

6 July 1987

DISCUSSION NOTE FOR MEETING WITH SECRETARY OF STATE FOR
ENERGY

1 Background

In recent years the Electricity Supply Industry has been at a low point in its investment cycle. Now the combination of electricity demand growth and the retirement of ageing power stations is foreseen as creating a rapidly growing electricity supply gap starting in the early to mid-1990's. In consequence, the CEGB faces an exceptional investment programme - perhaps £20 billion by 2000.

On the one hand, this reinforces the case for electricity privatisation. With the ESI needing to renew its assets over the next 20-30 years, what better time to privatise the industry; in a liberalised private sector industry the renewal process will then be shaped by competition and the disciplines of the market; and the Government's public expenditure programme will be relieved of a substantial burden.

On the other hand, the Government faces a dilemma. Unless the higher cost of funding an investment programme of perhaps £20 billion in the private sector is exceeded by the efficiency gains from privatisation, the effect of electricity privatisation will be to increase electricity prices to the disbenefit of consumers and the economy. This problem is made more acute by the fact that in fighting inflation the Government has held back electricity prices so that the current real rate of return on the ESI's assets is only 2.75% compared with the Treasury's norm of 5% real. Just to get back to the Treasury norm would entail electricity price increases of

some 2% pa above inflation for the next 3 years.

There will of course be efficiency gains associated with electricity privatisation, but they will only be substantial if the form of privatisation adopted makes provision for vigorous competition in liberalised coal production and electricity generation industries, neither of which is a natural monopoly.

The link with coal production is crucial. Nearly 80% of our electricity is generated from domestically produced coal. (This proportion will change little before 2000 since the increase of nuclear capacity from new stations will be offset by the retirement of old nuclear plant.) The CEGB represents 75% of British Coal's total market. The present regime is illiberal and uncompetitive. The CEGB is very largely denied access to cheap imported coal. Supplies of low cost coal from our own small private sector are severely limited. Yet coal production and electricity generation - roughly half and half - account for at least three-quarters of the cost of our electricity supplies. The CEGB describes the reduction in its coal supply costs as the "greatest single opportunity for the CEGB to reduce electricity costs and hence keep electricity prices, particularly to industry, more competitive".

2 Problem

The problem is how to make sufficient provision for vigorous competition in liberalised coal production and electricity generation industries whilst taking realistic account of the practicalities and the following constraints:

- the need to command the support of the ESI's management;

- the need - with ESI management support - to gain the acceptance of electricity unions who have already launched a campaign against electricity privatisation and who have frightening power to disrupt the life of the community and damage the economy.
- likewise, without management support there is a serious risk that work on the ESI's heavy investment programme would be disrupted, jeopardising the adequacy of electricity supplies in the 1990's and beyond.
- The limitations of the 4-year window for action provided by the Government's third term.

3 Conclusions

- Long term sustainable benefits to electricity consumers and the economy at large should be the primary objective of electricity privatisation.
- The link between the ESI and the British coal industry must be confronted and tackled from the outset. We need a co-ordinated plan for the privatisation of both electricity and coal.
- Although it is essential that the objective of this plan is vigorous competition in liberalised coal production and electricity generation industries, the requisite restructuring of the electricity and coal industries cannot be achieved in a traumatic "big bang"; the development of competition in liberalised markets will have to be progressive and evolutionary. But the seeds must be sown at the outset.
- Although the Government will want to lay the foundations for liberalised private sector electricity and coal industries as fully as possible in the third

term, the four year period available in practice should not be regarded as an absolute constraint. (It is more important that the foundations are well laid to secure the benefits for electricity consumers and the economy than that the process is completed in four years.)

4 Outline Proposal

Electricity

- Privatised the 12 Area Boards as individual plc's. Some, but not much, grouping of individual Area Boards into larger organisations could be considered.
- The CEGB would remain intact and be privatised in such a way as to force it to compete on an equal footing with third-party generators. To ensure fair competition, the national grid would either be separated from the CEGB or left under CEGB operatorship subject to tight regulation to ensure market access by competing generators.
- The privatised distribution companies would inherit electricity supply contracts with the CEGB whereby the supply of bulk electricity would taper away over time. This will leave an electricity supply gap to be filled through competition between the CEGB and alternative supply options including, for example, imports from say France or a number of smaller energy-efficient initiatives such as Combined Heat and Power schemes.
- The regulatory regime for the distribution companies would be designed to encourage them to exercise initiative and enterprise in procuring electricity and developing the electricity market to the mutual benefit of supplier and customers. For example, wherever possible and practicable (eg in the industrial market)

competition between the distribution companies would be encouraged.

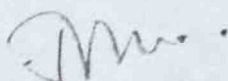
The formula for regulating electricity prices to end users (akin to $RPI-X+Y$ for gas) would be based on assumptions - and later, experience - of performance and capability close to industry best ~~to~~ practice. Thus the best performers would be rewarded with higher margins than the indifferent performers. Competition through emulation would show up in the bottom line.

- Third party generators are likely to compete fiercely with the privatised CEGB for supplying incremental electricity. A Hong Kong based company has just completed a 700 MW power station in mainland China in 22 weeks for a cost of some £250 million. By comparison, Sizewell B will cost over £1500 million for 1200 MW of capacity and will take 7-8 years to complete. (There could be parallels with the effect of new printing technology on Fleet Street or the effect of the minibus revolution on the local bus industry.)

Coal

- At an early stage, the framework of the coal industry should be liberalised along the lines already proposed by the Energy Select Committee, ie akin to the existing regimes for oil and gas production.
- The Government would undertake to keep British Coal essentially intact whether in the private or public sector, but the licensing and regulatory functions of British Coal would be transferred to the Government; likewise, the receipt of royalties on coal production. British Coal would be expected to pay an appropriate royalty on the coal produced from its low cost, open cast operations.

- The severe limitations of the scope of our small, private sector coal production industry would be removed. Licences for new deep or open cast coal acreage would be tendered competitively.
- Management/employee buy outs of British Coal's deep mines would be invited and encouraged.
- The restrictions on coal imports would be removed. The illiberal supply arrangements between the CEEB and British Coal would be scrapped and replaced by new arrangements conducive to competition and enterprise.



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