PRIME MINISTER

ELECTRICITY PRICES

It is now clear that the current level of electricity prices cannot be justified, and that corrective action should be taken as soon as possible. In practice this means that, at the very least, prices should not increase at all next year, whereas on the old basis there would be an increase of about 5%.

The Government have repeatedly stressed the importance of proper economic pricing in the monopoly nationalised industries, not least in the energy sector. We have stuck to those principles - that prices should reflect marginal costs - in the face of considerable unpopularity in the case of gas, the price of which to the domestic consumer has risen by 10% in real terms over each of the past three years. Electricity prices too have been rising in real terms since we came to office.

The Chief Secretary and I are at one in believing we must continue to stick to this approach. We also agree, as do our economic advisers, that in the light of studies on electricity prices over the past months, current prices have been found to be higher than would result from a proper application of economic principles. A report which, with the agreement of the Chancellor, I commissioned earlier this year from Coopers and Lybrands on the CEGB Bulk Supply Tariff (BST), has demonstrated that insufficient account is being taken of substantial, and continuing, over-capacity; currently, charges contain an element related to the cost of building new power stations to meet growing demand, whereas no new stations are likely to be built for this purpose for many years to come. (Nuclear stations are needed on solely strategic and cost-saving grounds). Coopers also criticised the CEGB's practice of recovering all overhead costs through prices, whereas on economic grounds only those elements which are marginal should be included.

Charges are thus too high. I cannot continue to defend them, to the CBI, NEDC or anyone else. To achieve a defensible position, we must interpret long run marginal costs in a way that takes fully into account the realities of lower demand and excess capacity. The resulting change in price levels would of course also accord with a normal commercial response to such a situation. Coopers reported in July, since when my officials have kept the Treasury constantly in

touch with progress. I have also discussed the key issues, summarised in the Annex, with the Chairmen of the CEGB and the Electricity Council. I am satisfied that we now have a responsible and quantified view from them on Coopers' main criticisms, which relate to the calculation of capacity charges and overheads. In their report Coopers did not quantify the effect on prices of appropriate corrective action on capacity charges but accept that, broadly, it would be to reduce prices by 5-10%. The CPRS agree (para 6.7 of their Report on Electricity Prices for Industry).

Coopers also suggested that electricity prices should reflect the true price of coal as a traded commodity. The CPRS have also argued that coal prices to the CEGB should be related to import prices. The Treasury agree in principle. I do not believe that we need to take a view on this aspect of the matter now, but it is clear that any move in this direction would imply a still greater reduction in electricity prices.

The standstill I am proposing is thus in itself at the low end of the range of adjustment indicated. To do still less and phase it over more than one year could not be defended. Moreover, our review of electricity prices is public knowledge, and to continue the present over-pricing would be totally inconsistent with the Government's economic pricing policy.

This proposal would, of course, have an adverse effect on the industry's EFL and hence on the PSBR. This has been quantified in the note by officials at some £350 m in 1983/84. The resulting EFLs for the ESI would be:

	1983/84	1984/85	1985/86
£m	-12	-123	-355

However, the officials' note leaves out of account the £150 m p.a reduction in public sector costs, not to mention the 0.2% reduction in the RPI which would flow from a 5% reduction in electricity bills. In any case, the public expenditure consequences are properly seen as the cost of abolishing a surcharge which has unintentionally arisen through the financial target set three years ago. Since 1979, the industry's demand estimates have been revised downwards substantially and recovery from recession has been delayed. In other words, what I

propose is akin to a reduction in taxation.

We need to reach decisions by the end of this month for the industry to translate them into detailed tariff proposals for 1983/84.

I am copying this minute to the Chancellor of the Exchequer, the Secretary of State for Scotland, the Chief Secretary to the Treasury and to Sir Robert Armstrong.

