MT.

PART 18

CONFIDENTIAL FILING

Gas and Electricity Pricing Policy
Gas and Electricity Industries EFLs
Industrial Energy Policy
Future of the Gas Industry

IN ATTACHED FOLDER:
DRAFT LICENCES x 4
+ Energy Committee second report on Gas Prices 14-2-90

NATIONALISED INDUSTRIES

PT1: September 1979
PT18: January 1990

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~10.1.90~~							
~~19.1.90~~							
~~23.1.90~~							
~~26.1.90~~							
~~5.2.90.~~							
~~7.2.90~~							
~~9.2.90~~							
~~12.2.90~~							
~~15.2.90~~							
~~1.3.90~~							
~~12.3.90~~							
~~16.3.90~~							
~~22.3.90~~							
~~26.3.90.~~							
6.4.90							
PT18 ENDS							

PREM 19/3098

HMSO Dd8963031 6/88 C60 GP2265 CCN13412 (3932)

PART 18 ends:-

BP to SCOT. OFF. 6.4.90

PART 19 begins:-

DTI to SCOT. OFF. 1.5.90

CONFIDENTIAL

Cile LPO

cePU

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

6 April 1990

Dear Jim,

ELECTRICITY PRIVATISATION: SPECIAL SHARES

Thank you for your letter of 6 April. I note that your Secretary of State is content to discuss these points further with the Financial Secretary. I should be grateful if you could report the outcome of any further discussions in due course.

I am copying this letter to Tim Sutton (Lord President's Office), Stephen Flanagan (Financial Secretary's Office), John Neilson (Department of Energy), Martin Stanley (Department of Trade and Industry), Stephen Leach (Northern Ireland Office) and to Sonia Phippard (Cabinet Office).

Yours,

Barry

Barry H. Potter

Jim Gallagher, Esq.,
Scottish Office.

CONFIDENTIAL

ccPU

SCOTTISH OFFICE
WHITEHALL, LONDON SW1A 2AU

Barry Potter Esq
Private Secretary
10 Downing Street
Whitehall
LONDON

6 April 1990

Dear Barry,

ELECTRICITY PRIVATISATION: SPECIAL SHARES

Paul Gray's letter of 16 March to Stephen Flanagan in the Financial Secretary's Office suggested that the Financial Secretary and my Secretary of State might discuss further the special shares for the Scottish Electricity Industry. My Secretary of State will of course be happy to do so.

He has noted, however, that as, whatever happens, the special share in the National Grid Company will not be time restricted in England and Wales, the shares in the companies owning the Grid in Scotland will have to be the same. The Grid is of similar strategic importance in Scotland and the fact that it is under the control of 2 separate companies does not diminish its importance. In order to ensure the independence of the Scottish Transmission System, my Secretary of State will therefore find it necessary to ensure the independence of the 2 Scottish companies.

The special shares will also serve the purpose of maintaining the Government's view that in order to have competition in the Scottish Electricity Industry, given the view taken on vertical integration, it will be necessary to have 2 separate companies. If the special share is time limited, then there is a danger that at the end of that period the larger of the companies will simply take over the other, and remove all internal competition from the Scottish Electricity Supply Industry. My Secretary of State has countered criticism of our case for privatisation by pointing to the fact that it will bring back control of this strategic industry from Whitehall to Scotland itself. The Scottish electricity companies will be 2 of Scotland's largest plc's. Against that background he cannot lightly entertain the prospect of control of the whole of Scotland's electricity system being concentrated in a single set of hands. He does not believe that the normal operation of competition policy would be an acceptable substitute for a special share in the hands of the Secretary of State for Scotland which ensures that no one shareholder can gain more than a 15% stake in either of the 2 Companies. That is something which my Secretary of State would very much wish to avoid.

Finally, the Secretary of State is mindful of the commitments made to both Houses of Parliament during the passage of the Electricity Bill. In those commitments, the Government did not link the special share protections to the nuclear undertaking, and did not suggest to Parliament that they were contemplating a change of course in special shares when it was announced, before the Bill had completed its passage, that the nuclear undertaking would remain in the public sector. If the Government were to renege now on earlier assurances, my Secretary of State expects that there would be widespread opposition from Government benches, as well as among Opposition parties.

My Secretary of State is not therefore convinced of the economic case for change, and even if it were compelling, his view is that it would be much better for the special share to be reviewed in due course in the light of experience, and any action to redeem it justified to Parliament at the time.

My Secretary of State will, however, be happy to discuss these points further with the Financial Secretary.

Copies of this letter go to Tim Sutton (Lord President's Office), Stephen Flanagan (Finance Secretary's Office), John Neilson (Department of Energy), Martin Stanley (DTI), Stephen Leach (Northern Ireland Office) and Sonia Phippard (Cabinet Office).

Yours sincerely,

Len Wright

pp J D GALLAGHER
Private Secretary

NAT IND: Gas &
Electricity Pt 18

Prime Minister

Nuclear held by temporary subsidy

An understatement. I understand Delors tried to block approval.

PRCG 28/3

ELECTRICITY PRIVATISATION

I am pleased to be able to tell you that the Commission today approved our proposals for the Non-Fossil Fuel Obligation and associated levy and the proposed package of support to deal with the liabilities of Nuclear Electric and Scottish Nuclear. I understand we will also be receiving the political comfort letter on the competition aspects of the new electricity regime. There had been some earlier procedural difficulties but Leon Brittan was able to overcome them. This is good news and will allow vesting to proceed as planned on March 31 without the need for temporary expedients.

At the same time we received Commission approval for our coal State Aids proposals and so the financial reconstruction of British Coal can now proceed.

I am copying this minute to Douglas Hurd, John Major, Nicholas Ridley, Malcolm Rifkind and to Sir Robin Butler.

John

28 March 1990

Secretary of State for Energy

ES Plt.

TONY BALDRY M.P

PARLIAMENTARY UNDER SECRETARY OF STATE FOR ENERGY

Department of Energy
1 Palace Street
London SW1E 5HE
01 238 3169

MBPM
RRCG
29/3

John Redwood Esq MP
Parliamentary Under Secretary of State
for Corporate Affairs
Department of Trade and Industry
1-19 Victoria Street
LONDON
SW1H OET

27 March 1990

Dear John,

ELECTRICITY PRIVATISATION: RTP ASPECTS

Thank you for your letter of yesterday.

I am content with your proposals, subject to the couple of minor drafting amendments to the order which your officials agreed with mine, and for the amended order to be made as soon as possible.

I am grateful for you and your officials' constructive approach to these RTP issues, and would be grateful if my officials could continue to be kept closely in touch with developments on the further orders and directions proposed.

As ever

Tony

TONY BALDRY

P.S. I am copying this letter to recipients of yours.

NAT IND: Coal-Electric PT18

570

dti

the department for Enterprise

John Redwood MP
Parliamentary Under Secretary of State for
Corporate Affairs

CC

Tony Baldry Esq MP
Parliamentary Under
Secretary of State for Energy
Department of Energy
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Department of Trade and Industry

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NBPM

Direct line 01-215 4417
Our ref
Your ref
Date 26 March 1990

PRCG 27/3

Dear Minister

ELECTRICITY PRIVATISATION: RTP ASPECTS

My Department has been working closely with yours, and with representatives of the Electricity Supply Industry (ESI), to ensure that the necessary procedures are agreed and in place by Vesting Day in relation to proposed exemption orders under section 100(2) of the Electricity Act.

The main features of the arrangements on which officials in our two Departments are now agreed are as follows:

1. An initial section 100 exemption order will be made during the early part of this week, to come into force on Vesting Day. The coverage of this first order will be confined to agreements which:

   (a) cannot be made until 31 March or later, and which will thus be unable to take advantage of the provisions of section 1-00(4) of the Electricity Act (which allows a period of six months from the commencement of section 100 for the furnishing of particulars to the Director General of Fair Trading (DGFT) of those agreements made before commencement, during which period consideration can be given whether to exempt such agreements or to furnish them); and/or

   (b) will be entered into in such numbers that it would be impracticable to furnish particulars to the DGFT pending the coming into force (with full retroactive effect) of a section 100 exemption order, notwithstanding the possibility of applying to the DGFT for an extension of time for such furnishing.

The main types of agreement falling into the above categories are those which would be registrable solely by reason of the parties agreeing to complY with the Grid or Distribution Codes; together with agreements for connection or supply to two or more persons (eg two customers sharing the same premises, or a customer and a second-tier supplier) which would be registrable only by virtue of the fact that there are more than two parties to the contract. The effect of the order will be to exempt agreements containing only certain kinds of restrictions from registrability under the Restrictive Trade Practices Act 1976 ('RTPA').

2. A second order under section 100(2) of the Electricity Act will be made as soon as reasonably practicable post-Vesting, to come into force not later than the end of June. This will cover the main agreements (eg Pooling and Settlement, the initial Contracts for Differences, NGC and PES Connection and Use of System Agreements, NFFO Qualifying Arrangements, NFPA Arrangements, French and Scottish Interconnector Arrangements and the British Grid Systems Agreement) which lie at the core of the industry restructuring and privatisation arrangements, and for which exemptions have been agreed in principle between our two Departments. These agreements will generally be made prior to 31 March, and will thereby benefit automatically from the provisions of section 100(4) of the Act. Provided that an exemption order is made within a period of six months from commencement of section 100, the agreements in question will not be subject to any requirement to furnish particulars to the DGFT, and there can be no risk of voidness or third party action. In practice of course we shall ensure that any necessary orders are made well within such period - and effectively by not later than the first week in June - in order to allow the full 40 days praying period to have elapsed prior to issue of the first prospectuses.

An advantage of leaving this second order until after Vesting is that it enables us not only to specify many of the agreements by name, to put beyond doubt the question of whether they are covered by the exemption (since agreements can be specified only after they have been signed), but also to ensure that the scope of application of the order is sufficient to cover the kinds of agreements for which it is intended. In many cases this can be achieved only once the contractual arrangements themselves are settled and in place.

dti

the department for Enterprise

3. A 'comfort letter' will be issued by DTI officials later today, confirming the Department's present intentions in relation to the scope of application of any section 100 exemption orders made post-Vesting. The terms of such letter have been agreed between our respective officials, and with the relevant industry legal advisers. Separate 'comfort letters' will be issued by the OFT in relation to agreements falling outside the scope of section 100(2) of the Electricity Act (as relating other than to the generation, transmission or supply of electricity), confirming where appropriate that on the basis of its evaluation so far, the Office does not consider that the agreements (eg for the procurement of cables or overhead transmission lines, or for research and development into new systems of metering) will prove unsuitable for directions under section 21(2) of the RTPA.

4. It is also intended that orders should be made pre-vesting under sections 9(5) and 18(5) of the RTPA in respect of certain standards and engineering recommendations prescribed or adopted by the Electricity Council, or by its successor body the Electricity Association Ltd. These orders will ensure that where parties are required to comply with such standards or recommendations as part of the terms of everyday commercial agreements or transactions, this does not have the effect of bringing the agreements within the scope of RTPA registrability.

These arrangements have been discussed extensively with the relevant legal advisers to the ESI, who have expressed themselves content.

I attach a draft of the proposed first section 100 order. This is substantially in the form in which we expect to make the order - hopefully either today or tomorrow. The order has of course been drawn up following consultation with the DGFT and DGES, as required by section 100(3) of the Act.

Copies of this letter go to the Prime Minister, Peter Lilley, Ian Lang and Sir Robin Butler.

Yours Sincerely

Maralle Jovossis

JOHN REDWOOD

(approved by the Minister and signed in his absence)

Recycled Paper

STATUTORY INSTRUMENTS

1990 No.

ELECTRICITY

The Electricity (Restrictive Trade Practices Act) (Exemptions) Order 1990

Made ...	**1990**
Laid before Parliament	**1990**
Coming into force	**31st March 1990**

The Secretary of State for Trade and Industry, in exercise of the powers conferred on him by section 100(2)(b) of the Electricity Act 1989(a) and after consultation with the Director General of Electricity Supply and the Director General of Fair Trading(b), hereby makes the following Order:-

Citation, commencement and interpretation

1. (1) This Order may be cited as the Electricity (Restrictive Trade Practices Act) (Exemptions) Order 1990 and shall come into force on 31st March 1990.

(a) 1989 c.29.

(b) See section 100(3) of the Electricity Act 1989.

(2) In this Order -

"the 1976 Act" means the Restrictive Trade Practices Act 1976(a);

"the 1989 Act" means the Electricity Act 1989;

"agreement" has the same meaning as in the 1976 Act;

"distribution code" means a code of practice for the development, maintenance and operation of a system for the distribution of electricity with whose provisions a licence holder is required, by the terms of his licence, to comply;

"exempted person" means a person who is, or a member of a class of persons who are, exempt, by virtue of an order made under section 5 of the 1989 Act, from the requirement to hold a licence under that Act;

"grid code" means a code of practice for the development, maintenance and operation of a system for the transmission of electricity with whose provisions a licence holder is required, by the terms of his licence, to comply;

"grid systems code" means a code of practice relating to the furtherance or maintenance of or the connection of or

(a) 1976 c.34.

relationship between the electricity transmission systems belonging to persons holding a licence under section 6(1)(b) of the 1989 Act;

"information provision" has the same meaning as in the 1976 Act;

"licence holder" has the same meaning as in Part I of the 1989 Act;

"restriction" has the same meaning as in the 1976 Act.

Exemptions from the 1976 Act

2. The agreements relating to the generation, transmission or supply of electricity to which, by virtue of section 100(2)(b) of the 1989 Act, the 1976 Act does not apply and is deemed never to have applied are agreements which -

(a) meet any of the descriptions of agreements specified in the Schedule to this Order; and

(b) satisfy the condition specified in that Schedule in connection with the relevant description.

March 1990 Parliamentary Under Secretary of State,
Department of Trade and Industry

SCHEDULE

Article 2

AGREEMENTS EXEMPT FROM THE 1976 ACT

1. (1) Any agreement to which a licence holder or an exempted person is a party.

(2) The condition which must be satisfied by an agreement of a description set out in sub-paragraph (1) above is that, except for any term of which, for the purpose of determining whether the agreement is one to which the 1976 Act applies, no account is to be taken by virtue of any provision of of that Act or the Restrictive Trade Practices Act 1977(a) or any instrument under either of those Acts -

(a) the only restrictions or information provisions contained in the agreement relate to either or both of the following matters -

(i) compliance in whole or in part with the terms of one or more of the following codes: a distribution code, a grid code, or a grid systems code, or

(ii) requiring a person not a party to the agreement to comply with the terms of any one or more of those codes; or

(b) the only restrictions or information provisions

(a) 1977 c.19.

contained in the agreement, other than restrictions or provisions referred to in sub-paragraph (2)(a) above, are restrictions or provisions accepted by only one party to the agreement.

2. (1) Any agreement under which a licence holder or an exempted person agrees to provide to one or more persons any one or more of the following:-

(a) a supply of electricity;

(b) distribution, transmission or connection services relating to a supply of electricity;

(c) other services relating to a supply of electricity or any of the services referred to in sub-paragraph (1)(b) above.

(2) The condition which must be satisfied by an agreement of a description set out in sub-paragraph (1) above is that -

(a) the only restrictions or information provisions contained in the agreement are one or more of the following restrictions or provisions -

(i) restrictions or provisions of a kind referred to in paragraph 1(2)(a) of this Schedule; or

(ii) restrictions or provisions relating exclusively to goods or services supplied in pursuance of the agreement; or

(b) the only restrictions or information provisions contained in the agreement other than restrictions or provisions of a kind referred to in sub-paragraph (2)(a) above -

(i) are accepted only by parties to the agreement to whom the goods or services are supplied pursuant to the agreement, and

(ii) are made as between one or more of the persons referred to in (i) above on the one hand and the person by whom the goods or services are to be supplied on the other.

3. (1) Any agreement between two or more persons each of whom is a licence holder or an exempted person having as its sole objective the furtherance or maintenance of or the connection of or relationship between the electricity transmission or distribution system or systems belonging to the parties to the agreement.

(2) The condition which must be satisfied by an agreement of a description set out in sub-paragraph (1) above is that the only restrictions or information provisions contained in the agreement are one or more of the following restrictions or

provisions -

(a) restrictions or provisions of a kind referred to in paragraph 1(2)(a) of this Schedule; or

(b) restrictions or provisions relating exclusively to goods or services supplied in pursuance of the agreement; or

(c) restrictions or provisions relating [exclusively] to the furtherance or maintenance of or the connection of or relationship between the electricity transmission or distribution system or systems belonging to the parties to the agreement.

EXPLANATORY NOTE

(This note is not part of the Order)

This Order specifies descriptions of agreements relating to the generation, transmission or supply of electricity to which the Restrictive Trade Practices Act 1976 ("the 1976 Act") is deemed not to apply and never to have applied. By virtue of section 100 (1) of the Electricity Act 1989 electricity is treated as goods for the purposes of the 1976 Act. This Order provides that agreements meeting any of the descriptions set out in the Schedule to the Order and satisfying the relevant condition specified in that Schedule will nevertheless fall outside the provisions of the 1976 Act.

CONFIDENTIAL

CCPU.

TPM

SCOTTISH OFFICE
WHITEHALL, LONDON SW1A 2AU

Tancred Tarkowski Esq
Private Secretary to the
Chancellor of the Exchequer
HM Treasury
Treasury Chambers
Parliament Street
LONDON
SW1P 4AG

NBRM

PRG
23/3

22 March 1990

Dear Tancred

SCOTTISH ELECTRICITY: REGULATION

Further to the Chancellor's letter of 20 March and the Secretary of State for Energy's letter of the same date, my Secretary of State is content to delay announcement of X values for the Scottish industry to meet Mr Wakeham's concerns. He therefore intends to proceed to publish the draft Scottish licences by means of a written answer today and to announce the X values, also by written answer, early next week. As requested, the terms of the announcements will be cleared at official level.

I am copying this to Paul Gray, Neil Thornton, Steve Catling, John Neilson, Sonia Phippard.

Yours sincerely
Nigel Jamieson

pp **J GALLAGHER**
Private Secretary

EJD080P9

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1 fst.sb/Lilley/21.3.90.2

CONFIDENTIAL

Treasury Chambers, Parliament Street, SWIP 3AG

NBPm

The Rt Hon John Wakeham FCA JP MP
Secretary of State for Energy
Department of Energy
1 Palace Street
Victoria
LONDON SW1E 5HE

PEc6 23/3

22 March 1990

Dear John

DISTRIBUTION COMPANIES' EFFICIENCY SAVINGS

pps attached

Thank you for your letter of 20 March to John Major.

You have proposed a set of X factors which produce an average outcome of RPI+1.1. I am disappointed that this is a more lax outcome than that indicated by Tony Baldry two weeks ago, let alone my own recommendation of around RPI-0. The gearing percentages agreed with the distcos also represent a less tight outcome than those which your advisers thought possible. I note also that the initial dividend and dividend cover remain to be clarified. I am sure that you agree that these are an integral part of the financial structure and I hope that you will include them within your current assessment of cash flows before finalising the detailed proposals to be agreed with the distcos.

Though I am not persuaded that the outcome on X and gearing represents the best that the distcos should be able to achieve, I recognise that time is short and that you have had some tough negotiations with the chairmen in order to bring them down from RPI+2.2 or so. In the circumstances I will not press my arguments further. Whatever the Chairmen think of the settlement, I hope they understand that we regard it as generous; and that we are now expecting their wholehearted cooperation in meeting our marketing and flotation objectives.

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fst.sb/Lilley/21.3.90.2

CONFIDENTIAL

I agree that the X factors for England and Wales should be announced on Thursday. I understand that Malcolm Rifkind is content for his announcement to slip slightly, without jeopardising the Xs set out in his letter of 16 March. I would be grateful if your officials could consult mine on the terms of the announcement.

I am copying this letter to the Prime Minister and to Malcolm Rifkind.

Yours ever

Peter

PETER LILLEY

CONFIDENTIAL

NATIND
Gas & Elec
Pt 18

RESTRICTED

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

21 March 1990

ELECTRICITY PRIVATISATION: X FACTORS IN THE DISTRIBUTION COMPANIES' PRICE FORMULAE

The Prime Minister has seen your Secretary of State's letter of 20 March to the Chancellor of the Exchequer. She is content with the proposed approach.

I am copying this letter to John Gieve (HM Treasury) and Jim Gallagher (Scottish Office).

PAUL GRAY

John Neilson, Esq.,
Department of Energy

RESTRICTED

cc PU

TPM

THE RT HON JOHN WAKEHAM MP

No need to write at - pc.

Prime Minister 2

Department of Energy
1 Palace Street
London SW1E 5HE

01 238 3290

PRC 6 21/3

PRC 6 21/3

The Rt Hon John Major MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

21 March 1990

Dear John,

with pc.

ELECTRICITY PRIVATISATION: X FACTOR IN THE NATIONAL GRID COMPANY

In my letter of 20 March about the X factors for the Area Boards, I said I would be writing separately on the National Grid Company (NGC). I have now concluded negotiations with David Jefferies, the Chairman of NGC, and this letter sets out my proposals for X and debt.

My objectives in the negotiations with NGC have been essentially the same as with the Area Boards. My aim has been to:

(i) ensure that future price increases to electricity customers are kept to the minimum;

(ii) ensure that NGC is able to finance its already large but growing capital investment needs (some £3.5 billion at today's prices over the next 10 years);

(iii) ensure that the price regime sets a tough discipline on reducing controllable costs; and,

(iv) ensure the business is able to produce reasonable profit growth.

Added to this, there have been factors specific to NGC of which I have had to be mindful:

(v) because NGC is not itself to be directly floated, I have endeavoured to ensure we obtain full value for the tax payer by way of proceeds; and,

(vi) in view of the limited control that NGC's shareholders, the PESs, can exert over the company and its investment programmes, I have aimed to ensure that NGC is financially independent and that it can fund its investment programme on the basis of its own balance sheet.

Peter Lilley in his letter to me of 15 March recommended that a tight X, to the order of plus 1, should be set for NGC. I have considered this carefully and discussed it with the Chairman of NGC. The X-factor in NGC's price control formula applies to prices only for 2 years. To this extent, the financial profiles of the business are less dependent on the value of X than for the Area Boards. However, NGC is being set up as a new separate business. Management priorities must initially be ensuring the success of the business and in particular the operation of the pooling and settlement business. Our management consultants Touche Ross have concluded the scope for efficiency savings in the X period is limited. In the medium term, however, once the business has established itself the scope for efficiency savings should be much greater. This was one of the main reasons for keeping the first X-period short. The regulator will be in the best position to assess efficiency savings once the business is properly established. There is a further point, that because NGC is only now being set up as a separate company, its costs are subject to some uncertainty. This was a further reason for keeping the initial X-period short.

I believe the right balance between putting maximum pressure on NGC's costs through the X factor and recognising the uncertainties in the company's cost base as it develops its new corporate functions and businesses is struck with X set at RPI-0. Taking into account the growing burden that NGC faces on capital expenditure, and the pressure that will place on costs through increased depreciation, I believe that RPI-0 should result in controllable costs declining by 4% over the three year period to 1992/93.

It has been one of my key priorities in reaching a view on NGC's capital structure to maximise the proceeds we will obtain. A high level of debt will place a continuing tough discipline on NGC to control its costs.

Peter Lilley has recommended an injection of £1 billion of debt. I have considered this carefully. In setting the level of debt, we cannot ignore the very real risks to the business of capital expenditure in addition to that currently being forecast proving to be necessary. The restructuring of the industry and introduction of competition mean that there is a real possibility of additional capital expenditure proving to be necessary to strengthen the grid to cope with closure of old plant and the development of new generation projects in different locations.

Despite these risks, I have persuaded David Jefferies, the NGC Chairman, that the level of debt should be £970 million. This is a very high figure; it is, I believe, the maximum level of debt the

SECRETARY OF STATE FOR ENERGY

company can bear, without jeopardising its sustainability, and represents a major concession by NGC. This level of debt was acceptable to the Chairman, however, only on the basis that X was set at RPI-0. I believe this is the right approach. I do not think it would be right to buy an artificially high value of X by substantially reducing the level of debt.

This level of debt is consistent with HCA book interest cover not falling below 4.0 times in any year on the basis of our assumptions (which are not shared by NGC). This ratio is based on extensive discussions between Kleinwort Benson, the Department's merchant banking advisers, and experts in the debt markets. To the extent that NGC's assumptions rather than ours prove to be correct, the ratio could dip below 4; Kleinworts advise that this is not unacceptable. However I believe in view of the company's extensive investment programme and borrowing needs, it would be wrong to set initial debt on the basis of lower cover on our assumptions nor would that be acceptable to the Chairman of NGC.

As with the Area Boards, I propose to announce the value of NGC's X and finalise the company's licence tomorrow.

I am copying this letter to the Prime Minister and to Malcolm Rifkind.

Yours ever

John

JOHN WAKEHAM

NAT INDS:
Cons + Elec Pt 18

CC PU

THE RT HON JOHN WAKEHAM MP

SECRETARY OF STATE FOR ENERGY

Department of Energy
1 Palace Street
London SW1E 5HE
01 238 3290

NBPM
PRCG
21/3

The Rt Hon Malcolm Rifkind MP
Secretary of State for Scotland
Scottish Office
Whitehall
LONDON
SW1A

21 March 1990

Dear Malcolm

REGULATION OF THE SCOTTISH ELECTRICITY SUPPLY INDUSTRY

Thank you for sight of your proposals circulated under cover of your letter to John Major of 15 March. I know our officials have kept in close touch on proposals north and south of the border and I am content with what you suggest. I look forward to seeing the statement Ian Lang proposes to make.

Copies of this letter go to recipients of yours.

Yours ever

John

JOHN WAKEHAM

NAT. IND. Electricity Pt 18

CC PU

RESTRICTED

THE RT HON JOHN WAKEHAM MP

SECRETARY OF STATE FOR ENERGY

Prime Minister,
There has been some tension between Treasury and D/Energy about the "X" factors; the Treasury have urged holding them down. You'll wish to see the outcome John Wakeham has negotiated – paragraph 5 and the Annex – and to note he proposes to announce them on Thursday.
Agreed PM
PRCG 20/3

Department of Energy
1 Palace Street
London SW1E 5HE

The Rt Hon John Major MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
London SW1P 3AG

20 March 1990

Dear John,

ELECTRICITY PRIVATISATION: X FACTORS IN THE DISTRIBUTION COMPANIES' PRICE FORMULAE

at flap

Further to my letter of 7 March, I have held a series of negotiating meetings with the Chairmen of each of the Area Boards. This letter reports on the outcome.

2. In these negotiations, I have been mindful of the importance of:

(i) ensuring that future price increases to electricity customers are kept to the minimum;

(ii) ensuring that the businesses are able to finance their growing capital expenditure needs (some £10bn over the next 10 years);

(iii) ensuring that the price regime sets a tough discipline on reducing controllable costs; and

(iv) ensuring that, subject to the above, the businesses are able to produce reasonable future profit growth, and that Chairmen are given a regulatory and financial regime that they accept produces a reasonable foundation for a successful flotation.

3. The outcome of the negotiations is satisfactory. It will enable us to continue to get the message across that prices to franchise customers will be held at the rate of inflation for the

RESTRICTED

next three years. This is good news for electricity customers and meets your concern that we should not be giving the wrong signals at a time when we are stressing the need to bear down on inflation. I shall also wish to get across the further message that within this price ceiling we have been able to set a regulatory and financial regime which will enable the industry to invest £5bn over the X period in the distribution network to maintain security of supply, a rate almost double what has been necessary over the past 5 years. A further point to get across is that the major part of the total price to customer (getting on for 80%) is the cost of electricity generation. This is the area into which we have introduced real competition.

4. I understand the point you make in your letter of 8 March about Chairmen having the incentive to exaggerate their unwillingness to accept tough Xs. It was for this reason that I have met each Chairman personally, and pressed very hard indeed on X. In the event, no Chairman resigned although this seemed a very real prospect during the negotiations which in a number of cases required my meeting with the Chairman on three separate occasions. I am sure you will appreciate, however, that at the end of the negotiations, I must make the difficult judgement as to how far the Chairmen can be pressed without seriously jeopardising the success of the subsequent flotations.

5. The values of X which I propose to set are listed in the attached Annex. Weighted on a per customer basis for the Area Boards, the average is RPI+1.1. The Chairmen have, with reluctance accepted that this is a reasonable basis for the subsequent flotations. In the light of your letter, I had considered imposing values of X tighter than this. It is my judgement that to do so would have put in jeopardy the success of the subsequent flotations. The active cooperation of the Chairmen in selling the industry despite having accepted values of X they believe are tough will be an important element in ensuring a successful sale. You should be aware, however, that a number have expressed concern that, even with the X values I propose, the level of growth on their assumptions may be lower than 3%, leaving the flotations exposed to risk of adverse movements, particularly on load between now and the Autumn if the market ceases to share our views about good economic growth in 1991. Given the importance we both attach to setting a tough discipline through X, I am prepared to take this risk with the flotation.

6. On gearing, I know that your officials have pressed for levels as high as 67%. I do not believe such a level is

SECRETARY OF STATE FOR ENERGY

reasonable; it totally ignores the very real risks in the supply market which is quite unlike the monopoly distribution business; it fails to recognise the risks to the business that arise from the radical restructuring of the industry; and it also fails to recognise the very real difficulties we will have in persuading potential investors that they can have confidence in the industry as an investment despite its absence of a track record and despite the radical restructuring of the industry. This is not the right privatisation to set unprecedented high levels of gearing. I have therefore negotiated, with some difficulty, gearing levels of 40-50% for the majority of Boards with the industrial Boards at 35-40%. This represents a major advance on the Boards' own proposals of up to merely 20%. A full assessment of the cash flows resulting from the restructuring of the industry will be necessary before this broad understanding can be translated into a precise level of debt to be injected. I shall be setting out detailed proposals on this in due course.

7. I shall be writing separately on my proposals for X and debt for NGC.

8. The date of vesting is now fast approaching. In order to be able to keep to the timetable, I would like to announce the values of X and thereby finalise the licences on Thursday 22 March. I appreciate that this is the same date as Malcolm Rifkind was proposing to make his announcement. I believe very strongly that the X factors for England and Wales should be announced first. If the Scottish RPI-X factors are announced first, it will make the presentation of the position in England and Wales much more difficult. I fear I must therefore ask Malcolm (to whom I am copying this letter) to delay his announcement of the X factors (though not of the other points on the Licence). I appreciate the concern he has raised in his letter of 16 March, that further delay could lead to the hardening of the Scottish industry's attitude, but hope he can agree to hold the position until the beginning of next week.

9. I am copying this letter to the Prime Minister and to Malcolm Rifkind.

Yours ever

John

JOHN WAKEHAM

RESTRICTED

SECRETARY OF STATE FOR ENERGY

FINAL VALUES OF X

	DISTRIBUTION X	SUPPLY X
EEB	RPI+0.25	RPI+0
EMEB	RPI+1.25	RPI+0
LEB	RPI+0.00	RPI+0
MANWEB	RPI+2.50	RPI+0
MEB	RPI+1.15	RPI+0
NEEB	RPI+1.55	RPI+0
NORWEB	RPI+1.40	RPI+0
SEB	RPI+0.65	RPI+0
SEEB	RPI+0.75	RPI+0
SWALEC	RPI+2.50	RPI+0
SWEB	RPI+2.25	RPI+0
YEB	RPI+1.30	RPI+0

RESTRICTED

NAT IND: Gas + Elec Pt 10

fst.sb/fst/19.3.90.4 CONFIDENTIAL

cc PG

NBPM
RAC6
20/3

The Rt Hon Malcolm Rifkind MP
Secretary of State for Scotland
Dover House
Whitehall
LONDON
SW1A 2AU

20 March 1990

Dear Malcolm

SCOTTISH ELECTRICITY: REGULATION

-File with PG

Thank you for your letters of 15 and 16 March to John Major.

I am content with your pricing proposals for Scotland, and with the X values you propose for transmission, distribution and supply. It is important that privatisation should be associated with downward costs, and your proposals secure that. SP in particular might have been able to carry somewhat tighter Xs, but I am aware of the future uncertainties associated with their business, and of the other difficulties that you mention in securing tighter Xs.

