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CABINET

MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

INDUSTRIAL ENERGY PRICING

MEMORANDUM BY THE SECRETARY OF STATE FOR ENERGY

Since circulating my paper on Energy Prices (E(80)120), I have considered this issue further. Colleagues may find it helpful in discussing that paper to see an alternative presentation of the arguments concentrating on some of the main points.

2. No-one questions that the recent doubling of world oil prices and the consequent enormous upward pressure on all other energy prices is an uncomfortable and harsh process to which to have to adjust as the whole world is trying to do. Here in Britain we have every reason to let these prices work through - both in allowing oil and gas to be traded at market values and requiring the coal and electricity industries to pay their way by the earliest possible date. Market prices for oil and gas are the only alternative to detailed state control of the price - and therefore the returns and investment - in these limited, internationally-traded resources and would make sense even if they did not have major beneficial implication for the PSBR. Similarly, electricity and coal industries that make a decent return on assets offer the best hope of escaping from the cost-plus mentality which can otherwise bedevil them - and has bedevilled them - and will allow them to make essential cost-saving investments from their own resources. The pace at which fuel prices move towards the levels required to achieve these objectives should, of course, be carefully considered. It cannot be dictated solely by the apparent consequences for the PSBR because these can be offset or negated by the costs of adjustment which can result in lower public sector revenues and increased expenditures if the strains on industry are too great. Nevertheless, the broad strategic direction must be correct.

EFFICIENCY IN THE NATIONALISED INDUSTRIES

3. Of course, none of this provides an iota of excuse for our energy supply industries to be inefficient and live "fat". On the contrary, the pressure on their efficiency should be ever tighter so that the maximum benefits can be ploughed back into further expansion.

This applies especially to the nationalised energy industries from whom we, as shareholder, are entitled to expect the most vigorous performance on costs, whether their pri are market-driven (gas) or cost-driven (coal and electricity). I have made this clear from the start to these huge concerns and backed words with actions in the following ways;

(a) setting extremely tight financial disciplines for each the energy nationalised industries. For example, the financ strategy set earlier in the year for the NCB has undoubtedly strengthened the Board's resolve in accelerating the closing of uneconomic pits from the rate proposed by the Board last year of 1½m tonnes pa to their current target of 2½m tonnes this year they plan to achieve 3m tonnes and I hope there wi be further improvements in future years. The elimination of high cost pits not only helps the financial position of the NCB, but also that of the CEGB which takes two-thirds of the NCB's production; coal and other fuels account for some two-thirds of the CEGB's total costs. The same tight discipline sharply accelerated the CEGB's plans for power station closu and manpower reductions;

(b) performance indicators. It is vital that we ensure monopoly state industries do not meet financial and profit targets merely by putting up prices. I shall therefore be setting performance indicators for the gas and electricity industries in the near future and will consider a performan aim for the NCB early in the New Year when we have reviewed their financial strategy targets as it is important not to set them inconsistent targets;

(c) requiring priority for investment programmes which cu costs. For example the 15 GW nuclear programme is designed reduce the cost of the electricity, while low cost high-productivity pits such as Selby will have a similar impact coal costs, especially when coupled with the faster closure uneconomic pits;

(d) independent assessment and investigation. We have recently taken powers to have the cost and efficiency of nationalised industries examined by the Monopolies and Mergers Commission. The CEGB has been under rapid investigation under these powers, and the results will be available shortly;

(e) coal import facilities. At my request the CEGB is actively studying the possibility of new coal import facilities which would further increase the pressure on UK prices;

(f) competition. We will be lifting restrictions on private generation to encourage long term competition in the electricit market;

(g) Board appointments. We are strengthening the Boards of the nationalised industries, particularly the NCB and CEGB, by bringing in outside directors from the private sector with a more commercial background and outlook.

4 It is particularly important to improve efficiency and productivity in the coal industry because of its effects on electricity prices. Many of the policies I have outlined above are designed precisely to do this. We must also keep up the pressure on other nationalised industries. In this contextcolleagues might be interested in seeing the attached note on some of the steps being taken by the CEGB to improve efficiency. (ANNEX)

5 But it is necessary to bear in mind the timescale in which these measures will have their full effect. Efficiency cannot be increased fast enough to make any significant difference to energy costs, and thus to the prospects of energy-intensive industries, during the immediate recession period. While we will be unrelenting with measures to improve efficiency in the nationalised industries, I believe we will need to consider their relationship with Government and the sanctions which can be used to substitute for market competition.

