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FROM : S A ROBSON
DATE : 16 OCTOBER 1984

PS/CHIEF SECRETARY

c.c. Chancellor of Exchequer
Mr Bailey
Mr Monck
Mr Burgner
Mr Scholar
Mr Webb
Dr Bird

MISC 106 : GAS AND ELECTRICITY

Attached is the full briefing for the meeting on October 19.

2. It consists of my submission of 12 October giving a general overview plus detailed supporting material.

3. Could you please circulate to MISC 106 members. I am dealing separately with No 10 and the Cabinet Office.

SAR

S A ROBSON

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CONFIDENTIAL

FROM : S A ROBSON
DATE : 12 OCTOBER 1984

Chief Secretary

c.c. Chancellor of Exchequer
Mr Bailey
Mr Monck
Mr Burgner
Mr Scholar
Mr Webb
Dir Bird

MISC 106 : GAS AND ELECTRICITY

This is a general brief for the meeting on October 19. Detailed briefing on the elements of our approach is attached.

2. The position is basically as follows. In order to meet the E(A) target for nationalised industries you have asked Mr Walker to produce savings on gas and electricity (compared to baseline)to (£m).

	1985-86	1986-87	1987-88
	-400	-600	-1000

He has offered nothing so far and has merely endorsed the industries bids which together total (£m) :

	+183	+535	+959

This means the gap is

	585	1135	1959

These figures are in paragraph 1 of the MISC 106 paper.

3. Your proposals for closing this gap can be described as fllows :

<u>ESI</u>

- Financial target rising to 4½% over next 3 years; averaging 3.6% (para 5 of paper)	-250	-400	-700
- Savings on capital expenditure, asset sales and efficiency (para 5 of paper)	-175	-375	-450

	1985-86	1986-87	1987-88
BGC			
- savings on capital expenditure and in other areas (para 8 of paper)	-70	-150	-260
- average 4 per cent real price increase (para 6 of paper	-220	-440	-774

If these measures were all agreed, they would more than cover the gap. Annex I of the detailed brief covers BGC and Annex 2 the ESI. Each Annex has a contents page.

4. The key points to make are :

(a) the savings on capital expenditure and in other areas are relatively small for both gas and electricity and are no more than an attempt to substitute for the absence of market pressures for efficiency. For BGC the savings are equivalent to 1 per cent of costs in 1985-86 rising to 3 per cent in 1987-88. For the ESI, the cuts build up about 8 per cent of costs.

(b) the ESI financial target is well below returns in the private sector (currently about 8½ per cent). It could be achieved with prices rising little or no faster than inflation (i.e. 4-5 per cent) if the industry really went for the cost savings open to it in the way a private sector company would.

(c) gas is underpriced and something around 20-25 per cent. This is based on figures from BGC and the department. You are only looking for to close about half this gap.

5. Mr Walker may use the following.

Baseline should be increased on account of corporation tax - this was considered by E(A) and rejected. The target was set on the existing baseline. Commentators would see messing with the baseline as a pure "fiddle". In any case our savings are justified on merit regardless of the treatment of corporation tax. Private sector companies have to trim their affairs to meet their CT payments; so should nationalised industries.

<u>Treasury totally unrealtistic</u>- not so. Mr Walker's officials have been consistently unable to rebut our proposals. They have latterly refused to enter into any dialogue about them.

<u>Proposals would upset electricity unions during miners strike</u>- this is pure scare tactics. The unions have shown themselves wholly responsible in relation to exploiting the miners strike and in relation to increasing the efficiency of the electricity industry in the past.

<u>Treasury proposals lead industries into huge profits</u> - these industries have vast capital assets (ESI over £35bn, BGC over £14bn), their returns would not be large. ESI at 3½ per cent would be well below most large public sector companies (e.g. BP at 8.7 per cent, ICI at 6.8 per cent, Hanson Trust at 18 per cent) BGC profits might rise to 8-9 per cent by 1987-88, unless the money were taken out using the gas levy.

<u>Gas levy increase would not help public expenditure</u>. Formally correct but it would help PSBR. The position on the gas levy could be carefully spelt out in public expenditure presentation - as it was in the main table of the 1982 White Paper.

<u>BGC have a financial target of 4 per cent</u> - true but when this was set Treasury and Energy Ministers specifically agreed that it was subject to review of BGC's prices.

<u>Price increases fuel inflation</u> - It is not the Government's policy to tackle inflation by holding down nationalised industry prices. The increase in gas price would add only about 0.3 percentate points to the RPI by 1987-88.