The proposed regulatory regime in Scotland has a number of differences from that in England and Wales. However, I accept that these will be justifiable by different structural characteristics, and they do not of themselves jeopardise a level playing field between companies north and south of the border. I suspect that the Scottish companies' concern about competition from England and Wales has a negotiating element; but whether it materialises will depend to some degree on the coal contracts still to be concluded, and any disadvantage will in due course fall away as Miller gas comes on stream and the nuclear contracts align to the English and Welsh pool price.

It will clearly be important to resolve uncertainty about future coal well prices before flotation if the taxpayer is not going to be heavily exposed to a discount from uncertainty. Indeed, unless a deal is in place this summer there must be a risk of damage to the institutional marketing campaign. I am sure that you and John Wakeham will be pressing both sides accordingly.

I recognise the difficulty in regulating for some of the benefits of Miller gas to be passed to consumers; although that should in

FINANCIAL SECRETARY TO THE TREASURY

due course be the effect as competition develops. In the shorter term, Miller gas will be of very substantial benefit to the companies, although whether the taxpayer gets proper value will depend on investor uncertainty as to when it comes on stream. I will be looking to take the benefit fully into account when the companies' capital structures are set.

I am content with an announcement on Thursday. Please could your officials clear its terms with mine?

I am copying this letter to the Prime Minister, Nicholas Ridley, Sir Geoffrey Howe, and John Wakeham, and to Brian Griffiths and Sir Robin Butler.

Yours ever

Peter

PETER LILLEY

NAT IND
GAS & ELEC Pt 18

ccPU.

SCOTTISH OFFICE
WHITEHALL, LONDON SW1A 2AU

NBPM at this stage.
Await Treasury reaction.
RRCG
16/3

The Rt Hon John Major MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON
SW1P 3AG

16 March 1990

Dear Chancellor

REGULATION OF THE SCOTTISH ELECTRICITY SUPPLY INDUSTRY

Further to my letter of 15 March about the terms of an announcement about licensing and price regulation of the Scottish electricity industry, I am now in a position to seek your agreement to my conclusions on X values for the transmission, distribution and supply segments of the vertically integrated Scottish companies.

Following an efficiency review of the Boards' costs by my regulatory and technical advisers, and detailed negotiations with the senior management of the Scottish industry, I have concluded that the following X values should be applied:-

	Scottish Power	Scottish Hydro-Electric
Transmission	1.0	0.5
Distribution and Supply	0.5	0.3

I have reached these conclusions taking account of the Boards' inevitably conservative views of the achievable costs savings over the next 5 years and also bearing in mind the kinds of values which I understand are being contemplated by John Wakeham for England & Wales. Clearly, we would not wish the Scottish companies to be markedly outside the range of values for the Distribution Companies and the National Grid Company but different considerations do apply in Scotland. In particular, growth in profitability of the Scottish companies is less sensitive to X values because of the substantial impact of generation and my advisers are satisfied that satisfactory profit growth for the Scottish companies as a whole can be achieved when my proposals on regulation of generation costs are taken into account. The X values I am proposing are not the most aggressive which could be contemplated but they do strike a balance between the interests of the companies and the taxpayer on the one hand and customers on the other and I believe they will be readily achievable by an averagely competent private sector management. The figures will accommodate capital expenditure projections significantly above historic levels, which the Scottish Boards feel will be necessary to maintain

EML074Q6

security and operational efficiency on their systems; and they assume modest revenue savings as well as the additional costs flowing from restructuring and privatisation.

The Scottish Boards will not voluntarily accept X values which are more aggressive than those being proposed in England & Wales and they have a fairly clear idea of the range of values being discussed with John Wakeham. However, I believe they will acquiesce to my proposals if I move reasonably quickly and I am therefore anxious to press ahead with an announcement of X values alongside our announcement on the regulatory and licensing arrangements which has now been set for next Thursday. I appreciate that John Wakeham may wish to make his announcement of X values first and I therefore hope he will be able to do so in the early part of next week. Any further delay on my part is very likely to lead to a hardening of the Scottish industry's attitude which will make it more difficult to deliver an acceptable outcome.

I am copying this to the Prime Minister, Nicholas Ridley, Sir Geoffrey Howe, John Wakeham, Brian Griffiths and Sir Robin Butler.

Yours sincerely

Jim Reville

pp MALCOLM RIFKIND

(Approved by the Secretary of State and signed in his absence).

EML074Q6

NAT IND: Gas & Elec pt 18

CONFIDENTIAL

file JD
(c:\Electricity)

10 DOWNING STREET

LONDON SW1A 2AA

bc: BG

From the Private Secretary

16 March 1990

Dear Steven,

ELECTRICITY PRIVATISATION: SPECIAL SHARES

The Prime Minister has seen the Financial Secretary's two letters to the Secretary of State for Energy dated 9 February and 14 March, together with the letters from the Secretary of State for Trade and Industry dated 15 February, the Secretary of State for Scotland dated 21 February, and the Secretary of State for Energy dated 5 March.

The Prime Minister understands the Secretary of State for Energy's reluctance to reopen the issue of special shares with the generators at this stage; and she agrees that if the Scottish companies were to retain timeless special shares, it would be very difficult to justify different arrangements for the generators in England and Wales. But on economic grounds, she considers that the arguments put forward by the Financial Secretary and the Secretary of State for Trade and Industry for changing the arrangements for the Scottish companies and the generators are correct in the light of the changed circumstances. The Prime Minister therefore thinks the next step should be for the Financial Secretary and the Secretary of State for Scotland to seek to resolve their differences on the treatment of the Scottish companies.

I am sending copies of this letter to Martin Stanley (Department of Trade and Industry), Jim Gallagher (Scottish Office), John Neilson (Department of Energy), and Sonia Phipard (Cabinet Office).

Yours,
Paul

PAUL GRAY

Steven Flanagan, Esq.,
Office of the Financial Secretary,
HM Treasury.

QTJ.

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I support John Wakeham in NOT reopening this issue now. If however Malcolm could be persuaded otherwise (which I doubt) and if John W.'s oppⁿ is overcome, — the DTI Treasury line is right economically

MT

PRIME MINISTER

ELECTRICITY PRIVATISATION: SPECIAL SHARES

We discussed briefly at lunchtime the attached papers which you saw in the box last night. You wanted to think further about this.

You were reluctant to endorse the Treasury/DTI proposal to extend time limited special shares to the Scottish companies and the generators. Your main concerns seemed to be:

- the threat of a French takeover;

- not upsetting John Wakeham's balancing act on electricity privatisation;

I think these concerns can be met:

- the way to stop undesirable French takeovers is through the normal use of Mr. Ridley's powers. That is the approach he favours (see Flag B). Whereas the timeless special share is in danger of preventing effective competition developing.

- the main protagonist for the status quo is Malcolm Rifkind, not John Wakeham (if Malcolm Rifkind can be persuaded to accept time limited shares for the Scottish companies, then John Wakeham will go along with the same arrangement for the English generators).

So I think the balance to be struck is between the Rifkind arguments (Flag C) and the Treasury counter-case (Flag E) which is supported by George Guise (Flag F).

(i) Do you want to support the Treasury/DTI as recommended by George Guise?

or

(ii) Prefer to support the Malcolm Rifkind defence of the status quo, notwithstanding the nuclear change?

PRCG.

PG

15 March 1990

JD c:electricity

cc P.U.

CONFIDENTIAL

SCOTTISH OFFICE
WHITEHALL, LONDON SW1A 2AU

The Rt Hon John Major MP
Chancellor of the Exchequer
House of Commons
LONDON
SW1A 0AA

NBPM

15 March 1990

Dear John,

REGULATION OF THE SCOTTISH ELECTRICITY SUPPLY INDUSTRY

I am writing to seek your and colleagues' agreement to draft licences for Scottish Power and Scottish Hydro-Electric and in particular the price control arrangements which have been the subject of recent discussion between your officials and mine. I would hope to have an oral statement in the House about the licensing and price control arrangements next week to coincide with publication of the draft licences. — in attached folder.

The Scottish licences are composite documents reflecting the vertically integrated structure of the Scottish industry and incorporate licences for public electricity supply, transmission and generation of electricity. The document, a copy of which is attached, follows closely in most important respects the parallel draft licences published by John Wakeham on 12 February and have been the subject of close consultation with John's officials. Apart from the price control conditions which I discuss below, there are no material differences from the comparable documents for England & Wales to which I need draw your attention and which cannot be justified on the basis of the different structural arrangements for Scotland. I also intend to publish a draft generation licence and draft second tier supply licence for independent operators in Scotland, copies of which will be circulated at official level. Both documents are very much in line with the equivalent drafts already published for England & Wales.

The composite draft licence does not yet contain the detailed price control condition which my officials are in the final stages of drafting and will circulate shortly at official level. The important elements of my proposals are as follows:

- the Scottish Public Electricity Supply companies will enjoy the same level of franchise protection as their counterparts in England & Wales in order to ensure a level competitive playing field in the early years: these arrangements were a necessary prerequisite to the industry accepting a nuclear supply contract and should help pave the way for agreement on a coal purchase contract with British Coal;

- average distribution and transmission revenues will be capped and indexed by RPI-X: I aim to take decisions on X values shortly;

- the initial average price of electricity generation within the overall supply price will also be capped and indexed for the first 4 years by RPI: regulation will thereafter move over progressively to an index derived from average generation prices in the England & Wales competitive market (identical arrangements will apply for indexation of the nuclear price in the contract between Scottish Nuclear Ltd and the 2 Scottish supply companies);

- price regulation will extend over the first tier supply market up to 10MW: there would be no direct price regulation in the above 10MW, second tier supply and wholesale markets;

- there will be a subsidiary cap on average prices in the below 1MW market which will restrict price rises to be no greater than the movement in the overall price cap;

- there will be no provision for specific pass through of generation costs to customers - the Scottish companies will therefore enjoy improved profitability when Miller gas comes on stream but will have to absorb the costs of any future agreement with British Coal for supplies in the home market within the tariff continuity constraint: I believe this is a fair quid pro quo for the taxpayer and the consumer.

The Scottish industry and my advisers accept that this is a well balanced package which provides long term protection for consumers while at the same time offering substantial profit opportunities for the companies. RPI indexation of generation prices in the early years reflects the known costs of nuclear and Miller gas and should provide a useful discipline upon negotiations with British Coal for the balance of the Scottish industry's fuel requirements over the next few years (although I would very much hope that the outcome will be a real decline in coal prices as in England & Wales). The transition to a reference price based on England & Wales generation prices will take place over a further 4 years when the full force of competitive pressures should be emerging in the wider GB market. For the longer term the use of an index derived entirely from generation prices south of the border will ensure that the disciplines of the competitive market are impressed upon the Scottish vertically integrated companies while yet giving those companies full incentive to improve profitability by reducing costs as compared with that wider market. The subsidiary cap on the below 1MW market is required to protect non-mobile customers who might otherwise suffer from 'tumbledown' of costs as prices are pushed down in the contestable market. I propose to include provision in the licence for this subsidiary cap to be reviewed by the DGES after 4 years (when the franchise is reduced to 0.1MW); but it does seem likely that competition will emerge more slowly in Scotland, given the surplus of capacity and the vertically integrated structure of the industry, so that the cap may need to be retained for some considerable time. The 10MW cut off and the exclusion of second tier supply and wholesale activities from the regulated market will reduce price volatility and remove other distortions which would be likely to operate against the interests of customers and the companies themselves. Again, it may well be appropriate to reduce the size of the regulated market in Scotland progressively as price competition emerges over time.

I am discussing with the Scottish industry average tariff increases of no more than 8.5% next year and the price control arrangements above should ensure that tariffs remain broadly in line with inflation for the following 4 years, the precise movements being subject to the X values which I have yet to determine. The Scottish industry will also aim to hold prices in the above 1MW market steady in real terms for at least a year, in line with the undertaking which John Wakeham has obtained from the industry in England & Wales.

These price control arrangements are substantially different from those for England & Wales largely because of the requirement within the Scottish vertically integrated structure to impose direct control on all components of the overall electricity supply price, whereas the generation price in England & Wales will be effectively unregulated because of the protections available from competition. However, the arrangements should ensure a broadly level playing field throughout GB and that overall price movements in Scotland broadly track those in England & Wales.

I should be glad to have your agreement to these principles and to Ian Lang announcing them to the House next week (on Thursday 22 March). I would also aim to be in a position to announce X values for the Scottish companies, about which I shall be consulting you shortly. I shall of course circulate a draft of the proposed statement in due course.

I am copying this to the Prime Minister, Nicholas Ridley, Sir Geoffrey Howe, John Wakeham, Brian Griffiths and Sir Robin Butler.

Yours ever,

MALCOLM RIFKIND

fst.sb/fst/13.3.90.5

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Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon John Wakeham FCA JP MP
Secretary of State for Energy
Department of Energy
1 Palace Street
Victoria
LONDON
SW1E 5HE

14 March 1990

Dear John

ELECTRICITY PRIVATISATION: SPECIAL SHARES

with PG

Thank you for your letter of 5 March. I have also seen Nicholas Ridley's letter of 15 February, and Malcolm Rifkind's letter of 21 February.

As a general rule, we need to ensure that the interference of special shares in market mechanisms is kept to a minimum. They could reduce companies' ability in the long term to raise capital in the markets; they certainly prolong the period when the Government is placed in the awkward position of choosing between bidders, as demonstrated during the Jaguar takeover. And as Nicholas Ridley pointed out, business placed in the private sector should be subjected to private sector disciplines as far as possible. Unnecessary provision of timeless special shares would go against this fundamental principle.

I agree that the National Grid Company (NGC) should retain its timeless special share, not only to protect its pivotal position at the centre of the supply system, but also to preserve its independence from its shareholders, the distcos. But I have difficulty in accepting that the position of the grid in Scotland is analogous. It will not be subject to a comparable structure; it will be held in two parts by two companies, and will be an integral part of those companies. Neither company will possess

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FINANCIAL SECRETARY TO THE TREASURY

the horizontal integration and consequent strategic power of NGC. NGC's special share not only places a 15 per cent limit on individual shareholdings, but entrenches its independence from the distcos. A timeless special share in the Scottish companies would not, because of the structural differences, secure the independence of the Scottish grid.

Like the Scottish companies, the distribution companies are very substantial businesses in their own areas. Yet we all agree that time-limited special shares are adequate for them.

Malcolm's other concern was that a single monopoly might be created in Scotland. But any takeover would be subject to competition law. For a takeover to happen, the MMC and the relevant Secretary of State would have to agree that it was not against the public interest. Similar considerations apply to the generating companies south of the border. Malcolm also expressed concern about cross subsidy of rural areas in the North; but our policies on this have statutory underpinning in the Electricity Act, and the MMC would be bound by that. Any outside interest buying into the industry would be bound by existing licensing and statutory requirements.

Our commitment to timeless special shares in the Scottish Companies and National Power (NP) rested on the need to protect the nuclear assets they would be holding. This is no longer the case. In the light of the advantages of keeping special shares to a minimum, I would favour restricting timeless shares to NGC. I do not really accept the analogy with the Scottish grid. But the arguments seem even weaker for extending timeless shares to the gencos in England and Wales, where there is full potential for sufficient competition between many suppliers to secure an efficient structure. Time limited special shares will be sufficient to protect these companies from predators as they adjust to the new industry structure. Beyond that we should let the beneficial effects of competition in the equity market take effect, subject to the regulatory regime and the usual mergers supervision; they will be sufficient to meet any strategic concerns.

I am sure you will appreciate my uneasiness about using special shares to continue to occupy the commanding heights of the economy.

I am copying this letter to the Prime Minister, Nicholas Ridley and Malcolm Rifkind.

Yours ever

Peter

PETER LILLEY

NAT. IND Electricity Pt18

PRIME MINISTER

ELECTRICITY PRIVATISATION: SPECIAL SHARES

Last year you agreed that the electricity distribution companies in England and Wales should have only time limited special shares following privatisation. But permanent special shares were agreed for:

- the England and Wales National Grid Company, reflecting its pivotal position at the centre of the supply system;
- National Power and the Scottish companies, because they would include the nuclear assets;
- PowerGen, on the basis that it was difficult to treat it differently from National Power as the other main generator.

Last month you saw a note from the Financial Secretary (Flag A) arguing that, following the decision to retain the nuclear assets in the public sector, a change should be made to time limit the special shares in National Power, PowerGen and the Scottish companies - although the share in the Grid Company would remain timeless. You simply noted my initial reaction that this seemed a sensible response to the new electricity structure.

Since then, there have been exchanges between colleagues:

- Nick Ridley (Flag B) supports the Treasury case on competition;
- but Malcolm Rifkind (Flag C), and John Wakeham (Flag D), are opposed to a change. Malcolm Rifkind argues that, since grid transmission is integrated in the two Scottish companies, these must retain

timeless special shares. John Wakeham argues that if the Scottish companies have timeless shares, the same has to go for the generating companies in England and Wales.

The Financial Secretary (Flag E) has now responded. He argues that the Scottish position can be distinguished from the National Grid Company in England and Wales, and he continues to press for time limiting the Scottish companies and the English generators.

George Guise (Flag F) strongly supports the Treasury/DTI line.

You have been most reluctant to make any intervention in other electricity issues to upset the skilful balancing act John Wakeham has been performing. But I don't think that is an aspect that need concern you in this case; there is no question of upsetting delicate negotiations between the different parties, it is simply a matter of the Government's decision on special share arrangements.

Given that the protagonists are currently split 2:2, I imagine they are all awaiting your further reactions.

Do you want to weigh in in support of the Treasury/DTI as recommended by George Guise?

PRG.

PAUL GRAY

14 March 1990

cle JD

cPU

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

12 March 1990

Dear Stephen,

ELECTRICITY PRICES IN NORTHERN IRELAND

The Prime Minister was grateful for your Secretary of State's minute of 7 March. She is content for him to proceed with an announcement on the lines proposed, and would be grateful for a further report in due course on the work in hand for a White Paper on privatisation of Northern Ireland Electricity.

I am sending copies of this letter to the Private Secretaries to the members of E(A) and to Sir Robin Butler.

Yours,

Paul

PAUL GRAY

Stephen Leach, Esq.,
Northern Ireland Office.

PRIME MINISTER

NORTHERN IRELAND ELECTRICITY

Last autumn you saw a progress report from the Northern Ireland Office on their planning for privatisation of Northern Ireland Electricity (NIE). The conclusion was that work should continue, with a view to a White Paper sometime this year; but that meantime it would be appropriate to announce the decision to bring to an end the tariff link arrangement which has been in operation since 1981.

The attached note from Peter Brooke (Flag A) now sets out his proposal to announce an end to the tariff arrangements by means of a written PQ. He will indicate that, in the longer-term, NIE tariffs must be based on long run sustainable costs of generating and distributing electricity in Northern Ireland. But for the year ahead he will say that the average electricity price increases will be held to some 8 per cent.

Peter Brooke's note is, in my view, a rather thin report, and says nothing about more general planning for privatisation or for a White Paper. George Guise (Flag B) expresses similar sentiments. But the only immediate issue is whether Peter Brooke should proceed with his announcement about the tariff link, and both George and I suggest you should agree to this.

Content to agree Peter Brooke's proposal, while asking him for a further report in due course on planning for the White Paper on privatisation?

PRG.

Yes m

PAUL GRAY
9 MARCH 1990

a:\economic\NIE.mrm

B

CONFIDENTIAL

PAUL GRAY 9 March 1990

NORTHERN IRELAND ELECTRICITY PRICES

Peter Brooke's proposals have the support of the Treasury but only after a behind the scenes argument about the level of price rises.

The Treasury believe that a price hike of the order of 20% is necessary to put NIE tariffs in line with the long run sustainable price of generating and distributing electricity in Northern Ireland. The Northern Ireland Office have been arguing that the figure is nearer 10% and that, prior to privatisation, increases in line with RPI are all that are needed! This argument is continuing and the Treasury hope to have it resolved by the end of the summer.

Peter Brooke's paper is an apologia for the progress report promised to E(A) last October. The general proposal is sensible. The tariff link is clearly an anachronism, particulary in view of the imminent privatisation of UK generation. Like any other commodity, electricity in Northern Ireland will have to be priced such as to enable it to be profitably produced. However, the figure of 8% which the paper indicates for the NIE tariff increase from April 1990 has been set only after much pressure from the Treasury. Northern Ireland's original proposal was for 6½%.

There is clearly a tendency in the Northern Ireland Office to put electricity privatisation into the "too difficult box" and pressure will have to be maintained on them to think commercially. The danger of leaving the major price hike to privatisation itself is that this will then be seized upon by the Opposition as another example of the private sector milking a monopoly - cf water privatisation. The Treasury are clearly on top of the problem and I do not recommend intervention from here as yet.

Gg

GEORGE GUISE

chex.ps/tt/19 **CONFIDENTIAL**

cc 9/1

NBPM d this dec.

PM Co
9/3

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

8 March 1990

Rt Hon John Wakeham FCA JP MP
Secretary of State for Energy
Department of Energy
1 Palace Street
LONDON
SW1E 5HE

Dear Secretary of State,

DISTRIBUTION COMPANIES' EFFICIENCY SAVINGS

Thank you for your letter of ~~7~~ March.

I am glad that you agree that the X factors should put strong pressure on the companies to improve their efficiency. And as you say, the negotiations with the companies are a matter for you. But I am very sorry that you were unable to speak to Peter Lilley yesterday, following Peter's meeting with Tony Baldry. I am sure you recognise that the Treasury has expertise in and responsibility for the whole area of privatisation and I would be grateful if you could take full account of the following considerations.

On the evidence of past privatisations, the Chairmen are all too likely to exaggerate their unwillingness to accept tough Xs. They have certainly had every incentive to do so in the negotiations to date. In entering the debate now, you have the chance to take a fresh view and start from X factors that are consistent with profit growth of 3 per cent and high gearing.

I am sure you realise that an average outcome of RPI+X would be most unhelpful: it sends quite the wrong signal at a time when we are stressing the need to bear down on inflation. And it could damage our presentation of the privatisation programme. Fortunately, our officials' calculations suggest that, consistent with these aims for profit growth and gearing, an average outcome of RPI-0, with RPI-X for a majority of the distcos, would be feasible. Both results are plainly very desirable. It is against these aims that we should assess the outcome of your negotiations next week.

I am copying this letter to the Prime Minister.

Tancred Tarkowski

pp JOHN MAJOR

[Approved by the Chancellor of the Exchequer and signed in his absence]

NAT INDS Gas+Elec Pt 78

Confidential

cc PX

THE RT HON JOHN WAKEHAM MP

cc

Department of Energy
1 Palace Street
London SW1E 5HE

01 238 3290

NBPM

The Rt Hon John Major MP
Chancellor of the Exchequer
HM Treasury
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

7 March 1990

Dear John

Tony Baldry has reported his discussions with Peter Lilley on the subject of the level of the X factors to be contained in the pricing formulas for the public electricity suppliers and the National Grid Company.

I can assure you that I fully share the Treasury's wish to have X factors which will put strong pressure on these companies to improve their efficiency and to reduce their costs. To this end I will be seeking as demanding X factors as I believe are justifiable and consistent with the flotation of these companies and achieving a proper return for the taxpayer's assets. But I am sure you will agree that the negotiation has to be left to me, and the recommendation as to what is justifiable and deliverable must be mine. I will, of course, keep you informed of progress and seek your agreement to my recommendations.

I am copying this letter to the Prime Minister.

Yours ever

John

JOHN WAKEHAM

NAT INDS Gas + élec Pt 18

A cls

PRIME MINISTER

ELECTRICITY PRICES IN NORTHERN IRELAND

Flag A 17

In October 1989, I undertook to advise E(A) colleagues before making any announcement about future electricity prices in Northern Ireland. Following discussions with the Chief Secretary, I am now in a position to make an announcement and I propose to do so by means of a Written Answer in the House.

The central feature of the announcement will be the decision to bring to an end the tariff link arrangement which has determined Northern Ireland Electricity's (NIE's) prices since 1981. At that time, because of high oil prices, NIE's tariffs had risen well above those in Great Britain and this was considered an unreasonable burden on the NI community and a real obstacle to economic development. Under the link arrangement, NIE's tariffs were set equal to those of the highest area boards in England and Wales and its consequential revenue deficits were met by Government subsidy. Since the fall in oil prices in 1986, however, NIE has been profitable and no subsidy had been needed.

Following a review of the tariff link arrangement, my predecessor and the Chief Secretary agreed that the link should be discontinued. The decision was also influenced by the consideration that, since NIE is to be privatised, it is clearly necessary for it to move back to setting its tariffs by reference to its own costs

SECRETARY OF STATE FOR NORTHERN IRELAND

rather than those of other Boards. In my Parliamentary Answer I shall explain the reasons for the ending of the link and I shall point out in addition that the fundamental changes which are taking place in the structure of the electricity industry in England and Wales mean that it is no longer appropriate.

In announcing the end of the tariff link, I must give an indication of the tariff setting principles which will replace it. I have agreed with the Chief Secretary that,in the medium and long term, NIE's tariffs must be set on the basis of the long run sustainable price of generating and distributing electricity in Northern Ireland - that is, the price at which electricity can be generated and distributed efficiently while providing for renewal and development of the system and producing an acceptable rate of return. It has not been possible so far to establish precisely what the long run sustainable price should be, though much valuable work has been done by officials and advisers on the question. It seems certain that the long run price will be higher in real terms than it is at present, but there are a number of uncertainties including, for example, the price effect of an interconnector with Scotland. I shall, therefore, not be able to give any clear indication about the path of electricity prices in Northern Ireland in the longer term, though I shall say that economic pricing is the ultimate aim.

I shall, however, have to say what the increase in NIE's tariffs for the year from April 1990 is likely to be. Ideally, I should have liked to be able to derive this increase from a clearer view of the long term sustainable price and the stages by which that should be attained. As is clear from the above, I do not at present have all the information I need to be able to do this. However, in the light of the work done so far, I have agreed with the Chief Secretary that an increase of 8% on average would be appropriate and fully consistent with the objective of moving over time to a long run sustainable price.

In order to give NIE time to implement tariff changes by 1 April, I need to make the announcement by 9 March.

I am copying this to members of E(A) and to Sir Robin Butler.

P.B.

PB

7 March 1990

NAT IND: Electricity Pt 18.

PRIME MINISTER 5 March 1990

SPECIAL SHARES IN ELECTRICITY GENERATORS

It is unfortunate that timetable constraints are forcing the privatisation of fossil fuelled generation as a duopoly. The original justification for the duopoly was that we had to build a big enough cage to hold the nuclear generators. Without that requirement, the logical form for privatisation would have been 4 or 5 generating companies, probably grouped according to the coal fields that supply them. This would have been a natural step towards the ultimate privatisation of coal.

Just as the nuclear red herring led us into the generation duopoly - the cage with no bear in it - so it is leading John Wakeham, led on by Malcolm Rifkind, into a false conclusion about special shares. It is perfectly reasonable for any newly privatised organisation to have a special share for a limited period. Management experiences a real jolt when its business goes private because alien and unfamiliar issues suddenly appear on all sides. It is therefore perfectly reasonable to allow management a breathing space of, say 5 years, to adjust to such new elements without worrying about threats from its share register. However, to make such takeover protection permanent is a totally different matter.

With the current duopoly structure, there will be many cosy anti-competitive practices carried over from the present CEGB. The newly appointed Regulator, Stephen Littlechild, will be hardput to flush them out. He will also have to be ever on his metal to dissuade new ones from coming into being. Ultimately, the competitive situation should right itself as the supply companies develop other sources of electricity, including power stations which they may build themselves. This natural process of evolving from a duopoly into a regime of proper competition will be totally frustrated if the big generating companies are given permanent protection from takeover.

If there is to be limited competition in the consumer market, at least let it prevail in the share market! At the end of 5 years the special share should evaporate, just as it will in the distribution companies. The risk of not setting a time limit, and leaving it to the initiative of the Secretary of State, is that it will never be the right time to lift the special share. Remember the build up of pressure over Jaguar. Because the special share had only one year left to run, it was possible to build the case that an unreal market was developing. If there had been no automatic expiry deadline, Ford and GM would not have put their energy into building up takeover proposals of the kind which ultimately prevailed.

Permanent takeover protection is bound to sustain inefficiencies. The companies will operate as though they were still state owned. There will be no automatic market discipline to examine performance or the level of their price earnings ratio. Dividends will be miserly and vast sums will be spent indulging their engineers in new power station designs. There will be a continuation of the kind of hopelessly uncommercial thinking which led to those assets, both nuclear and fossil fuelled, which it is proving so difficult to privatise.

To protect a management from its shareholders is ultimately to protect it from its customers. There is no commercial or national case for maintaining a golden share in the generating companies and the producer led arguments from Rifkind and Wakeham should be soundly trounced. The Treasury is right to reopen the issue and the arguments in the DTI letter are excellent.

The national security case, raised in particular by Rifkind, is weak. Under emergency conditions government can take control of any strategic asset. Furthermore, the MMC is obliged to consider the national interest in assessing takeovers. It is not merely competition which it must address. A future takeover of an electricity generator would be referred to the MMC who would be obliged to consider every factor in concluding whether the bid should proceed. There are therefore adequate safeguards and the Rifkind argument is both hyperbolic and bogus.

CONCLUSION AND RECOMMENDATION

Support the retention of a special share against takeover for a period of 5 years and no longer.

George Guise

GEORGE GUISE

cc PU.

THE RT HON JOHN WAKEHAM MP

SECRETARY OF STATE FOR ENERGY

Department of Energy
1 Palace Street
London SW1E 5HE
01 238 3290

The Rt Hon Peter Lilley MP
Financial Secretary to
The Treasury
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

5 March 1990

Dear Peter

ELECTRICITY PRIVATISATION: SPECIAL SHARES

9th's flag.

Thank you for your letter of 8 February. I have also seen Nicholas Ridley's letter of 15 February and Malcolm Rifkind's letter of 21 February.

I find Malcolm's arguments for retaining indefinite shares in the Scottish companies very compelling. And if the Scottish companies were to have permanent special shares, it would be extremely difficult to justify different arrangements for the generators in England and Wales.

You will be aware that, in the run-up to vesting, we are having to resolve a number of difficult issues, often to the perceived detriment of National Power and PowerGen. It would be unwise now to re-open the issue of special shares with the industry.

In these circumstances I must ask you not to reopen the decision on special shares that was taken a year ago.

I am sending a copy of this letter to the Prime Minister, Nicholas Ridley and Malcolm Rifkind.

Yours ever

John

JOHN WAKEHAM

NAT INDUSTRIOS !

Garnêlee Pt 18.

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

1 March 1990

Dear Tancred,

TIMING OF ELECTRICITY PRIVATISATION

The Prime Minister was grateful for the Chancellor's minute of 26 February, which she has noted without comment.

I am copying this letter to John Neilson (Department of Energy), Jim Gallagher (Scottish Office) and Sonia Phippard (Cabinet Office).

Yours,

Paul

Paul Gray

Tancred Tarkowski, Esq.,
HM Treasury.

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Treasury Chambers, Parliament Street, SWIP 3AG
01-270 3000

Prime Minister

You saw my summary of this in the papers for the Chancellor's Statement. Announcements have now been made. But you may like to glance at the minute itself. DRCG 18/2

PRIME MINISTER

TIMING OF ELECTRICITY PRIVATISATION

As you will recall, John Wakeham, Malcolm Rifkind and I have been considering this matter. This minute sets out our decision and informs colleagues of certain implications.

2. Our objective is to complete the sale of the electricity industry before the Election. The sale will involve 12 distribution companies and 2 generating companies in England and Wales and 2 vertically integrated companies in Scotland.

3. The timescale is short. The distribution companies will not be ready for sale before Autumn 1990. Our City advisers are clear that all the sales must be completed before the summer holidays in 1991. They advise that the pre-Election shadow would make sales after that date very risky and, possibly, impracticable.

4. To fit all the sales into this period, John, Malcolm and I have agreed that, subject to market conditions, the 12 English and Welsh distribution companies should be sold in Autumn 1990 and the 2 generating companies in February 1991. The 2 Scottish companies would, again subject to market conditions, be sold around May-June 1991. This would complete the sales in an orderly manner in the time available.

