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NBPM

PRIME MINISTER

ELECTRICITY PRICES AND LARGE INDUSTRIAL CONSUMERS

file with MEA

Nigel Lawson has commented in his minute of 1 August on the proposals in my minute to you of 26 July. As he says, Treasury officials were not involved in the joint paper prepared by my and DTI officials. However, the doubts expressed by Nigel seem to stem from a rather narrow understanding of the benefits of the scheme that I have proposed. I think our approach to this should reflect a rather wider vision than the long run marginal cost of NCB coal.

The scheme is designed in the first place not as an aid to the coal industry but to improve the competitiveness of our energy intensive industries - chemicals, steel, industrial gases, paper and board, and glass. Although it is true that, in general, our electricity prices compare favourably with those overseas, it is precisely in those sectors where the cost of electricity matters most that our firms are at a real disadvantage. Utilities in other countries have realised the importance of cheaper electricity for the preservation and growth of those sectors and have tilted their tariffs in favour of industries with large electricity loads and with high load factors. The extent to which they have done this is evident in their published tariffs, and highlighted in the annual surveys agreed by the CBI with the Electricity Council.

But apart from lower tariffs, utilities in other countries also have special deals for their biggest consumers. These terms are kept secret, but some of the NEDC members who came to see me have first hand knowledge of them from their subsidiaries and associates in Europe. They maintain that electricity prices overall to their competitors in Europe are up to 20% cheaper. That is the size of the gap that these proposals are aiming to bridge; they will not, even so, come anywhere near to equalising the prices given to large consumers in other EEC countries.

I considered with Norman Tebbit 18 months ago a variety of ideas put forward by the Electricity Council under which our electricity prices to intensive users could be made competitive. Given the costs and structure of the CEGB's bulk supply tariff, I could see no way in which prices could be further reduced without relaxing the esi's financial target and EFL. There was also the risk of legal challenge of "undue preference" under the Electricity Statutes to which Nigel refers in the second paragraph of his minute. It was largely because of that risk that the present proposals involving the NCB have been put forward. By making cheaper coal the basis for the cheaper electricity, there is less risk of legal challenge to the electricity supply industry. I shall of course consult the Law Officers when I have approval in principle for the scheme.

The impact of the scheme on NCB finances - and therefore on the benefit/cost ratio for the scheme as a whole - will be considerably better than Nigel implies. The NCB is closing pits as fast as it can. But it is unrealistic to expect that this will, overnight, reduce NCB production into line with inland demand. Once the current period of CEGB stockbuild is over, NCB will, at least for a short period, have coal production surplus to inland requirements. During this period the value to the NCB of coal not sold to the CEGB is its export netback of £27/t (or less if sterling remains high). In the longer term, and once NCB production is in line with inland requirements, incremental sales will not delay closures but will allow expansion of new relatively low cost capacity. In the time period we are talking about such capacity will comprise expansion of existing low cost pits. Such incremental production could be achieved for significantly less than £32/t but the NCB consider that £32/t represents, in the long term, the average marginal cost of incremental output, including a 5% real rate of return.

Nigel concludes that this scheme is "a form of selective subsidisation of industry". I believe it is much more than that. It is an imaginative and cost effective scheme under which our coal industry can expect to win sales and our energy intensive industries will be given a specific and tailored incentive to maintain production or expand investment. That investment is in key areas such as chlorine.

(If chlorine production declines, our manufacturing industries dependent on chlorine - such as plastics and synthetics - will also decline. Chlorine is not a nice commodity to transport in bulk across Europe). The message from NEDC is clear: if these industries are not given an incentive to maintain or expand their capacity, they will wither; and the jobs will wither too.

As for the overall profits made by ICI and British Oxygen, that seems to me to be not the main point; what matters is the profitability of those operations which would be affected by my proposals. The reality is that both companies are mobile in their future investment plans and will disinvest in the UK if the opportunities are not there. It will be too late to reverse the trend when disinvestment sets in.

Finally, I have not understated in my proposal the possible costs to the NCB. These cannot be quantified with certainty, but they will be small by comparison with the benefits to industry. It is these wider benefits - more production, more investment and more jobs - that justify the public expenditure costs; and it is on that basis that I invite support from my colleagues for the scheme.

I am copying this minute to Nigel Lawson, George Younger, Nicholas Edwards, Norman Tebbit and Tom King and to Sir Robert Armstrong.

Peter

PETER WALKER

12 August 1985

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