International comparisons - Domestic gas prices are the lowest in Europe alongside the Dutch. Prices in France and Germany are 40-50 per cent higher. Industrial gas prices are 20 per cent below Continental levels. On electricity, industrial prices are in line with the Continental, apart from France with its large nuclear generating capacity.

pp S. Cllingworth

S A ROBSON

ANNEX 1

BRITISH GAS CORPORATION

The Treasury's proposals for savings are made up as follows (£ million) :

		1985-86	1986-87	1987-88
A.	Savings on gas purchase, capital investment asset sales and efficiency			
1.	reducing surplus gas supplies	-25	-45	-115
2.	phase out R&D into SNG	-10	-20	- 40
3.	increased land sales	-5	-10	- 10
4.	reduced capital expenditure	0	-40	- 55
5.	reduced working capital	-20	-30	- 40
6.	lower trading costs	-10	-20	- 30
	Total after adjustment for tax consequences	-70	-150	-260
B.	Gas prices			
7.	Gas price increases	-220	-440	-774

Detailed notes on each are set out in the following sections.

1. REDUCING SURPLUS SUPPLIES OF GAS

	1985-86	1986-87	1987-88	(£ million)
Savings proposed :	-25	-45	-115	

BGC are forecasting peak day gas surpluses by 1987-88 of some 9m therms a day (or about 8 per cent of demand). In part this is needed for insurance against particularly cold weather or supply uncertainties, but at least half is an expensive over-provision of supply. The Treasury proposals are :

(i) contract for less gas. BGC have already agreed contracts for supplies for 1985-86 and 1986-87, but in 1987-88 some gas has yet to be contracted. If BGC did not contract for about half the outstanding gas there would be savings of :

-	-	-100

(ii) delay filling Rough. Rough is a BGC storage facility which is soon to be completed and brought into use. Delay in filling Rough would not save on gas costs (since the gas has to be paid for anyway) but saves on operating costs :

-15	-15	-15

(iii) delay Morecambe II : Morecambe is being developed by BGC to meet peak periods of demand. The second stage is planned to become operation in 1988-89. It is not needed until the following year. One year's delay would provide :

-10	-30	-

Points to Make

- BGC is planning to pay for around £150m worth of gas (to fill Rough and by prepayment for unwanted gas) over the IFR period that it will not be selling until later years. Some guarantee of security of supply is sensible but guarantee on this scale (i.e. 9 million therms or 8 per cent over supply) is over-insurance on a scale that would be intolerable for a private sector firm.

- BGC are loathe to supply relevant facts and figures. A Wood Mackenzie analysis confirmed that BGC will have surplus supplies into the late 1990s. Wood Mackemzie also show that this surplus gas will be found in storage (i.e. Rough) in BGC's own fields (i.e Morecambe) and third party peak supplies. These are the areas where savings are proposed.

- There is evidence that BGC is not making full use of its ability under interruptible supply contracts to cut off supply to industrial consumers at times of winter peak. The essence of these contracts is that customers accept this risk and get correspondingly cheaper gas. As BGC is not in practice cutting these supplies to help meet peak times of demand it means these consumers are getting gas on the cheap (quite apart from the question of economic pricing). BGC should exploit its interruptible contracts to the full.

<u>Defensive</u>

<u>Should not confuse peak demand with annual demand where no surplus is expected</u>
Proposals aimed at peak demand and gas purchased but not for sale in IFR period. The proposals would in <u>no way</u> jeopardise BGC's ability to match annual supply and annual demand.

<u>BGC nearly ran out of gas in 1981-82. Could happen again. Statutory duty to suppl</u>
BGC's forecasts show peak surpluses much higher in 1987-88 than ever expected in 1981-82. Even after Treasury proposals, BGC will have an unprecedent margin to meet demand, including demand in severe winter .

<u>Surpluses needed in case Frigg gas ends prematurely</u>
Already taken account of <u>in</u> BGC's contingency margin (the "overall risk adjustment",) which would be preserved under Treasury proposal. Proposals are aimed at surpluses in <u>excess</u> of what is needed for insurance.

2. Phase out research into substitute natural gas (SNG)

	1985-86	1986-87	1987-88	£ million
Savings proposed	-10	-20	-40	

BGC are currently spending around £30 million a year on research into the production of synthetic gas from coal. In 1987-88 they want a further £10 million for a design study for a prototype full-scale SNG plant. And they are retaining around sites in cities (some hundreds of acres) for ultimate use as SNG plants. Our proposal is to run down the research work by 1987-88. SNG is seen as one possible replacement for UKCS natural gas.

Points to Make

- The increase in forecast North Sea reserves and the prospect of higher levels of sales of gas by the USSR to Western Europe means that the time when SNG is needed is receding. Sir Denis Rooke has recently been quoted as saying that the UK will not need to depend on SNG before 2050. As a result this R&D is far ahead of its time. It needs shelving.

- BGC want to complete the present phase of R&D before putting it on the shelf. Between now and 1990 this will cost around £200 million. It is unlikely that the technology will stand still. The research done in this period will almost certainly be out of date by the time it is needed. It is money wanted.

- if possible the private sector should build and run SNG plant. There is already some interest by oil companies in the US and, when the time is right, interest should also emerge in this country. It would be wrong to give BGC such a lead in this technology at the taxpayers expense that it can effectively "shut out" the private sector.