5. One consequence of these arrangements is that the sale of the generating companies will come shortly before the 1991 Budget Statement. This will create very difficult problems for Treasury Ministers in relation to prospectus and legal disclosure requirements. As colleagues will be aware, as vendor of shares in a privatisation, the Government has an obligation under law to disclose information and facts which are material to the prospects of the company whose shares are being sold, or to potential investors in these shares. There is a standard trawl of departments on this matter close to each of the sales. Disclosure does not simply relate to decisions which have been taken. It also embraces the settled intentions of departments.

6. Certain tax changes could be material to the prospects of the electricity companies, or to potential investors in their shares. In the period up to the 1991 Budget, Treasury Ministers will, therefore, have to decide either not to introduce any such tax changes, or to disclose them ahead of the Budget Statement in the prospectuses of the electricity companies. This is a situation I would have much rather avoided, but it is one I am prepared to accept in the interests of successfully completing the privatisation.

7. In his minute to you of 8 January, John Wakeham set out the relevance of disclosure considerations to our continuing discussion of environmental policy. I am sure he was right to emphasise the need for a clear statement of Government policy on the environment early this Autumn. This would also apply to any taxation measures designed to benefit the environment. If there were any such measures, they could well be material to the prospects of the electricity companies and be a matter for disclosure in the prospectuses. The timetable we have now established for privatisation means we will need to have established a clear position on such tax measures by the early Autumn.

8. I am copying to other members of the Cabinet and to Sir Robin Butler.

John M.

[J.M.]
26 February 1990

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SCOTTISH OFFICE
WHITEHALL LONDON SW1A 2AU

The Rt Hon John Wakeham MP
Secretary of State for Energy
1 Palace Street
LONDON
SW1E 5HE

NBPM
PRCG
26/2

23 February 1990

Dear Secretary of State

MEETING WITH SIR LEON BRITTAN: 27 FEBRUARY

Unfortunately I am unable to join you at your meeting with Leon Brittan on Tuesday next. I have every confidence that you will be able to maintain a solid UK line.

My purpose in writing is principally to stress the paramount importance which I attach to the maintenance of a life of station nuclear contract between the Scottish nuclear company and the 2 Scottish electricity companies which are to be privatised. In seeking to meet Commission concerns, we have gone as far as we can in making provision for any of the parties to require a review of the terms of the contract after 15 years. The unequivocal advice from my financial advisers is that any shorter period would seriously jeopardise the prospects for flotation.

The UK Government and the Scottish Electricity Boards have not alighted on 15 years by chance; it is at that time (around 2005) that the Hunterston B AGR station is expected to close. This would remove 1150MW of capacity from the Scottish system, so that should the nuclear contract be terminated at that point as a result of a review of its terms, the level of over-capacity then extant in the Scottish system could be expected to have assumed manageable proportions. But this will not be the case over the next 15 years.

We are effectively proposing to restructure the Scottish electricity market by allowing the controlled introduction of competition to bring an orderly transition to the free market. It would be both uneconomic and perilous to move faster. Uneconomic, because the free play of competition in the presence of substantial surplus capacity would drive down prices to system marginal cost, giving industry and commerce in Scotland a windfall benefit from artificially reduced prices. It is neither in the interests of the UK taxpayer nor in the interests of the Commission's competition policy that the State Aid which the UK Government would need to inject

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in these circumstances should be substantially increased and market distortions exacerbated. Moreover, in relation to the State Aid, we have no effective choice. The costs of the nuclear investment programme have already been sunk, and the liabilities in relation to decommissioning will need to be met willy nilly. If the Commission are not prepared to countenance the arrangements which we have proposed, they will be forcing the UK Government to choose between writing an open cheque to underwrite the nuclear operation or to go back on our commitment to introduce competition at all.

Introducing competition in a surplus market without the element of certainty which we propose for at least 15 years would also be perilous. The prospect of cut throat competition at the end of the contract period would put in serious doubt the continued financial viability of the Public Electricity Suppliers in Scotland. We could not ignore the risk to security of supply. Were our proposals as outlined above to prove an absolute sticking point with the Commission, I should need to consider carefully whether I could justify proceeding. These risks would be such that I am advised by our merchant bankers, BZW, that investors would not be prepared to accept them without very substantial discounting. They do not believe that we could successfully float the 2 Scottish electricity companies in those circumstances.

What we are offering the Commission is a finely balanced compromise between, on the one hand, massive State subsidy to the nuclear undertaking which would result from the completely free play of competition within the structure we have established and, on the other, the maintenance of a State monopoly for the foreseeable future. It represents a means of setting Scotland firmly on the road to a more competitive environment which can only be effectively achieved when the existing surplus of capacity has been substantially reduced. I should not like to leave Leon in any doubt about this. The proposal for an open review of the contract at 15 years is simply not negotiable, so that Commission insistence on a shorter period could halt us in our tracks.

I am sorry that I shall not be there to deploy these arguments in person. You will, however, have been fully briefed by one of my officials, who will also accompany you on Tuesday.

I am copying my letter to the Prime Minister, the Chancellor of the Exchequer, Nicholas Ridley and Sir Robin Butler.

James Reville

pp MALCOLM RIFKIND

Approved by the Secretary of State and signed in his absence.

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cc PM.

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SCOTTISH OFFICE
WHITEHALL, LONDON SW1A 2AU

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NBPM will
S/S Energy expects.
PLCB
23/2

Peter Lilley, Esq MP
Financial Secretary to the Treasury
Treasury Chambers
Parliament Street
LONDON
SW1P 4AG

21 February 1990

Dear Peter,

flap.

ELECTRICITY PRIVATISATION: SPECIAL SHARES

Thank you for your letter of 9 February concerning special shares in the 2 Scottish electricity companies and the England and Wales generators. I have also seen Nicholas Ridley's letter of 15 February.

I do not share your view that, as the nuclear generating stations are to remain in the public sector, there is no longer a need for Government to have timeless special shares in either the Scottish companies or the England and Wales generators. I leave John Wakeham to address the case of the GenCos but I believe that there remain overwhelming reasons why we should retain special shares in the Scottish companies for the foreseeable future.

The 2 Scottish electricity companies are of great strategic importance to Scotland. They will be amongst the largest plcs in Scotland and will play a vital role in all aspects of the Scottish economy. Moreover, the Scottish companies are vertically integrated and will retain ownership and control of the Scottish grid. In our earlier discussions, we recognised that the grid both north and south of the border was a special case. I take it that you continue to believe that the National Grid Company requires a timeless special share and I cannot contemplate an outcome for Scotland which would place control of the transmission network north of the border in a different position.

In publishing our White Paper on privatisation of the Scottish industry, I also made clear our view that it would be unacceptable to create a single monopoly licensed to generate, transmit and supply electricity throughout Scotland. Yet this will be perceived as an all too likely outcome of offering only "fledgling protection" for 5 years. In the light of their previous approach to Scottish Hydro-Electric, the management of Scottish

Power would be likely to regard any change as an open invitation to plan a takeover strategy, complicating enormously the process of a joint flotation of the 2 companies. The threat of takeover, from other parts of the industry or outside interests would in particular create serious concerns in the North of Scotland, for example about the continued dedication of the hydro benefit to underpin the high costs of distribution and transmission in that area. I do not believe we can realistically rely on the MMC mechanism to secure the industry structure to which I attach so much importance.

Quite apart from these substantive arguments, I believe it would be quite wrong to change course at this late stage. The Government gave firm assurances to Parliament during the passage of the Electricity Bill that we would retain a special share in the Scottish Companies for the foreseeable future. Indeed, specific amendments to the Bill were only withdrawn on the strength of those assurances. I am convinced that we should be regarded as acting improperly were we now to provide that special share protections lapsed after 5 years. There would, at the very least, be considerable political opposition to any retreat from our earlier undertakings.

Against this background, I must ask you to accept the status quo. The retention of special shares without limit of time is not of course an irrevocable step. It will be open to the Government at any stage in the future to redeem such special shares as and when they are believed to have outlived their usefulness. That step would need to be justified to Parliament at the time; it is not a battle which we can or should fight now.

I am copying this letter to the Prime Minister, John Wakeham and Nicholas Ridley.

Yours ever,

Mal

MALCOLM RIFKIND

NAT IND :

Gas + Elec Pt 18

cc/

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the department for Enterprise

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The Rt. Hon. Nicholas Ridley MP
Secretary of State for Trade and Industry

Rt Hon John Wakeham MP
Secretary of State for Energy
1 Palace Street
LONDON SW1

Department of Trade and Industry

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Date 15 February 1990

NBPM at this stage.
PRCO 15/2

Dear John

ELECTRICITY PRIVATISATION: SPECIAL SHARES

Peter Lilley sent me a copy of his letter of ~~9~~ February to you. I have also seen Number 10's letter of ~~12~~ February.

In the course of our collective discussions during 1988 on this issue, it was recognised that the existence of nuclear capacity in the private sector would merit special consideration, and that a timeless special share would afford suitable protection for such businesses.

The exclusion of the nuclear business from the sale effectively negates the original justification for advocating a timeless special share for the generators and the Scottish companies.

The fundamental and guiding principle in privatisation must be that business is placed in the private sector to be subjected to private sector disciplines as far as possible. These disciplines include the competition legislation, and only where special circumstances arise in which it is necessary to protect a vital national interest should the use of a timeless special share be considered. Such special circumstances no longer arise in the case of the generators and the Scottish companies, and I agree that a time-limited special share of five years duration would now appear appropriate.

I am sending copies of this letter to the Prime Minister, Malcolm Rifkind, and Peter Lilley.

Yours ever
Nicholas

Recycled Paper

NAT IND :: Gas + Electricity Pt8

[Mr. Frank Dobson]

domestic consumers are all being put second to the requirement that has been placed on him by the Prime Minister, which is get the industry sold off as quickly as possible?

Mr. Wakeham: The hon. Gentleman asked me 10 questions. He is right that his first question—about Scotland—is a matter for my right hon. and learned Friend the Secretary of State for Scotland, and I shall certainly put it to him.

The hon. Member then talked about price increases and about fattening up the industry for privatisation, as he put it. He must make up his mind fairly soon about whether we are fattening up the industry for privatisation or selling it for a song. The fact is that we are doing neither. We intend to privatise the industry at a proper and fair price. If the hon. Gentleman had listened to what I said about price increases, he would have heard me say that I did not expect that on average there would be any price increases in real terms and that prices would stay the same in real terms. I shall not quote the Labour party's record on electricity prices as there are plenty of other questions to answer.

The hon. Gentleman asked me not to be vague about large users of electricity. I certainly shall not be vague and I have said that I expect the industry to offer terms to the large users and to any user over 1MW of consumption and to keep the price increases to the RPI for the current year. Thereafter, they will be in a position to negotiate freely for prices within the market and I know that a number of them are already setting about that task.

The hon. Gentleman's fourth question related to domestic prices. I have said that customers below 1 MW will have the benefits of the overall price control and of regulation. I see no reason why their prices should increase by much more than the rate of inflation this year, although the area boards have not yet made their proposals. The price control formula will ensure that price rises are limited so that there will be no real increase in prices for the next two years. As I have said, they are maximum figures, and the area boards could well do better for many of their customers.

With regard to the fossil fire levy that I announced, the hon. Gentleman is misleading the House if he states that it is an additional impost on electricity consumers. Consumers pay for the cost of nuclear power in their bills at the moment. The levy simply brings the matter out in the open, as set out in the Electricity Act 1989, and there will be no increase in the price of nuclear power as a result of the change. The levy will still be there, but at 10·6 per cent. it is less than a lot of people thought, and it will decrease over the next eight years.

On the question of the obligation to supply, or the security of supply, I believe that the present arrangements under the Electricity Act are better than the previous bureaucratic arrangements of the Central Electricity Generating Board. Under the Electicity Act, the area boards are required to offer terms to any customers in their area and that offer will be backed up by the licensing conditions and by stiff financial penalties. Therefore, they will have a clear legal obligation to contract for sufficient supplies to meet the requirements in their areas.

The hon. Gentleman is right to raise the important matter of energy conservation. He should remember that over the past 10 years there has been a substantial improvement in energy efficiency in Britain. While there has been a 20 per cent. increase in gross domestic product, we have used the same levels of energy. We expect that to continue. It is very much in the consumer's interest to pursue improvements in energy efficiency. Several proposals in my statement will improve energy efficiency further. First—

Mr. Jeff Rooker (Birmingham, Perry Barr): How much longer?

Mr. Wakeham: The hon. Gentleman's hon. Friend asked me 10 questions and I have not finished answering them. If he does not like it, he should speak to his hon. Friend about it.

The overwhelmingly important factor in efficiency of energy consumption is to create competition in generation. The area boards will have a responsibility to encourage energy efficiency and will draw up codes of practice.

The Government stand by their commitment to ensure that the European convention on flue gases, to which we are signatories, is met. Proposals will be made to do that in the most effective and efficient way possible. Negotiations on the most effective way will include desulphurisation retrofitting of electricity stations. In some stations, it will not be necesary because of the planned changeover to gas. Negotiations with the industry are being held now. I confirm that the Government are fully committed to the European directive. The industry will be fully committed to any environmental matters that arise out of the Environmental Protection Bill currently going through the House.

The hon. Member for Holborn and St. Pancras asked me about renewables and combined heat and power procedures. We did not include CHP power stations in the renewables. We believe that CHP proposals can provide some of the most efficient forms of electricity generation. There will be a great incentive for builders of electricity generating stations to use those principles wherever appropriate. In the initial period, most CHP proposals will come within the proposals for own-generation, which will be free of the fossil fuel levy. Builders of power stations will benefit from that.

The hon. Gentleman is wrong about privatisation. The purpose of privatisation is to provide customers with a better deal by encouraging competition in electricity generation. It can be seen from the date of my statement that that has already begun. At the end of the transitional period all consumers will benefit.

Several Hon. Members *rose*——

Mr. Speaker: The House knows that I always endeavour to look after the interests of Back Benchers and give them at least as long as Front-Bench Members. However, I ask hon. Members to put their questions succinctly so that we can get on with the business set down. This is a private Members' day.

Mr. John Hannam (Exeter): Does my right hon. Friend recall that it was not long ago that the Labour party forecast price increases after privatisation in excess of 20 per cent.? Now Labour Members grumble that prices will increase at the level of inflation, something that the Labour Government did not achieve. Will he accept the thanks of consumers for the steps that he has taken to stabilise electricity prices after privatisation? Will he

I also intend to lay at the same time an order setting the initial non-fossil fuel obligation for the public electricity supply companies. The intention of the obligation is not only to ensure that existing and committed nuclear plant in England and Wales is contracted for; it is also to encourage the development of commercial renewable energy sources. Around 300 projects have been put forward to the area boards in response to that policy. The Government have been extremely encouraged by this response and wish to ensure a full contribution from renewables to the NFFO. Given the size of the response, it has not been possible to assess all those projects fully by the time the initial order needs to be made.

Accordingly, the initial order will cover only nuclear capacity. I intend to allow a further two months for the area boards to complete their negotiations with renewable operators and I shall then lay a second order relating specifically to renewables. That will ensure that renewables projects can be assessed fairly and a proper contribution obtained.

The initial order will, therefore, amount to some 8,000 MW or so in toal for the period 1990-91 to 1997-98. As I told the House on 9 November, the Government will review the prospects for nuclear power in 1994. Decisions about the level of the obligation beyond 1998 will be taken then.

Returning to the licences, the conditions on security of supply have been amended to ensure that all suppliers meet the current standards of security, except where their customers choose otherwise. Suppliers may meet that condition by becoming members of the new electricity trading pool that is being established since the price of electricity in the pool will include a capacity charge that reflects the value of secure supplies to customers. Suppliers will have economic incentives to ensure sufficient generating plant is available. I believe that that approach will provide secure supplies more effectively than central planning by a monopoly supplier.

As for competition in supply, the licences now incorporate provisions to implement the decisions announced on 29 September 1989. Those provide for an orderly and stable transition to a fully competitive market by allowing other suppliers to compete with the area supply companies for customers taking more than 1 MW at the outset, for customers taking more than 100 kW after four years, and for all customers after eight years.

The licences, therefore, contain corresponding transitional constraints on the premises which such competitors can supply. If they apply for licences to supply customers falling within those restrictions, I will look to the Director General of Electricity Supply to advise me on whether such licences should be issued.

Although I shall be disposed to act in accordance with the restrictions announced on 29 September, I accept that I will need to exercise discretion to deal with particular circumstances that already exist or may arise. Such cases will be considered on their merits. The licences also contain transitional limits on the extent to which National Power and PowerGen can engage in direct sales to enable competition in supply and new supply arrangements to develop.

The arrangements that I have set out today mark the successful achievement of another stage in this privatisation. When the new companies are vested on 31 March, this country will have the most competitive electricity supply industry in the world. I know that those in the industry are keen to be privatised to respond to the new challenges and to rid themselves of the dead hand of the public sector. I am sure also that the public will welcome the benefits of competition and will seize the opportunities to invest in the new companies.

Mr. Frank Dobson (Holborn and St. Pancras): I thank the Secretary of State for his statement. I realise that my first point is not a matter for him, but will he confirm for the benefit of my Scottish colleagues that a statement on what is to happen to the electricity industry in Scotland will be made in the House.

The Secretary of State told us about his amazing $RPI-X+Y$ formula, but there must be a more important definition of Y. Everyone in the country will want to know why it is necessary for there to be any electricity price increases. Will he confirm that price increases are quite unnecessary and are needed only to fatten up the industry for privatisation? Is it not the case that, over the past three years, coal prices have gone down by 6 per cent., electricity prices have gone up by 12 per cent., the generating board's profits have gone up by 90 per cent., and the new coal contract envisages further reductions in the price of coal? So why is it necessary to have any price increases for consumers?

The Secretary of State is an accountant and he is usually fairly precise, but his statement was rather vague about price increases to be faced by major industrial consumers in particular, such as the special steels industry, the chemicals industry and paper and board mills. Will he guarantee that he will not handicap those companies by enormous price increases in the run-up to 1992? What will be the increases for domestic consumers in future years?

Will the Secretary of State confirm that a nuclear levy of 10·6 per cent. means that nuclear power costs must now be at least 40 per cent. more than the cost of electricity produced at conventional stations? If that is the case, why does he insist that the most expensive stations on the system provide the base load while the cheapest power stations on the system are not run all the time? Surely that is the reverse of common sense.

I hope that the Secretary of State will forgive my colleagues and me if we do not comment on the licences, because we have had the details only since 3 o'clock and we have not had an opportunity to consider them in detail. However, do the licences place an obligation to supply upon the two main generating companies? If not, how can there be any guarantee of security of supply? Will the licences promote energy conservation by the distribution companies? Will they require the generating companies to install equipment to clean up flue gases, or is there truth in the rumour that the right hon. Gentleman is allowing the generating companies to wriggle out of their obligation to clean up flue gases? In other words, is it true that he is willing to accept them continuing in their present dirty ways, as they have for the past two decades, to make the industry more attractive to private purchasers?

We welcome the news that there are many applications for renewables, but will the Secretary of State reconsider the position and allow combined heat and power to be included in that category, and thus give it the boost that it needs?

Finally, will the Secretary of State confirm that everything in his statement amounts to him putting privatisation first, and that the interests of industrial consumers, the balance of payments, the environment and

[Sir Ian Lloyd]

analysis of sub-Saharan Africa in the recent report of the World Bank, would not it be extremely stupid to go along the lines suggested by Mr. Mandela and strengthen sanctions, when as my right hon. Friend said, the South African economy is the powerhouse of the whole of sub-Saharan Africa? That is what we must now recognise and support.

Mr. Waldegrave: I find my hon. Friend's analysis rather attractive. The present circumstances have their parallels: the extremists on both sides sometimes end up in the same position. I have never been able to understand why it should be thought that damaging the economy of South Africa further would bring about any progress at such a juncture.

My hon. Friend asked about Mr. Mandela and sanctions. Mr. Mandela has made it perfectly clear that he is a loyal member of the ANC, and the view that he has expressed is ANC policy. No one imagined that he would change ANC policy overnight, and there was no surprise whatever when he took the stance that he took.

Mr. Tony Benn (Chesterfield): Is the Minister aware that the Prime Minister's view—reflected in his answer—is open to a wholly different interpretation: that apartheid is a system of economic exploitation, made possible by the denial of political rights, and that the profits from it accrue to foreign investors, many of whom live in this country? The Government's opposition to sanctions has been motivated more by a wish to preserve the economic interests of their business friends than by any interest in the Africans themselves?

Mr. Waldegrave: Not for the first time, the right hon. Gentleman has the wrong conspiracy theory. If he wants to examine the way in which economic pressures are affecting the position, he should recognise that it is perfectly clear that those who want dialogue and fundamental change in South Africa are now to be found among South Africa's business community. They know that without the use of all the country's resources—including both blacks and whites—the economy will begin to be damaged, and they are a force for progress.

Mr. Michael Knowles (Nottingham, East): Let me follow up what my hon. Friend the Member for Havant (Sir Ian Lloyd) said about the World Bank report. There is only one democratic country in the whole of Africa, and that is Botswana. We can see Namibia becoming independent next month, and we have high hopes of freedom in South Africa. Will the British Government then press for the abolition of the one-party state in Zimbabwe, Zambia and Tanzania?

Mr. Waldegrave: The World Bank report makes depressing reading. The great prize in southern Africa is a peaceful transition of Africa's most powerful economy to its proper ownership—ownership by all South Africa's people. We believe that Mr. Mandela wants that, and that Mr. de Klerk is entering on the great task. We welcome what Mr. de Klerk has done, and for that reason we support him.

Electricity Privatisation

3.57 pm

The Secretary of State for Energy (Mr. John Wakeham): With permission, Mr. Speaker, I should like to make a statement about electricity privatisation, the publication of the draft regulatory licences for the industry and the non-fossil fuel obligation.

Good progress continues to be made in preparing the electricity supply industry for vesting on 31 March. The House will be aware that the second commencement order under the Electricity Act 1989 was made at the end of January. Today I am taking another important step towards completing the restructuring of the industry.

I have today made available to the House copies of revised drafts of the licences to be issued to the successors of the Central Electricity Generating Board and area electricity boards, which were initially published on 10 January 1989. The revised drafts take account of the commitments made during the passage of the Electricity Act, and of consultations since the original drafts were published. Other licensees will receive licences based on those drafts, but tailored to their particular requirements. Regulations are being laid today setting out how to apply for a licence and the details of the application procedure. The exemption order identifying those who will not require a licence is also being tabled today.

The principal changes in the draft licences published today are in the conditions dealing with price control, security of supply and the transition to a competitive market. The revised conditions are explained in detail in the explanatory notes that accompany the licences.

The average price for all customers supplied by the public electricity supply companies will be controlled by an RPI – X + Y formula, where Y represents the actual costs to the companies of purchasing the electricity supplied. Customers taking more than 1 MW will benefit from the competition in supply that will be introduced by privatisation. I expect many of them to enjoy price reductions. It may take some time for customers to gain experience of the market and negotiate terms. I have therefore sought an undertaking from the industry that it will use its best endeavours to offer a one-year real price freeze to customers taking more than 1 MW.

Customers taking less than 1MW will benefit from an addition to the price control. Although the industry has yet to propose a final figure, I see no reason why the average price to these customers should rise by much more than the current rate of inflation this year. The price control should prevent any further real increases before the end of March 1993. Indeed, the public electricity supply companies could well be able to offer some real price reductions to these customers in this period.

I believe that the combination of these controls will be more effective than the yardstick price control proposed in the original draft licences. Altogether I do not expect the average price for all customers to rise in real terms this year.

All of these expectations on prices allow for the effect of the fossil fuel levy, which I intend to set for 1990-91 at a rate of 10·6 per cent. on the value of final sales. I expect the rate of levy to decline significantly over the next eight years. I shall be laying regulations under which the levy will be established and collected shortly.

Union has contributed—many other things have also contributed—to the change in atmosphere. We are well aware that the advice of the Soviet Union to the ANC, the South-West Africa People's Organisation and other organisations in southern Africa has been to seek dialogue and peace.

Mr. Stanley Orme (Salford, East): Will the Minister reconsider his remarks about the white backlash sweeping away President de Klerk? Should not he be more positive in his approach to the liberal whites and the black majority in South Africa? Were not his earlier remarks very unfortunate?

Mr. Waldegrave: If I spoke with urgency, I meant it. The person who is under most immediate pressure from his constituency is President de Klerk, which is why it is right that we should signal to him that there are benefits for his constituency in going down the road to peace and dialogue.

Mr. Nicholas Soames (Crawley): Will my right hon. Friend encourage, in every international forum that he attends, a full and generous response from the international community to the fundamental changes that have taken place in South Africa, and which need to take place in the future? Does he agree that the hopes and aspirations of the black community in South Africa will be best served by peaceful and steady reform and not by a headlong rush into what may be a very dangerous period?

Mr. Waldegrave: The challenge facing all sides is to transfer the most powerful economy in Africa to its rightful owners—all the people of South Africa—under a proper constitution and without revolutionary chaos in the process. I agree with what my hon. Friend said about that. The steps that have been taken by Mr. de Klerk, which have transformed the situation away from the simple certainties of the past few years and to which we are already seeing a response from Mr. Mandela, deserve our wholehearted support.

Ms. Diane Abbott (Hackney, North and Stoke Newington): Is the Minister aware that it will have been noted that he went out of his way to praise the courage of President de Klerk but said nothing about the courage of the tens of thousands of people who struggled for a generation to bring about yesterday's historical event? Is the right hon. Gentleman aware that the Prime Minister is widely regarded in this country and abroad as a fifth columnist for apartheid? In her headlong rush to drop sanctions before there has been a word from de Klerk about bringing down the fundamentals of apartheid and about one person, one vote, is not she—like collaborators and fifth columnists throughout time—exposed as redundant, marginal and out of step?

Mr. Waldegrave: I do not agree with the extravagance of the hon. Lady's language. The importance of the events in South Africa should not be underestimated. It is easy to imagine this opportunity being lost because we do not rise to the scale of the events but stick to the old rhetoric—that is the danger which faces us. My right hon. Friend the Prime Minister is as determined as any of us in the House to see the destruction of apartheid. We need, therefore, to get negotiations under way quickly, and that is what Mr. de Klerk is doing. Hon. Members have paid tribute many times to those who have suffered and who continue to suffer under apartheid. It is worth thinking of those people in South Africa who are not alive today and who could have contributed to this process of peace. If Mr. Steve Biko were alive today, he would contribute to the process of reconciliation and negotiation.

Mr. Cyril D. Townsend (Bexleyheath): I welcome the call by my right hon. Friend the Foreign Secretary for a measured response to this historic event. That response should be co-ordinated to the maximum extent with our European Community partners, the Commonwealth and, in particular, the United States, which has taken a strong line on sanctions. Does my right hon. Friend agree that sanctions were imposed not for the release of one distinguished and courageous leader from prison but to help bring down a system that was seen as unjust by the international community?

Mr. Waldegrave: My hon. Friend is right—the objective of the House and of the world is the destruction of apartheid. It is vital to get negotiations going. In 1986, the Council of Minister reaffirmed

"the urgent need for a genuine national dialogue"

in South Africa and proposed various sanctions to bring that about. We believe, as Mr. Mandela clearly believes, that that national dialogue is about to begin.

Several Hon. Members *rose*——

Mr. Speaker: Order. I remind the House that this is a day for private Members' motions and that an important statement is to follow this private notice question. I shall call two more Members from each side, and then I am afraid that we must move on.

Dr. Dafydd Elis Thomas (Meirionnydd Nant Conwy): The Minister of State referred a number of times to giving "signals" to the present regime in South Africa. Is not the concern throughout the House, including that of the hon. Member for Bexleyheath (Mr. Townsend) about the fact that the Government are contributing to confusing signals? As the right hon. Gentleman is a strong advocate of a common foreign policy in the European Community, will he assure us that the British Government will not take position with the Council of Ministers whereby it seeks to withdraw any sanctions at this stage? Does the right hon. Gentleman accept that there is no parallel between the democratic movement in central and eastern Europe and the changes in South Africa? The South African regime is based on institutional racism. That is qualitatively different from any other lack of democracy worldwide.

Mr. Waldegrave: The lack of democracy in Stalinist Russia was built on institutionalised persecution of the population by a so-called vanguard. The institutional racism of South Africa is an equal or greater evil. Both are evils, and we should welcome the destruction of both.

The hon. Gentleman asked me about the European Community. We will discuss these matters with our partners, but we do not believe that it would be right at this moment to send no signal to the South African Government.

Sir Ian Lloyd (Havant): I give the warmest possible endorsement to my right hon. Friend's analysis and the sentiments that he expressed. Does he agree that the three greatest dangers now are the extremism of the extreme Right, the extremism of the extreme Left and the extremism of the extremely stupid? In the light of the

Mr Slw
c. PU

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

12 February 1990

Dear Steve,

ELECTRICITY PRIVATISATION: SPECIAL SHARES

The Prime Minister has seen and noted the Financial Secretary's letter of 9 February to the Secretary of State for Energy concerning the implications of the decision to hold the nuclear stations in the public sector for the special shares arrangements to apply to the privatised electricity companies.

I am copying this letter to John Neilson (Department of Energy), Jim Gallagher (Scottish Office) and Martin Stanley (Department of Trade and Industry).

Yours,
Paul
(PAUL GRAY)

R

Steven Flanagan, Esq.,
Financial Secretary's Office,
HM Treasury.

RESTRICTED

cc D/C
①
Press
DM.

THE RT HON JOHN WAKEHAM MP

SECRETARY OF STATE FOR ENERGY

Department of Energy
1 Palace Street
London SW1E 5HE

01 238 3290

Paul Gray Esq
Private Secretary to
The Prime Minister
10 Downing Street
LONDON
SW1

12 February 1990

Dear Paul

STATEMENT ON ELECTRICITY PRIVATISATION

I attach a revised draft statement on electricity privatisation which my Secretary of State intends to make this afternoon. Copies of this letter are being sent to Sonia Phippard, Gillian Kirton, Stephen Wall, John Gieve, Martin Stanley, Jim Gallacher, Stephen Catling, Murdo MacLean and Bernard Ingham.

Yours
John

J S NEILSON
Principal Private Secretary

RESTRICTED

STATEMENT

With permission, Mr Speaker, I should like to make a statement about electricity privatisation, the publication of the draft regulatory licences for the industry and the Non-Fossil Fuel Obligation.

Good progress continues to be made in preparing the electricity supply industry for vesting on the 31 March. The House will be aware that the Second Commencement Order under the Electricity Act 1989 was made at the end of January.

Today I am taking another important step towards completing the restructuring of the industry. I have today made available to the House copies of revised drafts of the licences to be issued to the successors of the CEGB and Area Electricity Boards which were initially published on 10 January 1989. The revised drafts take account of commitments made during the passage of the Electricity Act and consultations since the original drafts were published.

Other licensees will receive licences based on these drafts but tailored to their particular circumstances. Regulations are being laid today setting out how to apply for a licence and the details of the application procedure. The exemption Order identifying those who will not require a licence is also being tabled today.

The principal changes in the draft licences published today are in the conditions dealing with price control, security of supply and the transition to a competitive market. The revised conditions are explained in detail in the explanatory notes that accompany the licences.

The average price for all customers supplied by the public electricity supply companies will be controlled by an RPI-X+Y formula, where Y represents the actual costs to the companies of purchasing the electricity supplied.

Customers taking more than 1 MW will benefit from the competition in supply that will be introduced by privatisation. I expect many of them to enjoy price reductions. It may take some time for customers to gain experience of the market and negotiate terms.

I have therefore sought an undertaking from the industry that they will use their best endeavours to offer a one year real price freeze to customers taking more than 1 MW.

Customers taking less than 1MW will benefit from an addition to the price control. Although the industry has yet to propose a final figure, I see no reason why the average price to these customers should rise by much more than the current rate of inflation this year. The price control should prevent any further real increase before the end of March 1993. Indeed the public electricity supply companies could well be able to offer some real price reductions to these customers in this period.

I believe the combination of these controls will be more effective than the yardstick price control proposed in the original draft licences. Altogether, I do not expect the average price for all customers to rise in real terms this year.

