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PRIME MINISTER

Public Expenditure Survey 1983: Electricity Prices
(C(83) 36)

BACKGROUND

The Ministerial Group on Public Expenditure (MISC 99) agreed with the Secretary of State for Energy, and recommended to the Cabinet, a package of savings on the nationalised energy industries. In addition to a reduction in the NCB's investment programme, £128 million was to be found by efficiency savings from the gas and electricity industries (we understand that the bulk is, in fact, to come from the electricity industry); and a further £210 million was to come from an increase of 3 per cent in electricity prices in England and Wales. In the absence of his Secretary of State, the Minister of State, Department of Energy, pointed out that the electricity supply industry (ESI) might be unwilling to increase prices in this way, and that the Government had no statutory power to require it to do so. The Secretary of State therefore wished to have discretion to agree to alternative proposals providing equivalent savings. The Cabinet took the view that the proposed price increase was fully justified; in particular, it avoided the risk that subsequent price increases might have to be more severe than was desirable. The Cabinet were not ready at that stage to regard efficiency savings as a substitute for desirable price increases. The Secretary of State for Energy was invited to make strenuous efforts to persuade the ESI to accept the Government's views (CC(83) 33rd Conclusions, Minute 4).

2. Since then there have been exchanges with the Chairman of the Electricity Council, Mr Philip Jones (see in particular his letter of 21 November attached to the Secretary of State for Energy's letter to the Chancellor of the Exchequer of 24 November), and between Ministers (see in particular the Chancellor's letter of 29 November and the Secretary of State for Energy's reply of 8 December). Your Private Secretary's letter of 8 December asked

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the Secretary of State for Energy to circulate a note to the Cabinet for discussion. This was to cover three points:

(i) What alternative savings have the ESI discovered, and are they acceptable?

(ii) Are the prices proposed by the ESI consistent with the principles of economic pricing?

(iii) Is the proposed balance between domestic and industrial electricity prices sensible?

3. In response to this the Secretary of State for Energy has circulated his memorandum C(83) 36. His proposal (paragraph 11) is "to leave the industry now to minimise price increases within the new and exigent EFL". This means in practice, as the rest of his paper indicates:

(a) that the industry would do its utmost to live within the already announced EFL for 1984-85 of minus £740 million (ie repayments to the National Loans Fund of that amount);

(b) that it would not do so by unacceptable devices such as running down coal stocks at the expense of power station endurance or "end-year switches of money"; and that the industry would be reviewing working capital requirements as urged by the Treasury;

(c) that it would be ready to propose price increases during the year if necessary to achieve the EFL.

The Secretary of State also argues that the resulting prices are reasonable in economic terms and that they hold a proper balance between domestic and industrial consumers, the small increase for industry in 1984-85 offsetting the small reduction for industry in 1983-84.

MAIN ISSUES

4. The main issues before the Cabinet are as follows:

(i) Should the proposals on electricity prices in C(83) 36 be accepted?

(ii) If so, should any conditions be attached to that acceptance?

(iii) If not, how should the ESI be made to increase prices in 1984-85?

Should the proposals be accepted and, if so, on what conditions?

5. In considering whether the Secretary of State for Energy's proposals should be accepted, the Cabinet will need to satisfy itself on the following points:

(i) Is the proposed path of price increases now satisfactory? One of the main reasons why MISC 99 favoured an increase of 3 per cent in 1984-85 was to ensure that the increase in 1985-86 could be 3 per cent rather than 6 per cent as envisaged earlier by the industry. The Electricity Council has now told Mr Walker that its latest forecast is for a price increse of only 3 per cent in 1985-86 even if there is little or no price increase in 1984-85. If this had emerged in time for the discussions of MISC 99 they might well have taken a different view. There may be some residual concern about the possibility of a price increase which the ESI is ready to contemplate later in 1984-85 should it prove necessary to meet the EFL. If there was any danger that this increase might, as a result of postponement, have to be higher than the 3 per cent originally proposed by the Government from 1 April 1984, this would not produce a satisfactory path. This is a point on which Mr Walker and the Electricity Council might be asked to give reassurance.

