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1 November 1984

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PRIME MINISTER

ENERGY AND EXPENDITURE SAVINGS

We agree with Cabinet Office's recommendation that you should aim for £2.2 billion of savings from gas and electricity.

The outstanding issue is the balance between gas and electricity, and between cost reductions and price increases. Unlike Treasury, we would prefer more emphasis on cost-cutting and less on price increases.

Should we continue to overlook the potential large contribution from selling retail activities and the upstream gas assets? These might be an unallocated part of the overall figure for general asset sales, but would make an important contribution to total public spending targets in future years.

On price increases, we would settle for Peter Walker's 1 per cent per annum real price gas increase, and no real increase in electricity. This means we need further additional cost-saving measures to get to £2.2 billion, and to pocket the Corporation Tax at the same time.

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British Gas Corporation

BGC has a £3 billion gold-plated cost structure. We agree with the Treasury that savings can be achieved by reducing gas supplies (although we would be more cautious than the Treasury on this); and in phasing out R&D into synthetic natural gas.

We believe more could be squeezed out of land sales. We would suggest £10m, £15m, £15m in 1985-86, 1986-87 and 1987-88 respectively.

On capital expenditure, we think the Treasury are far too modest. More effective project management, procurement and cost control on this £1 billion per annum programme should deliver more than £0m, £40m, £55m. Remember that 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.

On working capital, again the Treasury line is modest. A working capital increase of £900 million over 3 years should be a prime target for substantial cuts. Working capital has already escalated from 12 per cent to 21 per cent of

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turnover over the last 5 years - a new high. BGC should now be asked to correct it vigorously.

They also have much more scope on trading costs. Out of a total of £2 billion, we can do better than £10m, £20m, £30m.

Electricity Industry

Again, Treasury are being pessimistic on the scope for reducing working capital. The electricity industry has £3 billion tied up. We would suggest much tougher action.

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 endpoint as the Treasury - progressive reductions reaching £620 million per annum by 1987-88, 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.

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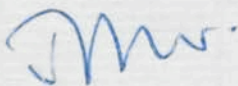
Conclusion

We are suggesting the following increases in cost-cutting
(compared to Treasury numbers):

	£m		
	1985-86	1986-87	1987-88
<u>Gas</u>			
Sale of assets: land	5	5	5
Reduced Capital expenditure	50	60	45
Reduced working capital	20	70	70
Reduced trading costs	30	60	90
<u>Electricity</u>			
Working capital	30	30	30
Operating costs		unchanged	
<u>Total</u>	<u>£135m</u>	<u>£225</u>	<u>£230m</u>

Asset sales of retail and contracting (gas est. £160m;
electricity est. £100m) and of upstream gas reserves (est.
£2bn) would also help.

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JOHN WYBREW