6 As regards efficiency in the coal industry, concern has been expressed about the CEGB/NCB agreement. The NCB's pri[…] to the CEGB were rising faster than the rate of inflation prior t[…] that agreement. The first step was therefore to bring down the rate of price increase to no more than the rate of inflation. Th[…] CEGB are now pressing the NCB to raise prices at a rate below th[…] of inflation - an outcome which would be highly desirable but whi[…] the NCB will find it very difficult to achieve.

WHAT OTHER COUNTRIES ARE DOING

7 It is still true to say that average UK electricity and gas prices are broadly comparable with those on the Continent. (I de[…] with the North American position in paragraph 8 below). Most of[…] representations we have received are not about average prices, bu[…] rather about electricity prices for large and energy-intensive us[…] and the price of new or renewed firm gas contracts. While we do […] have full data - despite repeated requests the CBI have still no[…] given us their data, although I hope they will when Terence Beck[…] comes to see me today - I accept that at least in some cases our competitors in Europe may have a price advantage over us in resp[…] of some electricity and gas contracts.

8 There are three possible causes of these disparities. First in the case of electricity (which in general is not internationa[…] traded) some countries' costs are much lower than ours as a resu[…] of a large nuclear programme (France), abundant hydro power (Can[…] Norway and to a lesser extent, France and the USA) or abundant o[…] cast coal (USA). This we must accept. Secondly, in the case of all members of the EC other than ourselves have decided to load […] more on to domestic prices and less on to industrial prices. Ev[…] when the price increases to our domestic gas customers already ag[…] are fully implemented they will be much more favourably treated […] their European counterparts. Thirdly, there are undoubtedly cas[…] of unfair competitive practices both in the USA and in the EC. […] calls for a robust response and for eighteen months we have been applying increasing pressure to the USA, in the IEA and elsewher[…]

We must intensify this. As a result of the efforts of Peter Walker and his colleagues, the European Commission have taken the Dutch to the Court for subsidising their glasshouse industry. I suspect that this case is by no means unique and that there are other cases of subsidisation to large users. But in order to take effective action we need hard facts about subsidisation. Our industry has often failed to provide this. Much of the work will inevitably have to be done by our industries themselves. But my Department has been in touch with the other Departments concerned about identifying cases where unfair competition is damaging our industries.

9 I am concerned about the slow rate of deregulating gas prices in the USA. We must press the new Administration to accelerat[…] this process. But this will not be easy to achieve. We must therefore use all the weapons we have at hand. First, I agree with the recommendation in the report by officials (paragraph 7.3) that the decisions on a more rapid move to economic pricing at the various Summits must be tightened up. Secondly, we must press our Community partners to ensure that the Commission tackles the Americans on this issue; (I raised this matter with Davignon when he was here last week and he is keen to act). Thirdly, my officials are working with other Departments on what additional pressure can be brought to bear on the Americans, including the imposition of countervailing duties in appropriate cases.

MARGINAL COST PRICES IN THE ELECTRICITY INDUSTRY

10 My officials discussed this issue, with Frank Tombs and Fred Bonner (Deputy Chairman of CEGB) on 24 October. The Council said then that since short run marginal cost (SRMC) respresents a large part of the total cost of producing electricity, selling it without covering fixed costs would not help companies who want a large and continuing reduction (eg Bowaters who were seeking 50%). Nor would selling at SRMC to companies in difficulty have any significant effect in generating extra revenues or increasing sales. Most companies want cheaper electricity, not more at present. However, I have asked Keith Joseph whether we can get his people to draw up a list of companies in particular

difficulties on electricity costs (eg in steel or ceramics) to see what can be done.

11 There are legal problems which prevent Area Boards openly giving particular customers preferential treatment (which would in any case be greatly resented by small industrial and commercial users). But some Boards can and do cut prices a little to custom in temporary difficulty and they should be encouraged to do so. Area Boards also help their customers to programme their electrici demand to obtain the maximum benefit from the Bulk Supply Tariff.