All of these expectations on prices allow for the effect of the fossil fuel levy, which I intend to set for 1990/91 at a rate of 10.6% on the value of final sales. I expect the rate of levy to decline significantly over the next eight years. I shall be laying the regulations under which the levy will be established and collected shortly.

I also intend to lay at the same time an Order setting the initial Non-Fossil Fuel Obligation for the public electricity supply companies. The intention of the Obligation is not only to ensure that existing and committed nuclear plant in England and Wales is contracted for. It is also to encourage the development of commercial renewable energy sources. Around 300 projects have been put forward to the Area Boards in response to this policy. The Government has been extremely encouraged by this response and wishes to ensure a full contribution from renewables to the NFFO.

Given the size of the response, it has not been possible to assess all these projects fully by the time the initial Order needs to be made.

Accordingly, the initial Order will cover only nuclear capacity. I intend to allow a further two months for the Area Boards to complete their negotiations with renewable operators and I shall then lay a second Order relating specifically to renewables. This will ensure that renewables projects can be assessed fairly and a proper contribution obtained.

The initial Order will, therefore, amount to some 8000 MW or so in total for the period 1990-91 to 1997-98. As I told the House on 9 November the Government will review the prospects for nuclear power in 1994. Decisions about the level of the obligation beyond 1998 will be taken then.

Returning to the licences, the conditions on security of supply have been amended to ensure that all suppliers meet the current standards of security, except where their customers choose otherwise.

Suppliers may meet this condition by becoming members of the new electricity trading pool that is being established since the price of electricity in the pool will include a capacity charge that reflects the value of secure supply to customers. Suppliers will have economic incentives to ensure sufficient generating plant is available. I believe this approach will provide secure supplies more effectively than central planning by a monopoly supplier.

As for competition in supply, the licences now incorporate provisions to implement the decisions announced on 29 September 1989.

These provided for an orderly and stable transition to a fully competitive market by allowing other suppliers to compete with the area supply companies for customers taking more than 1 MW at the outset, for customers taking more than 100 kW after four years and for all customers after eight years.

The licenses, therefore, contain corresponding transitional constraints on the premises which such competitors can supply. If they apply for licences to supply customers falling within these restrictions, I will look to the Director General of Electricity Supply to advise me on whether such licences should be issued.

While I shall be disposed to act in accordance with the restrictions announced on 29 September, I accept that I will need to exercise discretion to deal with particular circumstances that already exist or may arise. These cases will be considered on their merits. The licences also contain transitional limits on the extent to which the National Power and PowerGen can engage in direct sales to enable competition in supply and new supply arrangements to develop.

The arrangements that I have set out today mark the succesful achievement of another stage in this privatisation.

When the new companies are vested on 31 March, this country will have the most competitive electricity industry in the world. I know that those in the industry are keen to be privatised to respond to the new challenges and to rid themselves of the dead hand of the public sector. I am also sure that the public will welcome the benfits of competition and will seize the opportunity to invest in those companies.

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cc PU.

CONFIDENTIAL

Treasury Chambers, Parliament Street, SW1P 3AG

Prime Minister²

Seems a sensible response to the new electricity structure.

PRCG 9/2

The Rt Hon John Wakeham FCA JP MP
Secretary of State for Energy
Thames House South
Millbank
LONDON
SW1P 4QJ

9 February 1990

Dear John

ELECTRICITY PRIVATISATION: SPECIAL SHARES

Colleagues agreed last year on a special shares package covering the water and electricity industries. This included permanent special shares in National Power (NP) and the Scottish companies, which was mainly a reflection of their nuclear assets. And it was decided to place PowerGen on the same footing as NP.

However, we have now decided to hold the nuclear stations back from the sale. So that rationale for permanent special shares ceases to apply. I therefore suggest that we extend to the generators and the Scottish companies, special shares of the form agreed for the distribution companies, which limit individual shareholdings to 15 per cent, and which are automatically redeemed after 5 years.

This would help achieve the aim of creating a framework for a competitive industry to evolve. A permanent special share in a company shelters it from the threat of takeover, which in a commercial environment is a necessary incentive to management efficiency, as well as prolonging the period during which the Government may be placed at the awkward position of choosing between bidders. It may also reduce the ability of the companies in the long term to raise capital in the markets. Furthermore, the UK is seeking to persuade the EC to take steps to reduce the barriers to takeover in the Community; the fewer barriers we erect ourselves, the more credible our message will be.

The arrangement I propose would be sufficient to protect the companies from predators during the initial period of adjustment to the new industry structure, and private sector environment. After this initial period, the regulatory regime and the normal

FINANCIAL SECRETARY TO THE TREASURY

mergers supervision under the Fair Trading Act will together be sufficient to meet any strategic considerations, while allowing the evolution of a competitive sector free of permanent controls on ownership.

I am sending copies of this letter to the Prime Minister, Malcolm Rifkind and Nicholas Ridley.

Yours ever

Peter

PETER LILLEY

CCU

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FINANCIAL SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SWIP 3AG

Rt Hon John Wakeham MP
Secretary of State for Energy
Department of Energy
1 Palace Street
Victoria
LONDON
SW1E 5HE

NBPM
PRCG
13/2

9 February 1990

Dear Secretary of State,

ELECTRICITY PRIVATISATION: DRAFT LICENCES

You wrote to John Major on 7 February about ~~publishing~~ the draft electricity licences.

I note that the licences now contain a requirement on the generators to produce separate accounts for their separate businesses. This must be right. It is important that the electricity market develops competitively and we cannot be sure yet of the degree of market power that the generators will have in practice. The correct way forward must be to ensure that the Director has sufficient information at his disposal to detect any abuses by the incumbent generators, particularly with regard to cross-subsidisation and non-discrimination. Separate accounts will provide a useful source. In the longer term, of course, it will be for the Director to decide what information he needs to carry out his duties best.

So I agree with you that these licences provide a satisfactory basis on which we can proceed, and I am therefore content for you to publish them, as drafted, on Monday 12 February.

Yours sincerely,

pp **PETER LILLEY**
(approved by the Financial Secretary and signed in his absence)

NAT IND:
GAS + Elec Pt 18

cc DM
Press
Political
Stc.
Q.

THE RT HON JOHN WAKEHAM MP

SECRETARY OF STATE FOR ENERGY

RA

Department of Energy
1 Palace Street
London SW1E 5HE

01 238 3149

Prime Minister
The main focus of attention seems likely to be what is said about prices.

Paul Gray Esq
Private Secretary to
The Prime Minister
10 Downing Street
LONDON
SW1

9 February 1990

PRG 9/2

Dear Paul

STATEMENT ON ELECTRICITY PRIVATISATION

As you know my Secretary of State intends to make a statement this Monday on electricity privatisation.

I attach a copy of the first draft of his statement and will let you have a further copy Monday morning if it is revised over the weekend. Copies of this letter have been sent to Sonia Phippard, Gillian Kirton, Stephen Wall, John Gieve, Martin Stanley, Jim Gallacher, Stephen Catling, Murdo Maclean, and Bernard Ingham.

Yours

pp JOHN NEILSON

DRAFT STATEMENT

With permission, Mr Speaker, I should like to make a statement about electricity privatisation, the publication of the draft regulatory licenses for the industry and the Non-Fossil Fuel obligation.

Drafts of the licences to be issued to the successors of the CEGB and area electricity boards were published on 10 January 1989. I have today made available to the House copies of revised drafts. These take account of commitments made during the passage of the Electricity Act and consultations since the original drafts were published.

Other licensees will receive licences based on these drafts but tailored to their particular circumstances. Regulations are being laid today setting out how to apply for a licence and the details of the application procedure. The exemption Order identifying those who will not require a licence is also being tabled today.

The principal changes in the draft licences published today are in the conditions dealing with price control, security of supply and the transition to a competitive market. The revised conditions are explained in detail in the explanatory notes that accompany the licences.

The average price for all customers supplied by the area companies will be controlled by an RPI-X+Y formula, where Y represents the actual costs to the companies of purchasing the electricity supplied. Customers taking more than 1 MW will benefit from the competition in supply that will be introduced by privatisation. I expect many of them to enjoy price reductions. It may take some time for customers to gain experience of the market and negotiate terms. I have therefore sought an undertaking from the industry that they will use their best endeavours to offer a one year real price freeze to customers taking more than 1 MW.

Customers taking less than 1MW will benefit from an addition to the price control. I see no reason why the average price to these customers should rise by much more than the current rate of inflation this year. The price control should prevent any further real increase before the end of March 1993.

I believe the combination of these controls will be more effective than the yardstick price control proposed in the original draft licences.

All of these expectations on prices allow for the effect of the fossil fuel levy, which will be set for 1990/91 at a rate of 10.6% on the value of final sales. I expect the rate of levy to decline significantly over the next eight years. I shall be laying the regulations under which the levy will be established and collected later this week.

I shall also be laying later this week an Order setting the initial Non-Fossil Fuel Obligation for the public electricity supply companies. The intention of the Obligation is not only to ensure that existing and committed nuclear plant is contracted for. It is also to encourage the development of commercial renewable energy sources. Around 300 projects have been put forward to the Area Boards in response to this policy. The

Government has been extremely encouraged by this response and wishes to ensure a full contribution from renewables to the NFFO. Given the size of the response, it has not been possible to assess all these projects fully by the time the initial Order needs to be made.

Accordingly, the initial Order will cover only nuclear capacity. I intend to allow a further two months for the Area Boards to complete their negotiations with renewable operators and I shall then lay a second Order relating specifically to renewables. This will ensure that renewables projects can be assessed fairly and a proper contribution obtained. It is, however, clear that sufficient capacity is likely to come forward to fill the initial tranche set aside for renewables in the Obligation.

The initial Order, which will amount to some 8000 MW or so in total for the period 1990-91 to 1997-98 will ensure that all existing nuclear plant is contracted for for their planned lifetimes. This will maintain the valuable contribution nuclear power makes to diversity of energy supply throughout most of the 1990's. As I told the

House on 9 November the Government will review the prospects for nuclear power in 1994. This will include the level of the obligation beyond 1998.

Returning to the licences, the conditions on security of supply have been amended to ensure that all suppliers meet the current standards of security, except where their customers choose otherwise. Suppliers may meet this condition by becoming members of the new electricity trading pool that is being established since the price of electricity in the pool will include a capacity charge that reflects the value of secure supply to customers. Suppliers will have economic incentives to ensure sufficient generating plant is available. I believe this approach will provide secure supplies more effectively than central planning by a monopoly supplier.

As for competition in supply, the licences now incorporate provisions to implement the decisions announced on 29 September 1989. These provided for an orderly and stable transition to a fully competitive market by allowing other suppliers to compete with the area supply companies for customers taking more than 1 MW at the outset, for customers taking more than 100 kW after four years and for all customers after eight years.

The licenses, therefore, contain corresponding transitional constraints on the premises which such competitors can supply. If they apply for licences to supply customers falling within these restrictions, I will look to the Director General of Electricity Supply to advise me on whether such licences should be issued. While I shall be disposed to act in accordance with the restrictions announced on 29 September, I accept that I will need to exercise discretion to deal with particular circumstances that already exist or may arise. These cases will be considered on their merits. The licences also contain transitional limits on the extent to which the National Power and PowerGen can engage in direct sales to enable competition in supply and new supply arrangements to develop.

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cc PS

SCOTTISH OFFICE
WHITEHALL, LONDON SW1A 2AU

NBM

RRCB
12/2

The Rt Hon John Major MP
Chancellor of the Exchequer
HM Treasury
Treasury Chambers
LONDON
SW1P 3AG

9 February 1990

Dear Chancellor,

ELECTRICITY PRIVATISATION: DRAFT LICENCES

I have seen John Wakeham's letter of 7 February setting out the proposed licensing regime for the ESI successor companies in England and Wales. I understand that John wishes to make a formal statement when publishing these licence documents on Monday of next week.

My officials have kept in contact with those at the Department of Energy during the development of the licensing regime both north and south of the border; and we have tried to ensure a consistency of approach given the GB nature of the regulatory regime as it applies to the GB competitive market. I am therefore happy with the framework now proposed for England and Wales and for John to proceed with his statement next week as proposed. My officials are in contact with John's over the form of that statement.

Inevitably, the finalisation of the licensing regime in Scotland will have to take account of the structure now developed for England and Wales and this, coupled with a number of purely Scottish issues which have had to be resolved in the licensing context, means that publication of the draft Scottish licenses will take a little more time. I hope however to have all outstanding issues resolved soon with the aim of publishing our licenses by the end of this month. I will wish to consider making a statement at that stage and will consult colleagues over the proposed licensing framework and pricing issues for Scotland beforehand. So far as initial prices and price regulation are concerned, we are in discussion with the industry and I shall come forward with proposals shortly. My officials are keeping yours in touch with our thinking as it develops.

I note that it is the intention to make the licence application regulations and the licence exemption order at the same time as the statement. Both documents are of GB application and have been signed by John and myself in our respective capacities in relation to the industry in Scotland and in England and Wales.

MCN06103.020

I am copying this letter to the Prime Minister, Nicholas Ridley, John Wakeham, Chris Patton, Brian Griffiths and Sir Robin Butler.

Yours sincerely

Ken Wright

pp MALCOLM RIFKIND

(Approved by the Secretary of State and signed in his absence)

MCN06103.020

NAT IND: Gas + Elec
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dti
the department for Enterprise

The Rt. Hon. Nicholas Ridley MP
Secretary of State for Trade and Industry

cc. P. U.

CONFIDENTIAL

The Rt Hon John Wakeham MP
Secretary of State for Energy
Department of Energy
1 Palace Street
LONDON
SW1P 3AG

Department of
Trade and Industry

1-19 Victoria Street
London SW1H 0ET

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NBPM

RMG 9/2

Direct line
Our ref 215 5622
Your ref PE4AMS
Date 9 February 1990

Dear John

ELECTRICITY PRIVATISATION: DRAFT LICENCES

I have seen your letter of 7 February enclosing the latest drafts of the electricity licences for the ESI successor companies.

I am content with your wish to publish the draft licences and make the announcement. I am also content with the licence applications regulations and the licence exemption order.

I am copying this letter to the Prime Minister, John Major, Malcolm Rifkind, Chris Patten, Brian Griffiths and Sir Robin Butler.

Yours ever

Nicholas

CEPG

2 MARSHAM STREET
LONDON SW1P 3EB
01-276 3000

NBPM

PRG
9/2

My ref

Your ref

The Rt Hon John Wakeham MP
Secretary of State
Department of Energy
Thames House South
Millbank
LONDON
SW1P 4QJ

9 February 1990

Dear Secretary of State

ELECTRICITY PRIVATISATION: DRAFT LICENCES

Thank you for sending me a copy of your letter of 7 February to John Major enclosing copies of the draft licences to be issued to the ESI successor companies.

In the time allowed for comments it has obviously not been possible for my officials to examine the documents in detail. However my main concern is that energy efficiency should be encouraged as much as energy use, and I trust that the licences will be sufficiently flexible to allow offers of least-cost planning services to develop.

I am copying this letter to the Prime Minister, John Major, Nicholas Ridley, Malcolm Rifkind, Brian Griffiths and Sir Robin Butler.

Yours sincerely

R Bright

CHRIS PATTEN

PP (approved by the Secretary of State and signed in his absence)

Recycled Paper

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CONFIDENTIAL

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c:\ elec. GAM
bc: BG

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

8 February 1990

Dear John,

ELECTRICITY CONTRACTS, PRICES AND PROCEEDS

The Prime Minister was grateful for your Secretary of State's minute received in this office on 29 January, and has also seen the response from the Financial Secretary dated 5 February. The Prime Minister has noted these exchanges without comment.

I am copying this letter to John Gieve (Treasury), Martin Stanley (Department of Trade and Industry), Jim Gallagher (Scottish Office) and to Sonia Phippard (Cabinet Office).

Yours,
Paul

PAUL GRAY

John Neilson Esq
Department of Energy

CONFIDENTIAL

cc PU (letter only)

THE RT HON JOHN WAKEHAM MP

Department of Energy
1 Palace Street
London SW1E 5HE
01 238 3290

NBPM

ACG 8/2

The Rt Hon John Major MP
Chancellor of the Exchequer
H M Treasury
Treasury Chambers
LONDON
SW1P 3AG

7 February 1990

Dear John

ELECTRICITY PRIVATISATION: DRAFT LICENCES - in attached folder

Last January we published drafts of the electricity licences which would be issued to the ESI successor companies. Substantial progress has been made with our proposals since then. The successful passage of the Electricity Act, the settlement of the underlying contractual framework and the agreement to a transitional package which allows for the progressive development of full competition in the electricity market have all been reflected in the latest drafts of the licences which I now enclose.

These drafts are the culmination of intensive discussions with the industry as well as taking account of the concerns of other parties. We have also taken appropriate soundings of the Director General of Electricity Supply and officials from the principal Departments concerned.

I believe the drafts now provide a satisfactory basis on which we can proceed. Given the need to give clear signals in advance of vesting to other players in the industry who may require licences, or who wish to consider and organise alternative supply arrangements, it is my intention to publish these licences as soon as possible. They would form part of a broader announcement on electricity pricing which I propose to make next week, and would also be accompanied by the licence applications regulations and the licence exemption order which

SECRETARY OF STATE FOR ENERGY

I plan to lay on or around that day. Copies of the revised drafts are therefore enclosed for your early clearance. I would welcome any comments by Friday 9 February.

I am copying this letter to the Prime Minister, Nicholas Ridley, Malcolm Rifkind, Chris Patten, Brian Griffiths and Sir Robin Butler.

Yours ever

John

JOHN WAKEHAM

PRIME MINISTER

ELECTRICITY CONTRACTS, PRICES AND PROCEEDS

John Wakeham has now finalised his proposals for electricity contracts, and proposes to make a Parliamentary statement next week. He is planning to mention this in Cabinet tomorrow. I have not previously shown you his latest minute (flag A) setting out the conclusion that the best way of dealing with large electricity users would be to provide a one year RPI+X cap on price increases. This seems a sensible outcome to both George Guise and me. The Financial Secretary (flag B) has now concurred, although he opposes the possibility of a further extension of the cap arrangement after the first year should there be pressure to do this.

pp. Diana Smith

PAUL GRAY
7 February 1990

C:\wpdocs\economic\cap (pmm)

fst.sb/fst/6.2.2.mlr.

CONFIDENTIAL

cc/u.

Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon John Wakeham MP
Secretary of State for Energy
Department of Energy
1 Palace Street
LONDON
SW1E 5HE

5 February 1990

Dear Secretary of State,

ELECTRICITY CONTRACTS: LARGE INDUSTRIAL USERS WITH PG

You sent to John Major a copy of your minute ~~of~~ 29 January to the Prime Minister.

I have no objection to your proposal to limit the cap for large users for 1 year, subject to any arrangement being financed, as previously envisaged, by a slightly higher than otherwise price in the franchise market, which in turn argues for keeping down the cost of the scheme in fixing its parameters.

You raise the possibility of extending this scheme at the end of the first year if we are subject to further lobbing then. I see no case for this. The cost would fall in one way or another directly on taxpayers, be wholly unacceptable to the competition authorities in Europe and here, and damage the credibility of any efforts by us to attack the cross subsidisation of large users by European electrical utilities.

I am copying this minute to the Prime Minister, Nicholas Ridley, Malcolm Rifkind and Sir Robin Butler.

Yours sincerely

pp PETER LILLEY
(approved by the Financial Secretary and signed in his absence)

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COPY NO 1 OF 7

PRIME MINISTER

ELECTRICITY CONTRACTS, PRICES AND PROCEEDS

Flap pt 17 Flap pt 18

On 21 December, I circulated proposals on the contracts to be signed between the Area Boards and generators. On 16 January, I wrote to the Chief Secretary about amendments to these proposals that had proved necessary to improve the generators' profitability.

After further discussion with the industry and correspondence with the Chief Secretary, we have now reached the stage where the Area Boards, National Power and PowerGen have agreed contract prices. The level of nuclear revenue has also been decided. There is still a lot to do in the next two weeks to turn these decisions into agreed portfolios of contracts between the twelve Area Boards and all three generators. However, I believe progress has been sufficient to enable vesting of the new structure to take place on 31 March.

You will recall that one area of concern about the contract proposals was their effect on intensive users, who might face price increases as large as 15% real. Last July, colleagues agreed that there was nothing that could be done to reduce such increases without risking challenge under UK and EC competition legislation. However, in the recent correspondence, I reported my intention to pursue with the industry the possibility of a three-year RPI+5 price cap for all users over 1 MW.

In discussion with the industry, it has been established that such an arrangement could be put in place. But it would be cumbersome and complex. And it would be unattractive to the Director General of Electricity Supply (DGES) and our financial advisers.

What is more important, the large users have made it clear that such a scheme would be very unattractive for them. They do not accept our forecasts of the market price or the need for any price increase. Since the new structure of the industry is not yet in place and the new pool or spot market is not operating, it is impossible to point to evidence that the market price requires an increase in their prices. That evidence will only become available and public over the first year's operation of the new structure.

I have therefore concluded that a one-year RPI+X cap on price increases for users over 1 MW would be a better solution. X will have to be set in the light of information on the number of customers affected, since the lower the permitted price increase the more customers will be affected and the greater the cost and complexity. However, I believe we should be able to set the cap below RPI+5, given that it is only a one-year deal. The advantages of this arrangement are:

(a) it should be possible to give large users a more acceptable price increase at April;

(b) it would give them a year to negotiate with the generators, the Scots, the French and different Area Boards or to consider their own generation schemes;

(c) it would meet the Government's policy of transferring all customers into a competitive market as soon as possible;

(d) it would mean that arguments about next year's price increase would take place against the background of tangible published evidence of the market price; and

(e) it would mean that these were arguments between suppliers, customers and the regulator, not arguments with Government.

As for the immediate argument in the next two months, I believe we should refuse to be drawn on price increases for 1991 and afterwards. We could justifiably say that we would not predict the market price of electricity.

A one-year cap would also be easier to implement. Since time is very short, I believe that is important. In the interests of further simplification, I also propose that this cap should be offered only by the Area Boards. It would greatly add to the complication to allow the generators to offer capped prices direct to customers. That is not to say that we would prevent them offering better prices if they felt able to do so, but I believe it is unlikely that they will.

Given the attitude of the large users, I see little alternative to a one-year deal and have told the industry that I will be seeking such an undertaking from the Area Boards. They are working up the necessary arrangements. If the situation at the end of the first year proved intolerable for large users, their first port of call would be the DGES. There would also be measures we could consider, such as the offering of cheap contracts by Nuclear Electric; but these would probably all need clearance with the UK and EC competition authorities and I believe we should view them only as a last resort.

I am copying this to John Major, Nicholas Ridley, Malcolm Rifkind and Sir Robin Butler.

John

SECRETARY OF STATE FOR ENERGY

Rec'd. 24 January 1990

NAT IND
Gas & Elec pt 18.

cc P/U.

THE RT HON JOHN WAKEHAM MP

Department of Energy
1 Palace Street
London SW1E 5HE
01 238 3290

The Rt Hon Norman Lamont MP
Chief Secretary
HM Treasury
Parliament Street
LONDON
SW1P 3AG

26 January 1990

Dear Norman,

ELECTRICITY CONTRACTS, PRICES AND PROCEEDS

Thank you for your letter of ~~24~~ January. You will also have seen Nicholas Ridley's letter of ~~19~~ January.

As you know, I am most reluctant to inflict real increases in electricity prices on the day the new structure of the industry is put in place and against the background of current concerns on inflation. However, our timetable does not permit any further delay. If you feel that the price increases implied by your proposals are necessary to protect public expenditure, I will acquiesce in a decision to set initial nuclear revenue at £2.1 billion in 1990/91 prices. Since we have to send the final notification of our proposals to the Commission as soon as possible, I cannot guarantee that it will be possible to find offsetting movements to deal with variations from the current projections in NE's costs and expenditure.

I can accept your proposal for the reduction in the levy over the 8 year period, so as to produce a 1997/8 price equivalent to a 8% real return on the current estimate of Sizewell costs. As you say this amounts to a reduction of some 4.50 percentage points in the levy. We have of course still to agree performance and other objectives for NE. I will certainly take your concerns into account when setting these, but we have not yet had NE's own assessment of what is possible in the immediate future. Any targets we set, however challenging, have to be realistic and to take account of the availability of funds for the investment that may be needed to achieve them.

I am copying this letter to the Prime Minister, Nicholas Ridley and Sir Robin Butler.

Yours ever

John

JOHN WAKEHAM

THE RT HON JOHN WAKEHAM MP

Department of Energy
1 Palace Street
London SW1E 5HE

01 238 3290

[illegible]

The Rt Hon Nicholas Ridley MP
Secretary of State for Trade and Industry
1-19 Victoria Street
LONDON
SW1H 0ET

26 January 1990

Dear Nick

ESI CONTRACTS, PRICES AND PROCEEDS

I owe you a reply to the points about price control in your letter of 4 January. — File with PG

I understand my officials have had some discussion with you on this subject and that your principal concern is the potential lack of competition in generation. I can see that insufficient competition in generation and full pass-through of generating costs in the price control would not be attractive for the Area Boards' franchise customers. But I think there are a number of answers to this concern:

- the initial contracts between the Area Boards, National Power and PowerGen will largely determine the input costs of the Boards for at least three years. We are approving these contracts. In that sense, generating prices will be regulated for the first three years or so;

- competition in generation and supply will develop and should be sufficient by the time the majority of contracts come up for renegotiation. Our decisions on pooling should help this by treating each power station as a single competing unit; but

- if there is evidence that the generators are abusing their position in the market, the DGES and Government can make use of the powers available under competition legislation.

I do not think we should use the price control applying to the Area Boards' successors to try to regulate monopoly behaviour by generators. That would expose the Area Boards to intolerable risks.

SECRETARY OF STATE FOR ENERGY

The proposal to apply a simple RPI-X constraint to the final prices charged by Area Boards to franchise customers demonstrates this. The initial three-year cap is possible only because of the coal agreements. By freezing the price of coal in real terms, these effectively remove most of the fuel price risk from Area Boards. It would not be sensible to assume that a similar RPI-X control could be put in place after the coal agreements have expired. If the Area Boards could not find generators and fuel suppliers willing to take the fuel price risk, such a control would inevitably expose them to the risk of bankruptcy, given that fuel costs are volatile and amount to almost half the cost of electricity. Such a control might well force the Area Boards to contract only with generators using British coal, on the basis that only British Coal would accept the fuel price risk; this would be a serious distortion of the market.

This leads on to the question of why we cannot apply an RPI-X+Y control to the franchise market alone. In principle, I accept that price controls should only apply to captive markets. However, you are aware of the problems of allocating costs between the franchise and non-franchise markets on a Board-by-Board basis. These include measurement and hypothecation across demand and time. It was partly their complexity that led me to abandon the yardstick. Ultimately, something along these lines may prove possible with metering developments, but in the meantime we need an overall structure which can be seen as potentially enduring into the medium term. Whether, on reviewing its operation, the Director chooses simply to reset a component of such control or adopt a new basis of control altogether is in any event a matter for him at the time: what is important now is to avoid a presumption that there will be wholesale change on an early time-scale.

I believe the RPI-X+Y formula, albeit on the market as a whole, achieves this objective. Moreover, it is of the right character for companies with large elements of costs over which they have no effective control.

As regards its effect on the non-franchise market, we need to look at what this means in practical terms. First, the RPI-X element imposes a degree of efficiency pressure on controllable costs. These are only a tiny fraction of the costs of supply to non-franchise customers, and I propose to make sure that they have an appropriate weighting in the RPI-X component itself by a relatively simple adjustment to the formula. This will mean that a PES will not be encouraged either to retain load at the expense of franchise customers, or to avoid meeting competitive pressures on prices in the non-franchise market. Second, the Y component caps only pass-through of generating costs in total: it does not mean that a PES must price up to the cap.

As far as franchise customers are concerned, the argument that the benefits of competition at the upper end of the market will extend to other customers through non-discrimination has some force - particularly since, like you, I am not disposed to make an early reduction in the level at which customers have a right to tariff

SECRETARY OF STATE FOR ENERGY

terms as well as the option of seeking a contract. Given this, and the choice between some regulatory stability and the prospect of complete and early changes to the rules as a whole, I would prefer to retain the overall ceiling. Clearly the non-discrimination conditions will be important, so that franchise customers are not exploited within the overall cap to the benefit of non-franchise customers. I think we have to rely on the DGES to enforce these conditions and to seek whatever information is necessary to do so.

Finally, although I am not keen to scrap the limits on successor generators' direct supply until it is demonstrated they will in practice create specific problems, I would like to keep this aspect under review for the present.

I hope you can now agree to my going forward on this basis. Copies of this letter go to recipients of yours.

Yours ever

John

JOHN WAKEHAM

NAT IND
Gas & electricity
Pt 18

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the department for Enterprise

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The Rt. Hon. Nicholas Ridley MP
Secretary of State for Trade and Industry

The Rt Hon John Wakeham MP
Secretary of State for Energy
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1 Palace Street
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Direct line 01 215 5622
Our ref JW4AGT
Your ref
Date 19 January 1990

NBPM
Pu6
19/1

Dear John

ELECTRICITY CONTRACTS, PRICING AND PROCEEDS

I have seen your letter to Norman Lamont of 16 January on electricity contracts, pricing and proceeds.

I am broadly content with your proposals. In particular, I should be concerned if the initial level of nuclear revenues were set so as to raise the average real level of customer prices.

I am copying this to the Prime Minister, John Major, Malcolm Rifkind, Norman Lamont and Sir Robin Butler.

Yours ever
Nicholas

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NAT IND: Gas + Elec Pt 18

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THE RT HON JOHN WAKEHAM MP

Department of Energy
1 Palace Street
London SW1E 5HE
01 238 3290

NB PM at this stage.

PRG 16/1

The Rt Hon Norman Lamont MP
Chief Secretary
HM Treasury
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

16 January 1990

Dear Norman

ELECTRICITY CONTRACTS, PRICING AND PROCEEDS

Thank you for your letter of 4 January, in which you argue that Nuclear Electric's initial level of revenue should be £2.25 billion, producing a 13% levy on the assumptions in my paper of 21 December. I have also seen Nicholas Ridley's comments on the subject in his letter of 4 January.

In the last week or so, we have been reviewing the contract proposals in the light of the latest information from the industry. Your officials have been closely involved. Our review has revealed that my paper of 21 December overstated the impact on prices of the contract proposals. The new figures suggest that it might be possible to raise the initial level of generator revenue by as much as £200 million without taking average price increases for all customers above 5-7%. All other things being equal, this would enable me to go some way to meeting your concern on nuclear revenue.

However, our review also shows that all other things are not equal. As I warned in my earlier paper, we have a problem with the profitability of the conventional generators. Our original analysis suggested that their combined post-tax profits would be as low as £375 million in 1990/1 and would grow by some 40% compound in real terms over the next three years. Both generators now argue that our projections of their costs and cash requirements are understated; that their initial level of post-tax profits is at the lower level of £300 million; that we have not taken full account of the financing burden of the FGD programme; and that we will not get proper value for the high rate of growth we are projecting. They also believe that our

SECRETARY OF STATE FOR ENERGY

underlying assumption that oil prices will rise by 4% real a year is too optimistic. On this basis, they believe their combined valuation will be less than £2 billion, and that this will be indefensible.

While I do not accept all their projections, I have concluded that we need to raise the initial level of National Power's and PowerGen's combined post-tax profits and reduce the subsequent rate of growth, so that we obtain better value. On a flat oil price assumption, for instance, it would require an increase of £300-350 million in our projections of the initial level of revenue to reduce the growth rate of post-tax profit to some 15%. On the generators' projections, a larger increase would be required. I believe the generators are exaggerating their costs to negotiate higher revenue, but it is clear that the present contract proposals must be significantly adjusted.

I also remain convinced that we need to mitigate the effects of the contract package on large users. The Area Boards' latest forecast is that the increases faced by their largest users will be 15-20% real and some transitional arrangement is clearly needed. Discussions with Professor Littlechild have indicated that he would prefer to avoid favoured treatment for particular users and that he believes it would be easier to defend a general cap on price increases for any user over the next three years. This cap would probably have to be set at RPI+5, subject to adjustment for fuel price movements. I believe the Area Boards, National Power and PowerGen will be willing to give an undertaking to offer any customer such an arrangement at the outset and I will be pursuing this approach with them and with the DGES. While it would involve some lower priced generating contracts, it should not require amendment to the coal agreement. The Government would be saying that the arrangement offered a transitional cap on price rebalancing, rather than a special deal for industrial customers, and we will have to ensure this approach can be accepted by the EC Commission.

