CONFIDENTIAL

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ELECTRICITY PRICES

You asked me about the Financial Times editorial of 23 January and similar press comment. The following comments may be helpful for general background.

Economic Prices

The Government's commitment to economic pricing is based on both economic and energy policy objectives. There is no conflict between the two:

- economic prices are not a tax upon energy users. Rather prices below economic levels represent a subsidy to energy users;

- such a subsidy would increase pressure on the PSBR and help to push up interest and inflation rates;

- subsidised energy prices would give the wrong economic signals for investment decisions, stimulate energy demand and lead to a waste of natural resources. Efficiency and conservation pressures would be reduced;

- this would be followed by a future painful readjustment when prices would inevitably have to rise to cover future costs of supply;

- economic energy prices will not raise the rate of inflation. Recent prices rises did not exceed the rate of inflation;

- the Government's whole attempt to introduce commercial reality into the nationalised industries would be defeated if prices were influenced by political rather than economic considerations.

It should also be stressed that the purpose of economic pricing is to simulate prices which would exist in a competitive market if, as in the case of gas and electricity, such a market does not operate. It is not an economists' abstraction unrelated to commercial reality. In a market place without differential pricing, long term survival would only be assured if prices covered the marginal cost of supply.

Electricity Prices

It was in recognition of the fact that economic prices need not take into account the cost of building new power stations at a time of overcapacity, that electricity prices were frozen in 1983/84 and will be increased by significantly less than the rate of inflation in 1984/85.

This pricing pattern was agreed at the time the financial target for these years was set in early 1983.

Since the target was agreed, Government pressure has achieved further efficiency savings and coal prices in the CEGB have moved closer to economic levels. Consequently the financial target will be exceeded, irrespective of any decisions on pricing. It is for this reason that the Government has been able to raise the EFL in 1984/85 to £740 million.

This decision is not in conflict with economic pricing nor with the Government's wish to set a clear financial framework in which the industry can operate. Economic pricing principles are taken fully into account when the target is set.

Economic pricing does not lead to excessive profits. The rate of return for the electricity industry on average total assets for 1983/84 and 1984/85 will be less than 2%.

Financial Times Editorial - 23 January 1984

The FT editorial misrepresents the Government's approach:

- Nigel Lawson, when Energy Secretary, did not use a different definition of economic pricing in setting the financial target in March 1983 compared with the Treasury's recent arguments. The target assumed a price rise of 1½% below the rate of inflation in 1984/85;

- the Government accepted and still accepts the general conclusions of the confidential Cooper and Lybrand report. The most significant recommendation was that long run marginal costs at a time of overcapacity should not include a capacity charge for building new plant but for retaining existing capacity on the system;

- the reason why the financial target will now be exceeded does not relate to the level of economic prices for electricity but to the efficiency savings which the industry has achieved and to changes in the coal price;

- the Cabinet does not set electricity prices and the Government has no statutory power to impose prices. Nevertheless the Government is committed to economic pricing throughout the public sector and to improving the efficiency of nationalised industries through demanding financial targets. Within these criteria, the industry is encouraged to operate in as commercial a manner as possible;

- there is no case for an additional regulatory body. If the electricity industry were to be transferred to the private sector, the need for a regulatory agency would depend upon the extent to which competition could be introduced.

The Role of Cabinet

The recent Cabinet discussion was not about economic pricing but about the credibility of the additional efficiency savings which the industry were promising as an alternative to the price increase which had already been agreed.

The problem was that the Electricity Council had offered further savings after the public expenditure discussions had supposedly identified the full scope for savings. As the Council were unable to indicate the source of these new savings, the Cabinet preferred a small price rise. The Electricity Council subsequently agreed with this view.

DLP.

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