OUR LINE FOR THE FUTURE

12 I am fully aware of the present predicament of that part of British manufacturing industry which gets hurt, rather than booste by high energy prices and of the need to give what help for adjust ment we can in energy and other fields without over-turning our whole medium term financial strategy. I believe the approach out-lined in E(80)120 and this paper will make some contribution to easing these industries' difficulties. In summary this was:

(a) an intensification of our efforts to improve efficiency and productivity in the energy nationalised industries, notab the coal industry;

(b) endorsement of the BGC's proposals to charge only some 75% of the equivalent of gas oil prices for renewed firm gas contracts (currently on 28p-30p) - a price that is well belo the prices now being charged by the largest German gas utilit (cost to PSBR £100m);

(c) pressure on BGC to reduce their price for new firm gas contracts from 40-42p to the price of renewed contracts for firm gas (cost to PSBR £10m);

(d) encouraging the Electricity Council and Area Boards to show what flexibility they can in bringing prices down close to SRMC on a temporary basis for large users in temporary difficulties, and to help their customers obtain the maximu

benefit under the existing Bulk Supply Tariff;

(e) tougher international action along the lines set out in paragraphs 6-8 above;

(f) pressing the three large oil suppliers to reduce their product prices.

13 I believe the above represents a positive response to the needs of industry. But our line has to take into account our economic strategy, on which the Chancellor has recently submitted papers to the Cabinet, as well as the position on EFLs which we discussed last Wednesday. We must also accept the harsh fact that a number of cases which have been drawn to our attention concern labour-intensive and energy-intensive industries which would be in difficulties in any case (segments of our steel, textiles and paper industries) regardless of the present recession, high interest rates, high exchange rate and increased energy prices. Many of the companies could do more to help themselves, eg Bowaters should have approached Manweb and not vice versa. Some of the complainants have not applied existing energy conservation technology to their operations. I am especially concerned when I learn of the massive reorganisation and ~~new manning~~ re-equipment going into Japanese industry, so as to cut sharply energy use and costs, and when I compare it with our own more dilatory approach - with certain creditable exceptions.

14 Finally there are three further equally important reasons why it is deeply in our interest to allow economic forces to work as far as possible in energy pricing. First, if we did not, we would disastrously delay the vast process of re-tooling and new investment in industry required to increase energy efficiency and cut energy use. Second we would delay the investment in new alternatives which almost every other country is pursuing - and those that do not will be the orphans of the 90's. Third, high energy prices, however painful for some, bring enormous opportunities for new industries in a major energy producing economy like ours. The more our business community seizes these opportunities, by investing more in our energy industries, offshore and onshore, as well as in energy

equipment industries and all their suppliers, the stronger we wil be relative to others. Already 36½% of all industrial investment is in energy and energy-related industries in Britain. This is job creation, not job destruction, and what is more, job and wea creation in precisely the areas where world demand is going to expand most vigorously.

D A R H

Department of Energy
3 November 1980

ANNEX

COSTS AND EFFICIENCY IN THE CEGB

1 The CEGB has for many years published a series of performance indicators (including some international comparisons). These have recently been extended and the 1979/80 figures are attached.

2 The CEGB has the objective of trying to keep unit costs of electricity constant in real terms; this notwithstanding that fuel, which accounts for over 60% of its costs, has been rising faster than the general rate of inflation. The measure of the Board's considerable success in this can be seen in Figure 1 attached.

3 The Board is also making special efforts to contain its fuel bills. The agreement with the NCB (aiming to get coal price increases below the inflation level) is a case in point. Further improvements are being sought by holding oil burn to a minimum and securing high availability and thermal efficiency from 500 and 660 MW coal fired sets.

4 The Board's 40% expenditure on items other than fuel is roughly divided between capital fixed charges (20%) and salaries, plant repairs and maintenance, research and administration. In the current financial year these latter items total some £~~100m~~ 1000m (out of total net expenditure of over £6,500m). Half that £~~100m~~ 1000m will be concentrated on maintaining nuclear plant, high merit coal fired plant and the transmission system. The Board is striving for the right balance between cutting repair and maintenance work to the minimum to produce immediate cash savings and ensuring that enough maintenance work is done to get the plant performance necessary to achieve the Board's cost per unit target this year without imperilling performance and costs in subsequent years.