Raising the conventional generators' profits will raise price levels generally. Restraining price increases to larger users will produce larger increases for other users. I am convinced that I will need to raise the generators' revenues by at least £200-300 million in the first year. The proposed cap on price rebalancing is likely to add £50-70 million, or some 0.5-1%, to the price increase we have been forecasting for franchise customers. Other things being equal, these two proposals will make it very difficult to meet our aim of keeping average price increases to all customers, and franchise customers in particular, in line with inflation. Adding on top the increase in levy you have proposed would make this impossible.

SECRETARY OF STATE FOR ENERGY

I have therefore reconsidered every element of the contract package to see whether there is any flexibility to meet your concerns on nuclear revenue by reducing revenue in other parts of the industry. After discussions with our financial advisers, I have reluctantly concluded that this would not maximise the benefits to public expenditure. If there is an overall price constraint, my conclusions on maximising benefits are as follows:

(a) prices for each part of the industry should be set at the maximum sustainable level;

(b) sustainable levels for the transmission and distribution monopolies will be set by the regulator. Our advisers have warned that investors may be concerned that returns above 6-7% may be regarded as potentially excessive by regulators. Accordingly, they cannot say that we would definitely get full value for any revenue in excess of a 6% real return on CCA assets;

(c) sustainable levels of generator prices will be determined by the new entrant price and by the level of market prices at the fourth year, when a large proportion of the initial contracts expire;

(d) taking revenue from NGC and the Area Boards to give to the generators would almost certainly reduce proceeds overall. The reduction in wires revenue would almost certainly be permanent, since the price controls would not allow it to be clawed back. The increase in generator revenue is only needed in the first two years. Moreover, profits in the monopoly wires businesses are likely to be more highly valued than in the competitive generators;

(e) allowing public expenditure to increase for just the first two years to enable generator profits to be increased within an overall price constraint would be less costly to the Exchequer. The obvious but impossible way to do this is to subsidise lower coal prices for the first two years. Another way is to take lower revenue in Nuclear Electric than we would otherwise like for the first two to three years.

In the light of this, the decision on nuclear revenue turns on the impact on customer prices. I am very reluctant to allow the average price for electricity to rise faster than inflation, especially against the background of two years of real price increases, the price rebalancing that will occur and our current concerns about inflation. The Government has made much of the downward pressure on prices that this privatisation will produce.

SECRETARY OF STATE FOR ENERGY

For these reasons I am reluctant to move from my proposal to set NuLec's initial revenue at £2 billion in 1990/1 (out turn prices). To adopt your proposal of £2.25 billion would add some 2-3 percentage points to the average price increase, taking it to some 7-10% nominal. Our latest financial projections for NuLec are attached. As you will see, the company is cash positive in all but the first two years. I can understand your concern about the estimated cash deficits in the first two years, but the analysis above suggests that they are the price for maximising expenditure benefits within an overall price constraint. For my part, I recognise that there are uncertainties in our price forecasts; and it may just be possible to concede an opening revenue as high as £2.1 billion for NuLec, the effects of which are set out in the attached projections. But I do not believe it will be possible to go further.

The timetable is very tight. We have to set prices for the conventional generators, Area Boards and NGC this week. I have therefore given the industry contract assumptions that are designed:

- to increase the first year level of generator revenues by £200-300 million and provide dividend growth closer to some 15%; and

- to provide a level of revenue for the distribution and transmission businesses equivalent to a 6% return on CCA net assets.

I will also be seeking an undertaking from the Area Boards and generators that, until 30 June, they will use their best endeavours to offer arrangements that cap average increases for any class of non-franchise customer at RPI+5 cumulative over three years, subject to normal fuel price adjustment clauses.

I believe we should decide the initial level of nuclear revenue when the impact on customer prices is clearer next week. But I hope you and John Major can agree that it will have to be in the range of £2-2.1 billion in 1990/1 prices and that we should work on that basis in state aids discussions with the EC Commission. On our revised assumptions, this level of revenue would produce a levy of around 10-11%, though the precise figure will depend on our final forecasts of SMP and pool price.

I am copying this to the Prime Minister, John Major, Malcolm Rifkind, Nicholas Ridley and Sir Robin Butler.

Yours ever

John

JOHN WAKEHAM

ANNEX

NULEC CASH FLOW

Provisional Estimates

(£ million MOD)

	1990/91	91/92	92/93	93/94	94/95	95/96	96/97	97/98
Revenue	2000	2040	2289	2385	2429	2417	2849	3011
<u>less</u>								
Revenue costs	1899	1968	2021	2088	2133	2014	2086	2022
Profit/Loss before interest	101	72	268	297	296	403	763	989
<u>plus</u>								
Depreciation	311	318	324	328	333	339	436	443
Interest	40	24	+21	26	47	52	73	99
Provisions	565	590	596	608	615	545	497	482
<u>less</u>								
Capital requirements and payments against provisions	1199	1252	1185	957	1052	1039	1232	1584
Net Cash Flow	-182	-242	24	302	239	300	537	429

Note:

1. Initial revenue of £2 billion and average price of nuclear electricity assumed to fall at 2.2% from 1990/1.

2. If initial revenue is set at £2.1 billion, net cash flow rises to:

-82	-138	135	423	374	458	700	609

3. If initial revenue is £2.1 billion and average price is held constant in real terms, net cash flow is:

-82	-93	242	600	628	794	1260	1255

NAT IND: Gas & elec pt 18

CC PU

THE RT HON JOHN WAKEHAM MP

SECRETARY OF STATE FOR ENERGY

Department of Energy
1 Palace Street
London SW1E 5HE
01 238 3290

Ian Lang Esq
Minister of State
Scottish Office
Whitehall
LONDON
SW1A 2AU

10 January 1989

Dear Ian

ESI CONTRACTS, PRICING AND PROCEEDS

Thank you for your letter of 5 January.

It is not my intention to create barriers to trading between Scotland and the rest of Britain. I think we all want a regime in which the Scottish companies can sell to and buy from the English pool and strike contracts direct with customers and suppliers. If the demand for such trading is great enough, then NGC and the Scottish companies will no doubt justify upgrading the interconnector. I do not see how my proposals frustrate that aim.

The complexities of putting in place contracts between twelve Area Boards and the three principal generators should not however be underestimated. We have very little time to achieve this. And I really believe the only way to get the new structure set up is to start it off with these contracts in place and to create scope for contracts with France, Scotland, and other generators to be signed after vesting. This will be achieved by the short-term nature of the initial contracts in England and Wales.

Our objective in treating electricity from Scotland like generators in England and Wales, in particular by requiring all sales and purchases to be made through the pooling and settlement system, is to give Scottish producers equitable treatment. The charges for use of the interconnectors and the transmission system will be a matter for the National Grid: I would expect them to reflect charges placed on generators in the north of England together with a charge for those assets used solely by the Scots.

SECRETARY OF STATE FOR ENERGY

I entirely agree that our officials should have further discussions about what is proposed. I understand a meeting has been arranged for later this week.

I am copying this to the Prime Minister, John Major, Nicholas Ridley and Sir Robin Butler.

Yours ever

John

JOHN WAKEHAM

NAT IND: ~~Gas~~ + Elect Pt. 17

CC PU

FROM THE MINISTER OF STATE

SCOTTISH OFFICE

WHITEHALL, LONDON SW1A 2AU

NBPM Minister stage.

PRCC 57.

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The Rt Hon John Wakeham MP
Secretary of State for Energy
1 Palace Street
London
SW1E 5HE

5 January 1990

ELECTRICITY CONTRACTS, PRICING AND PROCEEDS

I have seen your minute to the Prime Minister of 21 December and her reply of 2 January. I am sorry that my comments have been delayed.

Many of the proposals are specific to the England & Wales situation but we shall be considering the implications for Scotland in some areas, specifically relating to returns on the wires businesses, price regulation and tariffs. Most importantly from the Scottish point of view, we aim to put proposals to colleagues on the terms of the nuclear contracts in Scotland as soon as possible with a view to reaching agreement on detailed terms with the industry as early as possible.

There is one aspect of your proposals, however, on which I must reserve the Scottish position now. As you know, Malcolm Rifkind and I have been anxious to ensure that a full and fair opportunity is provided for the Scottish Companies to strike contracts with the industry in England & Wales for export of power on an upgraded interconnector. Only in this way will we be able to secure proper value for the surplus generating assets in Scotland at flotation and justify the Government's consistent claims that Scotland would be an important early contributor to competition in the England & Wales generation market. I am concerned that your proposals will frustrate that aim and will prevent early progress on the upgrading of the interconnector.

I readily recognise the need to avoid accusations of discrimination against the French in this context and it is for this reason that Malcolm has conceded that Scottish nuclear exports should not be included in the NFFO and thus command the higher nuclear price in the England & Wales market. However, we cannot accept without discussion your conclusion that Scotland should be treated identically in all respects to the French since this ignores the reality that the Scottish Companies will be an integral part of the wider GB industry: it is not appropriate to treat the whole of Scotland simply as a 'bolt on' generator. I cannot accept at this stage that there should be no scope for direct or contractual links between Scotland and the Distribution Companies at the outset. I am also concerned that the proposal to single out the Scottish interconnector from the rest of the grid and impose connection charges over and above the normal use of system charges will provide an artificial and potentially insuperable barrier to trading.

It is therefore imperative that we have an opportunity to explore your proposals in more detail and to consult the Scottish industry before reaching firm conclusions - I understand that such detailed discussions have already been conducted with the French. I therefore invite you and colleagues to agree that officials should urgently discuss the treatment of the Scotland-England interconnector and the associated trading arrangements before firm decisions are taken. I fully appreciate the need to make very rapid progress on these matters in order to achieve vesting on schedule but this is an issue of great significance to the prospects for flotation of the Scottish industry and to our claims to be creating a competitive framework for the GB industry as a whole.

I am copying this letter to the Prime Minister, John Major, Nicholas Ridley and Sir Robin Butler.

J. Nicholls

pp IAN LANG
(Approved by the Minister and signed in his absence)

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the department for Enterprise

CONFIDENTIAL & COMMERCIAL IN CONFIDENCE

The Rt. Hon. Nicholas Ridley MP
Secretary of State for Trade and Industry

The Rt Hon John Wakeham MP
Secretary of State for Energy
Department of Energy
1 Palace Street
London SW1P 3AG

Department of Trade and Industry

1-19 Victoria Street
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Our ref PB3AIJ
Your ref
Date 4 January 1990

Dear Secretary of State

ELECTRICITY CONTRACTS PRICING AND PROCEEDS

Thank you for copying me your minute to the Prime Minister of 21 December together with the paper on electricity contracts, prices and proceeds. I have also seen the reply from the Prime Minister's office of 2 January. I am broadly content with your proposals, subject to the two points discussed below.

Price controls

I have a major concern, on competition grounds, that our proposal to have an RPI-X+Y price control to cover all prices charged by the Area Boards, thereby allowing full pass-through of the majority of the generators costs, will not give proper protection to customers.

On the one hand, I believe we should do more to promote competition, in particular by announcing that there will not, after all, be any market share limits on direct supply to non-franchise customers by National Power and Power Gen. I understand that you accept that they will not work well in practice and that you are prepared to renounce them altogether during negotiations with the European Commission. I should welcome such a move.

Moreover, I believe that we could and should give a much stronger pro-competitive signal to customers and suppliers alike by giving up any attempt to regulate prices for the market as a whole, albeit retaining a simple RPI-X type control for all or part of the franchise market (a point to which I return below). I am not

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convinced by your financial advisers argument that the Area Boards would be unflotable without such an overall control. I understand that potential shareholders might want some assurance about what form any subsequent price control might take; and that there are considerable practicable difficulties about devising a control which covered only part of the market and which did not require frequent changes to the value of X. Nevertheless, shareholders may have to accept that changes in the rules may be necessary and will be the subject of negotiation between the DGES and the industry.

On the other hand, I believe we should provide effective regulatory protection to the smaller (up to 10 MW) non-franchise customers, who will not be covered by your proposed subsidiary RPI-X control, by ensuring that they do have the right to opt for tariff supply during at least the first year. This would give them the benefit of your control of initial tariff levels together with the rather weaker protection granted by the ban on undue discrimination between tariff customers. During this breathing space, we should expect these customers to negotiate contracts for subsequent periods in a competitive framework.

As regards the scope of the subsidiary control, I believe it should cover all the franchise customers, rather than just the domestic ones, even if this means that the control would have to be of the form RPI plus X, rather than RPI minus X. All the franchise customers will be captive and the non-domestic franchise customers may rightly regard themselves as not sufficiently protected by a combination of a price control for domestic customers and a ban on undue discrimination between domestic and other franchise customers.

Price changes and nuclear revenues

Thank you for providing an assessment of the price effects of your proposals on domestic and industrial customers, including the largest industrial customers, as I requested in my letter to you of 7 December. Like the Prime Minister, I am concerned that the largest customers should not face the sort of price increases outlined in Annex A of your paper. The exact figure for the levy is a matter of balance but I am inclined to support your view that we should aim at as low a levy as possible, consistent with NUCO not being a burden upon the Exchequer over, say, the next four or five years. The precise calculation of figures is of course principally a matter for you and John Major to decide, but I do not belive we should restrict our attention to revenue targets for the next two years. I certainly do not believe that we should put ourselves in the position of having to defend what might turn out to be a significant surplus in those years.

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the department for Enterprise

More generally, I believe we should aim at rates of return for the industry which allow us to demonstrate falls in prices to significant groups of customers, particularly domestic ones, to offset the high increases to the largest industrial ones. This will be important in political terms.

Definition of own-generation

On the definition of what own-generation should escape the levy, I am now satisfied that your officials have found the right balance between exempting own consumption by own-generators and preventing wholesale evasion of the levy.

Competition law

Lastly, as you state, we need to ensure that all your proposals are consistent with relevant UK and EC legislation.

I am copying this letter to the Prime Minister, John Major, Malcolm Rifkind, Sir Robin Butler and Professor Brian Griffiths.

Yours sincerely

(Approved by the Secretary of State
and signed in his absence)

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NAT IND - Gas + Elec

Pt 1

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ccl ✓

Treasury Chambers, Parliament Street, SW1P 3AG

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respond.
2 pps

Rt Hon John Wakeham FCA JP MP
Secretary of State for Energy
Department of Energy
1 Palace Street
London
SW1E 5HE

4 January 1990

Dear Secretary of State

ELECTRICITY CONTRACTS, PRICING AND PROCEEDS

John Major and I have discussed your paper of 21 December. We remain unconvinced that the levy should be as low as 11 per cent.

2. I understand that putting the package together involves a number of difficult judgements about competing objectives. But your recommendation does not accommodate our specific concerns, most recently set out in John Major's letter of 8 December, and diverges substantially from the presumption agreed when we took the decision last November to withdraw the nuclear stations from the sale. In particular, your proposals carry a continuing public expenditure cost, by comparison with our expectation in March, of £500 million a year. This is extremely unwelcome at a time when we are already facing a number of pressures on our expenditure plans.

3. You understandably express concern at the impact of a high levy on final prices, particularly for large users. But the cause of that problem is not the levy, but the need to unwind the very substantial and unjustifiable degree of cross-subsidisation in favour of this group in the past. We have long recognised this problem as one that would have to be faced sooner or later; we will be helped by the likelihood that large numbers of smaller industrial customers will see their prices fall in real terms. Lowering the levy would be a very inefficient means of assisting large users, since it would mean lower prices for all customers, with a substantial and continuing public expenditure cost. I would instead favour a transitional arrangement for large users of

the form that you propose, providing it is neutral in terms of proceeds and public expenditure. Whether the annual cap is RPI+5 per cent or some slightly higher number should, I suggest, be left to decide when we have the industry's final contract prices at the end of this month.

4. There is nothing in your paper on the implications of your proposals for Nuclear Electric. At an income of £2.0 billion the company will probably be in cash flow deficit for the next two years. I cannot accept this: not only is it contrary to a number of your own public statements and the basis on which we decided to withdraw the nuclear stations, it would be an immediate addition to our recently agreed public expenditure plans, of up to £0.2 billion in 1991-92.

5. I was also disappointed that your paper fails to provide quantification where there are trade-offs between proceeds and public expenditure. For example, if a higher levy was offset by somewhat lower generator profits, the reduction in proceeds on your illustrative assumptions would be smaller than the discounted value of the expenditure benefit (I agree that generators' profits alone could not absorb a large change). I would expect the same point to apply to the extent that the levy were financed by higher prices. (To mitigate the impact on the distcos of any effect on growth in demand, I favour a tight definition of own generation).

6. I nevertheless recognise the pressures that you are under from the industry and advisers to reduce the levy, and the limited room for manoeuvre to construct an acceptable package. In the interests of seeking agreement, John and I are prepared to see a reduction in the levy to 13 per cent, compared with the 15 per cent previously envisaged. That would secure a sufficient income for Nuclear Electric. Precisely how it is financed can be decided when we have the later projections but by comparison with your proposals, we would envisage a proportion being met from gencos' profits, although perhaps a larger proportion adding to prices.

7. I will be interested to learn of your proposals for how prices and the levy should move over time. This is not discussed in your paper, although will be important both in judging the overall acceptability of the package, and because of the implications for Nuclear Electric and future public expenditure. My presumption would be that NE's initial level of income should be sustained in real terms over the 8 year contract period. The rise in pool prices will mean a decline in the levy, possibly more rapidly than is needed for EC purposes. Franchise consumers will be protected by the run off of the coal contracts. A slightly higher price on day one will be much less unpalatable if we can point to the likelihood of real terms falls or at least stability thereafter.

8. For the rest of your package, I am content with the proposed structure of the contracts. I see that you do not see any possibility for contracts between the distcos and new entrants or between customers and gencos to be put in place before flotation. I am sure that in further discussion with the industry you will have in mind three questions about risks:

(i) whether we would not be creating too great a presumption in favour of the established players and patterns of supply to the detriment of competition.

(ii) whether investors will perceive the contacts in place at the time of flotation as sufficiently stable; their perception of risk could mean a heavy discount on proceeds.

(iii) whether our concern to treat Scotland on absolutely all fours with France might adversely affect the success in due course of the Scottish sales. I hope that you can reassure Malcolm Rifkind on this point.

9. I am content with your proposals for pricing nuclear contracts and for Nuclear Electric to sell into the pool. I note, however, that they will require the company to acquire the necessary skills, and also increase their commercial risks. This should in turn be reflected in NE's required rate of return and hence the justifiable price of nuclear output both in the initial and follow-on contracts.

10. I am also content to see the yardstick dropped in favour of full pass through and a subsidiary cap on the franchise market. This decision will, however be interpreted as an anti-competitive change of policy. It will be important to develop an adequate justification for wider use.

11. Finally, I note your proceeds assumptions. I hope that in practice we would be able to secure somewhat lower dividend covers, at least for the distcos and gridco. As my officials are discussing with yours the lengthy marketing campaign with the institutions provides an opportunity to overcome investors' initial cautious reactions to covers, gearing etc, and I hope that the Government's advisers will be guided accordingly.

12. To recap: John and I understand your concerns and the difficulties in accommodating a number of objectives. But you will similarly understand that the implications of your proposals for public expenditure are extremely unpalatable. In the circumstances I hope that you will accept the compromise we have suggested; for our part we would not hold out the prospect of moving any further.

13. I am copying this letter to the Prime Minister, Nicholas Ridley, Malcolm Rifkind, Sir Robin Butler and Professor Brian Griffiths.

Yours sincerely

Carys Evans

NORMAN LAMONT
(Approved by the Chief Secretary
and signed in his absence)

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

2 January 1990

Dear John,

ELECTRICITY CONTRACTS, PRICING AND PROCEEDS

The Prime Minister was grateful for your Secretary of State's minute of 21 December and the attached paper. She is fully content for him to finalise a package along the lines set out in consultation with the Chancellor and the Secretaries of State for Trade and Industry and Scotland. She has commented that she strongly agrees with the judgment in paragraph 3 of the detailed paper that price increases for intensive electricity consumers at the level set out in Annex A would be wholly unacceptable.

I am copying this letter to John Gieve (H.M. Treasury), Neil Thornton (Department of Trade and Industry), Jim Gallagher (Scottish Office) and Sonia Phippard (Cabinet Office).

Yours,
Paul

PAUL GRAY

John Neilson, Esq.
Department of Energy.

PART 17 ends:-

PG to PM. 22.12.89

PART 18 begins:-

PG to D/GNGRGY 2.1.90

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ELECTRICITY PRIVATISATION

BACKGROUND FACTS

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COPY NO. 1 OF 11

THE ELECTRICITY SUPPLY INDUSTRY
Background to Privatisation

The purpose of this paper is to set out the key facts about the electricity supply industry in England and Wales (ESI), not to consider the future structure of the industry in the private sector. It starts with a short historical introduction, and goes on to describe the current structure of the industry. It then gives an overview of the current state of the industry, its financial performance and prospects, before turning to a number of key features that are worth a closer look. It does not describe the industry in Scotland.

Historical Background

2. The ESI developed out of small private companies and municipal undertakings, some of which also supplied gas, essentially meeting local needs for lighting, industrial motive power and public transport. The commercial pressures that shaped the industry were the savings to be made by sharing generating capacity and the economies of scale to be obtained in generation. However, generating units of larger output require the construction of sufficient transmission capacity at higher voltages; and early legislation, designed to curb the possible abuse of monopoly power, did not encourage the necessary co-operation by essentially local undertakings. Construction of a major grid system only began in earnest with the establishment of the Central Electricity Board in 1926. In the 1930s the Board built an essentially regional 132 kilovolt transmission system, connected on a national scale, which enabled larger generating sets to be built. This process was continued after nationalisation by the construction of a 275kv system in the 1950s and a 400kv system in the 1960s, together known as the "super grid". As a result, the average size of new generating sets rose from some 25MW in 1920 to 660MW in 1980; and the

thermal efficiencies of generating plant in converting fuel to electricity more than doubled between 1920 and 1947, and rose a further 50% by 1980. The development of the transmission system also reduced the total amount of capacity needed to provide continuity of supply and the resulting savings more than paid for the capital cost of the grid. The ESI had 283 power stations in 1946; 122 were closed between 1973 and 1987; and the CEGB now has
82 82. The average real price of electricity for domestic consumers more than halved between 1920 and 1947, and fell by another third by 1970. Total sales of electricity per head of population rose some 10 times between 1920 and 1947, and rose a further five times by 1980.

3. The legislation applying to the ESI is archaic and has never been brought up to date. There are some 22 Acts, the earliest dating from 1882, specifically applying to the industry. Many of the older provisions still in force have little relevance to the modern industry and now prove difficult to interpret and apply. Before privatisation, the existing legislation will have to be brought up to date and adapted to a private sector industry.

Current Structure

4. The electricity supply industry in England and Wales comprises:

- the Central Electricity Generating Board (CEGB) which supplies 95% of power requirements and owns and operates the 275kv and 400kv national grid transmission system; the CEGB also specifies the performance requirements and supervises the construction of new power stations;

- twelve statutory independent Area Boards, each responsible in their geographical area for the distribution of electricity from the high voltage grid to the final consumer, through the 132kv and lower voltage distribution networks;

- the Electricity Council, which has a co-ordinating role in this federal industry, together with special responsibilities for the central management of finance and taxation, industry-wide industrial relations, research and advice to government.

Consumer interests are represented by twelve Area Electricity Consultative Councils, whose Chairmen sit on their respective Area Boards, and an Electricity Consumers' Council which represents consumers throughout England and Wales. These bodies, which are independent of the electricity supply industry, are funded by the Department of Trade and Industry.

5. An analysis of the structures adopted for the industry in other countries reveals a very diverse picture with many different structural patterns that have been made to work and to provide secure supplies. At Annex A is a summary description of the structure of the power industries of the principal OECD countries. Although there may be lessons to be learnt, no clearly preferred structure can be identified.

Overview

6. Electricity demand increased by an average of 1.2% per annum from 1970/71 to 1980/81, and by an average of 1.9% per annum from 1980/81 to 1986/87. In 1986/87, electricity demand on the CEGB system moved between a winter day-time peak of 47.9GW and a summer night-time low of around 12GW. The total demand on CEGB plant after allowing for load management and exceptional winter weather was about 44GW. The total declared net capability (DNC) of the Board's stations was 52.4GW, but this did not include capacity in reserve, capability provided by cross-border links and power stations which have not yet been formally commissioned.

The amount of spare capacity required is largely determined by the need to meet peak demand after taking account of capacity unavailable because of breakdowns and routine maintenance; but the CEGB's plans also have to make allowances for errors in forecasting demand and weather effects. At present, the CEGB plans to provide generating capacity sufficient to meet peak demand in all but nine winters in 100 years. The extent to which the Scottish Boards, France and private generators can contribute to peak demand in England and Wales could at present approach 5% of maximum demand, and their maximum potential contribution could be around 10% of unit requirements throughout the year.

7. The CEGB's capacity is provided by 82 operational power stations, of which four are not yet fully commissioned. The stations are linked by a national grid, consisting of some 9,000 miles of high voltage transmission lines. The grid allows the operation of stations on a national economic "merit order" to minimise the total costs of the system. The merit order, is based on marginal operating costs, but is subject to many constraints in practice. Electricity cannot be stored as such and so at any point in time supply must approximately equal demand. Any differences between the two are reflected in variations in the frequency and voltage of supply which are permitted only within limited tolerances. The output of the power stations must therefore be adjusted on a minute by minute basis to meet demand. The CEGB has a statutory duty to provide bulk supplies, and the Area Boards have a statutory duty to plan and carry out the distribution of those supplies to persons who require them. The ESI has over 21.7 million customers, supplied through over 380,000 miles of distribution system.

8. Following the construction of a national grid, it became possible to site large power stations near to sources of fuel and cooling water, as well as close to the customer. The economic choice was to site near sources of fuel and the UK's generating capacity therefore consists largely of coal-fired stations

located near coalfields and supplied by rail, with fewer oil and nuclear stations generally sited on or near to the coast (see Annex B). Generating in large stations distant from the main areas of consumption has led to strong north-south power flows, and pressure to build future capacity in the south to avoid the costs and environmental difficulties of having to develop the transmission system. It also means that generation is a fuel and capital intensive business, which determines most of the costs of electricity. As a whole, generation and transmission accounted for some 80% of ESI operating costs in 1986/7. Some 60% of CEGB costs were fuel costs, mainly costs of coal, which consequently account for some half of the total costs of electricity. It is still true to describe electricity as "coal by wire". Out of the 82 operational power stations, 12 large coal-fired stations accounted for some 60% of electricity supplied in 1986/7.

9. Not only does the CEGB dominate the ESI's cost base, it also dominates the asset base. The CEGB's CCA fixed assets of £27 billion (60% of their gross book value) account for some 75% of the industry's total fixed assets of £36 billion (50% of gross book value). The distribution side, dealing direct with 21.7 million customers, is more labour intensive. Of the industry's 131,000 employees, some 82,000 (63%) are employed by the Area Boards, and some 48,000 (36%) are employed by the CEGB. However, a much higher proportion of the CEGB's staff is technical and managerial, and the ESI's salary costs are split almost equally between the CEGB and Area Boards. As a whole, salaries and related costs account for some 15% of total electricity costs. However, total employment in the ESI has fallen by more than 40% from the 228,000 employed in the late 1960s. Salaries and related costs have fallen more slowly than manpower (by 8.5% since 1975) as salary costs per employee have risen in real terms (by 11% since 1975). This fall in manpower numbers will slow down and possibly reverse as staff are recruited to replace and maintain the ageing assets of the distribution and generating businesses.

10. Breakdowns of the ESI's costs, assets and employees are given at Annexes C, D and E.

11. Annex F gives the ESI's profit and loss account for 1986/7 on a CCA and historic cost basis. The current cost operating profit for 1986/7 was £1149.7 million and the profit after interest and taxation was £586.9 million. The comparable figures on an historic cost basis were £1877.8 million and £1315 million, implying a return on net assets of 13.75%. The overall return on CCA assets achieved in 1986/7 was 3.17%, compared to 2.65% in 1985/6. This compares with the financial target set by the government of an average annual rate of return of 2.75% over the three-year period to 1987/8. Since the industry has for some time faced no need for substantial investment in generating capacity, it has for some years been able to repay debt while earning this relatively low rate of return. In 1986/7 repayments totalled £1334 million, compared to £492 million in 1985/6. Average prices to domestic consumers have also declined in real terms by about 15% over the last 5 years.

12. More than 80% of the employees of the ESI are members of trade unions. In terms of numbers, the principal unions are NALGO, the EETPU, the EPEA, the GMBATU, the TGWU and the AUEW. However, the EPEA plays an important role, since virtually all the key operational, control and power station engineers are members. Most of the NALGO members are clerical and administrative staff in the Area Boards, but they include the computer staff operating the transmission and distribution control systems. The employees of the ESI have traditionally been loyal to their industry and aware of their responsibilities to consumers. They have usually sought to resolve disputes by negotiation through the five national joint bodies that cover all the various types of staff employed in the industry throughout Great Britain. In the context of privatisation, they are likely to support the unification of the industry and oppose any attempt

to divide the present structure further. Their other main concerns will be to protect employment, safeguard pension arrangements and to preserve the national negotiating arrangements currently enshrined in their individual contracts of employment. At Annex G are the most up-to-date figures on union membership held by the ESI, though these relate to 1984.

Key Facts

13. The previous section of this paper gives an overview of the current state of the industry. This section is intended to take a closer look at a number of key features:

(a) the economic importance of electricity: electricity accounts for 14% of fuel consumption by end users, compared to 33% for gas and 41% for oil. However, these figures understate the importance of electricity to the economy. It accounts for some 1.7% of GDP, some 73% of UK coal consumption and some 34% of UK primary fuel consumption. The functioning of essential industries and services, such as airports, railways, dockyards, gas distribution, coal mining, hospitals and communications, is reliant on electricity. Since there are no real alternatives to electricity in many markets, security and continuity of supply assumes great importance;

(b) the markets for electricity and the extent of competition with other fuels: the proportions of total electricity sales accounted for by the main customer sectors have changed considerably over the past thirty years: domestic sales have risen from 30 to 36% of total sales; industrial sales have fallen from 51 to 36%; and commercial sales have doubled their share from 12 to 24%. Agriculture, public lighting and other customers took the remaining 4% in 1986/7. The largest growth in sales volume is still in the commercial sector, which increased by 6.5% during 1986/7. Although electricity competes with gas for certain uses in the domestic sector, and in some industrial markets, only about one-third of sales are subject to any real competition. Unlike gas, there are substantial markets in which electricity has a monopoly, such as lighting, electronics and some motive power. Some 50% of domestic sales are estimated to be subject to competition, some 35-40% of commercial sales, and perhaps 20% of industrial sales.