Defensive

ACORD endorsed this programme as the most economic way of preserving the considerable technological advances made so far

ACORD (Mr Walker's advisory group of scientists) are concerned only solely with the science; not with the economics of SNG, nor with whether it is right for a nationalised industry to do the work. If the work is worthwhile, it will be picked up by the private sector.

<u>To stop the programme now would risk all future benefits</u>

Not so. There are plenty of examples of a technology being put on ice for a period and without detriment to the benefit (e.g. conversion of coal into petrol; vulcanised rubber). In any case the work BGC does today will be out of date when SNG needed.

3. Sale of Land

	1985-86	1986-87	1987-88	(£ million)
Savings proposed :	-5	-10	-10	

BGC currently has holdings of over 1700 acres of unused and underused land. the latest DOE register showed that this had increased recently. BGC is also planning to buy a further 1000 acres. Ending work on SNG (2. above) should release further sites.

Points to Make

- Nationalised Industires are source of the largest holders of unused land. Must keep up pressure for disposal. Manifesto said that Government would increase efforts to dispose of spare land.

- BGC currently hold around 25 sites for future SNG production. Even if SNG work were to continue, wrong to hold sites for up to 50 years. Assuming an end to SNG, some at least of the sites could be sold quickly.

Defensive

Sites are often old town gas sites and are chemically contaminated.

Cost of relamation is high.

Recognise difficulties, but release of SNG sites provides opportunity for a new market. Must be scope for increased receipts. There will be buyers if the price is right.

4. Reduce capital expenditure

	1985-86	1986-87	1987-88	(£ million)
Savings proposed :	-	-40	-55	
of which :				
exploration	-	-20	-40	
onshore	-	-20	-15	

Points to Make

- BGC's forecast expenditure on exploration for gas and development of gas fields increases markedly towards the end of the IFR period (up from £41m in 1984-85 to £146m in 1987-88). Ministers are looking for BGC to divert itself of the bulk of its interests in gas production and exploration. This activity should be left to private sector. BGC could sell its interests in these fields.

- The savings proposed onshore are small - about 5 per cent of programme - despite the fact BGC has offered no clear explanation for its investment plans. Why, for example, does it want to spend £100 million a year on capital expenditure in an area called "administration and general"?

- Proposals not excessive compared to planned capital investment programme of around £700m a year.

Defensive

Programme already tight. Bid represents savings on baseline and lower than historical level of investment

Previous level of capital spend contained substantial provision for Morecambe and Rough projects (over £2bn in total). This expenditure has in the event taken place quicker than expected and so fell in 1983-84 with consequent reductions in the IFR period. This is merely a timing change, not a change in the size of the programme.

Investment meets appraisal guidelines

We have no evidence that BGC's investment programme meets 5 per cent RRR. Indeed return on assets forecast to decline to below 3 per cent by 1988-89. Suggests that investment is not producing 5 per cent return. BGC produced no material on nature and justification for, programme - despite requests.

Exploration expenditure not within BGC's control

We have taken into account the degree of control BGC has over exploration expenditure in the proposals forsavings. In any case BGC should be divesting itself of its offshore involvement; and this would itself reduce size of investment programme (as well as producing receipts from the sale).

5. Reduce Working Capital Requirements

	1985-86	1986-87	1987-88	(£ million)
Savings proposed :	-20	-30	-40	

This is made up by a £10m a year reduction in stocks of working materials (other than gas), a squeeze on debtorsand reducing the forecast decline on gas creditors.

Points to Make

- Need to keep up pressure on working capital. BGC's want to see working capital increasing from £900 million to £1.8 billion over the IFR period.

- Reductions sought far from excessive. Stocks level of materials rose signficantly in 1983-84 and BGC propose holding to this increased level.

Defensive

Reducing stocks would mean a poorer service

Rationalisation of unnecessary store facilities, computerisation of records and other efficiency improvements should mean that there is scope for making savings through improved efficiency, rather than reduced service.

Debtors are planned to decline over IFR period. Not possible to improve further

Relationship between debtors and turnover remains virtually constant over period. BGC take pessimistic view of the economy over the next few years and so are too pessimistic about customers' ability to pay.

Reduction in gas creditors results from changing pattern of gas supplies

Accept this has some effect, but does not explain full change in forecast figures. BGC failed to produce any sensible explanation. Must be scope for improvement.

6. Reduce Trading Costs

	1985-86	1986-87	1987-88	(£ million)
Savings proposed :	-10	-20	-30	

BGC is on target to achieve its performance aim of a 12 per cent real reduction in unit net trading costs between 1983-84 and 1986-87 compared with 1982-83. The savings proposed represent a further small push for efficiency. About half the savings of 12 per cent were achieved in 1983-84 - leaving 3 years to get the other 6 per cent.

Points to Make

- Important to keep up the pressure for efficiency gains and improvement in productivity. BGC's Corporate Plan this year contained no information on efficiency indicators.

- Accept that BGC already achieving significant improvements in net trading costs. But about half of the savings required to meet performance aim were achieved in the first year. This suggests that the performance aim will not be tight enough discipline in the later years. The Select Committee on Energy drew attention to this.