(ii) Are the pricing proposals reasonably consistent with the principles of economic pricing? In general the thrust of recent discussions about economic pricing of gas and electricity is that gas has been underpriced (because the price has not taken adequate account of the world market price of the new gas supplies on which we shall increasingly have to rely) whereas electricity has been overpriced (because inadequate account has been taken of spare capacity and the low present requirement for investment). It would be difficult to argue a strong case on economic pricing principles for insisting on a 3 per cent rather than a smaller or nil increase in 1984-85. It would of course be contrary to the Government's general policy to subsidise electricity prices, which Mr Walker has sometimes seemed inclined to favour. But Mr Walker and the ESI would argue that a subsidy is not at issue here. The Cabinet was concerned at the meeting on 10 November that the financial target for the industry for 1983-84 and 1984-85, 1.4 per cent on current (not historic) cost assets, may be too low. If the target were to be increased, higher prices would probably be required. But, whatever the merits of increasing the target might be, it is not in practice easy to justify putting the target up again so soon after reducing it (from 2 per cent) in March 1983.

(iii) Is the impact on industry of the pricing proposals satisfactory? It emerged from the Electricity Council's letter of 21 November (and this is referred to in paragraph 10 of C(83) 36) that even if prices are frozen overall in 1984-85 charges for industrial and larger commercial consumers would rise by nearly 2 per cent and the increases for industrial consumers in the Midlands would come out nearer to 4 per cent. The question is therefore whether it would be feasible and desirable to change the balance of the ESI's pricing proposals in favour of the industrial consumer. The difficulty is that such price increases as might affect the industrial consumer appear to result not from any conscious decision by the ESI to load price increases on the industrial consumer but from the operation of the fuel price adjustment and from the fact that prices set by different Area Boards vary around the overall average. It would be odd for the Government at one moment to be pressing the case for more realistic and higher prices and at the next moment to be urging the ESI to charge lower prices to industry on industrial policy rather than economic pricing grounds. But the Secretary of State for Energy is already in touch with the ESI (paragraph 10 of C(83) 36) about alleviating the effects on industry of inter-area price differences.

(iv) Are the alternative savings credible and acceptable? It is unlikely that the dispute over electricity prices would have arisen if the ESI and Mr Walker had come forward with the alternative savings in the bilateral discussions or in MISC 99. It suggests either that something was being held back or that financial control and forecasting were not previously as tight as they should have been. But whatever view may be taken about the past, the Cabinet now has to consider whether there is sufficient assurance that the savings will be found in an acceptable way. Some assurances have now been given that certain unacceptable devices will not be used and there is a suggestion that particular attention will be paid to working capital requirements. Should agreement to Mr Walker's proposals be made conditional on further information being supplied about the ways in which the savings will be found? Or has this line of enquiry now been taken far enough in view of the general policy that it is for a nationalised industry itself to work out how it lives within its EFL?

Securing price increases opposed by ESI

6. If the Cabinet are not disposed to agree to the proposals in C(83) 36 it will be necessary to consider how the Government's views on prices can be made to prevail. One possible course would be to invite the Secretary of State for Energy to negotiate further with the ESI, making it clear that the Government finds their alternative proposals unconvincing. The Cabinet will probably however take the view that this approach has now been exhausted. Failing that, there appear to be only two possibilities:

(a) to take statutory powers to control nationalised industry prices; or

(b) to impose a smaller EFL, or a higher financial target, or both. If it were decided to proceed by setting a higher financial target, it will be for consideration whether to give financial targets statutory force (which they already have in a few industries); the question probably does not arise with EFLs, since Ministers already have statutory powers over the borrowing of nationalised industries.

7. Any legislation would probably be of general application, and not restricted to the ESI. If the Cabinet should favour this possibility, it would therefore be appropriate to invite Treasury Ministers to bring forward proposals.

Premature disclosures

8. The Cabinet's task has been made more difficult by widespread rumours and speculations in the media about the Government's views on electricity prices. You will no doubt wish to impress on your colleagues the importance of trying to avoid giving them further currency.

HANDLING

9. You will wish to invite the Secretary of State for Energy to introduce his memorandum. The Chancellor of the Exchequer might then be invited to reply; the Chief Secretary, Treasury may also have comments from the standpoint of public expenditure. The Lord President of the Council may wish to comment on any points relating to the work of MISC 99. The Secretary of State for Scotland may have comments on any implications for the electricity industry in Scotland, and the Secretary of State for Trade and Industry on the implications for industrial consumers, particularly regarding the balance between industrial and domestic prices. Should any question of legislation arise, the Lord President and the Lord Privy Seal would wish to give their views.

CONCLUSIONS

10. You will wish the Cabinet to reach conclusions on the following:

(i) Do they approve the proposals in C(83) 36 regarding electricity prices and the electricity supply industry's external financing limit in 1984-85?

(ii) If so, do they wish to attach any conditions to that approval?

(iii) If not, how would they wish to bring the electricity supply industry to agree to the Government's views?

approved by ROBERT ARMSTRONG
and signed in his absence.

Lindsay Wilkinson

14 December 1983