly due to the successful build up of fuel stocks which, in the increasingly uncertain world energy supply situation, the Government welcomes.

"In these exceptional circumstances, and having satisfied myself that the industry has taken all reasonable steps to absorb these unforeseen increases in its financing requirement, I have agreed to an increase in its external financing limit in the current year from (-) £68m to (+) £232m. This increase is partly met by prospective shortfalls in the financing requirements of other nationalised industries, and partly from the contingency reserve in the public expenditure plans; consequently it does not add to the public expenditure planning total".

BACKGROUND NOTE

The external finance limit for an industry is the limit on the amount of money that the industry may borrow, from all sources, in a given financial year.

Financial Times THURSDAY 1st DEC. 1983

file

Electricity prices 'could be cut by 7%'

By Ian Hargreaves

ELECTRICITY prices could be cut by as much as 7 per cent and then be held stable for a period without damage to the supply industry, according to an independent report circulating in Whitehall.

The report, by accountants Coopers and Lybrand, argues that the present formula used by the industry in setting electricity prices takes insufficient account of the gap in power station building caused by overcapacity.

But the report says that if allowance is made for the gap in power station building, it would trim the industry's annual requirement by between £500m and £700m — a saving which could be passed on as lower prices.

Government policy has been to ensure that electricity prices are set at an economic level, covering the costs of meeting additional demand and including a 5 per cent return on capital.

The report says that since overcapacity is likely to persist for up to 10 years, it might be possible for the industry to hold prices stable for several years after a price cut.

The report was commissioned by Mr Nigel Lawson, then Energy Secretary, following the 1981 Monopolies Commission report on the Central Electricity Generating Board.

It was intended to settle whether the tariff formula should be based on the hypothetical cost of new plant, the actual cost of existing plant or a mixture of both. Coopers decided on the cost of existing plant.

Although the report's findings have been challenged both the Energy Department and the industry, which considers the proposed formula to be improvident given need for nuclear stations such as the one proposed for Sizewell, it provides a sidelight on the controversy over electricity prices.

Mr Lawson, as Chancellor, has been pressing for higher prices and a larger payment by the industry to the Exchequer through its external financing limit. But he appears to have retreated from his initial demand for a price increase of 3 per cent next spring.

The line taken by Mr Peter Walker, the Energy Secretary, since Mr Lawson announced the tighter external financing limit in his autumn financial statement, is that it is up to the industry to make decisions about prices.

The Treasury had threatened to force prices up either by raising the Electricity Council's financial target from a 1.4 per cent return on net assets or by sending a letter specifically requesting the price increase.

Since criticism among Conservative backbenchers and in industry over the proposed price increases, Mr Lawson appears to have back-pedalled.

Unless he makes another move, the Electricity Council is likely next month to decide upon a zero average price change next April, which means some tariffs in certain unspecified areas could rise modestly, and to review the position later in the year.

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~~CC~~ NO.

Prime Minister
This crossed with my letter commissioning a note for Cabinet colleagues, to be taken next week. This is a small advance but no more. While X gives some reassurance, I don't think Y will cut much ice.
Agree await paper for Cabinet?
AT 9/12

Yes
MT

01 211 6402

PERSONAL AND CONFIDENTIAL

Rt Hon Nigel Lawson Esq MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
London SW1

8 December 1983

Dear Chancellor

ELECTRICITY PRICES

Thank you for your letter of 29 November.

I fully understand your concern that the electricity industry should in fact achieve the EFL set them for 1984/85 and that the NCB should not add more than is necessary to your public expenditure difficulties, though it is fair to say that the electricity and gas industries between them contributed over £400m to savings in 1984/85 in the recent Investment and Financing Review.

But I think we have to be careful not to treat these industries in much the same way as we would treat cash limited Government Departments. As you know, these are commercial undertakings and their EFLs, like the PSBR itself, are cash flow differences between very large flows of expenditures and receipts. In the case of the electricity industry, we are talking of an aggregate of the separate budgets of 13 statutory Boards. These are figures of a very different type and quality from many programmes of Government Departments, especially when one tries to look two or three years ahead.

I think this bears on the question of the precise identification of savings. I do not think we can look at this mainly or wholly in terms of specific cuts. What the industry has to do, and has said it will seek to do, is to manage its affairs so as to produce the £740m payment to the Exchequer in 1984/85.

The Chairman of the Electricity Council is confident that with a special effort, the industry will achieve this. If the Council finds that it cannot see its way to achieving the EFL without a price increase, it will impose a small increase during 1984/85. I think that the balance of this should be a matter for the Council to decide.

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only after the 1979-80 EFL was raised.

The Council have a good record in this respect. They have achieved their EFL in each of the past 5 years. They are on course for achieving their cost saving performance aim for the two years 1983/84 and 1984/85. Their latest view of their EFL overshoot in 1983/84 has risen from £170m to £184m, though the winter months, with their uncertainty for the industry's cash flow, lie mainly ahead. They propose to review the management of working capital, a point to which the Treasury has recently attached importance. Beyond this, they will now be looking at any and every area where some extraordinary savings can be made. As I have said, I shall be monitoring progress closely.

X There is no question of meeting the EFL by running down power station coal stocks. The figures to which you refer assumed a modest rundown of the CEGB's continental stock pile, which I know you would like to see, but which must in the end depend on our coal import policy. There is no impact here on endurance.

You also asked in your letter about the course of electricity prices to industry. Y The Council tell me that in 1983/4 industry will in fact fare better than domestic consumers as a result of the combined operation of the industrial tariff and the fuel price adjustment clauses. The operation of the fuel price adjustment clause in 1984/85 is expected to do no more than restore the balance between the two classes of consumer.

The Council is also well aware that, within an average price standstill, some Area Boards will need a small price increase anyway. I understand that they will be considering ways in which this might be alleviated and I shall certainly keep in touch with their thinking. But we are talking here of management at Area Board level and we have to bear in mind that it would be contrary to our general approach to efficiency to urge that the consequences of differences of financial performance between Areas be obscured by equalisation.

As regards the position of the NCB, my officials are in touch with yours about setting a revised EFL for 1983/84 which will impose a better financial discipline for the remainder of 1983/84. I think, however, that it would be quite wrong to require the electricity industry to achieve a higher EFL more than half way though a financial year simply in order to offset bad performance in another industry where anyway a large part of the trouble is attributable to a decision to carry over £130m of excess from the 1982/83 NCB EFL into 1983/84 in order to assist a PSBR outturn in 1982/83. I come back to the point that we are not here talking about two Departmental services within a single cash limit.

In fact, as I have said, the latest view of the electricity EFL overshoot in 1983/84 is £184m and, provided all goes well in the rest of the year, the 1983/84 PSBR will get the benefit of that. And the Chairman tells me that he has succeeded in convincing his Council that a rebate in 1983/84 would not be the right course; and that it would be better to minimise any tariff increase in 1984/85. So I have every hope that your point about 1983/84 will be largely met in substance, but without taking steps which would undermine the proper management and financial responsibility of the industries.

I think you may agree that there is here a satisfactory way forward on outstanding questions which could be reported as appropriate to colleagues.

I am copying this letter to the Prime Minister and to Sir Robert Armstrong.

Yours sincerely

Michael Reidy

for PETER WALKER
Approved by the Secretary of State and
signed in his absence.

Nat. Ind: Gas + Elect
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