- BGC's net trading costs are about £2 billion. Savings sought only represent a further ½ per cent per year improvement.

- BGC's plan show an unexplained 19 per cent rising in net trading costs (other than wages) between 1984-85 (£731m) and 1985-86 (£870m).

Defensive

Should not force BGC to exceed performance aim

Performance aim is a target not a ceiling. If further efficiency savings are available, would clearly be right to go for them.

7. Increase Gas Prices

	1985-86	1986-87	1987-88	(£ million)
Savings proposed :	-220	-440	-774	

BGC plans to increase tariffs roughly in line with the rate of inflation over the IFR period. This compares with their view last November (when their financial target was set) that prices should increase by about 1 per cent real a year. The Treasury proposal is for prices to rise on average by 4 per cent real a year from 1 January 1985 (i.e. 8-9 per cent nominal if inflation runs at 4-5 per cent). Note : Savings are pro rata to the increase in prices; each 1 per cent real a year over the period contributes :

	-55	-100	-194

Points to Make

- Proposals entirely consistent with successive Government's views on nationalised industry pricing as set out in a series of White Papers. 1967 White Paper (Cmnd 3437) stated that prices should generally cover "the cost of supplying on a continuing basis" including "provision for the replacement cost of fixed assets needed for the continued provision of service, together with a satisfactory rate of return on capital employed". The Department of Energy's own Green Paper on Energy Policy in 1978 echoed this in similar uncompromising terms.

- BGC has an implicit subsidy from Government since two thrids of its gas comes from contracts negotiated before 1975 which are low price because they are exempt from the North Sea tax regime. The subsidy is currently around £1½ billion. To earn its present financial target rate of return without subsidy would mean raising prices by about 25 per cent. Treasury proposals would remove about half of the subsidy by the end of the IFR period.

- No more reason that gas should be subsidised in this way than that car drivers should get petrol free of North Sea taxes on the crude oil.

- Underpricing of gas gives the wrong signals to consumers. It increases demand for gas (when there is overcapacity in electricity generation) and leads to wasteful investment. Even BGC recognise that there will need to be substantial real increases in prices in the 1990s as the older fields get exhausted. There is a clear economic case for moving towards economic prices now.

- Treasury and D/En officials have, following a remit from the PM in October 1983, been examining in detail the breakdown of BGC's costs and how they should be reflected in prices to the consumers. Using BGC's own figures, the analysis confirms, in the Treasury's view, the current 25 per cent under-pricing in the domestic market. (The figure reduces to about 17 per cent in the mid-1990s as a result of price increases which BGC acknowledge will be necessary by then). The position is broadly similar in the non-domestic markets but with interruptible sales to industry underpriced by 33 per cent.

- D/En argue that the analysis shows that the price per therm is at economic levels but admit that BGC is not covering other costs notably for connection and other consumer-related costs. The Treasury view is that these costs must be recovered from the consumer; in the price per therm if they cannot be recouped in any other way.

Defensive

The Treasury proposals would result in an unacceptably high level of profits

With 4 per cent real price increases, post-tax project in 1987-88 would be around £850 million (compared with £401 million in 1983-84). The (pre-tax) return on assets would be around 9 per cent, compared with the present financial target of 4 per cent. But compare :

	post-tax profit 1983	CC return on net assets
BP	£710m	8.7%
Royal Dutch/Shell	£1878m	7.9%
GEC	£310m	20.0%

BP and Shell's figures post-tax profit figures take account of North Sea tax regime. If it were not for the implicity subsidy to gas consumers BGC would be making a loss with present prices.

Treasury proposals would force BGC to exceed its financial target

The Chancellor and D/En Ministers agreed in November 1983 that BGC's financial target was provisional and subject to review in the light of the review of pricing policy. When pricing proposals have been agreed, we can look at the implications for the financial targer.

Sir Denis Rooke and the BGC Board will not accept the price increases

The Treasury proposals are clearly in line with successive Government's policy on energy pricing, and are consistent with the Corporation's statutory objection obligations.

Price increases can only be imposed using the gas levy, and this does not help public expenditure

[The gas levy is a charge on BGC's costs aimed at recouping for the Exchequer some at least of the benefit BGC gets from its cheap supply contracts. Gas levy payments are currently around £500m. But the levy is treated as revenue in the Government accounts. Thus if the levy were increases to force the price increases, there would be no benefit to public expenditure. The revenue side PSBR would however benefit.] We shall need to look at the size of the levy following agreement on prices. What is important now is to get agreement on prices. Even if the levy were used we could spell out the point in public expenditure presentation - as we did in 1982.

Price increases would be an additional burden on industry : indirect taxation

Raising prices towards economic levels is not a tax; it is merely removing an economic distortion and leads to better overall resource allocation. Comparison with industrial gas prices on the continent shows there is considerable scope for increases. (Latest figures show that UK industrial firm contract prices are nearly 20 per cent below the lowest continental prices).

