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10 DOWNING STREET

From the Private Secretary

5 November 1984

Dear Janet,

PUBLIC EXPENDITURE: GAS AND ELECTRICITY INDUSTRIES

The Prime Minister held a meeting today with the Secretary of State for Energy to discuss the gas and electricity industries. Mr. Gregson was also present.

The Prime Minister said that the decision reached after MISC 106's work was still very difficult, especially in 1987-88. Her understanding was that the Treasury had originally sought savings of £3.7 billion from the gas and electricity industries. The Secretary of State had pointed out that £1.5 billion of the industries' excess bids were attributable to higher corporation tax payments following the changes in the Budget. The Group had taken account of this in asking the Secretary of State for Energy to seek savings of £2.2 billion from the two industries over the three years of the survey. She understood that the Secretary of State for Energy had reported back to the Group saying that he could secure savings of £1.6 billion which could be extended to £1.9 billion. MISC 106 had been under the impression that this represented the effect on EFLs.

The Prime Minister said she believed the saving of £1.9 billion on the industry's EFLs could be extended to £2.2 billion. She accepted that it would be difficult to seek an increase in real gas prices beyond the one per cent which BGC appeared to be offering. Nevertheless, she believed that there was a good deal of scope for cutting costs. BGC's working capital was rising rapidly and it was buying more gas than needed with the balance being put into store.

On electricity, she believed that rather than increases of half a per cent less than the rate of inflation, prices could rise strictly in line with inflation. In addition, as last year's experience had demonstrated, there were substantial cost savings to be made. As it was the third year that was the most difficult, the savings for the two industries could be weighted towards that year.

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The Secretary of State for Energy set out his understanding of the discussion with MISC 106. The £1.9 billion of savings he had offered to MISC 106 did not allow for corporation tax; when allowance was made for this the effect on EFLs would be about £1.6 billion. He believed the Treasury's methodology was faulty as it made no sense to seek savings of a specific sum from the industries and then require a further sum to cover the additional corporation tax bill that resulted. The Treasury was, in effect, seeking to be paid twice.

The Secretary of State for Energy explained the difficulties he had experienced in securing even the £1.9 billion gross (£1.6 billion on EFLs). The industries had complained that they had had very tough EFLs imposed on them last year which they were finding it difficult to meet. Yet the Government was now seeking to tighten the regime still further. The negotiations had proved extremely difficult and, in his view, any attempt to go beyond £1.9 billion (£1.6 billion on EFLs) would provoke the Boards into refusing to accept the settlement. Instead, they would invite the Government to impose it upon them. This would create a political struggle in which it would be difficult for the Government to prevail. The two industries were now contributing £3 billion to the Exchequer compared with £260 million in 1979. He had been through all the suggestions made by the Treasury for savings and did not believe it would be possible to go any further - indeed, he believed that to secure savings of £1.9 billion (£1.6 billion on EFLs) would represent a major achievement.

The Prime Minister pointed out that following the discussion in MISC 106, the combined bids for the two industries in relation to base line were: -62; -85; + 215. She urged Mr. Walker to seek further savings which would bring the industries to base line in the third year. Mr. Gregson estimated that to achieve a saving of £215 million on EFLs would require gross savings of £250 million.

The Secretary of State for Energy said the only way he could secure any further savings was by giving an assurance to the industries that the progressive squeeze on them was at an end. He would consider how the savings suggested by the Prime Minister could be found. His office would agree a draft passage with Mr. Gregson for the MISC 106 report which had to be completed that evening and circulated the following morning.

I am copying this letter to the Private Secretaries to members of MISC 106, to Michael Reidy (Department of Energy) and to Richard Hatfield and Peter Gregson (Cabinet Office).

Yours sincerely

Andrew Turnbull

ANDREW TURNBULL

Miss Janet Lewis-Jones,
Lord President's Office.