5 More specifically the Board is taking a number of actions to meet its EFL and financial target not by price rises (which could further depress demand) but by redoubled cost cutting efforts and pruning out marginal capital expenditure. The main features have been:

i close scrutiny of the Board's programmes. For instanc in the 1980 Programme aggregate capital expenditure fo the quinquennium ~~has risen~~ been reduced by £700m at March 1980 prices compared with earlier budgeted figures.

ii Tight restraints on manpower, including a ban on recru during January to March 1980, ensured that the number of men in post at 31 March 1980 was no higher than a year earlier. Recruitment of staff from outside the CEGB is being restricted. To achieve this, despite th need to build up manpower to commission stations under construction, the budget submissions from operating un have been reduced by 1000 men, at a salary saving of £ Manpower in various Headquarters formations is to be reduced by 5% by 1982.

iii cuts in purchases of materials, goods and services (a reduction of £34m was achieved in 1979/80).

iv accelerated closure of older and less efficient plant. The Board has announced plans to decommission 3.4 GW o capacity in 1981/82. Some 3000 to 4000 jobs will go as a result.

v introduction of more stringent appraisal rules for optional investment; a 3-year pay back is now required

vi placing oil-fired units on a two-shift regime. This i a complex and difficult operation. The Board is also reviewing system security to establish whether there a commercial benefits from a degree of voltage reduction before bringing high cost peaking plant into operation at times of peak demand.

vii reduction in travel costs and postponement of work on improving office accommodation coupled with severe att to good housekeeping.

6 The investigation into CEGB's efficiency and costs currently being carried out by the Monopolies and Mergers Commission will provide a valuable cross-check on the Board's efficiency.

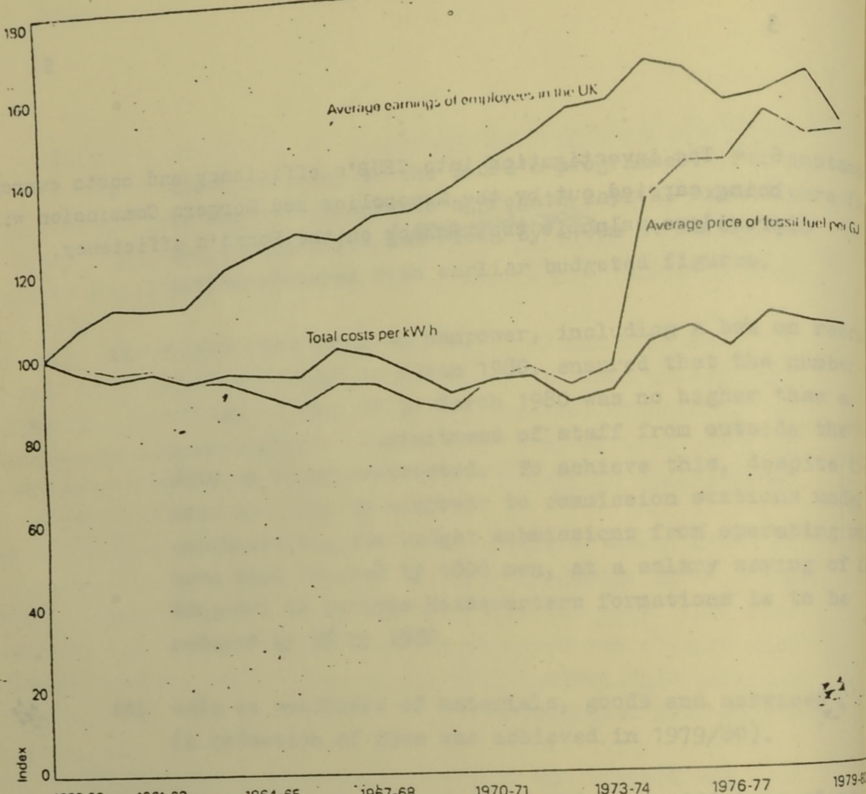


Figure 1: CEGB costs, average price of fossil fuel and average earnings, all adjusted for changes in the Retail Price Index (1958-59 = 100)

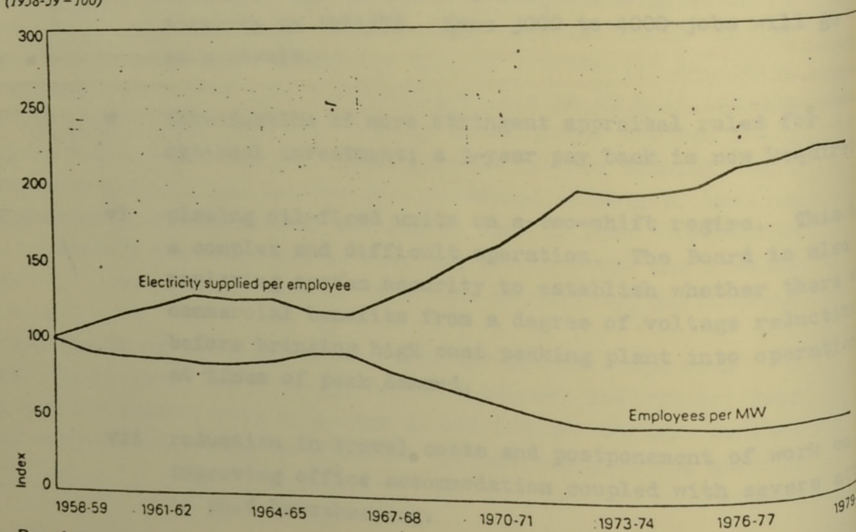


Figure 2: Manpower productivity indices (1958-59 = 100)