Price increases are inflationary

Gas customers have had little increase for two years. Since October 1982 gas prices have risen only 4.3 per cent (see table). Inflation is best defeated by keeping down the level of public expenditure. Removing economic distortions will improve the health of the economy. In any case, gas price increases would add only 0.3 per centage points to RPI by end 1987-88.

Some major contracts (e.g. ICI) cannot be increased as fast as the Treasury propose.

What the Treasury propose is an average 4 per cent per year. How this is split between customers is largely for BGC to decide.

GAS PRICE INCREASES

Domestic

April	1980	17%
October	1980	10%
April	1981	15%
October	1981	10%
April	1982	12%
October	1982	10%
January	1984	4.3%

Industrial

			Percentage increase on previous quarter of average firm/interruptible non-domestic prices
1979	1979	Q1	0.7
		Q2	2.6
		Q3	19.0
		Q4	13.3
	1980	Q1	3.2
		Q2	8.2
		Q3	12.6
		Q4	1.9
	1981	Q1	-
		Q2	0.2
		Q3	-
		Q4	-
	1982	Q1	-
		Q2	3.4
		Q3-1984 Q1	-
	1984	Q2	about 1½
		Q3	about 1½
		Q4	about 1½

ANNEX 2

ELECTRICITY SUPPLY INDUSTRY (ESI)

The Treasury proposals for savings are made up as follows (£ million) :

		1985-86	1986-87	1987-88
A.	Savings on capital investment, asset sales and efficiency			
1.	More realistic Sizewell timetable	-20	-70	-50
2.	Defer refurbishment of transmission, distribution and telephone systems	-60	-50	-50
3.	Defer/cancel new electricity generating projects	- 5	-60	-100
4.	Lower provision for connecting new customers	-	- 5	-10
5.	Reduction in cost of carrying out Area Board investment	-10	-20	-25
6.	Miscellaneous small savings on capital expenditure	- 5	- 5	-15
7.	Area Board non-operational investment	-40	-80	-80
8.	Lower coal stock	- 5	-15	-25
9.	Lower stocks of nuclear manuals	-20	-50	-50
10.	Improvements in debtors and creditors and lower engineering stocks	-10	-20	-20
11.	High asset sales	-15	-20	-25
12.	Higher connection changes	-20	-30	-40
	Total after adjustment for tax consequences	-175	-375	-450
B.	Financial target			
13.	Financial target averaging 3.6% over next three years	-250	-400	-700

Detailed notes on each are set out in the following sectors.

1. SIZEWELL TIMETABLE

1985-86	1986-87	1987-88
-20	-70	-50

Treasury has no wish to delay the project, but ESI's timetable does not allow time for :

(i) Public and Parliamentary debate of Inspector's report, even if on time.
(ii) Modifications to design (e.g. from safety recommendations).

ESI assume that Inspector's report on Sizewell enquiry submitted in July 1985, Government's formal decision in October 1985 : first "concrete poured" in September 1986.

Points to make

ESI timetable unlikely because :

(i) Government is committed to publish the Report and will have to allow debate in Parliament (in recess until beyond October).

(ii) Mr Walker acts in a quasi-judicial capacity and will have to hear objections : haste could lead to legal challenge.

(iii) The Inspector may recommend design changes : he has said he is not satisfied about ESI's arrangements with the Nuclear Installation Inspectorate.

Treasury figures assume start in March 1987, i.e. a six month slippage.

Capital Expenditure (Investment)

The investment figures are :

Capital expenditure in UK	1985-86	1986-87	1987-88	£m
Baseline	1195	1095	1123	
Provisional approval(1)	1016	767	-	
Revised bid compared to baseline	+23	+139	+99	
Treasury proposals compared to baseline (and as percentage)	-77 (-6%)	-71 (-6%)	-151 (-13%)	
Gap	100	210	250	

(1) Following IFR 83 ESI was given provisional approval to spend these figures : Treasury proposals are higher, so there could be no suggestion of bad faith.

2. DEFER REFURBISHMENT OF TRANSMISSION, DISTRIBUTION AND TELEPHONE EXPENSES

	1985-86	1986-87	1987-88 £m
Savings sought	-60	-50	-50
Total provision proposed by ESI	240	255	280

Points to Make

1. The level of disconnections from faults in the transmission and distribution system is running below the ESI's own targets (about $1\frac{3}{4}$ hrs per customer/year compared to 2 hrs).

2. MMC found in February 1984 that South Wales Board made no "attempt to assess the justification for particular levels of expenditure" [on refurbishment] and recommend full economic appraisal. We should not get committed to this programme until that has been done. Treasury has accepted a well founded case by Mr Younger for the North of Scotland Board.

3. CEGB are planning to purchase a complete new internal telephone and data transmission network costing (£50m), which could be deferred. Some circuits are rented from BT/Mercury, but CEGB also plan their own microwave and optical fibre links - it is questionable whether they need to enter that business.

