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14 January 1980

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FINANCIAL TARGETS FOR THE GAS AND ELECTRICITY INDUSTRIES

My consultations with the gas and electricity industries on 3-year financial targets reflecting the pricing proposals agreed by E Committee are now virtually complete. I should like to announce these as soon as possible, and in view of the reports (originating, I understand, from one of the regional Gas Consumer Councils) appearing in the Press last weekend about domestic gas price increases, would aim to do so later this week, probably by means of an oral statement to the House. I enclose a draft of my statement, which has I understand already been discussed with your officials. I would hope this could be an oral statement; if pressure of events indicates a written answer I would expect it to be somewhat shorter.

The targets are to be expressed as average annual rates of return on assets, calculated on a current cost accounting basis. The figure for gas (subject to final confirmation with the industry) is 10% and for electricity 4.8% (the gas figure being larger because of its smaller asset base which does not fully reflect its real main asset, access to gas in the ground; and because its profits include an element of "economic rent" in respect of the Southern Basin gas fields). The targets are averages of the expected rates of return in each of the three years and are compatible with agreed public expenditure figures as well as with the pricing proposals agreed by E Committee.

Some of the main assumptions underlying the target will be set out in target-setting letters which I shall send to the Chairmen when the statement is made and which I should expect to become public; but the bulk of the underlying figure work, amounting to projected "target paths" will be, or has already been, contained in confidential letters to the industries. Our officials will continue to be in touch over this.

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Recent news of further oil price increases will have emphasised to the public once more the fact that the days of cheap energy are over. The statement is nonetheless likely to attract a good deal of attention, and we must ensure that the case is presented as effectively as possible. I would therefore intend to give a fairly full explanation of the pricing strategy especially for domestic gas: indeed I welcome the chance to do so. But I do not in any case think there is any opportunity for the Government to duck this responsibility. The size of the domestic gas price increases stems directly from the Government's decision and was accepted with some reluctance by the Corporation themselves - and they will not be slow to point this out if they do not think the position has been made sufficiently clear.

You will see that I have also referred to two important areas of concern where the Government's intentions may be questioned: the special problems of the old and the poor, and the need to ensure that the nation as a whole derives appropriate benefit from our valuable North Sea gas reserves. I would like to have been more positive on both of these points, but recognise that this would require further collective consideration, which there would not be time to complete before the end of the month. Nonetheless, I am concerned that our ability to maintain our pricing strategy could be seriously weakened if we are unable to make any progress in these areas.

I realise that the two questions of high gas industry profits, and assistance to poorer consumers with fuel costs are separate, but it is inevitable that they will be linked in people's minds and I believe that we shall come under considerable pressure if we are unable to announce remedial measures, and indeed seem to be taking substantially less action than our predecessors did at a time of much lower real price increases.

On the question of high gas profits, and the possibility of an Exchequer charge, E Committee has of course already decided that Ministers should look in detail at two options identified in earlier discussions. I understand that Mr Lamont's Group on the Gas Industry will shortly be reporting on this - your officials have been kept in touch with the gas tax discussions. I also understand that a paper on the question of assistance with fuel costs is being prepared by DHSS officials for submission to their Ministers, in consultation with officials from other Departments. I believe that this matter also deserves collective discussion at an early stage, despite the very tight expenditure situation - even relatively modest developments could be of some importance in the presentation of our overall pricing strategy. I know you are very conscious of the public expenditure benefits of our gas and electricity pricing strategies: but I think we should not underestimate the difficulty of sustaining them over the period of the financial target and perhaps beyond. Additional assistance to those for whom

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higher prices mean particular hardship could well be a worthwhile price to pay for the achievement of these larger savings.

I am copying this letter to the Prime Minister, our other E Committee colleagues, Patrick Jenkin, Norman St John-Stevas, Angus Maude and Sir Robert Armstrong. Press leaks over the weekend have given us rather less time than I would have wished, and I would be very grateful for your response, and any comments our colleagues may have, within the next day or two.

