



Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

ELECTRICITY EXTERNAL FINANCING LIMIT
1979-80 AND 1980-81

I have seen David Howell's minute to you of 19 February which I understand is to be discussed in E Committee next Tuesday.

2. You will have seen my letter of 20 February to David Howell registering my strong disquiet that the industry did not inform us earlier of the prospective overrun of £300m. There is no disguising that the episode is damaging to the EFL system. I do not regard this as mitigated by the fact that the building up of stocks was undertaken with our encouragement; if this was expected to put a strain on the EFLs, it should have been identified and the issue put to us in advance. As I said in my letter, the conclusion suggests itself that either the industry's financial forecasting leaves something to be desired, or they simply do not take their EFL seriously. I suspect that the industry's failure to inform us earlier of the prospective overrun has a lot to do with the fragmented structure of the industry: the CEGB incurs most of the industry's capital and current costs, the 12 Area Boards receive the revenue from the public with the Council co-ordinating finances. Financial control must clearly be difficult in such circumstances, particularly if relationships between the Council and the CEGB are not as close as they might be. I hope therefore that David Howell's present examination of



the future structure of the industry will bear these points in mind.

3. Timing

The industry's EFLs for 1979-80 and 1980-81 are linked for the reasons explained in David Howell's minute. But I think that we ought to come to decisions at E Committee on the 1979-80 EFL even if we defer decisions, as I think we should, on what needs to be done to keep the industry within its published EFL of £187m for 1980-81. I say this because it is important to announce by the end of the first week in March the increase in this year's EFL, though there is a conflict between this general argument, which applied equally to the Post Office, and the need to avoid undermining the position of BSC management in their pay dispute. Any later announcement would discredit the EFL system since it would appear that the EFL was being adjusted upwards in the last days of the financial year simply in order to avoid a breach. It would be even more damaging to make no announcement, leaving the EFL at its present level. The nationalised industries would be bound to draw the conclusion that in the last resort the Government was willing to turn a blind eye to a breach, particularly if it was a big one. My conclusion therefore is that we ought to resolve at E Committee our response to the prospective breach in the industry's 1979-80 EFL.

4. 1979-80

David Howell points out in his minute that if the industry defers payments of about £100m from this year to next and makes savings of the order of £25m-£30m, this would leave a remaining excess of about £200m to be added to this year's EFL, making it £132m. I hope it will still prove possible to reduce the size of this excess.



5. I will shortly be reporting to Cabinet the consequences of the anticipated excesses of both the Electricity Council and the Post Office for this year's Contingency Reserve in accordance with the procedure in C(79)4. Briefly the position is that if the electricity industry's EFL was increased by £200m and that of the Post Office by £50m-£60m, in addition to the increase already announced as a result of the billing backlog (both figures in outturn prices), the remaining balance in the Contingency Reserve for this year would be reduced from £220m to £20m (both figures in Survey Prices).* At this stage of the year we can probably draw down the Contingency Reserve to this extent without undue risk, but it is uncomfortable to have come so close to exhausting the Reserve, and I shall have to report to Cabinet that there is virtually no room to accommodate further bids.

6. If colleagues agree, I suggest that there is an early announcement of the increase in the EFL of some £200m. David Howell and I would need to review the precise amount of the increase just before the announcement to take account of further effects of the steel strike on the industry; for every week the strike lasts, the cost to the industry is some £4m. The announcement will need to be presented with great care, particularly in view of possible repercussions on the steel strike. The announcement, which could be by way of a written answer, could emphasise the success of the industry in building up stocks in the face of the current uncertain energy supply situation. The answer might give some information on actual stock levels and end by pointing

*This assumes that BSC will find a way of processing its bills, despite the strike among its clerks, and would use its EFL to the full.



out that this was the main reason why the industry's EFL had to be increased by £200m. (Not all the £200m increase can be ascribed to the higher fuel stocks; some £200m of the £300m excess is certainly due to that cause, but some £75m of the £100m payments to be deferred into next year are for fuel bills.)