3. DEFER/CANCEL NEW GENERATING PROJECTS

1985-86	1986-87	1987-88	£m
-5	-60	-100	

Points to make

1. Given present overcapacity, no new projects are essential.

2. New wind energy and hydro-electric projects could be left to the private sector (under the 1983 Energy Act which gives a favourable framework). Mr Younger has agreed to drop these projects in Scotland - they are even less promising in England and Wales.

3. Following miners strike, it is most unlikely that we shall want to convert oil buring stations to coal burning. In any case the economics have not been established properly.

4. Some, though not necessarily all, new combined heat and power projects could be left to the private sector.

4. LOWER PROVISION FOR CONNECTION OF NEW CUSTOMERS

1985-86	1986-87	1987-88
0	-5	-10

Points to make

1. Industry assume current high level of new business continuing indefinitely - there should be a down-turn in later years with the normal business cycle.

5. REDUCTION IN COST OF CARRYING OUT AREA BOARD INVESTMENT

1985-86	1986-87	1987-88
-10	-20	-25

Treasury figures imply a 5 per cent real cost reduction by 1987-88.

Points to make

1. MMC commented on Yorkshire Board that costs of undertaking new investment "have been higher than they otherwise could be" (because the Board had only rarely had to ration capital expenditure).

2. Some Boards (e.g. East Midlands) have indicated scope for real reductions.

3. MMC suggested South Wales contract out more work to see whether this is cheaper than "own labour".

6. MISCELLANEOUS SMALL SAVINGS

	1985-86	1986-87	1987-88
	-5	-5	-15

For example; halting £10m refurbishment at CEGB's Headquarters in the City.

7. AREA BOARD NON-OPERATING EXPENDITURE

1985-86	1986-87	1987-88
-40	-80	-80

Background : "non-operational" expenditure covers vehicles, computers, land/buildings not directly required for supplying electricity.

Points to make

1. The level proposed by the ESI has increased by some 20 per cent since last year's IFR.

2. ESI have not been able to demonstrate that this programme meets the 5 per cent rate of return criterion. Nonetheless you have said you will not pursue these savings if the industry accepts the higher Financial Target.

8. LOWER COAL STOCKS

	1985-86	1986-87	1987-88
	-5	-15	-25

For the reasons given in Appendix A(b), Treasury consider ESI coal price assumption is too high. This affects the value of coal stock too. [Defensive : decision on the volume of coal stock cannot be taken until after the miner's strike. ESI's current assumption of restoration to pre-strike levels is sensible meanwhile.]

9. LOWER STOCKS OF NUCLEAR MATERIALS

1985-86	1986-87	1987-88 £m
-20	-50	-50

Points to Make

The ESI currently hold 7 years stock of nuclear fuel valued at £100m. This is much higher than their own targets of under 2 years. Treasury's proposed reduction - about 15 per cent over three years - could be achieved by a combination of :

(i) not replacing extra fuel consumed by higher output from nuclear stations - see Appendix A(c).

(ii) rephasing supply contracts (with Rio Tinto Zinc) as was done for Australian coal contracts last year.

(iii) Selling. The spot market is weak but CEGB expect it to firm up during the next two years.

[Defensive : we are not asking CEGB to do anything uneconomic. A case has been put to DEn that, after taking account of interest and stocking costs, there is a cost saving in selling now and buying again later - they have not replied.]

10. IMPROVEMENTS IN DEBTORS AND CREDITORS AND ENGINEERING STOCK HOLDINGS

1985-86	1986-87	1987-88	£m
-10	-20	-20	

Points to Make

1. ESI are assuming 2 per cent improvement in debtors. But performance indicators show 20 per cent variations between Boards. This suggests a faster rate of average reduction is possible; perhaps 4 per cent by 1987-88.

2. , On engineering stocks, the MMC were complimenting Boards earlier reductions but suggested even lower level were feasible.

11. SALE OF ASSETS

	1985-86	1986-87	1987-88 £m
Increase disposals by :	-15	-20	-25
[ESI present projections	-25	-18	-17]

Points to make

1. At 1 January 1984 ESI had over 2500 acres of unused or underused land, at 250 sites. Scottish Electricity have sold sites previously acquired for power stations but not now needed. CEGB could do so too.

2. Treasury accepts that asbestos stripping has reduced sale value of old power statins for other purposes, but CEGB have been slow to encourage as a going concern sales to private sector generators.

3. CEGB, which raises no finance itself, doesnot need Headquarters in the City (St Paul's Churchyard). Sale of the long-lease could give net receipts whether or not Board moved out of London. Follow example of large companies such as ICI, Blue Circle.

12. HIGHER CONNECTION CHARGES TO NEW CUSTOMERS

1985-86	1986-87	1987-88 £m
-20	-30	-40

Points to make

1. 50 per cent under charging cost of new connections is a cross-subsidy between existing and new customers.

