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DEPARTMENT OF INDUSTRY
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*Secretary of State for Industry*

27 October 1982

The Rt Hon Nigel Lawson MP
Secretary of State for Energy
Thames House South
Millbank
London SW1

Prime Minister

Industry and Energy are likely to be at loggerheads on these issues, with Energy arguing it was all settled at your meeting last week. Agree a meeting, after Nov 2, to discuss CPRS Report and these issues, including pk 6 ICI?
MCS 27/10

Dear Nigel,

Yes

CPRS REPORT ON ELECTRICITY PRICES FOR INDUSTRY

I have seen a copy of the Report circulated on ~~8~~ October. The industrial analysis contained in the report is excellent and a number of its recommendations - particularly those relating to coal - are most welcome. However, I am most concerned about the implications of the Report's conclusions for electricity-intensive users in general and for ICI in particular. None of these recommendations, nor the findings of Cooper and Lybrand about the capacity charge, are likely to provide enough relief for the electricity-intensive users who are suffering the most severe competitive disadvantage. I note that the Prime Minister raised the problem of ICI in a recent discussion on electricity prices which you had with Treasury Ministers last week. I understand that at the Prime Minister's meeting, it was agreed that there should be a standstill on electricity prices in 1983/84 together with adjustments to the EFLs for the ESI in 1982/83 and 1983/84. I hope that we shall be able to consider the detailed implications of these decisions for possible further adjustments to the tariffs for industrial electricity prices, and in particular for electricity-intensive users, prior to an early collective discussion of the CPRS report. In the meantime I thought I should let you know both my immediate reactions to the general issues raised in the CPRS report and the more specific problems highlighted in Sir Robin Ibbs' letter to the Prime Minister of 22 October.

2 The CPRS Report confirms once more that electricity-intensive users enjoy significantly lower prices abroad, not only because of cost advantages in some countries but also because of different tariff structures, Government subsidies and special deals. Three points are especially worth focusing on:

i) the extent to which (para 3.38) local industrial policy in Germany can add to the favourable deals negotiable through the German system. We cannot be certain that renegotiation of contracts will reduce the German price advantage significantly;

ii) the decision by the Dutch Government as recently as July 1982 to reduce prices paid by large consumers with high load factors;

iii) the extent to which the French prices, held down to meet the objectives of the Government's counter-inflation policy, have benefited French industry.

The key question is whether we should introduce further measures to compensate for these distortions, thereby enabling our industries to compete on a fair basis.

3 The CPRS is probably right in questioning whether the aluminium smelting industry is likely to be competitive in the UK in the longer term. But we should not write off the other electricity-intensive sectors which, for example, supply local markets with goods which are expensive to transport, or which exploit a technological leadership. They do have a prospect of survival here and we can improve that prospect by helping to match distortions in other countries' electricity pricing.

4 The CPRS recognise that lower electricity prices could make a significant difference to ICI's chlorine related activities. They estimate that output of up to £250 million per annum could be at stake, representing up to 4000 jobs at Runcorn and elsewhere. Sir Robin Ibbs and some of his ICI colleagues called to see me yesterday and gave me a very similar and realistic assessment of the action they would have to take over the next three to four years, if adequate relief is not forthcoming. 4000 jobs would be lost directly. If more substantial closures of chlorine capacity were to take place there would inevitably be knock-on effects on other parts of ICI's system with up to a total of 12,000 jobs and output worth over £700 million per annum at risk. The problems facing the company's petrochemical activities on Teesside would be further aggravated since closures in the chlorine-related activities would be likely to cut ICI's internal demand for ethylene by some 20 per cent. None of these figures take any account of local or national multiplier effects.

5 As far as other chemicals, steel, textiles and paper are concerned, the CPRS are of course right to say that electricity is only one of several problems, but nevertheless, it is a significant problem for them all, particularly near the low point of the economic cycle. These industries are doing what they can, in very difficult circumstances, to improve their competitiveness often by taking very unpalatable decisions. We

should not dismiss the idea of helping with electricity costs (where we are in a position to help) merely because they face other problems (where we often cannot help).

6 There are a number of useful recommendations in the Report, on nuclear power, world market-related coal prices, greater sophistication of the tariff, direct dealing with the CEGB, private sector generation and sale or lease of CEGB plant. The finding by Cooper & Lybrand that capacity charges have been set at excessive levels is particularly important and I warmly support the decision to implement this for the benefit of the generality of British industry. My fear, however, is that none of these measures would provide much relief for electricity-intensive industry in the short term, although it would be useful to have an assessment from your Department.