D A R Howell

Yours
David

With permission Mr Speaker I should like to make a statement about medium term financial targets for the British Gas Corporation and the electricity supply industry in England and Wales.

It is a fundamental objective of this Government's policy towards the nationalised industries that they should be set a clear financial discipline in which to work. We therefore opened discussions with the gas and electricity industries on medium term financial targets for the period 1980/81 to 1982/83. The external financial limits for 1980/81 announced last November were set in the light of those discussions, which have now been satisfactorily concluded.

It is essential, in a period of considerable international uncertainty over fuel supplies and rapidly rising fuel costs; that consumers should be aware of the true value of their energy consumption. The main factor in setting these financial targets has accordingly been the overriding need to move towards consistent economic pricing for each fuel so that our energy resources are properly used in the future. After a year in which crude oil prices have risen by 100% or more, this is bound to mean heavy increases in other fuel prices.

To take gas first: there are four reasons why domestic gas prices will have to rise. First our reserves of natural

gas represent a finite and increasingly valuable national resource. If it is underpriced, we shall burn it up too fast and bring forward the day when we have to turn to more expensive sources of supply. In fact, all analyses show that domestic gas is at present substantially underpriced. Hon Members will recall that even the Price Commission in their report last July, before recent oil price increases, concluded that domestic tariffs should be 30-35% higher.

Second, underpricing tends to divert scarce gas supplies from industry which would be willing to pay the proper price, as well as bringing the risk of shortages and supply cuts on cold winter days.

Third, underpricing concentrates the benefits on those who have access to gas supplies at the expense of the rest of the population. Economic pricing is essential if some of the financial proceeds from our natural gas resources are to be secured for the benefit of the nation as a whole.

Fourth, a sensible approach to pricing is also necessary to promote a proper balance of supply and demand. For industrial and commercial customers it has been the long standing policy of the British Gas Corporation to sell gas at a price broadly related to that of the competing oil product. The Government endorses this policy. The only alternative would be some form of arbitrary rationing and the risk of ever-increasing supply shortages.

Fifth, gas from new North Sea fields will cost up to several times more than earlier gas supplies and prices must reflect these much higher costs.

Against this background, and the background of soaring world oil prices, we have set the British Gas Corporation a target, expressed as an average annual rate of return to be achieved over the period April 1980 to March 1983, of 10% on average net assets valued at current cost. The target is related to current cost operating profit after taking account of depreciation but before interest and tax. It will be adjusted if necessary after introduction of the proposed new current cost accounting standard. Although it is expressed as an average rate of return, the actual rate of return achieved is expected to increase progressively over the target period.

Details of the tariff changes necessary to achieve the target are a matter for British Gas. However, in broad terms the Government expects domestic gas prices this year to increase by 10% over and above the rate of inflation, followed by comparable real increases in the following two years.

In the case of electricity, there is also underpricing, but it is less than in the case of domestic gas. The target has however been designed to go a substantial way towards correcting this. On the same basis as for gas and over the same period, the target for the electricity supply industry in England and Wales is an average annual rate of return of 1.8% on average net assets valued at current cost. As in the case of gas, details of tariff changes are a matter for the industry but the Government expects

prices to increase over the three year period of the target by about 5% over and above increases in the industry's own costs, of which fuel costs are the biggest element.

The Government has asked both BGC and the Electricity Council to phase this year's increases in two stages, one in April and another in October.

I recognise that adjusting to an era of higher energy prices brings serious problems for many consumers, especially the old and the poor. The new scheme of assistance with heating costs announced by my Rt Hon Friend the Secretary of State for Social Services on 22 October last was designed to provide worthwhile help for those in most need. We shall continue to take proper account of the cost of energy in our social policies and in determining benefit levels, particularly the levels of extra heating additions. We will keep under review, in this context, the whole range of help available to assist consumers with fuel bills.

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