2. Both consultants (Deloittes) and MMC have suggested review of current policy.

3. A conveninet way of increasing receipts without raising electricity prices as such.

Defensive

1972 MMC recommendations. It is true that the majority of MMC recommended against full recovery in 1972 (Cmnd 5036) when Government was holding down NI prices for counter-inflation reasons. But in their 1983 Report on Yorkshire Electricity they say "since that [ie 1972] report was produced, there have been changes in tariff structure and economic background, so there may be a case for reviewing connection charge policy".

Cost of new housing

Recognise that this change could add £1-200 to cost of a new house. Prepared to phase in over 3 years to give the housebuilders, building societies time to adjust.

13. FINANCIAL TARGET

Treasury's proposal is that rate of return on current cost assets be increased to 4.5 per cent by 1987-88 (compared to ESI's proposed 2 per cent) and average 3.6 per cent over IFR period. This would produce savings of (£ million) :

	1985-86	1986-87	1987-88
	250	400	70

It would require an operating profit of :

Rate of return (%)	2.8	3.6	4.5
Increase in operating profit compared to ESI proposal	+300	+610	+970

Points to make

2. Treasury assessment is that this return could be achievable by a combination of (at 1987-88 values) :

(a) Increasing prices in line with inflation, giving £350-400m. ESI assume inflation of 5 per cent, and :

Treasury price path	+5.0	+5.0	+5.0
ESI price path	+4.2	+3.4	+3.8

(b) Reduction in operating cost, giving £620m (see details at Appendix A). Treasury is not trying to "manage the Industry" but ESI's projections are noticeably cautious. MISC 106 may recall that when pressed last Autumn, they produced a further £250m savings for 1984-85.

3. This approach gives the right incentive to increase efficiency. If the ESI make more cost gains then real price reductions would be possible.

Defensive

"Treasury proposals mean huge profits"

It is true that operating profits (i.e. before interest and tax) would be higher. But "bottom line" profits after interest and tax would be around current levels (mainly because of higher Corporation Tax). The figures are :

Operating Profit (before interest and tax)(1)

	Current Target		Next Target		
	1983-84	1984-85 (pre-strike)	1985-86	1986-87	1987-88
ESI proposal	+901	+642	+740	+760	+775
Treasury proposal	+901	+642	+1040	+1350	+1750

Bottom Line Profit (after interest and tax)(2)

	1983-84	1984-85	1985-86	1986-87	1987-88
ESI proposal	+456	+242	+190	-130	-140
Treasury proposal	+456	+242	+400	+300	+500

Key points :

(a) ESI proposal involves bottom line losses of £80m over 3 years. The Comptroller and Auditor General criticised D/En (in a July 1984 report) for setting targets "which were not fully consistent with the statutory [breakeven] duty". The ESI proposal would repeat that error.

(b) There are companies with lower current cost assets than ESI which make higher bottom line profits (e.g. BP - £710m and Shell £1878m in 1983).

Notes

(1) Operating profit is difference between revenue and operating costs.

(2) "Bottom line" profit is operating profit less interest and Corporation Tax.

"Government told Select Committee in Energy that there are "good prospects" of the 1985-86 electricity prices increase being below the rate of inflation"

True, but this was not reported in the Government's response to the Select Committee report. The coal strike has removed the public expectation of lower electricity prices in 1985-86. Under the Treasury proposal, prices would still have fallen in real terms during this Parliament. Figures are :

	Domestic	RPI	Industrial
1979-80	18	20	21
1980-81	20	13	24
1981-82	11	10	13
1982-83	9	5	7
Total 1979-80-1982-83	86	56	81
1983-84	0	5	0
1984-85	1.5	4.5	2.5
Treasury proposal - in line with inflation to 1987-88	5	5	5
Total 1983-84-1987-88	17	27	19

Load Management Schemes

Treasury is content for the Industry to decide on the future of these schemes.

[Background : load management schemes were introduced in the 1980 and 1981 Budgets. They give large users discounts of up to 15 per cent in exchange for occasionaly interruptions of supply. The schemes expire at the end of 1984-85. There is doubt whether the cost savings (£120m a year) match the price reductions, and hence whether a cross-subsidy may be involved. But this is a matter that can be left to the ESI as long as they meet their financial target. Treasury would not favour any sudden changes.]

APPENDIX A

OPERATING COST SAVINGS IDENTIFIED BY TREASURY

The following figures give savings, compared to ESI, projected in 1987-88. In total they save £620m. With prices rising in line with inflation (£350-450m) this gives the £970m imprivement in profit required to increase the return on assets to 4.5 per cent in that year.

		(£ million) Savings by 1987-88
(a)	lower coal/oil prices than industry assumption	130
(b)	full use of new electricity link with France and existing link with Scotland	70
(c)	20 per cent greater output from nuclear power stations	150
(d)	Lower nuclear fuel costs	40
(e)	Faster manpower rundown	75
(f)	Lower real earnings for workforce	120
(g)	Lower depreciation plus other savings	50
		635
(h)	Less higher nuclear R&D costs	15
		620

Details on each itme supplied on following pages.