7 In these circumstances I do not believe there can be any question of withdrawing the 3 per cent flexibility allowance. Likewise, we need a permanent load management scheme, with a lower qualifying threshold, at least as generous as the existing Contracted Customer Load Scheme.

8 However, I am convinced we must do more - particularly for ICI's chlorine operation and perhaps for some of the other sectors too. I do not agree with the CPRS that the appropriate route for such assistance is through industrial policy aids. I would be most reluctant to use the Industry Act, even if such highly visible action escaped challenge in the European Community, because of the precedent this could set for industry to seek operating subsidies in respect of other costs.

9 I am not entirely persuaded by the thesis underlying the Report that present pricing policies may be expected to secure the optimum allocation of resources and are thus economically desirable. There are a number of reasons for thinking that this is not so: the under-pricing of electricity overseas to which I have already referred; the fact that industries in the private sector (whether in manufacturing or as energy producers) do not normally price according to marginal cost but according to what the market will bear; and the inclusion in the ESI's cost structure of the effect of past mistakes which it could not hope to pass on if it did not enjoy a monopoly position. As a matter of principle I do not believe we should allow private manufacturing companies to be penalised for the past mistakes of the nationalised energy utilities.

10 We all know that the problem stems from electricity prices and the ways other countries have found to distort these prices.

Surely we can find a way to compensate for those distortions? I am well aware of the problems over undue preference, but believe that officials of our two Departments should be asked once again to look, with the electricity supply industry, at what more can be done. One possibility might be to arrange for the sale or lease of power stations to interested companies, and ICI are very ready to give this idea further consideration. The CPRS support the idea on a fair economic basis, and I would not necessarily wish to press for a subsidised lease. But I think there may be an argument for combining leasing with the supply of NCB coal at a price linked to the export price, since this would be the best price that could be obtained for the coal if for example, ICI closed a significant part of its chlorine operation and the CEGB's requirement for coal fell accordingly. (It is perhaps relevant that the European competition facing ICI itself depends in part on UK coal exported to, eg German power utilities at "export" prices.)

11 Many of these points are relevant to the reply which the Prime Minister wishes to send to Sir Robin Ibbs, on which our Departments have been asked to advise.

12 I am copying this letter to the Prime Minister, Sir Geoffrey Howe, George Younger, Sir Robert Armstrong and John Sparrow.

Yours ever

Patrick

Nat Ind ✓JV

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*Secretary of State for Industry*

17 November 1982

Rt Hon Nigel Lawson MP
Secretary of State for Energy
Department of Energy
Thames House South
Millbank SW1

Prime Minister 2

Mr Jenkin wants to help ICI etc through lower electricity or coal prices.

MCS 17/11

Dear Nigel,

CPRS REPORT ON ELECTRICITY PRICES FOR INDUSTRY

Thank you for your letter of 2 November.

2 I think we are all agreed that ICI and others face a real and serious problem and are likely to continue to do so even after the adjustments which you have announced come into effect in April of next year. I will not reiterate here the reasons why I believe we should help them, but instead I would like to comment on your points about the choice of mechanism.

3 We have to face the fact that any action is likely to be counter to the strict requirements of the European Communities. Our partners - Italy, France and the Netherlands - do not allow this to deter them and nor should we. But if we are to take this approach it is important to avoid highlighting what we are doing. The Industry Act could be used, but we would have to make that use public and probably have to secure Parliamentary approval In those circumstances we would have little choice but to pre-notify the Commission of our intention to grant a state aid, pinning our hopes on the very slim prospect of securing Commission approval.

4 By contrast, reducing electricity costs to a handful of large users with unusual load characteristics could be done in a less public manner and in such a way that it would be more difficult for others to determine the amount of subsidy. If, for example, ICI were to enter into a contract directly with the CEGB, as British Rail and BNFL do, or alternatively if ICI were to lease a CEGB power station and were able to negotiate a coal deal with the NCB on terms which reflect the NCB's alternative netbacks from export contracts over the next few years, it would be very much harder for the Commission to demonstrate that a subsidy was involved. There would be no need, I take it, for us to isolate

these effects publicly in the adjustments which would be necessary to the financial targets for the public sector industries concerned. And there would be no need to pre-notify any state aid.

