SECRETARY OF STATE FOR THE ENVIRONMENT

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My ref:
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The Rt Hon John Wakeham MP
Department of Energy
Thames House South
Millbank
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NBPM

PRG 22/9

22 September 1989

Dear Secretary of State,

FORMULA RATING REVIEW

Thank you for your letter of 8 September. I have also seen the letters from Peter Walker of 29 August, Norman Lamont of 11 September and James Douglas-Hamilton of 12 September.

I note that you are content with the proposed rateable value for British Gas but have reservations about the proposals for the various parts of the electricity industry. The points in your letter about rateable values for the electricity industry have already been raised with my officials by the industry itelf, which naturally wishes to minimise its tax burden, and there have been extensive discussions in which your Department has been involved.

As you know, the working groups of officials set up two years ago to review the formulae for the gas and electricity industries, on which your Department was represented, concluded that the best way of deriving rateable values was to start from the industries' asset values, as shown in their Current Cost Accounts. We have done this, using much the same methodology in both cases. We have deducted substantial allowances from the CCA values before applying the prescribed decapitalisation rate of 6% to derive a rateable value. We have used the same approach for some of the other formula rated industries too - water, and the two telecommunications operators.

In the absence of conventional valuation by the Valuation Office - which we would both prefer - I do not think that there is any other satisfactory method of assessing the electricity industry. The approach which we have used is of course modelled on the "contractor's test" which is widely employed in conventional valuation. You refer to the valuation produced by the industry's agents based on its profits, but I am dubious whether a valuation derived from profits is valid for a regulated industry of this character. The assessment produced by the agents is certainly not accepted by the Valuation Office.

You have argued that the assessment should reflect possible changes in the values of the generating companies' assets as a result of their contracts with the suppliers after privatisation. However, the whole of the 1990 non-domestic revaluation is based on the state of the rental market at 1 April 1988. So rateable values for business as a whole will reflect rental levels at that date. It follows that in producing assessments for the formula rated industries we must use their 1987/88 accounts so as to achieve comparable values, although as my minute of 22 August to the Prime Minister indicated, I have accepted that we should reflect the proposed retrospective adjustments to the CEGB's 1987/88 accounts. There will however be provision in the formulae for year by year adjustment of rateable values to take account of changes in generating capacity. As you say, the 1995 revaluation will provide the opportunity for a comprehensive review, particularly if the return to conventional valuation is effected then; but I see no reason for believing that this would result in the substantial reductions in rates that you suggest.

You raise the question whether, in setting rateable values, an allowance should be made for the actual level of use of generating capacity and the distribution system. This seems relevant to us only to the extent that there is genuine spare capacity over and above that required to meet peak loading, and to provide standby and reserve capacity for plant out of service. My understanding is that the industry does not have excess capacity of this kind and therefore we have made no such allowance. I see no parallels with our treatment of the water industry here. For that industry we have made allowance for the fact that much of its assets were built in the last century and were provided in a very fragmented way by the old water undertakings. Modern replacement of these assets would permit rationalisation and lower costs. The same issue does not arise in relation to electricity.

I know that the industry believe that the low voltage distribution network - the local service connections to customers' premises - should be excluded from the assessment. It argues that under the plant and machinery regulations this network is not rateable. But those regulations do not and are not intended to cover the formula rated electricity industry. They are not relevant to this exercise. It is worth noting that in the case of the gas industry the value of service connections has been taken into account in arriving at the rateable value.

I fully share your concern that we should get the valuation of the industry right in both relative terms. However, the comparisons which you and the industry have made with the rates bills of manufacturing industry are misleading. The electricity industry makes much greater use of rateable plant in its productive process and one would expect its rateable value as a proportion of turnover to be greater than for manufacturing industry. The more readily comparable industry is again, I suggest, the gas industry, where you have accepted a rateable value representing a proportion of turnover very similar to that proposed for the electricity industry.

I do not see any justification in rating terms for reducing further the aggregate value of £1551m for the industry set out in my minute to the Prime Minister of 22 August. This assessment will only result in a very small increase in the industry's bill. Nor do I see any reason for giving this industry - uniquely - special transitional treatment. For rating purposes the CEGB and the area boards have always been treated as separate entities and were we to ring-fence the industry and in effect place it outside the transitional scheme applying to all other rate-payers, other large ratepayers with widely spread property holdings would want similar treatment.

We need to make the formula rating orders in November, and before that must consult the industries at Board level, the local authorities and other ratepayers. As a first stage I would like, next week, to write to the chairmen of British Gas and of the Electricity Council with my proposals. During the consultation period I would be happy to receive representations from the industries, if they feel it necessary; discussions between our Departments can also continue. If the case for any further reduction in rateable value were to be substantiated, we would have time to revise the figure before making the order.

I am copying this letter to the Prime Minister, Nicholas Ridley, Malcolm Rifkind, Peter Walker, Norman Lamont, Cecil Parkinson and to Sir Robin Butler.

Yours sincerely

pp CHRIS PATTEN

(Approved by the Secretary of State
and Signed in his Absence)

LG: Rates