(c) cost of fuel: Annex H shows the types of station owned by the CEGB, together with their fuel consumption in 1986/7. It shows that coal accounted for some 77% of fuel consumed, at a cost of some £3437 million. Although the joint understanding on coal supply between the CEGB and British Coal is designed to reflect competition from oil and imported coal, the CEGB has claimed it could make savings by increasing imports of coal by perhaps 30 million tonnes over five years. The CEGB is presently paying an average of some £45 per tonne (delivered) for BCC coal compared to a probable price for imported coal of the same quality of £34-39 per tonne (delivered). The arrangements governing the future supply of coal to power stations will need to be set out clearly at the time the industry is privatised, given the importance of coal costs. It would, for instance, require a 35% saving on ESI manpower costs to match the savings achievable by a 10% reduction in fuel costs;

(d) ageing assets and the need for new capacity: partly because of over-optimistic plant ordering in the 1960s, which led to a significant surplus of capacity that is only now disappearing, the CEGB is an industry of ageing ~~assets~~. Some 31GW of capacity was commissioned between 1962 and 1972, and more than 70% of the CEGB's capacity is now 15 years old or more. The distribution system also has a high proportion of old assets, with about 70% of fixed assets over 20 years old and, in some Area Boards, nearly 30% over 40 years old. Assuming a compound growth rate in electricity demand of 1.6% a year, and taking into account the age of existing plant, the CEGB forecast a requirement for 13GW of new capacity to be commissioned between 1995 and 2000, requiring an immediate start to the approval, ordering and construction of new stations. The CEGB's plan is to meet this requirement with the PWR at Sizewell, five further PWRs and four coal-fired stations. By itself, this plan would require investment of some £15 billion in 1987 prices by the end of the century. Taking into account the stations envisaged after 2000, the CEGB plan to invest almost £30 billion (1987 prices) to the end of the century, or almost £45 billion in estimated outturn prices. As a result, the CEGB envisage annual capital expenditure rising to some £3 billion in 1993/4 (1987 prices). Such an investment programme would offer considerable opportunities for the UK power plant and equipment manufacturers, and the construction industry. Some 95% of Sizewell contracts are expected to go to UK companies. Further details of the capital expenditure programme on new generating capacity are given in Annex I;

(e) nuclear power, R & D and fuel services: with 9 nuclear power stations commissioned, three in the final stages of commissioning (Hartlepool, Heysham I and Dungeness B), and a further two under construction (Heysham II and Sizewell B), the CEGB plays the leading role in the UK nuclear industry. In 1986/7, payments to the UKAEA from the ESI as a whole amounted to just under 15% of the UKAEA's total turnover. As of 1986/7, the CEGB has taken on 30% of the costs of the UKAEA's fast reactor programme and the cost of this to the Board will be about £31 million for this financial year. In addition, it provides about 70% of BNFL's income from UK fuel cycle services. It has also made provisions for £1.3 billion of reprocessing and waste disposal liabilities which are expected to be met by BNFL. The CEGB also provides technical backup for the South of Scotland Electricity Boards' nuclear stations. Nuclear stations accounted for some 9.6% of the CEGB's total capacity in 1986/7 and supplied some 16.4% of electricity supplied. In coal equivalent terms, nuclear fuel accounted for 16.2% of the Boards' total fuel consumption, at a cost of £534 million. On the CEGB's plans, nuclear stations will account for some 70% of investment in new capacity to the end of the century. However, if the magnox stations are all shut down at the end of their extended nominal lives (30 years) the proportion of total electricity supplied by nuclear may fall significantly in the 1990s before the PWRs are brought on stream, and this may be aggravated if the AGRs continue to perform below expectations;

(f) private generation: the 1983 Energy Act sought to liberalise the market by removing legal obstacles to private generation, making available the transmission and distribution systems to private generators to allow them to deliver power to any customer, and obliging the ESI to purchase privately generated electricity on an ? avoided cost basis. This Act has so far had limited effect largely because of the limited scope for economic entry by private generators at a time of surplus capacity, especially since the ESI has so far declined to enter into long term contracts with private generators. At the end of 1986 some 3.5% of total installed capacity in Great Britain was privately owned and 4.8% of total electricity supplied (excluding supply from BNFL and AEA nuclear stations) was privately generated, mainly by industry for its own use. Private generation has declined by over a third since its post war peak in 1973. In analysing this decline and future prospects, the three main categories of private generation should be considered separately: industrial generation for own use; private generation for the ESI's public supply system; and combined Heat and Power (CHP) schemes. The industrial own use sector, the traditional market for private generation, has declined with the size of the manufacturing sector and with lower demands for industrial heat, since electricity has traditionally been generated as a by-product of industrial steam raising. Private generation for the public supply system at present accounts for only some 0.5% of total available electricity and comes entirely from very small plant with some surplus capacity to export; there are at present no major private power stations supplying the grid. There are, however, a number of potential projects for private supply to the ESI under discussion, some involving power stations as large as 700MW. These projects largely fall into two categories: refurbishment or construction of coal fired stations, usually taking advantage of cheap coal imports; and gas fired projects, usually sponsored by oil companies seeking alternative markets for gas, which will need to exploit flexibility in the EC directives controlling the use of gas in power stations. There are also a number of smaller scale CHP schemes under discussion; but their viability will to some extent depend on finding an adequate market for heat. Annex J gives details of existing and potential private generators;

(g) regional differences in distribution: the twelve Area Boards in England and Wales supply different types of market. For instance, 47% of sales by the South Eastern Electricity Board were to domestic consumers, 26% to commercial consumers and 25% to industrial consumers; for the Merseyside and North Wales Electricity Board, the corresponding figures were 28%, 16% and 53%. In general, the Northern and Welsh Boards have a greater reliance on a declining industrial sector, whereas the Southern Boards have a greater reliance on a growing domestic and commercial sector. Comparisons between the performance of the Area Boards is therefore difficult to make, but in general the Southern Boards face better prospects in terms of sales growth.

(h) appliance marketing: the Area Boards own some 900 high street retail outlets, which provide direct contact with customers and through which electrical appliances are sold. In 1986/7, turnover and operating profit on appliance marketing amounted to £550 million and £39 million respectively, compared to £481 million and £32 million in 1985/6.

Environmental and Nuclear Safety Issues

14. The CEGB's plans to fit substantial flue gas scrubbing equipment to reduce sulphur emissions from three stations will involve a capital cost of some £600 million (1986 prices) over the next ten years or so, representing the equivalent of about half the cost of a new 1.8GW coal fired power station. Agreement between Government and the CEGB on the method of financing these plans is expected to be reached in the near future. The addition

of this equipment will also reduce output capacity and efficiency by up to 5%. The Board is also intending to replace the burners at all large power stations to reduce nitrogen oxide emissions, at a cost of some £170 million (1987 prices). Tighter regulations on emissions are being considered in the EC. However, the Government has not agreed to further retrofitting and the CEGB's plans for emission control at future power stations are in line with possible future EC requirements. The costs of controlling radioactive emissions fall mainly on reprocessing plant operated by BNFL, and are reflected in higher charges to the CEGB. The cost of the delay to the construction of the PWR at Sizewell caused by the Public Inquiry could be up to £70 million, according to the Department's latest estimates. The cost of holding the inquiry alone was £4 million, of which £2.5 million was provided by the CEGB. The Board has also made provisions totalling over £2.5 billion for the expected costs of decommissioning its nuclear power stations, reprocessing, storage and disposal of irradiated nuclear fuel, and decommissioning of facilities owned by BNFL. The last consent for a major tranmission line in the South-East was given 20 years ago and it is clear that any proposals for a new line would meet considerable opposition from those along its route.

15. Safety at nuclear power stations is regulated under the Nuclear Installations Act 1965 and the Health and Safety at Work Act 1974. These place statutory responsibility for safety on the operators. However, no power station may be built or operated without a nuclear site licence from the Health and Safety Executive (of which the Nuclear Installations Inspectorate is part.) The HSE have powers to close down unsafe plant at any time. At present the NII licences three organisations who operate nuclear power reactors - CEGB, SSEB, and BNFL. Under the licensing procedure the Nuclear Inspectorate require an operator to make a safety case. The NII does not set prescriptive rules but judges the safety case against their safety assessment principles; in this respect it differs from regulatory

authorities in most other countries. The operator must provide any research which is a necessary part of the safety case. Nuclear safety research is expensive; and much is at present carried out under contract by the Atomic Energy Authority.

Conclusions

16. The purpose of this paper is to give background information, not to reach conclusions; but a number of points may be worth highlighting:

- the historical pressure to achieve economies of scale in generation;
- the need to update the legislation regulating electricity supply;
- the lack of any clearly preferred structure for electricity industries overseas;
- the dominance of the asset base by the CEGB and of the workforce by the Area Boards;
- the dominance of the fuel and capital costs of generation in the cost structure of the industry;
- the CEGB's plans for new investment, of which some 70% is for nuclear stations, to replace the ageing assets of the industry and to meet growth in demand;
- the negligible level of coal imports taken by the CEGB and its stated belief that it could increase coal imports to 30 million tonnes a year within five years, making substantial cost savings;

- the barriers to entry faced by private generators during a time of surplus capacity which is now ending, and the potential projects under discussion;

- the regional differences in the market for electricity and the monopoly nature of some of those markets.

CONFIDENTIAL

LIST OF ANNEXES

ANNEX A

ANNEX A

ELECTRICITY SUPPLY INDUSTRIES OVERSEAS

AUSTRALIA

About 15 public electricity utilities. Four of the State Governments have their own power boards; in the other three States, the utilities generate and transmit electricity to other public corporations which distribute. In addition, a large hydro-generation scheme is jointly run by the Federal Government and some States. There is not integrated national grid but some interconnection. (Total installed capacity of supply system: 32GW approx.)

BELGIUM

Three large private sector companies account for about 90% of electricity generated. These and a small public sector generating body own and operate the transmission system. Distribution is the responsibility of local government which either operates a distribution monopoly itself or (more usually) grants a concession to the private sector. (Total installed capacity of system 13GW approx.)

CANADA

43 electricity utilities, mainly owned by the 12 provincial governments, account for 90% of electricity production. These utilities are also principally responsible for transmission and distribution. Ontario is an exception where distribution is carried out by a large number of small municipal undertakings. (Total installed capacity of system 90GW approx.)

FRANCE

One large electricity utility, accountable to the national government, which is responsible for generation, transmission and distribution. (Total capacity of system 82GW approx.)

GERMANY (FRG)

Generation comes from a mixture of public/private joint ventures (the vast majority), public authorities and private sector companies. Of these, eight regionally based but interconnected utilities dominate generation. Transmission is carried out by these eight largest utilities and other regional utilities; in some cases, they also carry out distribution. However, most distribution is carried out by a large number of small local distribution undertakings. (Total installed capacity of system 80GW approx.)

ITALY

Generation, transmission and distribution dominated by the state utility, which is responsible for 80% of total generation. Some 160 municipal authorities also generate, transmit and distribute. (Total installed capacity of system 44GW approx.)

JAPAN

Nine regional private sector companies dominate generation, transmission and distribution. Public sector utilities (one large one and a number of smaller regional ones) also generate and sell in the main to the nine companies for transmission and distribution. The private sector and public sector undertakings are interconnected and co-operate closely in load despatching. (Total installed capacity of system 140GW approx.)

NETHERLANDS

Generation and transmission is the responsibility of 16 provincial and municipal public authorities. Most of these also distribute. In addition, there are a large number of small municipal distribution-only authorities. A co-ordinating body owned by the generating companies operates the grid. (Total installed capacity of system 16GW approx.)

SPAIN

There are a large number (over 800) of mainly private undertakings grouped into 22 parent utilities. Of these, a third are power boards carrying out generation, transmission and distribution; the other two-thirds are distribution-only utilities. The transmission grid has recently been nationalised. (Total installed capacity of system 38GW approx.)

SWEDEN

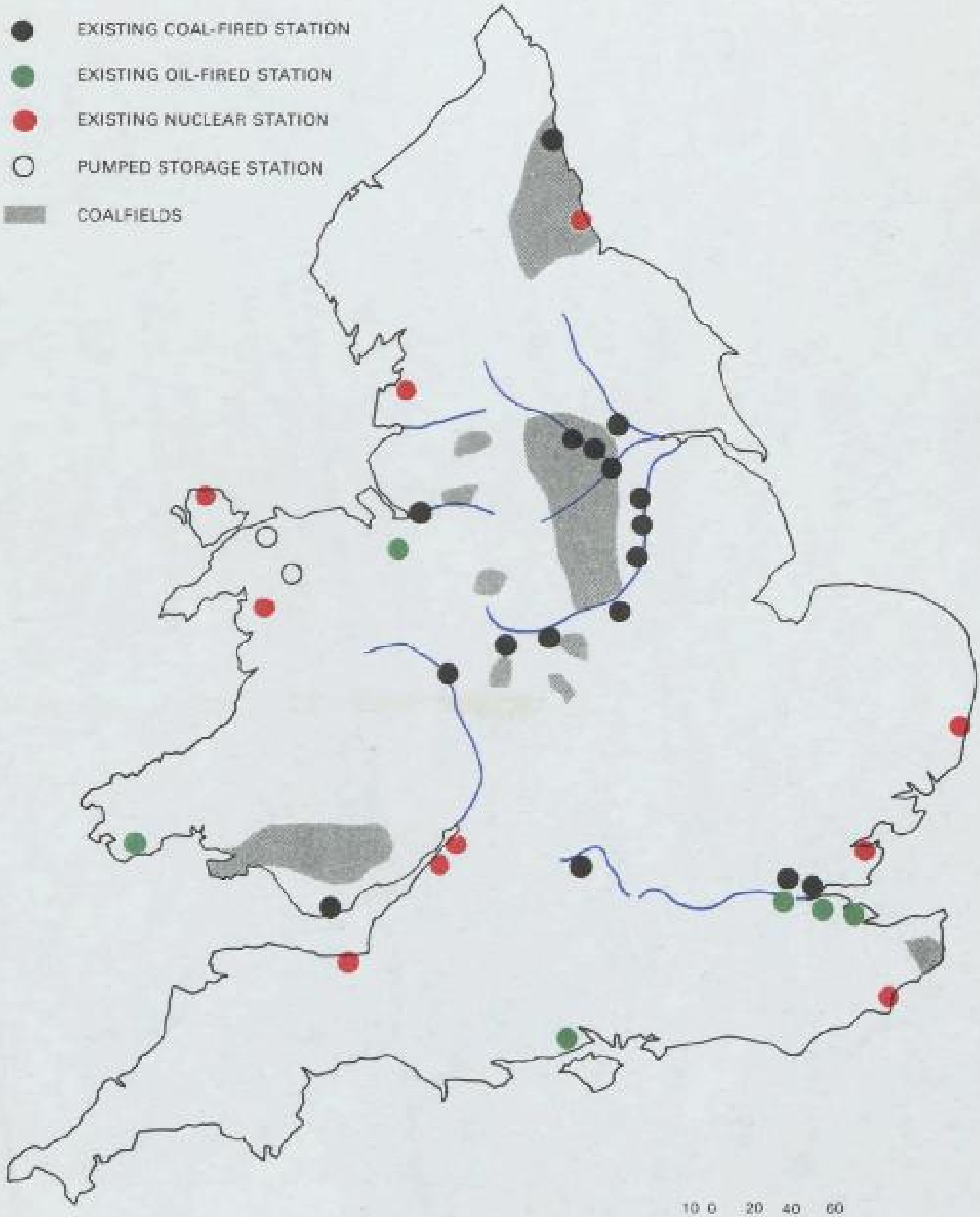
A large number of utilities (1500) the majority being in the public sector. These are dominated by the State Power Board (SSPB) which carries out half of the total generation. Most of the generating companies also transmit and distribute, but the majority of the distribution is actually undertaken by a large number of small private sector and municipal undertakings. (Total installed capacity of system 30GW approx.)

USA

About 75% of generation and distribution is carried out by private sector utilities which have a territorial monopoly of supply, but who co-operate to create "power pools". About 9% of total generation comes from Federal projects which wholesale electricity to smaller utilities for distribution. A further 10% is provided by State and municipal utilities who also distribute. There are also a large number of small co-operative undertakings (which account for 3.5% of production) which supply remote rural areas. There are three separate transmission networks covering most of the USA. (Total installed capacity of system 660GW approx.)

ANNEX B

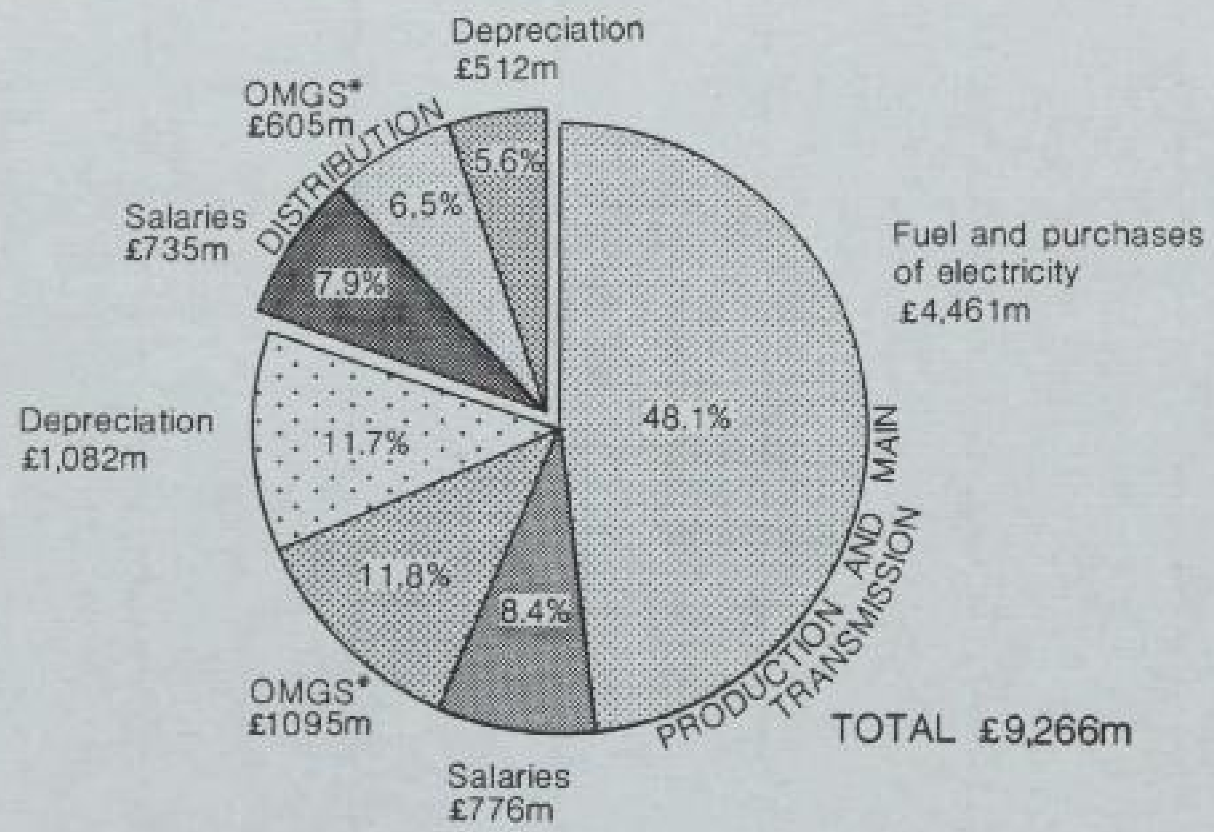
MAJOR POWER STATIONS SHOWING MAIN RIVER SYSTEMS AND COAL FIELDS



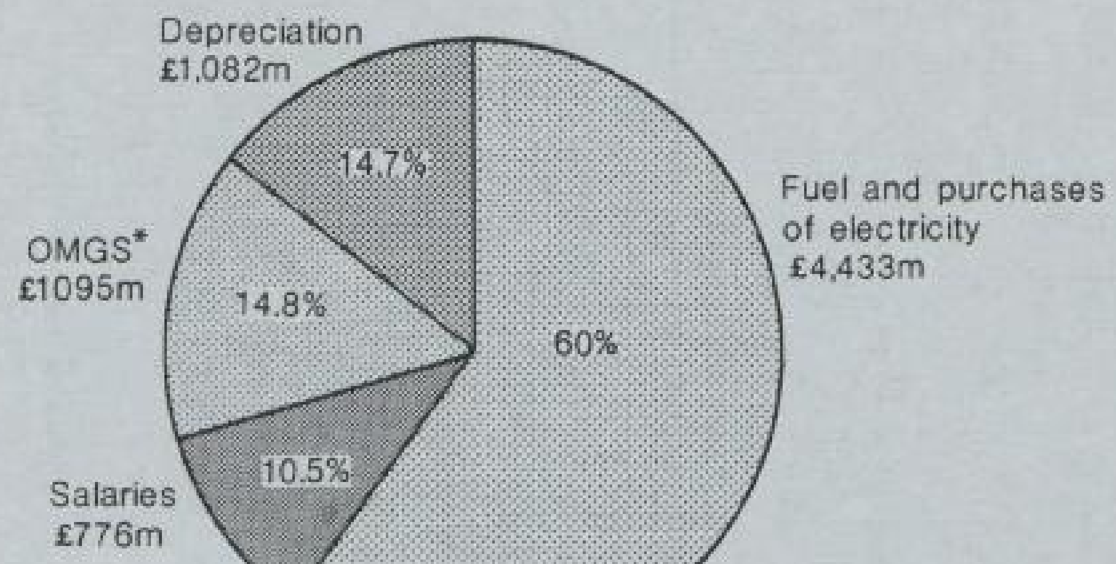
ANNEX C

ESI OPERATING COSTS

For ESI as a whole in 1986/87



For CEGB only in 1986/87

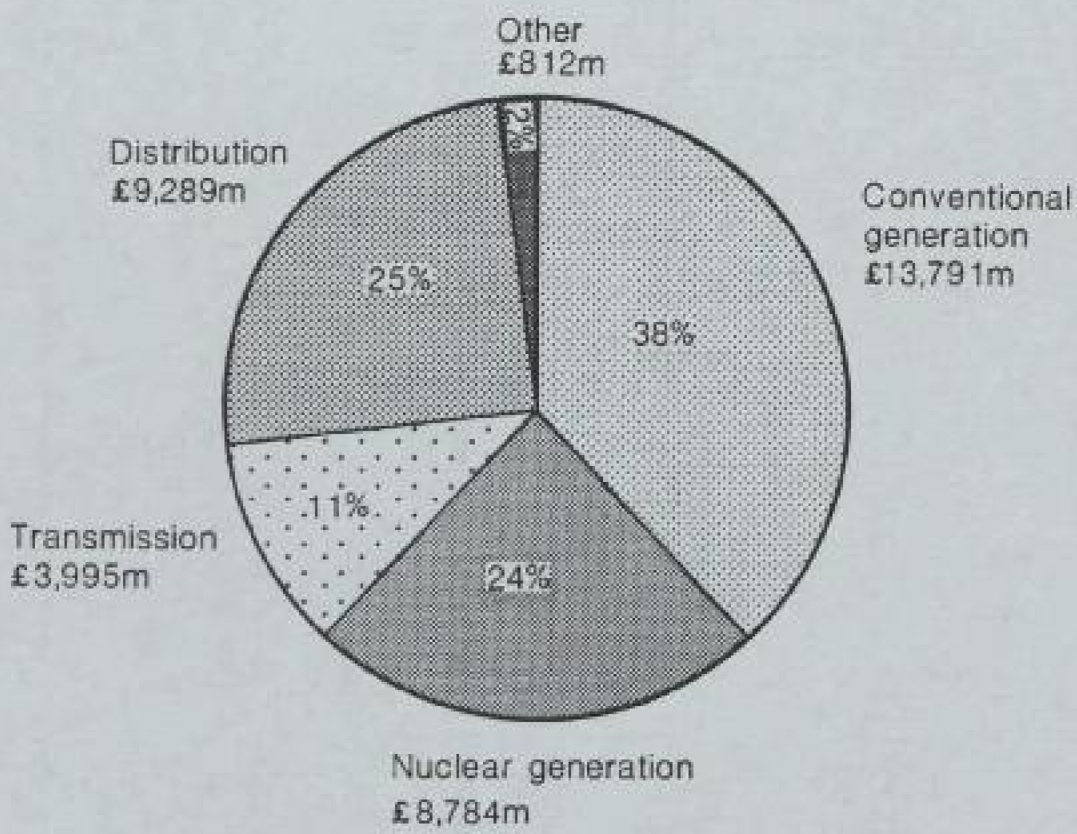


*OMGS is other materials, goods and services, and includes rents, rates and insurances

ANNEX D

ESI ASSETS

Tangible Fixed Assets
CCA Net book value at 31 March 1987

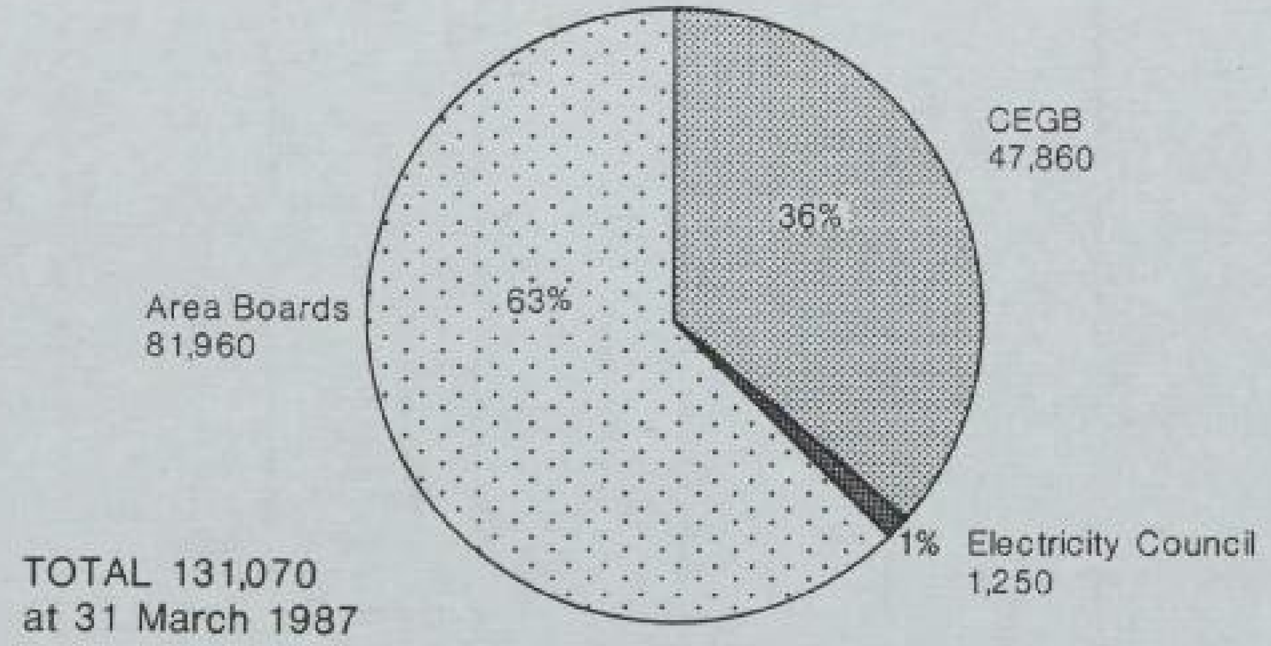


TOTAL TANGIBLE FIXED ASSETS	£36,671m
NET CURRENT ASSETS	£3,183m
CREDITORS AND PROVISIONS	(£2,788m)
NET ASSETS EMPLOYED	£37,066m

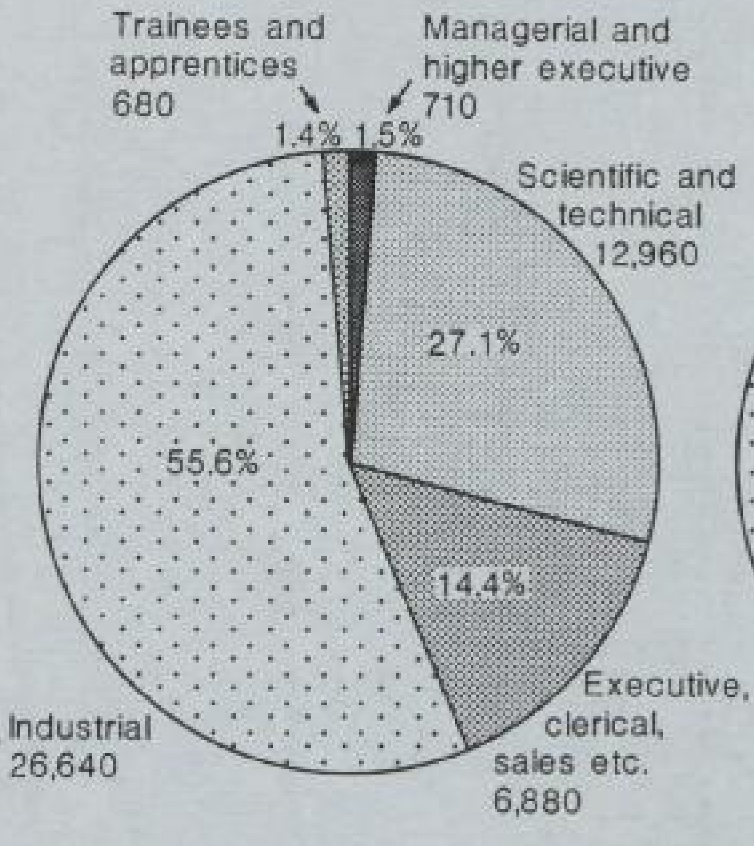
ANNEX E

ESI EMPLOYEES

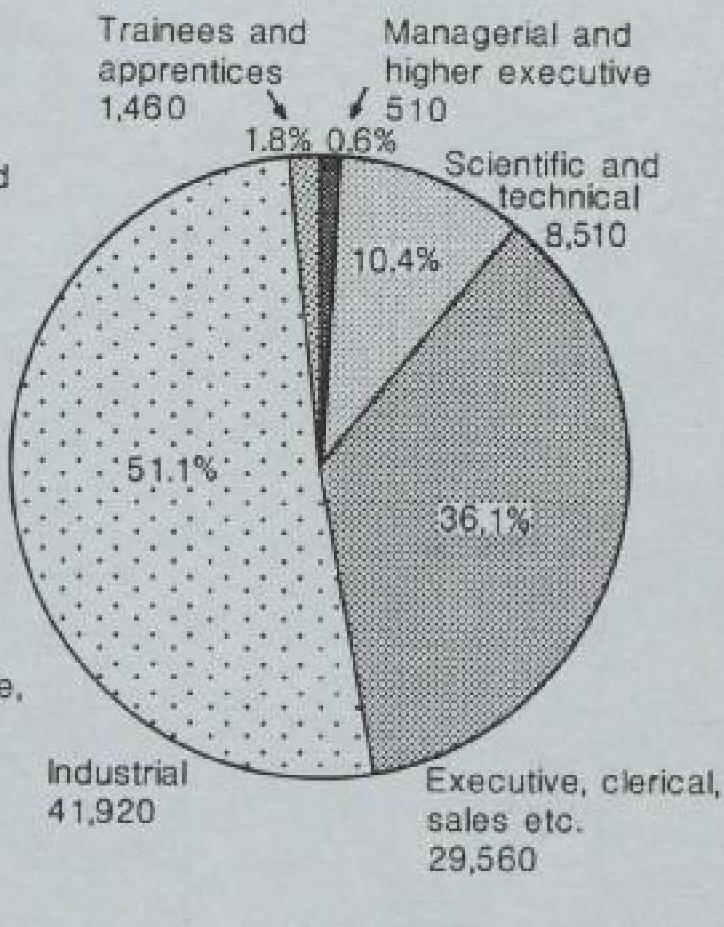
ESI as a whole



CEGB

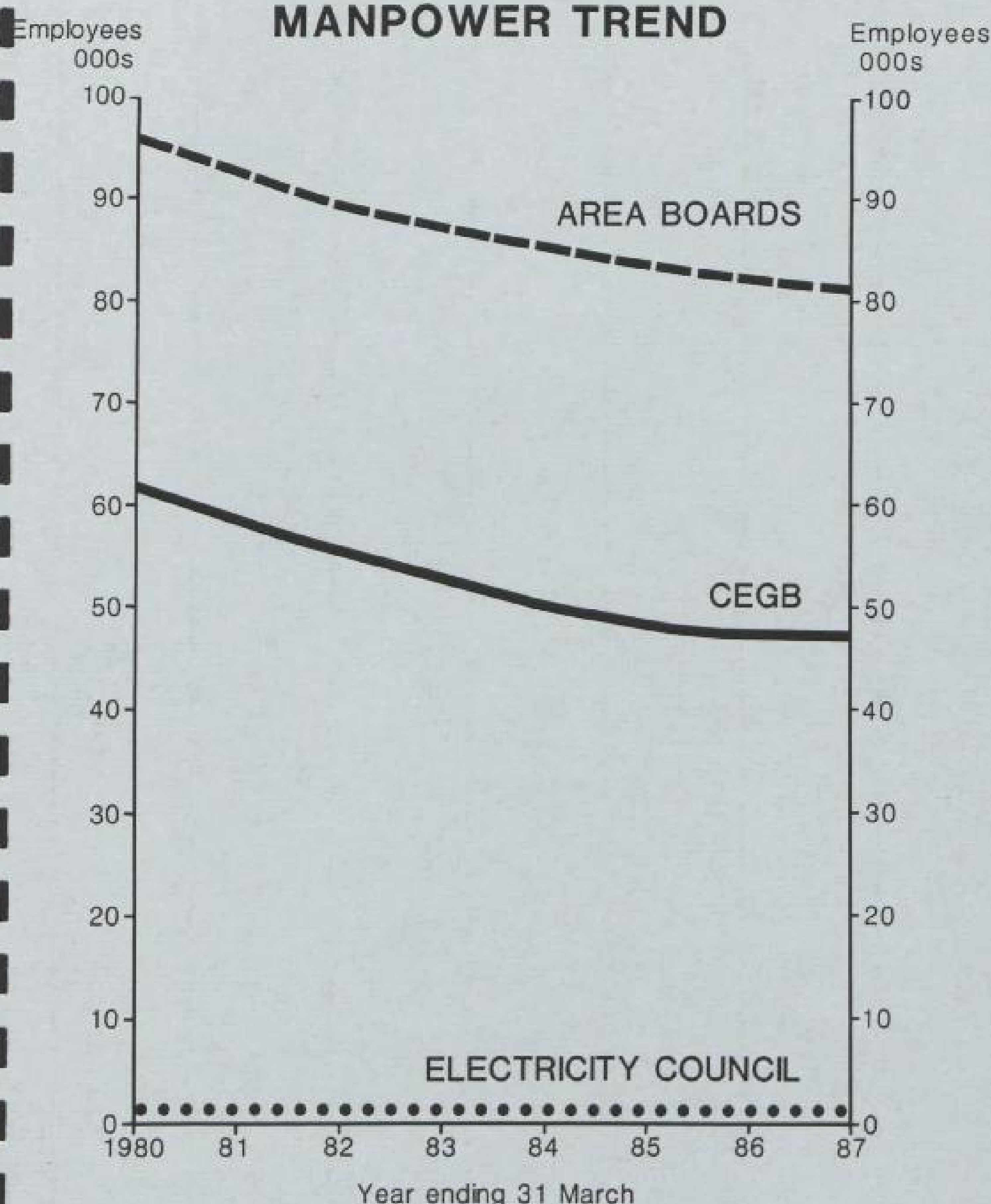


Area Boards



ANNEX E
FIGURE

MANPOWER TREND



ANNEX F

ANNEX F

ESI PROFIT AND LOSS ACCOUNT
and other financial statistics for the
Year to 31 March 1987

	CCA	HC
(a) Profit and Loss Account	£ Million	
Turnover	11,119	11,119
Operating costs	9,952	9,241
Operating profit	1,166	1,878
Monetary working capital adjustment	17	---
Profit before interest	1,150	1,878
Interest	436	436
Taxation	126	126
Profit for the year	587	1,315
(b) Other financial statistics		
Net assets employed at year end	37,066	13,729
Return on average net assets	3.17%	13.75%
Capital requirements:		
- Financed by internal sources	1,357	1,357
- Net repayments	1,334	1,334
- TOTAL	2,690	2,690
	========	=======

ANNEX G

NUMBER OF EMPLOYEES IN EACH TRADE UNION WHOSE SUBSCRIPTIONS ARE DEDUCTED BY EMPLOYING BOARDS - ELECTRICITY SUPPLY INDUSTRY - ENGLAND, WALES AND SCOTLAND AS AT 30 SEPTEMBER 1984

TRADE UNION	Number	% of Total
Association of Managerial Electrical Executives	196	0.2
Electrical Power Engineers' Association	23,999	18.0
National and Local Government Officers' Association	35,524	26.7
Association of Professional, Executive, Clerical and Computer Staff	1,381	1.0
General, Municipal, Boilermakers and Allied Trades Union	19,471	14.6
Transport and General Workers Union	12,485	9.4
Amalgamated Union of Engineering Workers	5,183	3.9
Electrical, Electronic and Telecommunications Union - Plumbing Trades Union	34,419	25.8
Union of Construction, Allied Trades and Technicians	505	0.4
Other	2	0.0
Total number of employees whose Trade Union subscriptions were deducted by employing Boards	133,165	100.0

The total number of employees on the payroll at 30 September 1984 was 152,274 and the percentage of employees whose subscriptions were deducted by Boards was 87.5%.

