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B/F if Mr Walker comes to see PM to settle his programme.
AT 29/10

PRIME MINISTER

26 October 1984

ENERGY - CONTRIBUTION TO PUBLIC EXPENDITURE SAVINGS

A. BRITISH GAS CORPORATION

BGC is buying gas at an average price of 16.3p per therm (including the Government's discretionary levy of some 4p per therm) and selling it at an average of 33.7p. What must be attacked is BGC's £3 billion gold-plated cost structure. Sir Dennis Rooke retires at the end of June 1986.

In summary, our rough feel for the potential cost savings, compared with the Treasury's numbers, would be:

£ million

1. Reducing Gas Supplies

	1985-6	1986-7	1987-8
Treasury	25	45	115
Policy Unit	25	45	75

The miners' strike calls into some question the wisdom of going for maximum savings when security of supply is at stake.

2. Phase out R&D into Synthetic Natural Gas

Treasury/ Policy Unit	10	20	40

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No commercial enterprise would still be doing this.

3. Sale of Assets

Treasury	5	10	10
PU - land	10	15	15
- retail & contract'g	-	160	-
- upstream interests	-	-	2000?

Our table makes the heroic assumption that something will be done about privatising the retail and gas production businesses. If gas production is sold to the private sector it reduces the capital expenditure programme of BGC considerably.

4. Reduced Capital Expenditure

Treasury	0	40	55
Policy Unit	50	100	100

More effective project management, procurement, and cost control alone, on a £1 billion programme, should deliver this. Some of the North Sea expenditure could be reduced (without full privatisation) by farm-outs (dilution of licence interests) and we agree with Treasury on the scope to cut the peripheral expenditure items. BGC should not be nationalising any more of the North Sea as they are currently planning.

5. Reduced Working Capital

Treasury	20	30	40
Policy Unit	40	100	110

The working capital increase of £1 billion over the 3 years would be a prime target for substantial reduction in any commercial enterprise. This alarming trend was already evident from the fact that working capital had increased from 12% to 21% of turnover over the last 5 years. Some of this is attributable to BGC's committing to take and pay for gas additional to requirements which have fallen below earlier forecasts. BGC should not now be spared the task of vigorously correcting the position.

6. Reduce Trading Costs

Treasury	10	20	30
Policy Unit	40	80	120

Given total trading costs of £2 billion and the significant real-terms reductions already achieved, BGC must be pushed further down this road.

7. Gas Prices

Treasury	220	440	774

There is a strong economic case for real gas price increases. However, there are some attractions in a bigger gas industry in view of our coal problems, and higher prices with a very profitable industry has political downside. On balance, we see the case for a modest real increase but would urge a greater thrust on costs than on real prices.

Totals (excluding higher prices):

Treasury	70	165	290
Policy Unit	225	360	460
Plus disposals of		160	2000

B. <u>ELECTRICITY INDUSTRY</u>

Treasury have also been a little cautious on the scope for cost savings in the electricity industry.

In summary, our feel for the potential cost savings compared with the Treasury's numbers would be:

1. Capital Expenditure

		£ million	
Treasury	140	250	290
Policy Unit	170	210	215

Our observation on ESI's capital expenditure programme of more than £1 billion pa, is that a hard-headed commercial approach to planning, execution, procurement and contract management can deliver significant further savings.

Whilst going further than the Treasury in reducing the fat, we feel that the additional savings will be more than offset by the repercussions of the miners' strike. Measures to increase flexibility and achieve greater security of supply will have to be tackled with urgency.

2. Reductions of Working Capital

Treasury	35	85	95
Policy Unit	65	105	115

We support the Treasury's views on the valuation of coal stocks and the reduced stockholding of nuclear materials. Elsewhere, the MMC Report has demonstrated what can be done by the more commercially-minded Area Boards. When attacking £3 billion of working capital, you can achieve more than Treasury's 1% in the first year.

3. Sale of Assets

Treasury	15	20	25
Policy Unit	15	20	145

We would include the sale of electricity retail outlets in 1987-8. At a rough guess this could contribute £100 million.

4. Higher Connection Charges

Treasury/ Policy Unit	20	30	40

The Treasury are right to insist on the implementation of the MMC Report recommendation that costs - tightly controlled - should be fully recovered from consumers.

Total for items 1-4 above:

Treasury	210	385	450
Policy Unit	270	365	515

5. Operating Costs

The industry's operating expenditure is approaching £10 billion. Fuel costs account for roughly half. In looking for savings, we would arrive at much the same end-point as the Treasury - progressive reductions reaching £620 million pa by 1987-8, but via a somewhat different route. Like them, we would want to see full use made of CEGB's nuclear capability and the new links with France and Scotland. However, we are very nervous about the proposed real reduction in the level of earnings of the 100,000 so-called non-sensitive staff in the industry. Nor would we feel happy with an explicit programme to achieve a more rapid rundown of manpower. This should not in itself be a target, but the natural consequence of vigorous management efforts to contain operating expenditure by reducing waste and inefficiency and improving productivity as turnover increases.

JW

JOHN WYBREW

dR.