B.D

pp. Secretary of State for Energy
18 October 1982

(signed in the Secretary of State's absence, but approved by him)

ANNEX

QUANTIFICATION OF PRICING PROPOSALS

The CEGB recovers its costs through a combination of capacity charges (about 20% of its total revenue) and unit rates. The Coopers Report focussed primarily on capacity charges. The basic capacity charge at present reflects a combination of new plant costs, and the costs of maintaining old plant on the system, together with some "balancing" overhead costs which are not included in any of the specific elements in charges. This package is intended to reflect the capacity cost to the CEGB of meeting a permanent increment to demand. The element appropriate for inclusion in today's price is obtained through an annuitised approach to costs extending 30 years into the future.

Coopers' key criticisms of this approach were:

(i) The cost of new plant is not relevant to today's prices. It will not become relevant for a number of years, because of over-capacity in the industry.

(ii) There is no case for anticipating future costs in today's prices as many as 30 years ahead - 15 years should be the maximum.

(iii) Prices should only reflect those overhead cost elements which are marginal, ie those which increase in proportion to increase in demand.

The CEGB have advised as following on these points:

(i) They accept that the capacity charge should reflect only the cost of maintaining old plant on the system. In 1983/84 the cost would be £22/KW, as compared with £28/KW on the old basis reflecting a combination of new plant and old plant costs.

(ii) They would expect the £22/KW number to remain constant in real terms for several years ahead, so that the question of anticipating future changes does not yet arise.

(iii) They believe that some 25% of overhead costs could be regarded as non-marginal, but there are considerable uncertainties and caution suggests that they should set prices next year to reflect only half of this reduction.

The BST accounts for 80% of prices to the final consumer. On the old basis it would have increased by 4-5% next year. On the new basis it would (depending on final details on unit rates) remain level or fall by up to 1%. Area Board charges make up the remainder of prices. These were not investigated by Coopers. The Electricity Council advise that on average Area Board charges will rise by around 3% or less. This would produce an effect of between 0 and 0.75% on average retail prices but with the normal variation between the 12 Area Boards of ± 2%. Set against the BST proposals, it indicates that prices should overall and on average maintain their 1982/83 levels in 1983/84.

The EFL cost in 1983/84 would be about £350m, of which something over half can be attributed to the exclusion of new plant costs (para 3 (i)) and the balance to the reduction in overhead charges (para 3 (iii)).

Prices in later years might be expected to rise broadly in line with the industry's own costs, on the same pattern as in current forecasts. The EFL cost in 84/85 and 85/86 would therefore be limited to the carry-over effect of the lower prices set in 83/84. The cost would be about £500m in 84/85 and £550m in 85/86 (greater than the cost in 1983/84 because the bill-paying cycle limits the cash effect of price changes in the first year), which would be offset (in PSBR terms) by the saving on public sector electricity costs of £150m a year.

Nat Ind
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SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ

01-211 6402

Prime Minister:

Michael Scholar commissioned this from Energy after your conversation with him about capacity in the electricity industry

29th December 1982

JJ
29/12

Michael Scholar Esq
Private Secretary to
 the Prime Minister
10 Downing Street
London SW1

Dear Mr Scholar

ELECTRICITY PRICES

You asked last month for additional clarification of the reasons for the electricity price standstill next year.

This was discussed in my Secretary of State's minute to the Prime Minister on 18 October; and the issues summarised in paragraph 5 of the note by officials attached to John Gieve's letter to you of the same date.

One important element in the standstill is a real reduction in the CEGB's capacity charge (which accounts for about 16% of retail prices), to reflect the fact that in present circumstances of over capacity in the industry, an increase in demand would not require the bringing forward of new capacity but only deferment of retirement of existing stations - a lower cost.

The CEGB's case for ordering Sizewell PWR does not rest on the need for new capacity but primarily on the potential for cost saving through displacement of existing more expensive plant. In that sense, Sizewell will be ordered ahead, and independently, of growth in demand. Sizewell costs should not and do not therefore feature in electricity prices which are related to the cost of the marginal unit of demand.

As Mr Lawson noted in his 12 November statement, the other important factor underlying the price standstill is improved thermal efficiency resulting from improvements in CEGB plant performance.

Yours sincerely
[signature]

pp MISS C E BROOKS
Private Secretary

DEC 1982

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