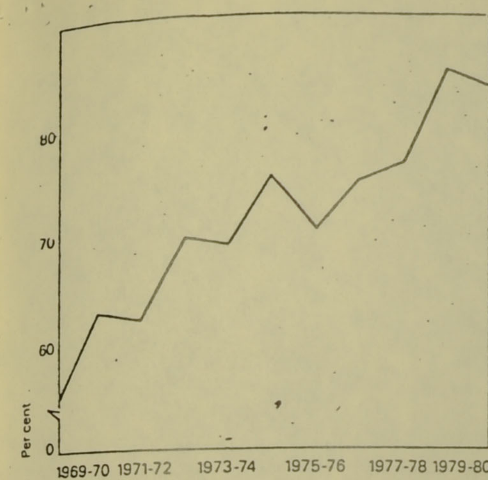
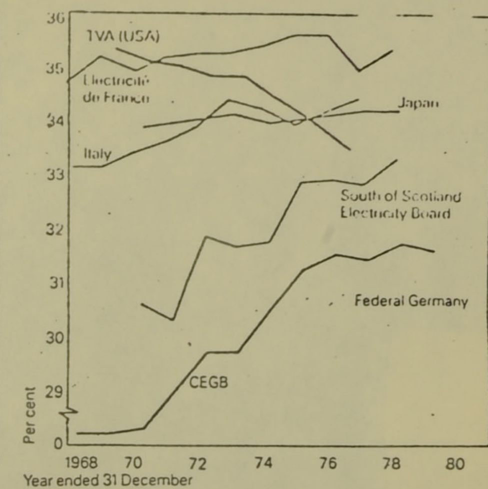


Figure 3: Mean availability of CEGB conventional 500-600MW single shaft generating units at time of daily peak for weekdays for the winter period (December, January & February)



Values plotted at date of end of financial year: 31 December for Electricité de France, Italy, and West Germany, 31 March for CEGB, Japan and SSEB and 30 June for TVA until 1976, thereafter 30 September.

Figure 4: Trends in conventional system thermal efficiency for the CEGB and other utilities

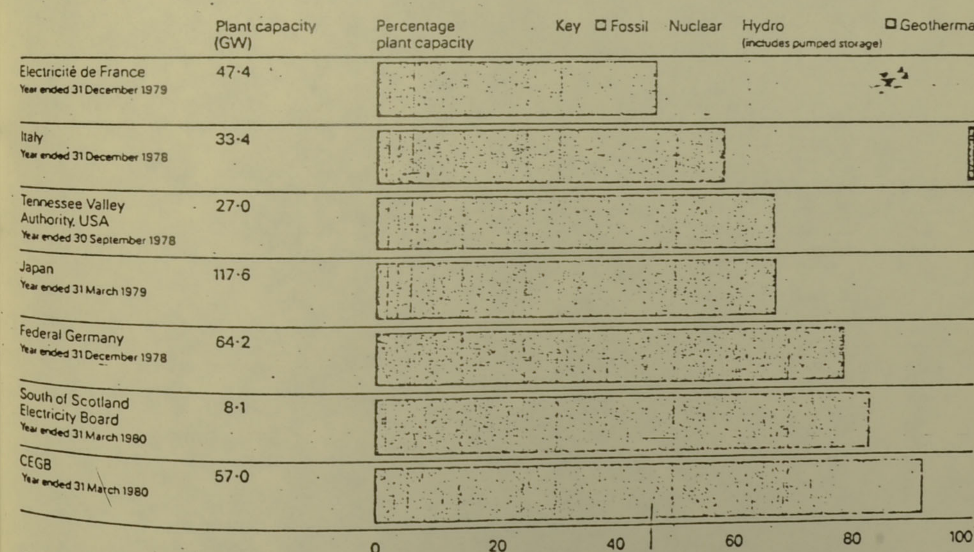


Figure 5: Plant capacity for various utilities classified by energy source