Qa 04444

To: MR LANKESTER

From: SIR KENNETH BERRILL

Electricity Council's External Financing Limits
for 1979/80 and 1980/81

1. Mr Howell's minute to the Prime Minister will be raised at next Tuesday's E Committee. The minute has exposed a situation that is very much worse than we in the CPRS anticipated when we recently raised the subject with the Prime Minister. For not only will there be a large breach this year of at least £300m. (less any deferrals of payments until 1980/81) but there is now a substantial breach in prospect for next year before any account is taken of possible carry forwards from 1979/80.

2. Mr Howell has given a graphic description of the difficult situation facing Ministers and a carefully designed package of measures is needed to handle this major test of the EFL system. Mr Howell's minute offers little guidance on this and he will have to come back with some firm proposals before decisions can be taken. Possible measures which the Prime Minister may wish him to consider are:

(i) Tariff in 1980/81. Clearly the previous concept of increasing electricity prices in April 1980 by the RPI rise and by another 5 per cent in October will not be adequate. At the same time the recent 30 per cent increase in gas prices in 1980/81 was justified by the need to begin to close the gap with electricity. This implies that the maximum for electricity might be 25 per cent and imposing it all in April would give the biggest yield. The industry's Consultative Councils will protest loudly against the sudden imposition of such a large increase, and they may ask for phasing (April and October). We doubt that the benefits of phasing would anywhere near approach the cost of lost revenue: as a rough rule of thumb, each one per cent of the rise deferred from April to October would cost the Electricity Council £25m.

(ii) Reducing the capital investment programme. The capital programme for 1980/81 is currently budgeted at over £1bn. Most of this is firmly committed to projects that are well advanced. The only two major projects at an early stage are a coal-fired station at Drax and the new AGR at Heysham.

At Drax, site construction has been under way for over a year and the major hardware contracts are placed. We agree with Mr Howell that the contractual commitments would probably make cancellation too expensive. It would also hit the plant industry hard.

The Heysham AGR is however a different story. Work has not started on site construction and the major hardware contracts have not yet been placed. With AGR costs escalating and electricity demand forecasts falling, it is virtually certain that if the AGR decision had been put forward today the answer would be 'No'. We believe that Mr Howell's minute exaggerates the effects of cancellation on the nuclear industry and on the plant manufacturers. It is true that Northern Engineering Industries (particularly the Reyrolle-Parsons arm) would be badly hit, but this might spur on the much needed rationalisation of the power plant industry. The nuclear design teams, NPC and GEC, on the other hand, would not be affected greatly provided that the Torness AGR for SSEB continued to go ahead.

(iii) Joint CEGB/NCB Financing of Coal Stocks. To the extent that the CEGB are carrying 'excess' coal stocks, i.e. above their normal operational requirements, this is clearly benefiting the NCB. Ministers will not wish to see stocks reduced in the face of the earlier NUM settlement date next year and it seems worth exploring the possibility that the NCB share the costs of the 'excess' stocks (valued at £100m. or so).

(iv) Deferrals of £100m. into 1980/81. The electricity industry believes that it could defer payments of about £100m. from this year to next (£50m. to the NCB; £25m. to the oil companies; and £25m. to CEGB plant and other suppliers). This would reduce their prospective 1979/80 breach to some £200m. On present prospects they may not be able to recapture this lost ground in 1980/81 and may have to continue this late payment into 1981/82.

(v) <u>To write off the £200m. against this year's Contingency Reserve</u>. It would probably be counter-productive to penalise the electricity industry further by forcing them to carry forward any of this £200m. over-run. The £200m. can all be attributed to circumstances outside the industry's control (higher fuel prices, low electricity sales, high arbitration award on pay, and high fuel stocks at Government encouragement). The Electricity Council can be faulted for not being aware of their likely 1979/80 over-run at an early date. But the main reason for the size of the over-run was that their EFL did not contain contingency margins for such a combination of unfortunate circumstances. But if they had insisted on such contingency margins the public expenditure problems facing Ministers would have looked that much worse.

4. This whole episode must call into question both the system for fixing nationalised industry cash limits and the quality of financial management in the electricity supply industry in England and Wales, i.e. the Electricity Council, the CEGB, and the twelve Area Boards. It would be interesting to ask why the SSEB, which has a unified structure, has not run into the same financial difficulties, and why it seems likely to live within the existing EFLs for this year and next.

5. I am sending a copy of this minute to Sir Robert Armstrong.

KB

22 February 1980