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CABINET

ELECTRICITY PRICES

Memorandum by the Secretary of State for Energy

At Cabinet on 10 November the Minister of State, Department of Energy, explained that the electricity supply industry was likely to raise difficulties about a price increase of 3 per cent from April 1984 included in the report of the Ministerial Group on Public Expenditure (MISC 99) to the Cabinet. The Secretary of State for Energy would use his best endeavours to persuade the industry to accept the Government's view on prices. But he had no statutory power to require it to do so, and he wished to have discretion to agree to proposals from the industry which would produce equivalent savings. The Minister of State had discussed the matter with the Chancellor of the Exchequer on this basis on 9 November. The Cabinet concluded however that it was not ready at this stage to regard additional savings as a substitute for the price increase.

2. Following the Cabinet decision I pressed the Chairman of the Electricity Council strongly to secure the agreement of the 12 Area Boards and the Central Electricity Generating Board to the 3 per cent price increase. I reinforced this by pointing out that the Government had now published an External Financing Limit (EFL) for 1984-85 which would require them to pay £740 million to the Exchequer. On 21 November, following two meetings of his Council, the Chairman sent me a reasoned reply, which I forwarded on 24 November to the Prime Minister and to the Chancellor of the Exchequer. There has been further correspondence between the Chancellor of the Exchequer and myself. The Electricity Council is ready to accept the imposed EFL of £740 million and to do its utmost to meet this through all the routes open to management; but is opposed to a 3 per cent price increase from April 1984.

3. In spite of the handicap of the National Coal Board (NCB), the energy industries have produced 71 per cent (nearly £2.7 billion) of the public expenditure savings achieved by the nationalised industries in the recent public expenditure survey. The electricity industry in particular has contributed over £1.8 billion over the 3 years and has accepted a negative EFL of £740 million in 1984-85. They are ready to meet the full requirements of MISC 99 on public expenditure and to try to give the Government the best of both worlds by avoiding or minimising any general price increase in 1984-85.

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## INDUSTRY'S RELUCTANCE ABOUT A 3 PER CENT INCREASE

4. Part of the background to the industry's resistance is that the Government were urging them in the opposite direction as recently as the spring of this year. The then Secretary of State for Energy urged the Electricity Council to change its approach to pricing, in the light of a report from consultants. They concluded that the Council could reduce the element in its prices attributable to future investment because the industry had no early need to increase capacity. With this in mind my predecessor agreed with the Chief Secretary, Treasury in March 1983 a lower financial target for the 2 years 1983-84 and 1984-85 than the Electricity Council had proposed; a return of 1.4 per cent on current cost assets instead of 2 per cent.
5. Since then the industry has been doing better than its financial target because of higher growth in the economy, lower inflation than forecast and greater efficiency. Its latest forecast is that it will overshoot its negative EFL of £418 million for 1983-84 by £184 million. It published good profits in July and is still under heavy pressure from industry and from the Consumer Councils to avoid price increases or to give rebates. Having forecast tentatively in July a need for a price increase of 6 per cent in 1985-86, the Council reduced this to 3 per cent in mid-November, removing the likelihood of a severe increase in that year.

## FINANCIAL FRAMEWORK AND PRICES

6. It is not surprising that the industry saw our request for a 3 per cent price increase as inconsistent with the financial framework we had already established. We are in some danger of over-determining the system by seeking to control both the financial framework and prices.
7. In fact I am clear that the right course is to manage these industries by reference to financial targets, to avoid varying these targets at short intervals and to leave price determination to them within the financial framework which the Government determines. That is how we describe our policy, both publicly and in letters to the Chairman of the industries, and I believe it is the only way to manage them efficiently. "Economic pricing" may be a valuable guide to the direction of price movements and a constituent in the determination of financial targets, but it is not a neat guide to individual price changes; and determining what is "economic" is open to great argument.
8. What is clear in the case of electricity is that any private competitive industry in their situation would not be making price increases. This is an industry with between 25 per cent and 30 per cent excess generating capacity and with gross over-capacity also in its principal supplier of raw material, the NCB. As my predecessor concluded, the right course for electricity prices is certainly not upwards. Although, as required by Cabinet, I have pressed the electricity industry to make a 3 per cent price increase, and have secured a gas price increase from 1 January 1984, I think it is self-destructive for a Government pursuing a rigorous policy against

inflation not to let the economy in general and British industry in particular have the benefit of low prices for a basic commodity like electricity when there is no question of any element of subsidy in doing so: quite the contrary.

9. There has been concern about how the electricity industry will achieve the £740 million EFL and whether it will run down stocks (reducing power stations endurance) or engage in end-year switches of money. The Chairman of the Council assures me he has no intention of resorting to these devices. Moreover he is ready to propose a price increase during the year if necessary to achieve the £740 million. I shall monitor their progress closely with this in mind. Meanwhile positive cash flow is at present running at an annual rate of £600 million. He is well on target to achieve cost reducing performance targets over the 2 years to 31 March 1985. He is reviewing working capital requirements as urged by the Treasury. The industry has a record of keeping promises and has achieved its financial target in each of the last 5 years.

10. Even without any tariff increase in 1984-85 there will be a small increase for industry under fuel adjustment clauses, balancing a small reduction for industry in 1983-84. I am in touch with the industry about inter-Area differences in the effects on industry. But none of this is any argument for further attempts to enforce the 3 per cent increase; quite the contrary.

#### CONCLUSION

11. On every ground it seems to me right to leave the industry now to minimise price increases within the new and exigent EFL. This would be right for public expenditure, for good nationalised industry management, for inflation, for British industry and for political reasons. I ask the Cabinet to agree accordingly.

P W

Department of Energy

13 December 1983