Of the remaining 12.5% a proportion paid their subscriptions direct to their union, and the remainder were not union members.

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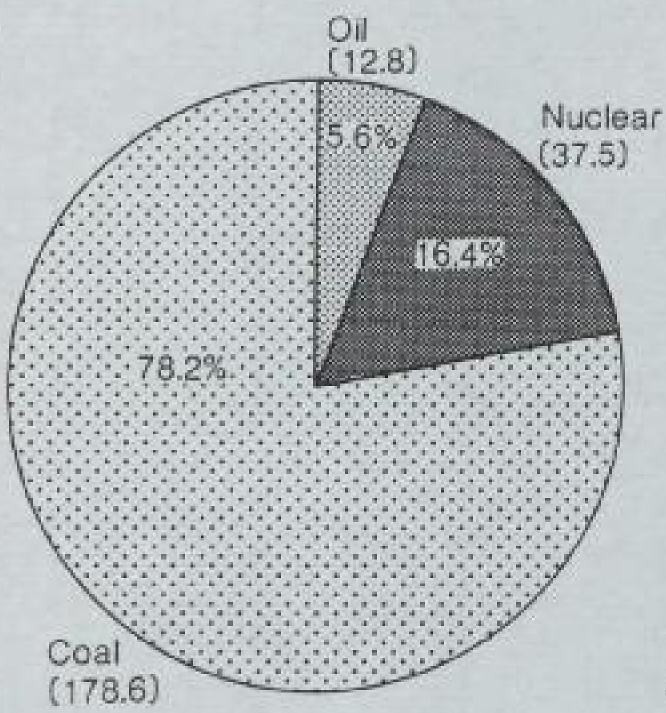
ANNEX H

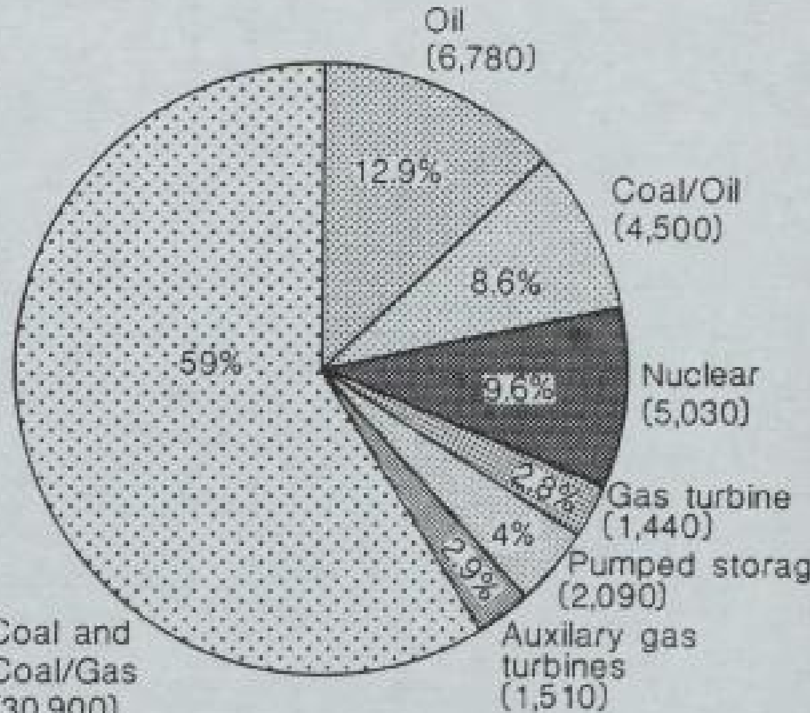
ESI POWER STATIONS AND FUEL CONSUMPTION

Electricity supplied in 1986/87 (TWh)



Total 228.4 TWh

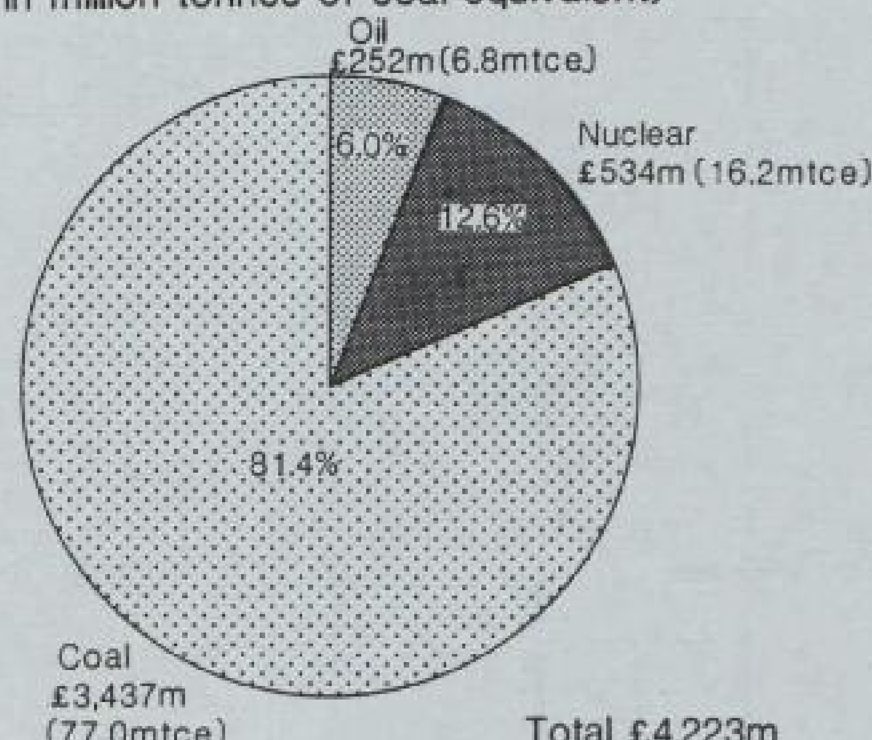
Declared Net Capability (MWso)



Total 52,360 MWso

Fuel Costs in 1986/87

(in £m, with total fuel consumption in million tonnes of coal equivalent)



Total £4,223m

ANNEX I

ANNEX I

CEGB CAPITAL EXPENDITURE ON NEW CAPACITY 1987-2005

(a) Capacity shortfall

CEGB forecasts suggests that total demand at winter peak in average cold spell conditions is likely to increase by nearly 25% by the year 2000 and its forecasts assume a compound growth rate in demand of 1.6% pa. On this basis, and assuming that a 19% planned capacity margin is required, the Board predicts a capacity shortfall commencing in 1994/5 and growing to 13 GW by 2000. This shortfall might be reduced if firm imports from Scotland are available in the late 1990's, and if old coal plant can be run beyond the end of its nominal life. It should also be noted that the potential for life extensions to other plant after 2000 is very substantial and could significantly reduce the new capacity needed in this period.

(b) Plant ordering plans

The CEGB's plans envisage the commissioning of Sizewell B in 1995 followed by five further PWRs and four coal-fired stations between 1995 and 2000. The sequence of commissionings currently planned for the period up to the year 2000 is:

	PWR	Coal-fired
1995	Sizewell B	2
1996	--	1
1997	--	--
1998	1	1
1999	2	--
2000	2	--

A further six PWRs and one coal-fired station are envisaged for commissioning between 2000 and 2003. The plans have yet to be accepted by Government beyond the decision to go ahead with Sizewell B. Because of the long lead time involved, the first tranche of plant will need approval in the near future. Lord Marshall has indicated that proposals for the next PWR and two coal-fired stations will reach the Secretary of State this year and applications for the next two PWRs are likely to be made next year. Planning inquiries on the next five PWRs after Sizewell are likely to run from 1988 to 1993, and construction would probably have to start between 1990 and 1992 to meet the Board's plans.

(c) Capital expenditure

Up to the end of the century, the Board's expenditure plans will involve (all figures in 1987 prices):

i) investment of £15 billion on the first family of PWRs and coal stations which are required by 2000;

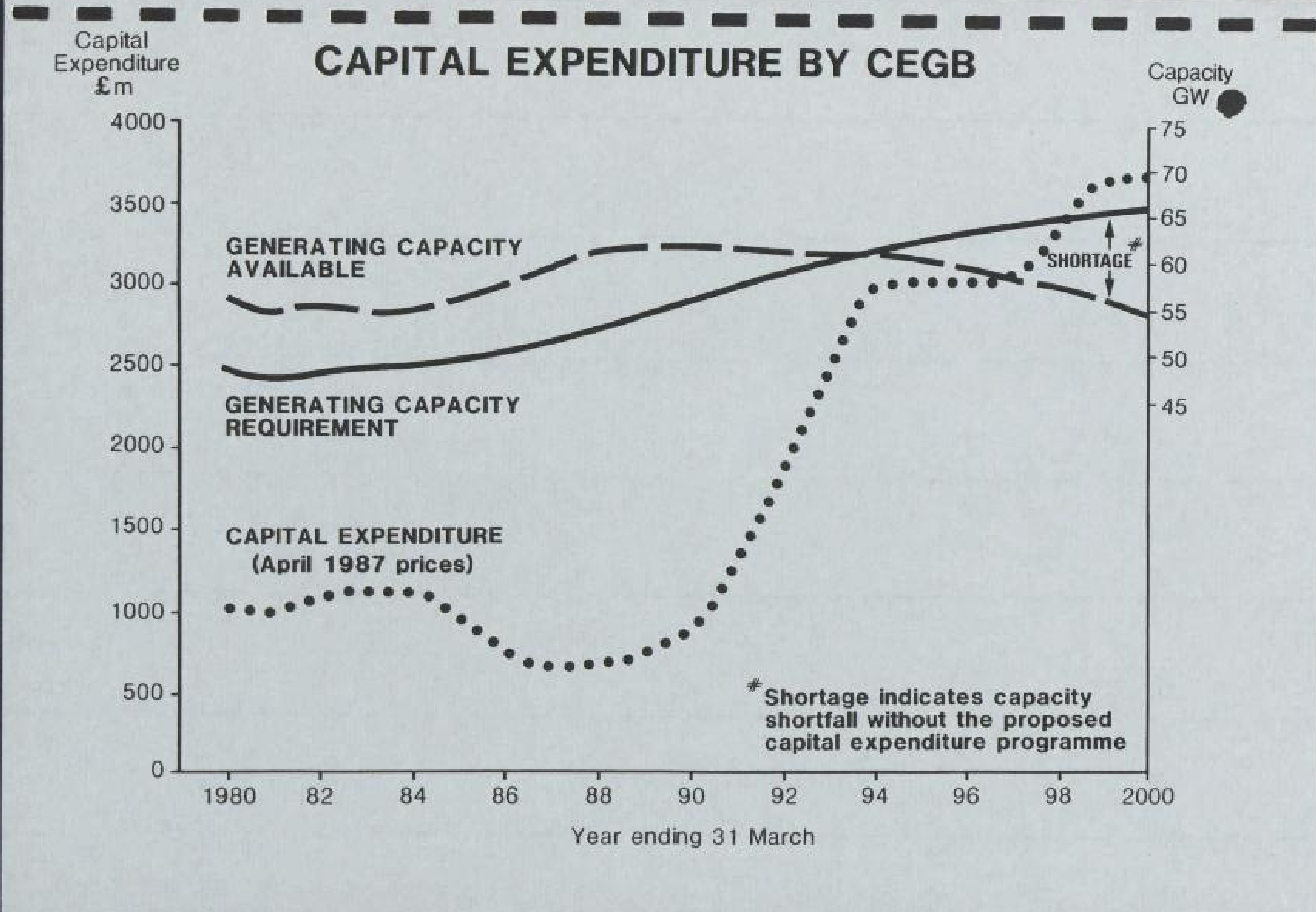
ii) investment of £10 billion on the further stations which are required by 2003;

iii) investment of £5 billion on transmission and generation-related projects.

Taken together this implies investment of £30 billion to 2000, at 1987 prices, or almost £45 billion in estimated outturn prices. In the next seven years, the period covered by the Board's detailed forward plans, capital expenditure, which is illustrated in the attached graph, is envisaged to grow as follows (£ million, 1987 prices):

	1987/88	1988/89	1989/90	1990/91
new power stations	206	297	407	771
power stations existing and under construction	309	223	216	220
transmission	121	133	155	155
other	29	87	102	174
Total	665	740	880	1320

	1991/92	1992/93	1993/94	Total for 7 years
new power stations	1281	1847	2277	7086
power stations existing and under construction	229	235	250	1682
for transmission	174	209	200	1147
other	166	209	223	990
Total	1850	2500	2950	10905


CAPITAL EXPENDITURE BY CEGB
Capital Expenditure £m
Capacity GW
4000
3500
3000
2500
2000
1500
1000
500
0
75
70
65
60
55
50
45
GENERATING CAPACITY AVAILABLE
GENERATING CAPACITY REQUIREMENT
CAPITAL EXPENDITURE (April 1987 prices)
SHORTAGE#
#Shortage indicates capacity shortfall without the proposed capital expenditure programme
1980
82
84
86
88
90
92
94
96
98
2000
Year ending 31 March

ANNEX J

ANNEX J

PRIVATE GENERATION OF ELECTRICITY

Including nuclear stations (670MWe) owned by the AEA and BNFL, total private generation capacity in Great Britain at the end of 1986 was some 3900MWe contributing some 6% of total electricity supplied in Great Britain (1% nuclear).

(a) Existing major private generators

The major existing private generators are largely industrial, producing electricity for their own use. Excluding the nuclear stations, the largest is Alcan in the North East with 390MWe. Other significant operators are:

London Transport	-	300MWe (scheduled to close in 1990)
ICI Wilton	-	250MWe
ICI Mond	-	220MWe (on three sites)
Esso Fawley	-	150MWe
BP Grangemouth	-	140MWe
Edmonton refuse-fuelled generator	-	60MWe

There are 103 private generators selling to Boards in Great Britain. Of these, 25 have capacities above 10MW; 19, between 1 and 10MW; and 59, below 1MW. Out of the 75 private generators exporting to Boards in England and Wales, 35 are small-scale Combined Heat and Power (CHP) operators.

(b) Potential private generator projects

Other than the potential Mersey and Severn Barrages, there are a number of more conventional projects under discussion which might lead to private generators supplying the public supply system:

Rogerstone - The CEGB has received two bids, from Ryan International and Coal Mining Development respectively, for this redundant 114MW coal-fired station in South Wales. Both companies are interested in refurbishing the station with a view to selling to the Area board.

Ewbank Preece - (a) In association with Schlumberger are exploring the possibility of constructing a 700MW coal-fired power station at Barking on an existing CEGB site. The power station would be owned by another company, such as Costains or Taylor Woodrow;

(b) are exploring the possibility of another 700MW power station on a local authority site at Shoreham;

(c) are investigating the possibility of a combined cycle power station at Inswarton Point near Plymouth. They have contacted British Gas about this.

Trafalgar House - are interested in installing a 300MW combined cycle gas turbine at Marchwood. The CEGB has asked that they consider a number of other sites.

(c) **Potential gas-fired private generation projects, principally for supply to the ESI**

A number of projects involving oil companies seeking alternative markets for gas are under consideration:

Peterhead - BP and Conoco are preparing to burn untreated sour gas from the Miller Field by converting the Peterhead power station (1.2GW) from coal. The electricity would be sold to NOSHEB.

Ranger/LASMO - are studying options for the disposal of gas from a sizeable southern basin discovery, including the conversion of a virtually redundant power station at Great Yarmouth.

Wytch Farm Development - BP plans to generate electricity from gas at Wytch Farm by installing two turbine generator sites capable of producing a peak output of 5.4MW. BP's own requirements are expected to be 1.5MW. The balance will be sold to SEB.

NEI - are investigating the possibility of constructing a gas-fired power station in East Anglia using gas supplied by Ranger.

BP, Conoco and Carless - are also studying prospects for electricity generation for own use and for sale at a number of small onshore developments.

(d) Combined Heat and Power (CHP) Schemes

Of the three "lead city schemes" receiving £750,000 of Government aid, Leicester (160MWe) is the nearest to commercial viability. The consortium involved has launched a company "Leicester Energy Ltd" to take the project forward in the private sector. Feasibility studies on Belfast and Edinburgh have been completed and the consortia are now preparing their reports for submission to Ministers before publication. Sheffield City Council and Tyneside are pressing ahead with plans to fuel CHP and District Heating Schemes with refuse.

SECRET

ELECTRICITY PRIVATISATION

KEY ISSUES

SECRET

COPY NO. 1 OF 11

ELECTRICITY PRIVATISATION
KEY ISSUES

This paper starts by identifying the objectives of privatising the electricity supply industry. In particular, it emphasises the importance of creating downward pressure on costs through competition. It describes two broad approaches to increasing competition within the ESI and identifies the key issues common to both of them, concentrating on their impact on the nuclear power programme, the UK coal industry, and the management of the generation and transmission system. The paper does not examine how the two approaches differ in their implications, nor does it address their feasibility or advantages and disadvantages. That analysis will be the subject of a separate presentation.

OBJECTIVES

2. In addition to extending share ownership and obtaining full value for public assets, the overall objective of privatising the industry must be to create a secure but more efficient and economic supply of electricity. To some extent, privatisation on any model will increase pressures for efficiency by:

- transferring a nationalised industry to the private sector, giving management freedom to manage, and subjecting it to a clear regulatory regime;

- requiring the new companies to raise finance in the private capital markets, so subjecting their investment plans and performance to commercial tests;

- making the new companies, and particularly their management, accountable to their shareholders and subject to the continuous scrutiny of the financial markets; and

- providing an opportunity to give all employees a direct stake in the performance of their industry, in the form of shares or share options.

However, these effects of transferring the industry into the private sector are unlikely by themselves to achieve the Government's overall objective.

3. A more detailed picture of the industry is given in a separate background paper, but there is a strong case for saying that creating a secure but more efficient and economic supply of electricity will require an approach to privatisation that aims to:

- introduce an effective measure of competition to improve efficiency, reduce costs and contain prices;

- avoid creating additional barriers to investment in nuclear power;

- contribute to the creation of an efficient and economic UK coal industry;

- meet any technical barriers constraints on changing the structure of the industry and to minimise the costs involved;

- establish a regulatory regime which gives protection against excessive price rises, creates real incentives for efficiency and sets standards of service to consumers, especially in the local distribution of electricity; and to

- privatise the industry as soon as is consistent with these other objectives.

Not all of these objectives are necessarily compatible, and trade-offs may have to be made between them. Each objective is addressed below and examined in detail in the Annexes to this paper.

4. There are a number of key points about the industry to bear in mind when considering these objectives. First, the ESI is an industry facing a substantial requirement for new generating capacity to replace ageing assets and to meet growing demand. This means that there can now be no delay to the approval, ordering and construction of new stations. On the CEGB's costs and plans, which may not be entirely relevant after privatisation, capital expenditure in 1987 prices will increase by almost five times from its current level of some £615 million to about £2860 million by 1993/4. Total capital expenditure to 2001 is expected to amount to almost £35 billion in 1987 prices. Even taking account of the greater efficiency and possibly different investment strategies of a privatised industry, the capital programme will be substantial. The industry is now ceasing to generate sufficient cash to repay debt; it will shortly face a growing and substantial borrowing requirement. Second, the CEGB expects some 70% of investment in new capacity to 2000 to be in nuclear stations and the Government has accepted the strategic case for a substantial nuclear programme. Third, the ESI is an industry in which coal-fired stations currently provide 78% of total electricity supplied and in which purchases of coal account for some 40% of operating costs. Fourth, the ESI is an industry in which generation and transmission have been developed into an integrated system

operated by a single body, with the aim of reducing system costs rather than simply the costs of individual generating units. Finally, domestic consumers only have direct contact with the Area Boards that carry out the local distribution of electricity, a natural monopoly into which it will be hard to introduce competition.

COSTS AND PRICES

5. Privatisation offers an opportunity to achieve cost reduction and efficiency through greater competition. This will be important in itself. It will be essential if the privatised electricity industry is to generate sufficient profit to finance its capital expenditure requirement and keep borrowing to acceptable levels.

6. Partly because it has for some years had surplus capacity, the industry has been able to keep its rate of return at relatively low levels; and it will require a substantial improvement in cash flow to finance the six-fold increase in capital expenditure envisaged between now and 2000, whether or not the industry is privatised. This improvement will probably have to be greater if the ESI is to raise the necessary finance in the private capital markets. In the short term, there will be the need to pay dividends, which may amount to more than £500 million a year. In the longer term, there will be a need to earn a higher rate of return than the historically low rates required by a public sector body subject only to a statutory duty to break even, taking one year with another.

7. One of the aims of privatisation should be to ensure that the industry finds a solution to its financing requirement that does not simply rely on price increases. This will be important because the difficulties of introducing real competition into the local distribution of electricity will

make it hard to change the public perception that the whole industry is a monopoly. Together with the reliability of supply, electricity prices are therefore likely to be the most obvious yardstick by which customers will measure the success of privatisation.

8. Annex A contains a preliminary analysis of the industry's future cash flow. Inevitably, this is based on the CEGB's projections and costs, and it therefore gives only one picture of the future. The tentative conclusions of this analysis can be summarised as follows:

-760 90-91

2000 -3500

(a) if reductions in costs of some £760 million a year were found by 1990/1 (outturn prices), growing to some £3500 million a year by 1999/2000, then price rises to maintain an acceptable financial performance by the privatised industry could be kept in line with inflation. The latter figure of £3500 million is equivalent to some £1850 million in 1987 prices and represents some 35 per cent of total costs in 1999/2000;

(b) the necessary reduction in costs by the end of the century falls to some £1500 million, if prices are allowed to rise in real terms by 1% a year between 1990 and 1995 and by 2% a year from 1995 to 2000. This figure is equivalent to some £795 million in 1987 prices, and represents 15% of total costs in 1999/2000;

(c) cost saving or price rises are, of course, not the only ways of improving net cash flow and maintaining an acceptable level of gearing. Capital expenditure can be reduced and the capital structure improved. A number of elements can therefore be combined to achieve an acceptable financial performance. These include: deferring capital expenditure through the extension or refurbishment of plant; leasing rather than purchasing assets; savings in fuel purchases; and improving the capital structure of the CEGB. Our initial work suggests that the scale of cost reduction, revenue enhancement and containment of capital expenditure which should be sought by the industry is substantial. For that reason, it would be premature to conclude that the industry will be able to avoid the need for continuing real price increases;

(d) these projections are based on the CEGB's capital expenditure plans as costed by the CEGB, and envisage the need for 13GW of new capacity by 2000. The Department's energy projections suggest that the CEGB may be underestimating the capacity requirement, which could range from 13 to 19GW by 2000, with a central estimate of 16GW. The principal sensitivities are the paths of economic growth and fossil fuel prices;

(e) it is hard to judge the scope for cost savings. A breakdown of ESI operating costs was given in a separate background paper and is repeated at Annex B. Generation and main transmission account for some 80% of ESI operating costs, and fuel accounts for some 60% of generating costs and some 50% of ESI operating costs. The CEGB claims that it could achieve substantial savings, perhaps of more than £500 million a year within 3 years, if it were allowed complete freedom in coal purchasing.

INCREASING COMPETITION IN GENERATION

9. Increasing competition in fuel purchasing does not necessarily require any change in the structure of the industry since it would be open to the CEGB to renegotiate its understanding with British Coal, purchase fuel more competitively and make use of sizeable coal imports. In terms of the structure of the industry, therefore, the most important requirement will be to introduce greater competition into generation and the provision of new capacity.

10. The scale of the CEGB's capital expenditure programme has two consequences. First, it makes it important to subject this renewal of ageing assets to competitive pressure. Second, it offers the opportunity to introduce competition into electricity generation on a significant scale whether or not the CEGB is divided. This is illustrated by the Department's tentative projection that some 40-50GW of new capacity or extensions of plant life will be needed by 2010. The aim would not just be to subject project management and plant construction to greater competition but, in time, to introduce competition into the business of generation and so put pressure on all generating costs. However, this approach depends crucially on whether private generators will wish, or be able, to enter the market in competition with the CEGB.

11. Against this background, it is possible to identify two basic approaches to introducing competition in the generation of electricity:

(a) growth: this assumes that private generators are willing to enter the market and that it will be possible to create a framework which enables private sector companies, or consortia, to compete for the provision of new capacity as private generators;

(b) division: this creates competition by dividing the CEGB into a number of separate generating companies.

12. The development of competition on these two approaches will be considered in a separate presentation. But there are of course a number of variants on both these approaches. Those that rely on the growth of private generation usually envisage leaving the CEGB intact, supplying one or more distribution companies. Some require the disposal of some part of the CEGB's capacity, as a basis for competition. Some also envisage removing the 400KV and 275KV national grid from the CEGB, on the grounds that this will ensure fair and equal access for private generators to the transmission system. On most models, the distribution companies are given the right to generate themselves, so creating potential competitors for the CEGB. Those models that divide the CEGB usually envisage the creation of 4 or 5 new generating companies, a separate transmission company, and 4 or 5 distribution companies. In almost all models, the obligation to supply is placed on the distribution companies, so shifting responsibility for bringing forward new capacity away from the CEGB to the retail end of the ESI.

13. On either of the two basic approaches, it is unlikely that private sector finance for capital investment would be forthcoming except on the basis of long-term supply contracts between the distribution or transmission companies and the generating companies. Equally, it is unlikely that any generator would build capacity without the assurance of long-term supply contracts. In general, such contracts would be likely to provide for a fixed capacity charge to enable finance to be raised and a variable energy charge. In such circumstances, competition for the supply of new capacity would take the form of competition in a long-term contract market. Potential entrants into such a market include the distribution companies themselves; plant manufacturers;

construction and mining companies; oil companies, especially those seeking new markets for gas; local authorities; and major industrial companies with surplus power from their own plant.

14. In some models, the separate generating companies created by dividing the CEGB are combined with regional transmission and distribution companies to form power boards. To some extent, this is the same as the unification of the industry on a regional rather than national scale. The danger is that it would lead to regional monopolies. It does not appear to add anything to the option of dividing the CEGB other than a further layer of organisational complexity.

KEY ISSUES

15. It is not the purpose of this paper to analyse the relative merits of the two basic approaches to privatisation outlined above. However, there are a number of issues which will arise on any approach to privatisation which are discussed in some detail in the Annexes to this paper and which demonstrate that some trade-offs are likely to be needed between the various objectives for privatisation:

(a) ESI cash flow: as mentioned above, if substantial cost savings and other cash flow improvements are not found, the industry's capital investment programme is likely to create upward pressure on prices; (Annex A);

(b) Nuclear power: subjecting investment plans to commercial tests may reduce the scale of future investment in nuclear power, which is favoured by the historically low discount rate (5% real) set by the government and used by the CEGB to appraise investment (Annex C);

(c) British Coal: subjecting fuel purchasing to purely commercial tests will lead in time to sizeable imports of coal, unless British Coal or private companies can meet the ESI's coal requirements at prices competitive with world market prices (Annex D).

(d) Technical constraints: the operation of the generation and transmission systems has become progressively more integrated over the last fifty years, with the aim of minimising cost and ensuring that the total system does not fail. The CEGB believes that splitting the two would incur significant costs and greatly increase the risk of system failure. The technical and commercial issues involved will need to be examined so that the costs and practicability of separating the Grid can be properly assessed. (Annex E);

(e) Regulation: on any structure there will be elements of monopoly, principally in local distribution and transmission, that will need strict regulation.

16. The timetables involved in privatising the ESI on the two basic approaches described above will be considered in a separate presentation. But it is worth highlighting two related tasks that the industry will be facing over the next five years. First, it seems likely that planning inquiries on the next family of PWR's, and a couple of coal stations, will take place over the next five years. If the expected capacity shortfall in the 1990s is to be met, and if the nuclear programme is to be successful, then it is crucial that these inquiries do not take as long as the Sizewell inquiry. Second, managing the related five fold increase in capital expenditure to 1995 and beyond, together with the associated

increase in staffing and workload, will require considerable management skill. Any delay or uncertainty in this programme would have implications for the plant manufacturing industry.