5 There is another reason why I am most reluctant to use the Industry Act. Our policy is only to use the Act to provide subsidies for investment in capital or R&D, and I do not believe that this Administration has ever used the Act to provide an operating subsidy. To do so now would set a most unfortunate precedent, which industry at large would seize upon to justify similar compensation for international disparities on any of their costs. I am most reluctant to go down that road, which would make it difficult for us to confine the problem to where it really lies: the electricity prices paid by the most intensive users.

6 I think that expenditure considerations are neutral as between the two mechanisms. If the Industry Act were to be used, I would be looking for an increase in the existing PES provisions.

7 I am, of course, aware of the legal difficulties unearthed in 1980 and 1981 when we were examining particular electricity schemes, but I have yet to be convinced that we cannot get round these difficulties. The CPRS argue that some of the existing load management schemes go beyond what is economically justifiable, yet no legal challenge has been mounted by the Commission on anyone else in respect to electricity prices. The NCB seems to be showing an undue preference to overseas customers in selling them coal below the prices charged here, but as far as I know this has not been challenged in the courts either. If colleagues do not wish to help ICI with their electricity costs, we will have to face the consequences, but it would be premature to conclude that no way can be found to do this until we have had the further examination by officials which I have suggested.

8 I am copying this to the Prime Minister, Sir Geoffrey Howe, Leon Brittain, George Younger, Sir Robert Armstrong and John Sparrow.

Yours ever

Patrick

✓c JV

Prime Minister (2)

MCS 9/11

Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon Patrick Jenkin MP
Secretary of State
Department of Industry
Ashdown House
L23 Victoria Street
London SW1E 6RB

8 November 1982

D Patrick,

CPRS REPORT ON ELECTRICITY PRICES FOR INDUSTRY

Thank you for sending me a copy of your letter of 27 October to Nigel Lawson about this report. I see from the NO.10 letter of 28 October that we are to discuss it collectively, but I write now with some preliminary views.

As you know, we have agreed EFLs for the English and Scottish Electricity Boards which would permit a standstill, on average, for electricity prices for 1983-84. This reflects the recommendation in the Coopers report that electricity prices in England and Wales should be based on a revised interpretation of marginal costs. It is important to bear in mind here that Coopers' definition of marginal costs, which we have broadly adopted, is made up of the net avoidable costs (NAC) of running a power station, energy charges (fuel costs) and relevant overheads. Following Coopers' work and our decision for a price standstill, electricity prices for both industry and domestic consumers ought now to be broadly moving to a level which reflects the costs imposed on the system by the consumers concerned.

You suggest that we should go further since industries in the private sector do not normally price according to marginal costs but according to what the market will bear. Some private sector firms are forced to do the latter even when it is lower than the former as a short-term expedient when trading conditions are poor. But no firm can make this a regular feature of its trading policy. If it does not cover its costs, it will become bankrupt. The protection of the Exchequer would prevent this in the case of a nationalised industry. But this ought not to be a reason for encouraging the industries to adopt uncommercial trading practices.

Some particular comments on your letter.

(i) You say that as a matter of principle you do not believe we should allow private manufacturing companies to be penalised for the past mistakes of the nationalised energy utilities. I agree.

But is is not clear what you have in mind here. As I explain above, the system of marginal costs which would underlie the prices, ought not to include any element for past mistakes. There is no suggestion in a marginal cost tariff that prices should include an element for the sunk costs of unsuccessful investment.

You may be suggesting that pricing should be made on the basis of an "optimal plant mix"; ie, one which assumed that the electricity industry and successive Governments had made with the benefit of hindsight all the right decisions about the mix, size, location etc of plant. But the CPRS discuss that argument in paragraph 3.16 of their Report. They point out that for the United Kingdom to price on the basis of an optimal plant mix would not give consumers the right signals about price. The timescale involved in the move to an optimal plant mix is too protracted for the signals to be relevant. The plain fact is that given the size and speed of our prospective nuclear programme, we could not be justified in basing the electricity tariff on low nuclear costs.

(ii) You suggest that one possibility might be for the sale of lease of power stations to interested companies. This is certainly something that might be considered, but paragraphs 3.17-3.18 of the CPRS Report are relevant here. The CPRS pointed out that for industrialists on load management terms, current prices are lower than would flow from the full cost of allocated coal plant. This would not be true for dedicated nuclear plant, where costs would be lower. The CPRS go on to point out that plant dedication can prove to be very risky for the user. In any event, if low cost plant is dedicated to individual consumers, either other consumers would have to bear the cost of the more expensive electricity coming from the less efficient plants, or the Exchequer would have to subsidise the difference.

