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CABINET  
MINISTERIAL COMMITTEE ON ECONOMIC STRATEGYGAS AND ELECTRICITY PRICES AND PUBLIC  
EXPENDITURE 1981/82-1983/84

## Memorandum by Secretary of State for Energy

The Committee on 17 October decided that price increases next April for electricity and domestic gas should not exceed the RPI increase over the previous 12 months, but invited the Chief Secretary and myself to propose alternative phasing for price increases over a 3-4 year period which would achieve a correction of underpricing comparable with that which I had proposed in my papers E(79)51 and E(79)52. The Committee also asked that in considering the phasing, the long term trend of the RPI and also the seasonal impact of changes on it should be noted. The Committee recognised the need for early decisions on 1980/81 prices because of the public expenditure impact. Cabinet agreed on 25 October the proposals for that year which I and the Chief Secretary had jointly put forward in my minute to the Prime Minister of 24 October. This paper, which has been agreed with the Chief Secretary, examines the impact of the pricing proposals in later years, and seeks the Committee's agreement that they should, after consultation with the industries, form the basis of medium-term financial targets.

The proposals

2. For domestic gas, Cabinet have now agreed an autumn 1980 increase of 10% to follow on the April RPI increase. Thereafter we propose annual real price increases each April of 10%. In sum, this would achieve the same degree of correction of underpricing which my earlier paper recommended, related to our estimate of total underpricing of 25-50%, and is fully consistent with the Committee's conclusion that the price of gas should be raised over a period of four years to the oil-related level.

3. For electricity, Cabinet agreed an increase of 5% in the autumn of 1980 to follow the April RPI increase. This will have the effect of correcting underpricing by broadly the same amount which I originally proposed, ie 2½% in 1980/81. Thereafter, we propose a similar rate of progress towards full economic pricing as under my original proposals. Further examination has shown that the figures underlying those proposals, set out in Annex C of E(79)52, imply an annual movement towards correction of underpricing from 1981/82 onwards of the order of 1½% (rather than the 1% mentioned in my earlier paper). Over the whole period, however, total correction of underpricing still falls slightly below the mid-point of the 5%-10% range by which we estimate electricity to be underpriced. The annual price increases from April 1981 would be additional to whatever increase was necessary to keep up with the electricity industry's costs, which mainly because of linked coal and oil prices, will probably rise somewhat faster than the rate of general inflation.

#### RPI

4. The direct effect of the 1½% electricity price increase on the RPI would be .04%, and the effect of the 10% domestic gas price increase on the RPI, .16%. Annex A deals with the RPI aspect in more detail.

#### Public Expenditure

5. In summary, the public expenditure shortfall (extra saving) compared with the Chief Secretary's bid is:

	(£M 1979 survey prices)		
	1981/82	82/83	83/84
Gas	330	300	130
Electricity	30	(132)	(390)

The table at Annex B gives further details. In the case of gas, the shortfall in each year against the September bid by the Chief Secretary arises in part from the decision to raise prices by no more than the RPI in April 1980; in part from the need to bring forward capital expenditure to meet peak winter demand; and in part from very recent revisions to the Corporation's forecasts. These figures are based on provisions estimates from BGC and there may be some scope for improvement. (The shortfalls in public expenditure do not take account of BGC's expected

payments of Corporation Tax which will however reduce the PSBR). In the case of electricity, the extra savings in 1982/83 and 1983/84 are caused largely by the more rapid move towards correction of underpricing now assumed.

6. Taking the two industries together a total shortfall of £360M is forecast for 1981/82, reducing to £168M in 1982/83 and converting into extra savings of £260M in 1983/84. Clearly, recouping the 1981/82 shortfall would be very difficult. For example, an additional 1% on domestic gas prices in April 1981 would yield only £11M in the year, and an additional 1% on electricity prices, £40M.

#### Next Steps

7. The Government, in making public its financial guidelines for the industries, should give a clear indication of the required medium term trend in prices. If colleagues accept these pricing proposals, I would propose to open discussions with the gas and electricity industries on medium term financial targets lasting for 3 years starting in 1980/81. It would be my intention to establish targets on the basis of an average rate of return related to current cost operating profit as a percentage of revalued net assets. Because of the requirements of the industries' consumer councils for prior consultation, the latest date at which an announcement of the proposed April price increases could be made would be early February next year. We shall however, need to pass on to the industries our guidelines on pricing immediately, in order to clear the way for agreement with them on 1980/81 cash limits within the timescale envisaged for publication (late November). In that context, it will also be necessary to make rapid progress with them on financial targets, and an announcement earlier than February may be desirable. In the announcement it would probably be necessary to state not only the targets themselves but also to indicate the likely incidence of price increases in 1980/81. We need to bear in mind that we have no statutory power to instruct the industries on the precise timing or scale of price increases, so that all this will have to be worked out in very close consultation with them.

Recommendations

8. We invite our colleagues:
- (i) a) to endorse the pricing proposals in paras 2 and 3; or
  - b) to consider whether, in the light of the public expenditure shortfall in 1981/82, there should be additional price increases in that year; and
- (ii) to agree that I should now open discussions with the gas and electricity industries on the basis of our decisions on prices with a view to establishing and announcing financial targets to run for 3 years.

D.A.R.H.

Department of Energy  
25 October 1979

RPI ASPECTS

1. The effect of the increases of 10% for domestic gas and 5% for electricity in the autumn of 1980 would be 0.3%. For the later years, the increases are defined in terms of real increases needed to move towards economic pricing, on top of what is needed to keep up with the rate of inflation, or to cover costs. In these terms, 10% on domestic gas prices will add 0.16% to the RPI, and 1½% on electricity prices will add .04% to the RPI as a direct effect.
2. The future course of prices is subject to many uncertainties. But it is expected that the 12-months' increase in the RPI will reach a peak in the second quarter of 1980. From then onwards the rate of increase should gradually decline though the extent and timing of this are uncertain. Phasing out underpricing of gas and electricity would not have a large effect.
3. It is doubtful whether the seasonal pattern of price changes should determine the timing of energy price increases. There is generally a cluster of increases in April e.g. rents, rates and any indirect tax increases. There is often a favourable period in the summer months as "seasonal food" becomes plentiful. But these patterns have no effect on the 12-months' increase in the RPI which is the most commonly used figure. Moreover, the effect of electricity and gas increases on the RPI is spread over 4 months with about three-quarters of the effect coming through in the second and third months after the increase. From the public expenditure point of view it is helpful to have price increases at the beginning of the financial year: otherwise a given RPI

effect produces only a fraction of its potential benefit to public expenditure in that year. From the industries' point of view too, April is a convenient time, since price increases during or just before the winter always attract more criticism from consumers.

PUBLIC EXPENDITURE EFFECT OF 1981/2-1983/4 PRICE INCREASES

£M at 1979 Survey Prices

<u>GAS</u>	81/82	82/83	83/84
September bid by Chief Secretary	- 530	- 680	- 760
As under pricing proposals	- 200	- 380	- 630
Shortfall	330	300	130
<u>ELECTRICITY</u>			
September bid by Chief Secretary	- 37	- 54	- 172
As under pricing proposal	- 7	- 88	- 218
Shortfall (extra saving)	30	(132)	(390)
Total Shortfall (extra saving) (gas and electricity)	360	168	(260)

Payments of Corporation Tax by BGC (reduce PSBR but not public expenditure)	140	270	420
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