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Dear Andrew

PUBLIC EXPENDITURE: ENERGY

I am attaching, as agreed, Treasury briefing for the Prime Minister's meeting on Monday with the Secretary of State for Energy. It may be that the Prime Minister would find it useful to have an oral briefing on Monday morning. If so, Treasury officials would of course be ready to attend.

Yours ever
David

D L C PERETZ

BRIEF FOR PRIME MINISTER'S MEETING WITH MR WALKER ON MONDAY 5 NOVEMBER

Aim

1. To secure Mr Walker's agreement to public expenditure savings on gas and electricity such that, taken together with the maximum savings on housing likely to be agreed by Cabinet, will allow the overall public expenditure targets to be reached. This suggests, as a minimum, savings on gas and electricity totalling £1,900 million over the three Survey years taken together; or, better, the savings of £2,200 million on gas and electricity which Mr Walker originally undertook at MISC 106 as his aim; or - better still, to mitigate the severity of the politically difficult cuts on housing which will otherwise be necessary - savings of £2,500 million.

Background

2. The gap on gas and electricity between Mr Walker's original proposals and the savings required by the Chief Secretary to achieve the (E(A) target for nationalised industries as a whole was £3677 million. This was spread over the three years as follows:

1985-86	1986-87	1987-88	(£million)
583	1,135	1,959	

3. At MISC 106 Mr Walker first undertook to try to secure savings over the three years of £2,200 million; then, at the meeting

FLAG A on 31 October he offered to deliver £1,900 million. At the 31 October meeting he said this figure was on the same basis as the £3,677 million - ie it represented a saving in public expenditure of that amount.

4. He has subsequently, we understand, written to say that the £1900 million was not on that basis - but is equivalent to

public expenditure savings of only £1,600 million, because £300 million has to be deducted from the gross savings to compensate the industries for the additional corporation tax payments they would make as a consequence of their higher profits.

5. It will be essential to establish from the start with Mr Walker that all figures in the discussion are on a public expenditure basis - ie there is no deduction for tax payments. It is, of course, true that as these industries become more profitable they will pay more Corporation Tax, and that their liability to do so has increased as a result of the Budget. Thus, the higher the gross savings secured the higher the Corporation Tax liability; so that to achieve a given amount of public expenditure savings necessarily requires gross savings in excess of that amount.

6. Mr Walker may argue that the Treasury should exclude nationalised industries' Corporation Tax from public expenditure, as it comes back to the Treasury on the revenue side of the PSBR. But we could not possibly alter the definition of public expenditure in this instance alone: public expenditure is defined in this area (as in all others) on a tax-inclusive basis (nationalised industries' EFLs, for example, take acccount of their payments of VAT and vehicle excise duty, as well as their national insurance contributions and Corporation Tax). Excluding Corporation Tax would be seen by the markets as a fiddle and would bring discredit to the Government. Furthermore, it would amount to full compensation for, or the abolition of, Corporation Tax for state industries alone (and only for some of these; other nationalised industries have accepted the present position), while still imposing it on private sector firms - grossly unfair.

Mr Walker's Proposals

7. Mr Walker has given the following breakdown of his gross

savings of £1,900 million:

£ million

	1985/86	1986/87	1987/88	3 Years
Gas	115	250	350	715
Electricity	130	450	600	1180
TOTAL	245	700	950	1895

8. On electricity, Mr Walker's savings are consistent with real price reductions of ½ per cent in each year (or, as he prefers to put it, they are consistent with nominal price increases of 4½ per cent a year, given that the industry is assuming that their costs, and general inflation will rise by 5 per cent a year); and with a real rate of return on assets of 2.3 per cent in 1985/86, 2.9 per cent in 1986/87 and 3.1 per cent in 1987/88.

9. These price increases, it should be noted, are low even in relation to the views of the Electricity Consumer Council, who argue that price increases should not be higher than general inflation. Each extra real 1 per cent on electricity prices would save - net, in public expenditure terms - £75m in 1985/86 (and £65m a year thereafter).

10. On gas, Mr Walker's figures would mean real price increases of 1 per cent a year (or, as he prefers to put it, nominal price increases of 6 per ccent, 7 per cent and 8 per cent in the three years, given that the industry is assuming - with characteristic pessimism - that their costs and general inflation will rise by 5 per cent, 6 per cent and 7 per cent in the three years). They are consistent with a real rate of return of 5 per cent in each of the three years.

11. Even after these price increases (which are modest compared with the 10 per cent annual real increases achieved during three years in the last Parliament), UK gas prices would be well below European levels. Prices are 40-50 per cent higher ~~than~~ in France and Germany; UK prices would still be well below the 28p per therm BGC are paying for Norwegian gas. This means that BGC is selling gas to industrial consumers for less than it is paying to the Norwegians without taking account of the costs of transmission, distribution, storage etc. Each extra real 1 per ?

cent on gas prices saves net, in public expenditure terms - £55m in 1985/86, £70m a year theafter).