(iii) Discussions last year in MISC 56 showed the problems of devising schemes to help certain categories of electricity users with their bills. Further discussions between Departments may be more successful. But we must try to avoid any scheme which is tailored specifically to benefit either one firm or a small number of firms. The "Mossmorran amendment" shows the pitfalls of this route.

(iv) An important conclusion of the CPRS Report is that exchange rate movements account for much of the changing disparities between United Kingdom and European electricity prices over recent years, reflecting our general loss of competitiveness. Although the excchange rate factor may not account for all of ICI's problems, it has some relevance. One of our prime aims is to help British industry to restore its competitiveness, but we will need to think very carefully before doing this by devices such as electricity prices below cost.

As I say, these are first reactions. I agree there are real problems here which we must discuss. The basis questions at issue are whether we should take measures to provide in effect a semi-permanent operating subsidy to some of our electricity intensive industries;

whether this should be done through the electricity supply industry and if so whether at the expense of the taxpayer or other electricity consumers. It would in my view be a mistake to think that there are more palatable alternatives which would really deal with the problem.

I am sending a copy of this letter to the Prime Minister, George Younger, Nigel Lawson, Sir Robert Armstrong and John Sparrow.

Leon

LEON BRITTAN

Nat Ind

Gas & Elec

CONFIDENTIAL

cc JV

Prime Minister (2)

Energy attempting to limit the area for discussion at your electricity CPRS meeting

01 211 6402

The Rt Hon Patrick Jenkin MP
Secretary of State for Industry
Ashdown House
Victoria Street
LONDON SW1

2nd November 1982

MCS 4/11

Dear Patrick

CPRS REPORT ON ELECTRICITY PRICES FOR INDUSTRY

Thank you for your letter of 27 October.

The Prime Minister has said it would be useful to discuss the CPRS report and the specific problems highlighted in Robin Ibbs' letter of 22 October. Such a discussion is clearly the best first step towards finding a solution to the important policy issue raised by Robin Ibbs.

I was surprised that in your letter you should have reverted to the idea of dealing with the problems of some large intensive users of electricity through changes in the pricing of electricity. This idea was examined in considerable detail by officials in 1980 and 1981 and the difficulties they saw in the way of providing operating subsidies through electricity prices were recognised by Ministers. This was one of the factors which led us to invite the CPRS to examine the general question. The CPRS have concluded that "electricity prices in the United Kingdom should be properly based on economic prices, without any subsidy from the taxpayer or cost subsidy from other consumers". Our freedom to depart from this position, assuming we wished to do so, is limited.

The difficulties of finding a remedy through electricity prices are no less significant today. Nor do they seem to me less important than those in the way of providing general operating subsidies through use of the Industry Act.

I am copying this letter to the Prime Minister and the other recipients of your letter of 27 October.

Thanse

Nigel

NIGEL LAWSON

Nat Fed, Gas & Elect, Pt 7

Not Ind

JV

SECRETARY OF STATE FOR SCOTLAND

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Prime Minister (2)

MES 17/11

The Rt Hon Nigel Lawson MP
Secretary of State for Energy
Thames House South
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SW1P 4PJ

10 November 1982

Dear Nigel,

CPRS REPORT ON ELECTRICITY PRICES FOR INDUSTRY

Patrick Jenkin's letter of 27 October to you details some of the problems being faced by our electricity intensive users and the difficulties we face trying to overcome those problems.

With my responsibilities for industry in Scotland I fully support Patrick's views that we should be doing more to help our industry at a time when electricity boards have considerable excess capacity and when our major competitors have held down their electricity prices to intensive users by fair means or foul. At the same time my electricity responsibilities enable me to understand the concern expressed in your letter of 2 November about the difficulties of finding a remedy through electricity prices.

The time may therefore be ripe for a radical look at the statutory obligations of undue preference and break even requirements, even though the former would create many problems for the industry and Ministers in deciding individual cases. On the latter point I realise that our aim should be for the industries to avoid making losses over lengthy periods but the electricity supply industry is in a peculiar situation and it may be some time before demand and capacity can be satisfactorily adjusted to one another. In any event I agree with Patrick that we should ask officials to look closely at what can be done to allow the electricity industry to act more commercially when dealing with industries that are in difficulty. I would of course want my own offiicals to be closely involved with these studies.

I am copying this letter to the Prime Minister, Sir Geoffrey Howe, Patrick Jenkin, Sir Robert Armstrong and John Sparrow.

Yours ever,

George.

Nat Ind, Gas & Elect, Pt 7

17 NOV 1982