A number of the savings will reduce ESI's coal burn and hence NCB sales. But the Treasury thinks it wrong in principle to shield NCB from market pressures by foregoing savings; and is prepared to cope separately with the public expenditure implications for NCB.

(a) Lower coal/oil prices (£130m by 1987-88)

On coal prices. ESI assume real increases cumulating to 2 per cent by 1987-88 and at 2 per cent a year thereafter.

Points to make

1. This is not consistent with their joint understanding with NCB for a 1.5% real reduction by 1987-88. Current policy is tolink NCB prices to world levels.

2. Recent studies by Treasury and Energy officials and by Scottish Electricity cast doubt on earlier projections of steep increases; and suggest world prices should remain roughly constant in real terms during the later 1980s (as a central assumption).

On oil prices, ESI assume real growth of 3 per cent a year to 1987-88.

Points to make

1. Interdepartmental and oil industry projections suggest no real growth.

[Defensive : Heavy fuel oil prices have hardened by about 5 per cent this year but that reflects :

(a) Heavy buying by CEGB during the miners strike.
(b) The weakness of sterling against the dollar due to the US elections and the miners strike.]

Background

ESI's projections on coal price match that original (1982) evidence to the Sizewell enquiry. We understand why they might not wish to change their figures now; but financial planning should make more realistic assumptions.

(b) Full use of new electricity links with France and existing link with Scotland (£70m)

ESI assume use of only one of the two new links to France (second completed in 1986).

Points to make

1. Prime Minister said in recent Ministerial correspondence that the logic pointed to utilising both links fully - that is the right basis for financial planning.

2. By 1988 further cheap supplies from Scotland should be available as the new Torness nuclear station comes on stream.

Background

Using the links, particularly with France, is 30 per cent cheaper than burning coal.

(c) 20 per cent more output from nuclear stations (£150m)

Points to make

1. ESI projections are over-pessimistic, assuming lower levels of output from AGR stations than has already been achieved at some.

2. Department of Energy have set the Atomic Energy Authority the objective (in Cmnd 9143) of helping the nuclear industry to achieve "power output at rated levels on all stations [Tsy underlining] by 1988". Treasury figures assume that is achieved.

3. Mr Younger has already agreed savings from assuming the higher level for the Hunterston AGR in Scotland.

(d) Lower nuclear fuel costs (£40m)

The ESI has negotiated real price reductions from British Nuclear Fuels plc. But the Company have told DEn and Treasury officials that they "hope to do better" and would accept a more demanding cost reduction aim from Government. Since BNFL are already earning over a 5 per cent return on this (monopoly) business, Treasury is content to see the further cost reductions passed on in even lower prices to the Electricity Boards.

(e) Faster manpower rundown (£75m)
ESI are assuming a 5-6 per cent reduction by 1987-88, but most of this comes from closing older power stations as new investment bears fruit. There is evidence of further scope for reductions of, perhaps, 5 per cent.

Points to make

1. ESI's own performance indicators for Area Boards show much wider variations in employees per 1000 customers than explicable by trading and geographical differences. The average is 16 per cent higher than the three leading Boards.

2. ESI's latest cost per unit for distribution and transmission is 30 per cent higher than for Scottish Electricity (Source : Scottish Electricity performance review).

3. MMC have commented in their reports on the need for the greatest "vigilance over numbers employed" (while commending Boards earlier efforts). Particular quotes are :

(a) Yorkshire Board should "as a matter of urgency consider ways of reducing its surplus of technical staff over a shorter timescale than in the past".

(b) South Wales Board should "adopt a more questioning approach to manpower costs" and "take steps to restore and improve on previous productivity levels" .... [following] "a significant drop" [in recent years].

4. CEGB have already indicated to DEn that they have excess staff in their regional organisation and in power station building/research divisions.

(f) Real reduction in level of earnings (£120m)

ESI assume earnings per employee rising by just under 1 per cent a year faster than inflation. Since 1979, earnings have increased by about 15 per cent more than manufacturing industry generally, taking ESI to near the top of the earnings league.

Points to make

1. Treasury recognise the industrial strength of certain key workers (totalling about 20,000 out of 130,000 employed in the industry). But excess pay levels are general. For example, a 1983 survey showed ESI copy typists earning - after 17 increments - about 10 per cent above leading industry employers (ICI, Shell) and 30 per cent above, more comparable, Clearing Banks/Insurance.

2. Treasury proposals for real reductions averaging about 1.5 per cetn a year are based on :

(a) Increases in line with inflation for the sensitive groups.

(b) Increase of about 2 per cent less than inflation for the others (this is the same as the Civil Service pay factor for 1985-86).

<u>(g) Minor savings</u> (£50m)

MMC Reports indicate scope for savings in many areas, including :

(i) Closer analysis of purchase costs.

(ii) Computer development.

(iii) Elimination of losses on repair business.

(iv) Contracting out maintenance work.

Savings on capital expenditure also reduces depreciation.

(h) Higher nuclear R&D costs (adds back £15m)

Transfer of cash from AEA (£22m) offset by £8m reduction in fast reactor funding.