Assessment of Mr Walker's Proposals

(i) Electricity

12. The Chief Secretary proposed savings in operating costs rising to £620m a year by 1987/88, and a return on assets of 2.8 per cent, 3.6 per cent and 4.5 per cent in 1985/86-1987/88. The Treasury believes that it will be well within Sir W Marshall's ability to achieve cost-savings of this order (ie rising to about 6 per cent of present total costs) by 1987/88. On this basis there would be no need for any real electricity price increases over the period; and the real return on assets employed would reach the Government's general 5 per cent objective only at the end of the three-year period.

13. The gap between the Chief Secretary and Mr Walker is some £700m over the three years. Mr Walker should be pressed to close this gap, either by abandoning the idea of real price reductions, or by insisting on more rigorous cost-savings, or both. Maintaining prices at current levels in real terms would on its own contribute £230m towards closing the £700m gap over the three years. Cost savings would, of course, be additional to these.

(ii) Gas

14. The Chief Secretary proposed cost savings of £70m in 1985/86, £150m in]986/87, and £260m in 1987/88, (£480m over the three years), and average real increases in gas prices of 4 per cent a year, worth £220m in 1985/86, £440m in 1986/87 and £770m in 1987/88, (£1350m over the three years). This implies a (pre-tax) real return on asses of around 9 per cent.

15. Mr Walker will argue that these proposals would result in an unacceptably high level of profits in the industry. But, after paying their North Sea taxes, BP and Shell's return on assets in 1983 has, respectively, 8.7 per cent and 7.9 per cent; and, because two-thirds of BGC's gas comes from pre-1975 contracts

which are exempt from North Sea taxes BGC has an implicit subsidy from the Government of around £1½ billion a year. There is every reason why BGC's windfall North Sea profits should be creamed off for the benefit of the taxpayer at large, rather than exclusively for the 3 in 4 households who are consumers of gas. This was, of course, the rationale for the gas levy, and if Mr Walker did not agree to the Treasury's present proposals there would be a strong case for an increase in the levy.

16. It may also be suggested that it is desirable to hold gas prices down to encourage a shift away from coal-dependent electricity. This suggestion may be turned on its head, as an argument against the electricity price reductions Mr Walker is envisaging. In the present public expenditure situation we cannot afford to let up on gas prices. Furthermore, there are severe limitations on the extent to which electricity users can switch to gas: many users - both domestic and industrial - are tied to electricity by the nature of their present (and likely future) equipment.

17. Mr Walker should also be pressed to increase the total cost-savings he has offered - some £400m over the three years - towards the £485m sought by the Chief Secretary.

Tactics

18. If Mr Walker were to agree to savings, on a public expenditure basis, of £1,900m over the three years (ie the offer he made to MISC 106 on 31 October but from which he has subsequently resiled) we would fall short of the Cabinet's overall public expenditure targets by some £870m in 1985/86, £770m in 1986/87 and £1420m in 1987/88. It should be noted here that Mr Walker's present offer, of savings of £1,600m on a public expenditure basis fall some way short of bringing these industries back to the Survey baseline.

19. MISC 106 has proposed savings in housing of £527m, £452m and £480m which, if accepted, would reduce these gaps to £344m

in 1985/86, £316m in 1986/87 and £944m in 1987/88 - figures which, if the Cabinet were to accept the less demanding overall target of keeping within the 1984 White Paper totals, would achieve this lesser goal.

20. But, as Mr Walker may accept, such large reductions in housing will be politically very difficult for the Government, involving as they do sensitive inner-city areas, and a large reduction in public sector capital expenditure.

21. To the extent, therefore, that Mr Walker can improve on his £1,900m offer, the severity of the cuts needed on housing can be abated. £2,200m - and, still better, £2,500m - would make a significant difference here. The Prime Minister may feel that, if he cannot be brought to agree to savings on a public expenditure basis of at least £1,900m - or, preferably, the £2,200m Mr Walker ~~understood~~ took as his aim - the issue would best be ventilated at Cabinet, so that the political difficulties of the required savings in housing and energy can be weighed against each other.

SUMMARY

22. The best approach may be

(i) to ensure that Mr Walker is conducting the discussion on the basis which is relevant to the Public Expenditure Survey - ie on a public expenditure savings basis, so that his savings will count £1 for £1 as reductions in the industries' EFLs;

(ii) to explain the overall public expenditure position, and the need to close the remaining gaps either through housing or energy savings;

(iii) given the political difficulties in the very large reductions in housing which are envisaged, and the gaps which would in any event remain, to urge

- no real price reductions in electricity

- real gas price increases of at least 1% a year

- maximum cost savings in both gas and electricity.