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Prime Minister (2)
The opening shots in what will be a tough battle.

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

2 August 1984

The Rt Hon Peter Walker MP
Secretary of State for Energy

Dear Secretary of State,

ELECTRICITY: NEXT FINANCIAL TARGET

I was a little surprised, as no doubt you were, to see figures starting to appear in the press last week about the Electricity Industry's position on the level of their next financial target. It seems early to start this debate.

As the debate does appear to have started, however, I thought I should let you know now that we shall be looking to move to a level of about 5 per cent, rather higher than figures attributed as the industry's view. This is based on the straightforward proposition that an industry which has long been required to earn a 5 per cent return on new investment (and is still expected to do so) should produce a 5 per cent return on its assets valued in current cost terms. Studies involving my officials and the industry suggest that the ESI's assets are properly valued to within about 10 per cent.

I doubt this given, coal strike apart, the enormous surplus capacity. AT

The immediate purpose of this letter is not, however, to open a debate on these broader policy issues. My concern is that this question should not be addressed solely in terms of target levels and prices. That would obscure the other key factor - the industry's own costs.

All the indications are of unparalleled scope for savings over the next three to five years. Some areas are:

(a) the continuing real reduction in power station coal prices under the new NCB/CEGB Joint Understanding.

(b) the availability of cheap French and Scottish electricity over the interconnectors.

(c) the coming fully on stream of the three delayed AGR stations with Heysham II to follow, and the extended life of Magnox.

(d) the new terms of trading between CEGB and BNFL aimed at cost reduction on nuclear fuel services (though yet to be formally approved between us), which should more than offset other nuclear cost increases.

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(e) the recent MMC report of Area Boards which have shown performance in containing costs which was (for example in South Wales) not "particularly impressive". The new performance indicators to be published shortly will give clear pointers to further areas for savings.

(f) the reduction in the number of CEGB's power stations, and the ending of a large building era, which should give new opportunities for major savings in the Board's overheads and manning.

(g) the fact that the industry have acknowledged that certain staff are overpaid. Total salary costs per unit increased by 9 per cent in real terms between 1979 and 1983, despite a manpower run-down, with employees moving steadily up the earnings' league table.

No doubt many other possibilities are evident to your Department.

I suggest, therefore, that we should tackle costs before beginning any discussion on prices, and that officials could begin by examining what reductions would be needed to achieve a 5 per cent target without real price increases. That is consistent with the approach recommended by E(A) on 3 July. Peter Rees, of course, will be in touch later about the implications for the 1984 Investment and Financing Review.

A copy of this letter goes to the Prime Minister and to Norman Tebbit.

Yours sincerely,
Judith Simpson

NIGEL LAWSON

approved by the Chancellor and signed in his behalf.

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SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ
01 211 6402

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Whitehall
LONDON SW1

15 August 1984

My Nigel

ELECTRICITY: NEXT FINANCIAL TARGET

Thank you for your letter of 2 August.

As you say, it is a little early to start a debate on the ESI's financial target before we have had, and been able to examine, formal proposals from them explaining the basis of the new financial target which they appear to favour.

I note your argument in favour of a much higher rate of return, 5%: that the industry has been long required to earn a 5% rate of return on new investment, and that therefore this ought by now to be achievable on all its net assets. The 5% Required Rate of Return - on new investment programmes as a whole - was however enshrined as a Government objective only in the 1978 White Paper (Cmd 7131). The bulk of ESI investment now productive was undertaken in the 1950s and 1960s; and it would be quite unrealistic to expect that, within 7 years of the publication of the White Paper, the industry's overall investment programme should be earning a return of 5% real - particularly in view of the substantial over-capacity which resulted from the ambitious growth expectations and investment programmes in the period up to about 1973. In that connection, I ought to say that I do not think that the view of your officials that ESI assets "are properly valued to within about 10%" is one which the ESI would accept, certainly as a basis for a 5% CCA return.

Moreover, the 1979 White Paper said that the opportunity cost of capital was only one of the factors in determining financial targets: sectoral and social as well as counter inflation policy considerations needed to be taken into account.

We should, at all events, be cautious about deriving financial targets (and therefore pricing levels) direct from asset values in the balance sheet - as distinct from expressing it in terms of a return on assets. In the first place, it is doubtful whether asset valuations take proper account of all the market and economic considerations which must influence our decisions on financial targets and pricing levels.

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My officials continue to debate these matters with yours and with the ESI. Secondly, assets in the ESI's accounts are valued on a CCA basis. Though the target rates of return of 1.4% or 2% may seem modest enough, they represent rates of return on an historic cost basis in the range 12% to 15% - by no means a poor performance compared with a good deal of the private sector, recognising that the industry is recovering from over-investment in the '50s and '60s and substantial over-capacity as a result.

All that said, I entirely agree with the main point in your letter: namely, that we should look hard at every opportunity to contain the ESI's costs, so as to achieve a satisfactory financial target without pushing up real prices; especially as it is no more than market and economic sense that a capital intensive industry with substantial over-capacity should improve its relative pricing, ie raise prices at less than the rate of inflation. My officials are already examining all the areas for cost saving you mention in your letter; and will be glad to discuss their conclusions with your officials in the normal way. I must make it clear however that cost savings of the order required to achieve a 5% return on net assets without any real price increase, cannot be achieved within the next few years. Such savings would be roughly equivalent to a reduction of 33% in the ESI's controllable costs. I intend to press the industry hard on the level of the next performance aim but cost reductions of £1 billion a year are impossible.

I am copying this letter to the Prime Minister and to Norman Tebbit.

PETER WALKER

Gas & Elec NAT. IND. Pt 9.