

Ref. A0424

PRIME MINISTER

Pricing Policy and a Financial Target for the Electricity Supply Industry
(England and Wales)

(E(79) 52)

BACKGROUND

This is a companion proposal to that on gas pricing, which will have been dealt with earlier in the meeting. In the case of electricity current prices are much nearer to "economic levels". If "economic level" is taken to be the long-run marginal cost of providing an additional unit of output (Annex A), then they are about 5-10 per cent underpriced in real terms. The paper proposes a price increase of $2\frac{1}{2}$ per cent greater than costs in 1980, and about 1 per cent per annum thereafter.

In cash terms this will mean a 22% increase.

2. In 1980-81 the industry would be about £83 million short of its financial target even allowing for the $2\frac{1}{2}$ per cent real terms rise in prices. Thus unless they can make economies, the price rise next year would need to be 4 per cent in real terms ($2\frac{1}{2}$ per cent plus $1\frac{1}{2}$ per cent extra) if the proposed cash limit is to be achieved.

3. The effect in time of the proposed real terms price increases would be to produce very large cash profits on a historic cost accounting basis - but when these are viewed in terms of the costs of replacing plant (current cost accounting) the projected returns look reasonable in relation to the expected return on new public investments. The industry would as a result of this income be able to finance from its own resources, and not borrowing, the major investments in plant that will be needed to cope with the long-term shift away from oil and gas. This would reduce the PSBR - with figures for income greater than the Chief Secretary has so far assumed in years after 1980-81.

4. The industry's assumptions about future costs are different from the Department of Energy's and may or may not be right; this could affect the price rises needed in money terms in each year. But the proposed strategy of an initial

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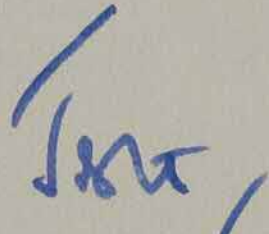
rise of $2\frac{1}{2}$ per cent (or 4 per cent) above costs and 1 per cent above costs thereafter is not affected by the assumptions. And the first of these rises is already built into the public expenditure figures for 1980-81 on which Cabinet reached decisions in July.

HANDLING

5. You might ask the Secretary of State for Energy to introduce the paper, and ask the Secretary of State for Scotland what proposals he has for action in Scotland. You might then obtain comments from the Chief Secretary, the Secretary of State for Trade and Sir Kenneth Berrill. Mr. Jenkin's views will probably have been covered in the discussion on gas prices.

CONCLUSION

6. Subject to the discussion you might conclude that the Committee -
- (i) Agree the Secretary of State for Energy's proposals (as set out in paragraph 12 of the paper).
 - (ii) Agree that the handling of the announcement will need great care and invite the Secretary of State for Energy to circulate his proposals for this.


JOHN HUNT

16th October, 1979