1980-81

7. Our starting point for our consideration of the industry's 1980-81 EFL must surely be that it is essential to hold the published EFL of +£187m and if at all possible to see some reduction in it on account of the 1979-80 excess. We will need to consider the impact on other industries if the electricity industry was allowed to exceed this year's limit virtually with impunity. This could seriously reduce the effectiveness of the system.

8. David Howell's minute reports the deterioration in the industry's financial prospects in 1980-81 as a result of higher coal prices, lower sales and salary increases above the level assumed. As he points out, this will have consequences for the EFL. But just as important, it will make it harder for the industry to keep on path for meeting the three year financial target announced last month. Indeed, irrespective of any problem with the EFL, action would have been needed in any event to recover unforeseen cost increases so as to keep the industry to its target path. There ought therefore to be no criticism that the rigidity of the EFL is forcing the industry to take action against its will - action is necessary to keep on path for meeting the medium term financial target, which the industries want us to treat as the main constraint of financial discipline.



9. We are not yet in a position to take final decisions on the action needed to keep the industry within its 1980-81 EFL, but I agree with David Howell that action looks to be necessary on tariffs and cuts in the industry's capital programme. I note, however, that he makes no reference to the possibility of savings through improved efficiency, reductions in overheads etc. The industry has been squeezed hard over the last 19 months, but I should be surprised if there were not some savings, however modest, to be had from this source.

10. I understand that we will soon have a report on the industry's review of its capital programme, particularly of the three projects, new oil fired power stations, Drax and the new AGR station referred to on the fourth page of David Howell's minute; I would hope that the Area Boards', admittedly much smaller, programme is also put under the scrutiny. I would not rule out action on the new AGR programme at Heysham. I understand that some tenders received show costs some 40 per cent higher than assumed and this, together with the industry's lower load forecasts, must reduce the economic case for proceeding with the station at least as quickly as now planned. Delay or cancellation would certainly cause difficulties for the plant industry and would be difficult to reconcile with the statement in the House of Commons on 18 December. There also could be consequences for the Scottish station at Torness, though presumably it does not follow that action on Heysham II would have to be mirrored by action on the Torness station. These are all real difficulties, but at a time when public expenditure is under such restraint, we cannot afford to order in advance of need what could turn out to be a white elephant costing well over £1bn. I recognise that the savings in 1980-81 from postponing or cancelling Heysham II will not be large, but they would be considerable in later years.



11. I also recognise the difficulty of action to reduce fuel stocks in the face of uncertainty about oil supplies and the advance in the NUM settlement date. But some reduction in oil stocks and in coal stocks, even if not as much as the 3m tonnes referred to by David Howell, could help reduce any increase in tariffs. No doubt David will let us know whether he expects coal production to exceed consumption next year and how the NCB will accommodate this with their published EFL. It is also relevant here that one element in the prospective excess in the industry's EFL for 1980-81 is higher coal prices - they now assume an increase of some 45 per cent in coal prices in the year compared to their earlier forecasts of 24 per cent. As we have seen before, excessive increases in the coal industry's costs are being borne by the electricity consumer.

12. Conclusion

So, to sum up, I suggest that there should be an early announcement of the increase in the industry's EFL for 1979-80 of some £200m on the lines indicated in paragraph 7 above. We should then decide as early as possible in March on the action that needs to be taken to keep the industry on the path to its financial target and within its 1980-81 EFL. For that purpose, we ought to know the outcome of the industry's review of its capital programme in the light of its lower load forecasts, and have a report on the case for, and the consequences of postponing or cancelling either or both of the AGR stations and for other large reductions in capital spending.

13. I am sending a copy of this minute to the Secretaries of State for Industry, Energy and Scotland, the Chief Secretary to the Treasury, other members of E Committee in view of our forthcoming discussion, and to Sir Robert Armstrong.

A handwritten signature in dark ink, appearing to be 'G.H.'.

(G.H.)



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