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SUBJECT FILED ON: ENERGY : Oil Prices Pt2

24 September 1984

MR TURNBULL

cc NAT IND : Gas & Elec.

BNOC PRICES

We agree with the analysis set out in Peter Walker's letter to the Chancellor.

The agonising over price differentials and BNOC's term custom just underlines the undesirability of keeping BNOC in its current form.

The Prime Minister might write approving the approach and reminding Energy of the need to examine BNOC's future again in the light of recent problems.

ELECTRICITY: NEXT FINANCIAL TARGET

Peter Walker's letter on this subject also has considerable justice in it. The replacement cost of assets in an industry as over-provided with plant as the electricity industry is a very academic concept.

What matters politically is:

a. a reasonable level of price increase for electricity, so that we do not incur the disopprobrium of back-door taxation;

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b. an effective means of applying pressure to the cost base of the industry, so that more profit and more cash flow can be generated for the public sector for a given level of revenue;

c. the Treasury are not undermined in their energy bilateral which is seeking substantial cash benefits from the electricity EFL.

The debate concerning all of the nationalised monopolies, including electricity, gas and water, should concentrate on the systems in place for enforcing detailed unit costings, for exerting pressure for greater economies of scale to be delivered, more asset sales, and better control of working capital.

JOHN REDWOOD

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AT 24/9

SECRETARY OF STATE FOR ENERGY
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The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
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21 September 1984

Dear Nigel

ELECTRICITY: NEXT FINANCIAL TARGET

Thank you for your letter of 13 September about the next financial target of the electricity supply industry.

I am afraid I am far from convinced by your proposition about using a 5% rate of return on all assets as a basis for pricing in the electricity supply industry. As I said in my letter of 15 August, I do not believe that the asset valuations which are essential to your proposition can bear the weight you are trying to put on them.

I believe we have to look at what would be the situation in an industry like the electricity supply industry in a private sector competitive market. As you know, the industry has heavy over-capacity which is likely to continue for many years to come. Against a peak winter demand of 41-42 Gigawatts it has a plant capacity of 58-59 Gigawatts. Even after allowing a 28% planning margin on top of peak demand, there is a surplus of 6 or 7 Gigawatts through the 1980s which is likely to decline only slowly in the early 1990s.

We have seen similar situations of over-capacity in other capital intensive process industries in recent year eg steel, bulk chemicals, oil refining. While over-capacity persists in these competitive situations, there is very little scope for valuing even the newest plant at replacement cost and then earning the opportunity cost of capital on it. Replacement cost accounting in such a situation exaggerates both earning power and value on disposal, often dramatically. Like electricity now, these have been industries which were not in an equilibrium situation.

It is only by exercising monopoly power, and not by any analogy with the private sector, that the electricity supply industry could attempt to earn 5% on all its existing assets, even as written down in their accounts. When undertaken at the direction of the Government this would in fact be taxation. You make the point that setting nationalised industry prices below economic levels is not part of our strategy, but I hope that setting them above economic levels for taxation purposes is not part of it either.

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Of course it was recognised in 1982/3 that the electricity industry is not on an equilibrium basis but in a situation of over-capacity when it was decided to base prices on avoidable costs following the Coopers and Lybrand Report. It was then said that the change in price levels resulting from the application of the avoidable costs principle "would of course accord with a normal commercial response to such a situation" (minute to the Prime Minister of 18 October 1982). I think that was quite right. There was then no proposal for a 5% return on all capital. I think we are at some risk of appearing to develop new "economic principles" simply as a means of raising prices.

You will recall that we discussed the question of a 5% rate of return on the existing assets of the water industry in E(NI) of 26 July. The proposition was not then accepted and officials were asked to do further work, bearing in mind the consequences for charges to the consumer. In the electricity supply industry, given its over-capacity, the case seems to me even weaker.

I am copying this letter to the Prime Minister, George Younger, Patrick Jenkin, Norman Tebbit and Nicholas Ridley.

PETER WALKER

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Electricity

24 SEP 1984