



SECRET

3.6 }  
2.2 } *double*  
*lowing* *38*

P.01420

PRIME MINISTER

Public Expenditure: Gas and Electricity EFLs

The Secretary of State for Energy "hopes to persuade" the gas and electricity industries to reduce their EFL bids by £1.6 billion over the three years (after allowing an offset for extra corporation tax to which the industries would become liable in making gross savings of £1.9 billion). A copy of Mr Walker's letter of 1 November setting this out is at Annex A.

2. It is suggested that your aim should be to persuade Mr Walker to increase this figure of £1.6 billion to £2.2 billion, ie to seek further savings of £600 million net from the two industries over the three years. The intention is however, unless Mr Walker is totally unyielding, to find a basis on which agreed recommendations can be put to the Cabinet on Thursday 8 November.

3. Annex B explains how far we have already moved from the Treasury's original ambition to achieve savings below baseline of about £2 billion. The Department of Energy started with bids to increase the combined gas and electricity EFLs by £183 million in 1985/86, £535 million in 1986/87 and £959 million in 1987/88. The offer which Mr Walker has made results in only modest reductions below baseline in the first two years and an increase in baseline in the last year as the following table shows:

£ million		
1985/86	1986/87	1987/88
-62	-85	+215

It should be borne in mind that the turnover of the electricity industry in 1985/86 is expected to be around £10 billion and the British Gas Corporation in 1985/86 around £7 billion.

SECRET

SECRET

MAIN ISSUES

4. The main issues are:
- i. how much more should the gas the electricity industries contribute?
  - ii. how should any extra savings be found?

How much more

5. On i. the important consideration is the overall public expenditure situation. On the basis of the agreements reached, assuming that MISC 106's very tough proposals on housing are accepted by the Cabinet in full, and assuming that the gas and electricity industries contribute no more than Mr Walker has offered, the public expenditure totals agreed by the Cabinet in July are likely to be exceeded by approximately the following amounts:

£ million		
1985/86	1987/87	1987/88
340	350	1250

Even if we get £2.2 billion for gas and electricity rather than the £1.6 billion Mr Walker has offered, there will still be a gap (say £250 million in 1985/86, £200 million in 1986/87 and £900 million in 1987/88) but it will be more manageable.

6. Mr Walker will tell you (see last sentence of his letter of 1 November) that it is "totally impossible to deliver more". He claims that his negotiations with the gas and electricity industry this year over their EFLs are the most difficult and contentious he has ever had with any nationalised industry in his Ministerial career. He will say that if he has to go back and ask for more he will lose the industries' cooperation totally.

SECRET

SECRET

7. You will have to judge how far Mr Walker can be pushed without provoking an unmanageable row in the Cabinet. Your line might be that the £2.2 billion target he agreed with MISC 106 was a reasonable one (on the assumption that it was net rather than gross) even though it fell far short of what the Treasury had asked for. You recognise his achievement in persuading the industries to accept £1.6 billion. However, in view of the difficult situation overall, you must ask him to press for another £600 million split between the two industries spread over three years.

8. I think that it is unlikely that you will be able to get him to commit himself to deliver £2.2 billion before the Cabinet discussion on 8 November. He is bound to say that he will have to go back to the industries and see what can be done. But it would be a major step forward to get him to undertake to try for £2.2 billion. That could be reported to the Cabinet as an agreed recommendation and would not require discussion.

#### How to make the extra savings

9. You may well find it difficult enough to persuade him to try for extra savings, without going on to constrain his and the industries' freedom of action in how to achieve the savings. The papers from the Treasury and the Policy Unit make a variety of suggestions, the Treasury leaning more in the direction of price increases and the Policy Unit favouring cost reductions.

10. On an objective assessment there would seem to be a case for pressing for a higher price increase for electricity. The industry's figure of 4.5 per cent in 1985/86 is on the assumption that inflation will be 5 per cent. It is therefore assuming a small real decrease, which is hard to justify. However, as you know, electricity prices have become a major political issue.

SECRET

SECRET

11. You may find it tactically best not to do more than float a few possibilities to show how further savings might be achieved, without getting into detailed figuring. In the last resort a commitment to try and achieve savings of the desired order is more important than the precise means.

#### CONCLUSIONS

12. However the meeting goes, it will be vital to know precisely where we stand at the end of it. The Lord President's paper for the Cabinet will have to be finalised on Monday afternoon for circulation on Tuesday morning. We shall therefore need to know whether:

i. the reductions in the gas and electricity industries' EFLs are to be £1.6 billion (net) on the basis set out in the Secretary of State for Energy's letter of 1 November;

or ii. greater reductions are to be sought and, if so:

a. whether the target should be £2.2 billion or some other figure;

b. what is the nature of Mr Walker's commitment to this target;

and iii. the energy programme is to be presented as agreed or disagreed in the Lord President's report to the Cabinet.

*PLG*

P L GREGSON

2 November 1984

SECRET