Treasury Chambers, Parliament Street, SW1P 3AG

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18 October 1982

Dear Michael,

PUBLIC EXPENDITURE AND ELECTRICITY PRICES

I attach a paper by officials which can serve as the basis for discussion at the Prime Minister's meeting tomorrow. It has been agreed with Department of Energy and the Scottish Office.

Copies go to John Kerr here and to Julian West, Muir Russell, John Sparrow and Richard Hatfield.

yours sincerely

for JOHN GIEVE

PUBLIC EXPENDITURE AND ELECTRICITY PRICES 1983-84 TO 1985-86
(Paper by Department of Energy, Scottish Office and Treasury Officials)

There is an unresolved issue on the public expenditure figure for the electricity supply industry in England and Wales. This is essentially concerned with future levels of electricity prices.

Current additional bid for the electricity supply industry in England and Wales (ESI)

2. The baseline provision in this year's Investment and Financing Review is:

			£m cash
	1983-84	1984-85	1985-86
Line 1 Baseline	-462	-543	-565

The present additional bid by the Secretary of State for Energy, which has been accepted by the Chief Secretary, is:-

Line 2 Current Additional bid	+100	- 82	-340

-362

The bid in line 2 for 1983-84 reflects the cost of continuing the scheme of assistance for major industrial users introduced in the 1982 Budget.

3. The present bid assumes that inflation and price increases will be as follows:-

Table A	1983-84	1984-85	1985-86
Inflation	7	6	5
Price	5	6	5

4. The figures above are based on a continuation of the present methods of determining electricity prices. It is now accepted in principle by the Treasury and the Department of Energy, on the advice of Coopers and Lybrand, that these methods do not correctly reflect economic pricing principles.

Since the 1960s, the aim has been to set electricity prices equal to long run marginal cost (ie. to reflect in today's prices the long term consequences of a change in demand for electricity). One element in costs - representing about 16 per cent of them - has been the cost of the additional plant needed to meet an increase in demand. But because the industry will continue to have substantial overcapacity, it is not planning to build new power stations for the foreseeable future (other than nuclear stations which are justified on cost-saving rather than capacity grounds). The plant element in marginal costs should thus reflect, not a new station (as in the present approach) but the much lower cost of deferring the retirement of an existing station. Coopers also suggested a new approach to other elements of cost, particularly overheads. Overall it was suggested that current prices were significantly higher than would result from a proper application of economic pricing principles, although Coopers did not quantify the difference.

6. The Department and the Treasury accept in principle that the optimum basis for prices is application of marginal cost principles. This could result, however, in a significant additional public expenditure requirement*. The effect on the finances of the industry also has to be taken into account. Without other cost savings a significant moderation in electricity prices could leave the industry with only a small pre-interest profit of very roughly ½ per cent in 1983-84 (compared with the target set for the industry over the last three years of 1.7 per cent on average). There would be a post-interest loss, although taking one year with another there should not be a breach in the industry's statutory duty to breakeven. The Treasury believes that the extent and phasing of correction to prices needs to be considered in the light of the Government's public expenditure and PSBR policies.

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* The approximate cost of each one per cent reduction in prices in April 1983 would be:

	1983-84	1984-85	1985-86
± 1% price change in April 1983 (E&W)	± 70	±100	±110

7. The electricity supply system in Scotland is separate from that in England and Wales. Prices to all classes of consumer, apart from the largest industrial users, are generally lower there. In part this reflects the different structure and level of costs either side of the border.

8. The Coopers' report did not cover Scotland where methods of price determination are somewhat different; and entirely fresh calculations would need to be made of the effect of applying the approach they suggested to the Scottish electricity system.* The external financing limit for 1983-84 agreed by the Secretary of State for Scotland and the Chief Secretary is £256m cash (this is £26m over baseline, due to rephasing of capital expenditure).

Beneficiaries

9. Detailed tariff prospects will need to be worked out by the industry in the light of the Government's decision on their future external funding and financial targets. Broadly, the benefits of price moderation would be spread across all existing consumers; the rough proportions would be domestic (40%), commercial (25%), and industry (35%). The recent CPRS Report shows that electricity prices were not crucial to other than a few sectors of British industry. These are generally benefiting already from the price reduction scheme introduced in the 1982 Budget. While any measure of relief would be welcomed by all consumers - and this is an area in which the Government is seen to be responsible for prices - there would be unlikely to be significant effects on the economy as a whole in the short term. In the longer term, by moving towards prices at the proper economic rate, consumers would be encouraged to make the correct decision on whether to invest in electricity or in other sources of energy; this should give longer term gains in overall economic efficiency.

* The approximate cost of each 1% reduction in prices in April 1983 would be:

	£m cash		
	1983-84	1984-85	1985-86
1% price change in April 1983	±10	±15	±16

Position of the Secretary of State for Energy

10. The Secretary of State for Energy considers in the circumstances that there is no case for increasing prices in 1983-84. This would increase the additional bid in line 2 above to:-

			£m cash
	1983-84	1984-85	1985-86
Line 3	+450	+420	+210

He is amplifying his position in a separate note.

The Position of the Treasury

11. The Treasury has long argued that nationalised industry prices should reflect marginal costs. They agree with the Department that some real reduction in electricity prices is merited in 1983-84. But they argue that alignment of prices with marginal costs needs to take account of public expenditure consequences, which in this case are potentially substantial. On Friday the Department of Energy provided figures on elements in the industry's marginal costs and the Treasury will now wish to consider these in detail with the Department and the industry in view of the substantial sums involved. This can be done quickly. A similar exercise needs to take place in Scotland. The Treasury believe that some phasing of real reductions in electricity prices may be needed for public expenditure reasons. In any event, the industry should be pressed further to absorb the loss of revenue, in addition to the savings already made, so as to minimise the increase in public expenditure.

12. The timing of an announcement also needs to be considered. One possibility is for an announcement in the Budget. This timetable would not prevent theSecretary of State from making positive statements in the meantime (eg to the December NEDC) to the effect that electricity prices will be below the rate of inflation next year.

Conclusions

13. The issues for discussion are:

a) the phasing of the reduction and how the public expenditure consequences should be dealt with;

b) the timing for final decisions and announcement.