NUCLEAR POWER

17. With the possible closure of the magnox stations at the end of the extended lives, the contribution of nuclear power will decline in the 1990s in terms of the proportion of total electricity supplied. To maintain the momentum of the nuclear programme, the CEGB has plans for completing Sizewell B and five further PWRs by 2000. A further six PWRs are envisaged by 2003. Planning inquiries on the first five are likely to stretch from 1988 to 1992. The application for the next PWR at Hinkley Point has reached the Secretary of State.

18. Even with Sizewell B in operation, the CEGB estimates that, on its plans, coal burn at the end of the century will still contribute 75% of electricity supplied. Experience has shown that it is unwise to rely too heavily upon the security or economic advantage of one fuel. The case for nuclear power does not therefore depend solely on its economic advantage. In national terms, there is a strong case on grounds of fuel diversity. To depend on coal alone for the country's baseload generating capacity would be irresponsible.

19. One question to be addressed is how to maintain the momentum of the nuclear programme, and to ensure that the next family of PWRs is successfully launched, during the transitional disruption of privatisation. We can expect opponents of nuclear power to exploit any opportunity for delay. This can no doubt be managed but it may have implications for the timetable for privatisation.

20. Another question is whether a privatised industry would accept the national case for fuel diversity or rest its investment decisions solely on the economics of PWRs. This is important because a crucial element in determining the economics of PWRs is the real rate of return (RRR) required from investment. The low RRR of 5%, fixed by the Government and used by the CEGB, favours capital intensive plant. A private sector company in a competitive market would use a higher RRR. On the Department's central estimates of capital costs, construction times and fossil fuel prices, PWRs become unattractive compared to other technologies at RRRs of 10% and above, unless other considerations, such as diversity, are taken into account. This assumes no improvement in the capital costs of coal-fired stations, which the CEGB are actively trying to reduce.

21. Annex C looks at these other considerations in more detail. It identifies three factors which will be important in influencing private sector companies in their decisions on nuclear investment:

(a) their ability to reduce capital costs and construction times through the replication of a standard PWR design in a steady ordering programme;

(b) concerns about the reliability of earnings from nuclear plant and the costs of environmental and safety regulation; and,

(c) concerns about the future price and availability of fossil fuels, and their dependence on coal-generated electricity.

BRITISH COAL

22. Annex D considers the impact of ESI privatisation on British Coal, given the objective that privatisation should contribute to the creation of an efficient UK coal industry. This is clearly important since some 70% of British Coal's UK sales go to meeting 95% of the CEGB's coal requirement. The joint understanding between the CEGB and BCC provides for the supply of 70mt at an average delivered price which is up to £12/t more than the delivered price of imported coal. There are physical constraints on how much coal the CEGB could import, and there may be little cost advantage in importing to inland stations situated on coal fields because of transport costs. But the CEGB argue that they could make substantial savings by increasing imports to 30mt over some 3 to 5 years. This would clearly create a considerable obstacle to break even by BCC. A clear statement on future fuel purchasing arrangements will be needed in any ESI prospectus.

23. Meeting the challenge from imports will be a considerable task for BCC. BCC has substantially reduced staff and increased productivity in the last two years, but full alignment with international coal prices by the early 1990's would require a much sharper reduction in manpower that the 35,000 BCC currently envisages by 1990/1. Cutting existing capacity by a further 25mt/a by then would involve shedding an additional 30,000 men, so almost halving the current workforce to some 75,000. If further industrial action has to be faced in achieving an efficient UK coal industry, the ability and willingness of the ESI to maintain electricity supplies will be crucial. The current contingency plans will have to be adapted to a private sector ESI and responsibility for the costs involved made explicit in any prospectus. In this context, the technical constraints on operating the generation and transmission system need to be considered, since changing

the structure of the system may reduce its flexibility to conserve coal in an emergency.

TECHNICAL CONSTRAINTS

24. The CEGB will argue that splitting the operation of the national high voltage transmission system from the operation of the nation's generating plant would incur significant costs and greatly increase the risk of system failure. To ensure generating stations are operated in order of cost and in such a way that the loads on the transmission system do not cause parts of it to fail, CEGB National Grid Control, through the Area Control Centres, continuously directs the use of power stations and flows in the transmission system. The Board does not believe that the integrated planning and operation of the system can be achieved through contractual relationships between generators and a separate transmission company except at excessive costs. On the other hand, parts of the industry, including some Area Board Chairmen, believe that transmission can be separated, provided the transmission company acts as the sole purchaser of power from generating companies and directs the use of generating capacity. The role of the generating industry in this latter model is reduced to managing individual power stations and providing output and new capacity within contractual arrangements. These arguments, which have implications for the structure of a privatised ESI, are described in more detail in Annex E and will be examined in a separate presentation.

REGULATION

25. Since the nature of the regulatory regime will vary with the structure adopted for the industry, this paper will not go into detail on economic regulation. However, there are three key issues which should be highlighted:

(a) Distribution: There is a strong case for saying that distribution and main transmission are natural monopolies because of the costs of duplicating resources. The privatised distribution companies will need careful regulation to contain prices. They will also need to be placed under an obligation to supply, since it is clear that no generating company could retain such an obligation if competition is to develop. The distribution companies will then have to decide whether to generate themselves or enter into long term contracts for bulk supply. It would also be desirable if domestic and industrial consumers could be given more power, through the regulator, to enforce standards of service, such as the time taken to connect or reconnect customers or to remedy faults. This last point needs further study in the context of the updating of electricity supply legislation that will be required before privatisation;

(b) Transmission: if transmission were to remain in the ownership of a privatised CEGB, or a separate transmission company, it would require strict regulation to avoid monopoly pricing. It would also be crucial to ensure that competing generators had fair and equal access to the transmission system, and that distribution companies had access through the system to the cheapest sources of generation. If ownership of the Grid was not transferred to the distribution companies, fair and equal access would have to be achieved through detailed and continuous policing of common carriage charges by the regulator;

(c) Generation: The degree of regulation of generation will depend on the level of competition that is introduced. Those approaches that introduce most competition into generation offer the prospect of moving towards minimal regulation of the ex-power station price of electricity.

DISTRIBUTION

26. This paper has concentrated on the question of introducing competition into generation and the implications of doing so. The key issues to be addressed in privatising the distribution side of the ESI are:

(a) the form of regulation, given the monopoly power of the Area Boards; and,

(b) the number of distribution companies required.

Some parts of the industry have argued for a single distribution company, or at least a holding company for the Area Boards, in order to balance the dominant position of the CEGB and to contract centrally for bulk supply. Others believe that some reduction in numbers will be necessary to ensure the financial viability of the companies and to simplify flotation. These arguments need to be considered further. However, it seems clear that decisions on the structure of the distribution side of the business, and on its regulation, will have to take account of decisions on the future structure of the generating industry and, in particular, the future ownership of the transmission system.

SUMMARY AND CONCLUSION

27. The beginning of this paper identifies a number of objectives for privatisation of the ESI. The analysis in the

rest of the paper suggests that there may have to be trade-offs between some of these objectives and concludes that:

- the CEGB's capital expenditure programme will put upward pressure on prices. This pressure will be greater in the private sector;

- capital expenditure and fuel costs will be the largest elements in the wholesale price of electricity;

- two basic approaches to introducing competition into generation can be identified: division of the CEGB or the growth of private generation over time;

- the economics of investment in PWRs will be less attractive to private sector generating companies in a competitive market;

- privatisation of the ESI on any approach will increase the pressure on BCC to reduce inland coal prices and to accelerate its programme to reduce costs;

- the CEGB believes that excessive costs would be incurred if operation of the transmission system was split from generation, which is likely to be one of the prerequisites of dividing the CEGB into a number competing companies.

ANNEX A

ANNEX A

ESI CASH FLOW

The ESI is facing the need for a very substantial capital expenditure programme to meet growing demand and to replace its ageing assets. On the CEGB's plans, which are shown graphically in Figure 1A, capital expenditure will rise by more than five times by 1999/2000.

2. The Department has analysed the cash flow projections of the CEGB with its financial advisers. This analysis involves assumptions about the dividend yield, interest cover, and the cash flow and level of gearing required to attract private capital on the scale required. The assumptions used by our advisers are:

- a gross dividend yield of 5%
- growth in dividends of 10%
- the need to avoid steadily increasing negative net cash flow as the capital expenditure programme gathers pace.

Clearly these assumptions are crude and need to be tested.

3. The principal conclusions of this analysis are:

(a) The changes made to prices within the next one to two years are not particularly significant for the longer term financing of the industry. Major price increases will tend to increase the value of the generating industry at the time of flotation and reduce debt. They do not establish, however, a capital structure that will be able to withstand the projected capital expenditure unless dividend cover at the time of flotation or the CEGB's equity capital is substantially increased, both of which will reduce overall net proceeds from the generating industry;

(b) if cost reductions of some £760 million a year were found by 1990/1, (outturn price), growing to some £3500 million a year by 1999/2000, then price rises to maintain an acceptable financial performance by the privatised industry could be kept in line with inflation. The latter figure of £3500 million is equivalent to some £1850 million in 1987 prices and represents some 35 per cent of total costs in 1999/2000;

(c) the necessary cost reduction by the end of the century falls to some £1500 million, if prices are allowed to rise in real terms by 1% a year between 1990 and 1995 and by 2% a year from 1995 to 2000. This figure is equivalent to some £795 million in 1986 prices, and represents 15% of total costs in 1999/2000;

(d) another way of achieving acceptable financial performance in the private sector, rather than simply cutting costs or raising prices, is to combine a number of elements so as to reduce capital expenditure and costs and to improve the capital structure of the CEGB. These include:

(i) deferring capital expenditure through the natural extension or refurbishment of existing plant, though the scope for this is limited until the last five years of the century;

(ii) leasing, rather than purchasing, assets wherever possible to even out the pattern of cash flows and improve overall tax efficiency;

(iii) increasing the savings in fuel purchases;

(iv) injecting debt into the Area Boards and increasing the capital base of the CEGB by a corresponding sum, though this will naturally reduce the value of the Area Boards.

(e) Our initial work indicates that the scale of cost reduction, revenue enhancement and containment of capital expenditure which should be sought is substantial. One combination which initial analysis suggests could produce an acceptable financial performance, and contain real price increases to 1% a year, would be:

(i) to reduce capital expenditure up to 10% in the last five years of the century;

(ii) to lease assets wherever possible (it may be difficult to lease nuclear power stations);

(iii) to assume fuel savings similar to those which the CEGB says are attainable;

(iv) to transfer £1 billion from the Area Boards to the CEGB.

However, a considerable amount of further work is needed to test the assumptions behind this analysis and the extent to which these changes could be achieved. In particular, we will need to discuss the questions of leasing and deferral of capital expenditure with the CEGB.

4. All these projections have, of course, been made on the basis of CEGB estimates of capital expenditure. These are based on the CEGB's estimates that 13GW of new capacity will be required by 2000 and more than 20GW by 2003. The Department has reconsidered its projections of long-term energy needs to check the validity of these estimates. The key variables in assessing future energy requirements are the future levels of economic activity and real fossil fuel prices. The Department has examined energy requirements for a range of growth rates of GDP from 1.25 to 2.75% and for a high, low and central path of fossil fuel prices. The high fuel price case assumes an international crude oil price rising from $15 per barrel in 1986 to $40 by 2000 (1986 dollars). The low case assumes a price of $18 in 2000. The central case assumes a price of $25 by 2000. This analysis shows final energy demand growing at about 2% pa to 1990 and between 0.5 to 1.5% pa thereafter. Within this, total electricity demand tends to grow at a slightly faster rate, though this depends on the real rate of return required by the ESI and the consequent effect on electricity prices. The Department's projections are based on a 5% real rate of return being reached by 1990, higher than the current target of 2.75%, and a sensitivity run based on a 10% RRR has been carried out.

5. The results, in terms of generating capacity requirements in England and Wales, are shown in Figure 3A. They suggest that, if anything, the CEGB is underestimating the need for new capacity. The Department's assessment is that the requirement for new capacity by 2000 could range from 13 to 19GW, with a plausible central case at around 16GW. Raising electricity prices by introducing a 10% RRR reduces this central case requirement to 14GW. It is worth noting that the

Department's's tentative assessment of the total need for either life extensions or new capacity by 2010 puts it at about the 40 to 50GW level. About half of this arises from stations reaching the end of their nominal lives. The rest is the result of growing demand.

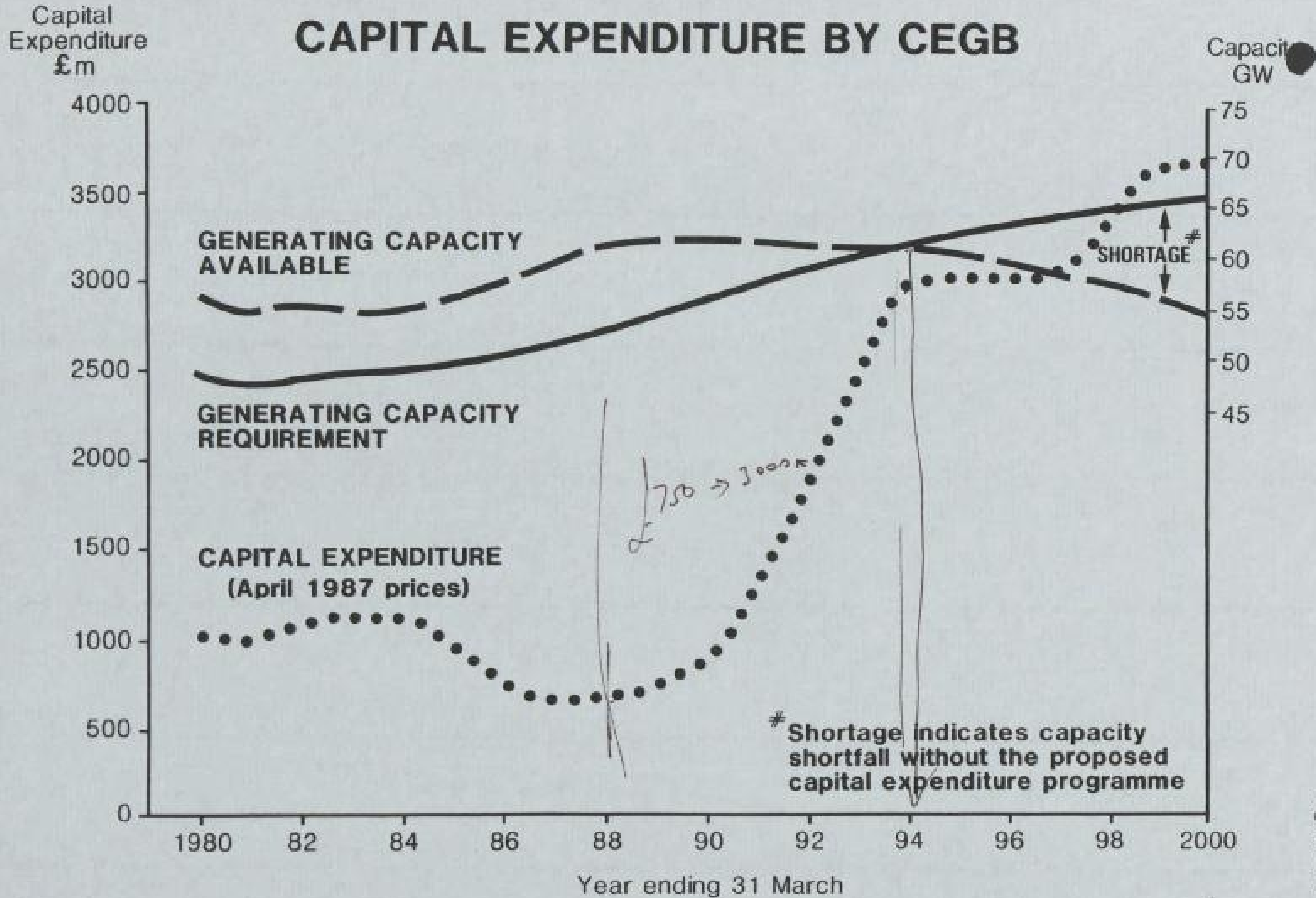

CAPITAL EXPENDITURE BY CEGB
Capital Expenditure £m
Capacity GW
4000
3500
3000
2500
2000
1500
1000
500
0
75
70
65
60
55
50
45
GENERATING CAPACITY AVAILABLE
GENERATING CAPACITY REQUIREMENT
CAPITAL EXPENDITURE (April 1987 prices)
SHORTAGE#
#Shortage indicates capacity shortfall without the proposed capital expenditure programme
£750 → 3000k
1980
82
84
86
88
90
92
94
96
98
2000
Year ending 31 March

Figure 1A

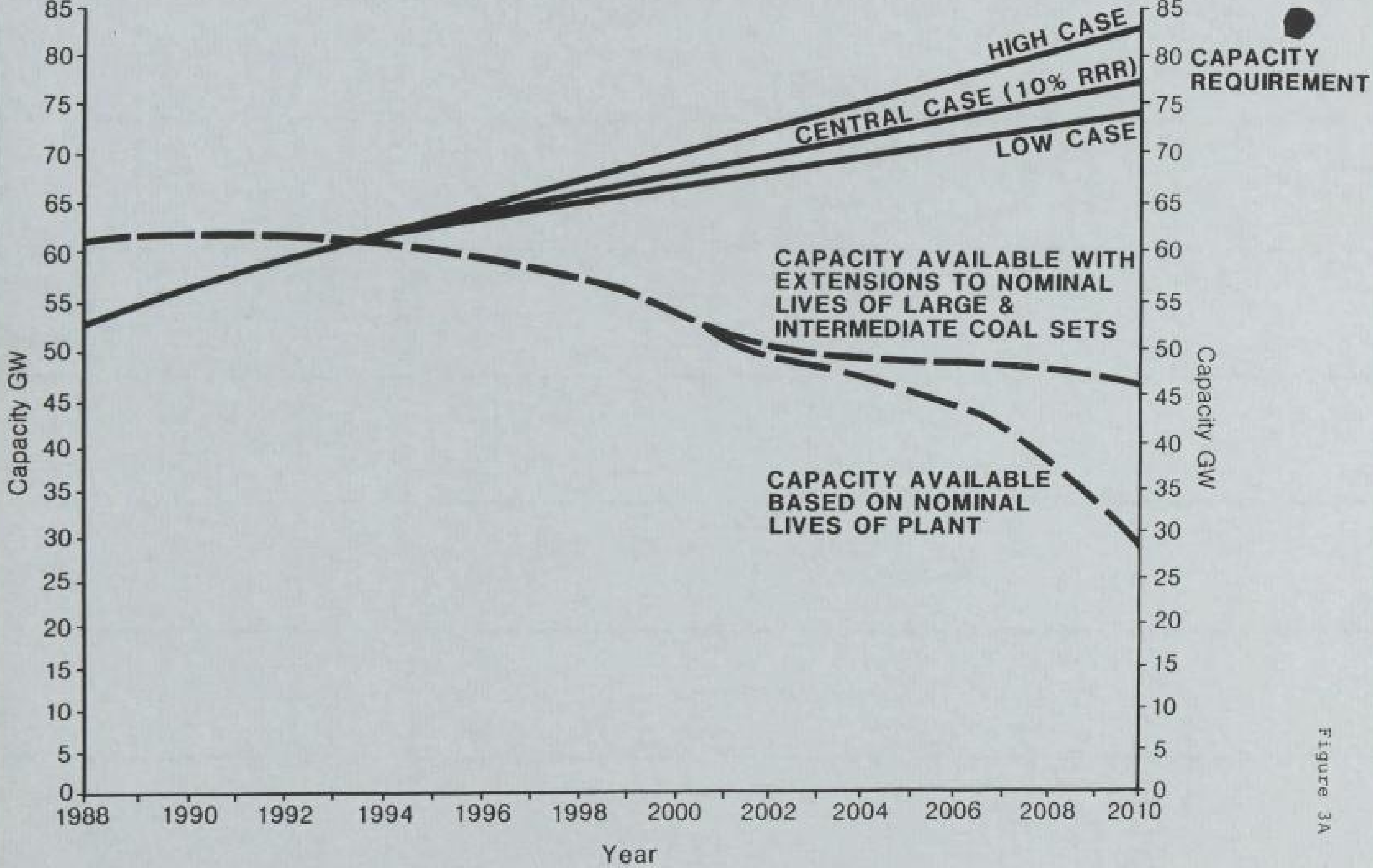
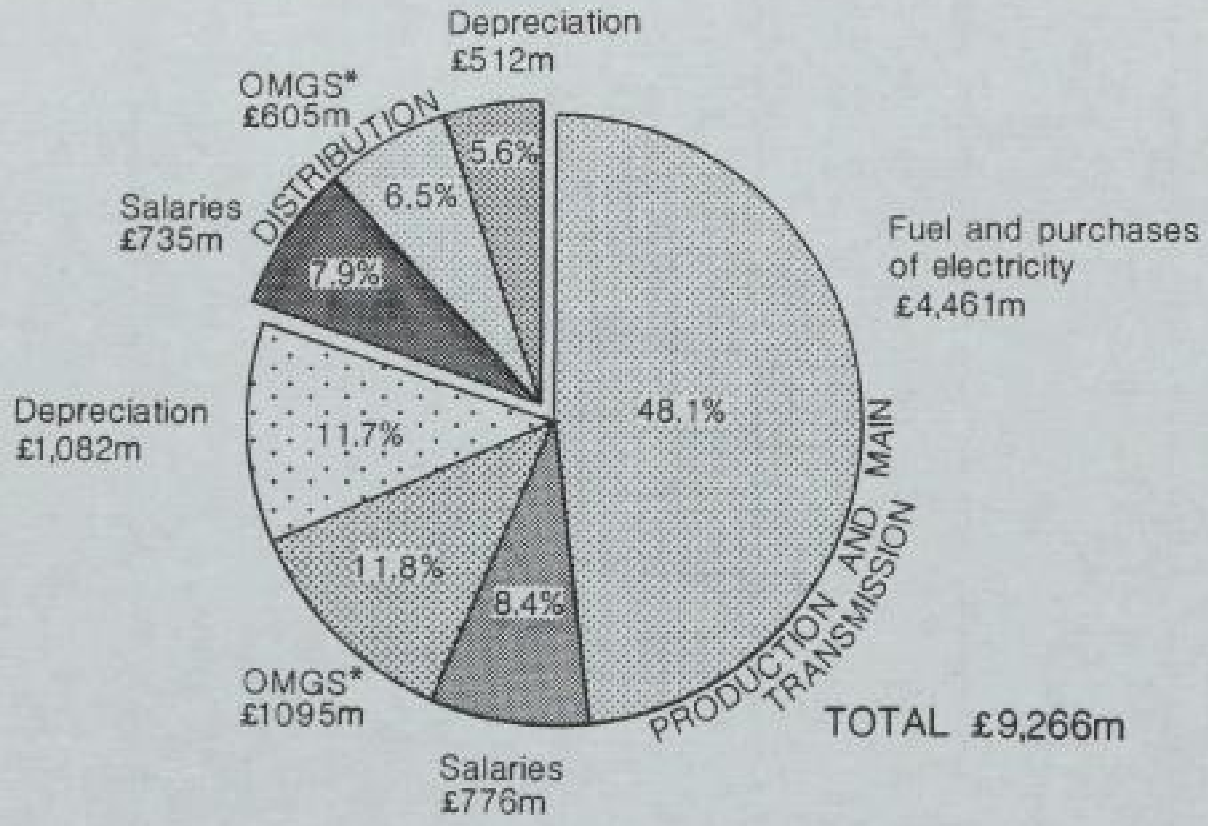

HIGH CASE
CENTRAL CASE (10% RRR)
LOW CASE
CAPACITY REQUIREMENT
CAPACITY AVAILABLE WITH EXTENSIONS TO NOMINAL LIVES OF LARGE & INTERMEDIATE COAL SETS
CAPACITY AVAILABLE BASED ON NOMINAL LIVES OF PLANT
Capacity GW
Year
0
5
10
15
20
25
30
35
40
45
50
55
60
65
70
75
80
85
1988
1990
1992
1994
1996
1998
2000
2002
2004
2006
2008
2010

Figure 3A

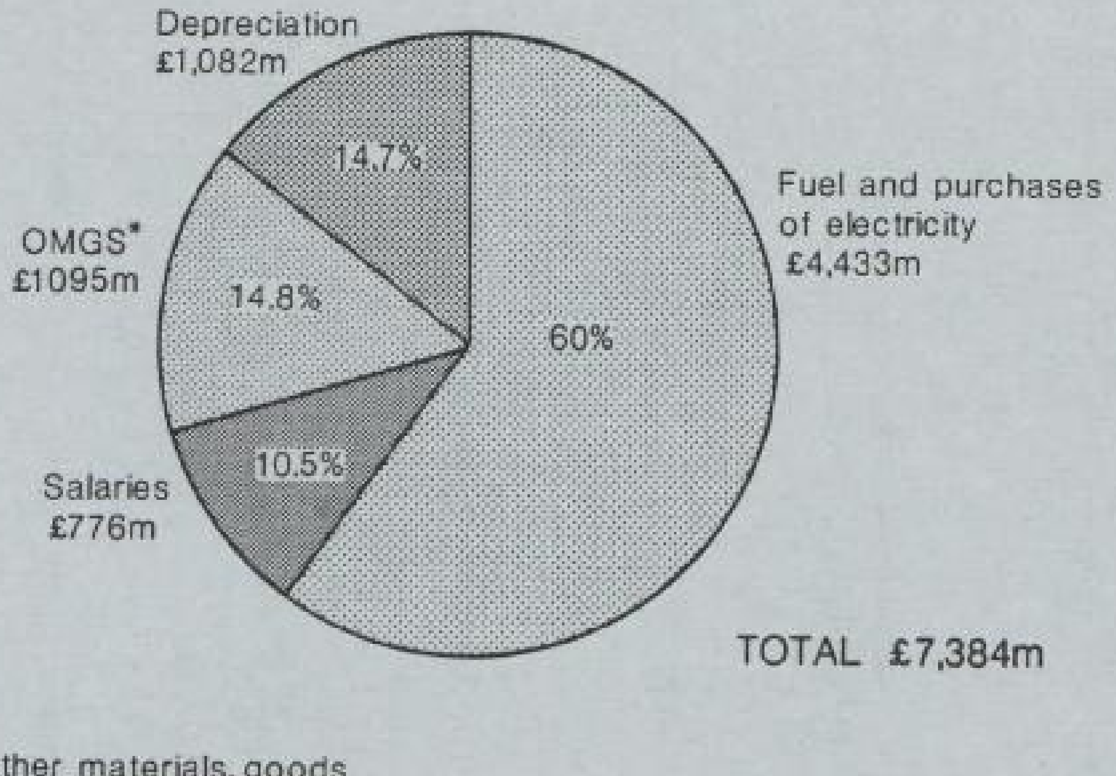
ANNEX B

ESI OPERATING COSTS

For ESI as a whole in 1986/87



For CEGB only in 1986/87



*OMGS is other materials, goods and services, and includes rents, rates and insurances

ANNEX C

ANNEX C

NUCLEAR POWER

In 1986/7, the CEGB's magnox and commissioned AGR stations provided some 10% of total declared net capability and some 16% of total electricity supplied. If the magnox stations have to be shut down at the end of their extended nominal lives, the first closures will take place in the early 1990s before the first PWR at Sizewell reaches its expected commissioning date in 1995. This loss of capacity and supply will however be balanced by the contribution from the commissioning of the four operating but not yet commissioned AGRs. Even so, the amount of nuclear generated electricity is likely to decline in the 1990s as a proportion of the growing volume of electricity sales.

The CEGB's Planned Nuclear Programme

2. To maintain a substantial level of nuclear generated electricity, the CEGB envisage the commissioning of the Sizewell PWR in 1995 followed by five further PWRs between 1995 and 2000. A further six PWRs are envisaged for commissioning between 2000 and 2003. Because of the long lead times involved, the first tranche of plant will need approval in the near future. An application for the next PWR at Hinkley Point has reached the Secretary of State and applications for the next two PWRs are likely to be made next year. Construction of the five PWRs following Sizewell would probably have to start between 1990 and 1992 to meet the CEGB's plans. The CEGB are pressing for an early Government statement emphasising the case for nuclear power in order to limit the scope of the necessary planning inquiries. As described in the main body of this paper, there is a strong case on grounds of fuel diversity for a nuclear power programme. Nuclear power stations also offer the prospect of

economic baseload generating capacity, provided they can be built to time and cost.

Economics of Nuclear Power

3. The current method of analysing investment choice in generating capacity is based on the concept of the system "net effective cost" (NEC). This indicates the estimated discounted total lifetime costs of constructing, maintaining and using a unit of capacity, less the associated savings to the rest of the system. The lower or more negative the NEC, the more attractive the investment. Clearly the required real rate of return (RRR), or discount rate, used is a crucial element in such calculations. The Government and CEGB currently use an RRR of 5% real for appraising investment decisions. This figure was based on comparisons with past real rates of return earned in the private sector. For whatever reason, the figure is arguably comparable to the real opportunity cost of money with little or no risk premium. For instance, the current yield on long term Government securities, a riskless investment, is some 10% or about 6% real. A private sector generating industry would certainly require a substantially higher RRR than the risk free cost of money.

4. At Figure 1C is a graphical presentation of the effect of varying RRR on the net effective cost comparison of a follow-on PWR with a coal-fired station. The calculations are based on the Department's computer model of the ESI generating system and of the way in which it is operated. This model, inevitably, differs from that used by the CEGB so the figures should be treated as giving only a broad indication of the results. Further, the comparisons given are sensitive to a number of assumptions, including the future price of fossil fuels, the cost and time of plant construction, and the cost of possible future environmental controls on either nuclear or

coal-fired stations. The calculations presented here are based on the Department's central perceptions about fossil fuel prices and the latest available estimates of capital costs and construction times. They suggest that the NEC comparison switches from PWR to coal at around the 10 per cent level of the RRR. However, this assumes no reduction in the capital costs of coal-fired stations.

Private Sector Concerns: Construction, Environmental and Safety Costs

5. As noted, these calculations are sensitive to the capital costs and construction times assured for PWRs. At a 10 per cent RRR the estimated 4 1/2 per cent reduction in capital costs in comparison with the Sizewell PWR, assumed by CEGB, is sufficient to ensure that nuclear plant is not ruled out on economic grounds. At a 15 per cent RRR a further 15 per cent reduction would be required for this to hold. As recommended by the Study Group on the Industrial Impact of Post Sizewell Nuclear Policy, the best hope of achieving such reductions lies in building PWRs to a fixed design and to a steady programme. This will be important if a privatised ESI is to continue to build nuclear stations, especially since private sector companies will be concerned about:

- the reliability of earnings from nuclear stations, given the poor performance of the AGRs;

- safety and the cost of environmental and safety regulation, given the impact that retrospective changes in nuclear safety requirements have had on US electric utilities;

- the potential costs of decommissioning and waste disposal, for which the CEGB has so far made provisions of some £2.5 billion;

- the potential cost of material and disaster insurance.

Strategic Considerations

6. The strategic case for building nuclear plant rests largely on:

(a) concerns about the future price and availability of fossil fuels;

(b) concerns about the dependence of the economy on electricity generated from coal;

The former assigns nuclear a role as a 'hedge' against higher than expected fossil fuel prices in the future. At a 10 per cent RRR the net effective costs of a follow-on PWR and a coal station are very close, suggesting a mixed plant strategy. At a 15 per cent RRR, however, even if oil prices were to reach $40 per barrel by the year 2000, which is the highest case used in the Department's projections, coal prices would be unlikely to rise sufficiently to cause the economics of the PWR to become more attractive than those of a coal station.

7. Quantifying the case for diversifying out of coal is more difficult, partly because nuclear power is not the only alternative. However, experience has shown that in national terms it would be unwise to rely too heavily on coal and that nuclear is a proven alternative. The question is whether a private sector company would place sufficient weight on fuel diversity and, if it did, whether it would prefer less capital intensive plant, such as combined cycle gas turbines, as the alternative to coal, rather than nuclear.

Implications for the Nuclear Industry and Safety Regulation

8. The implications of privatisation for the AEA's programmes - especially the fast reactor, which accounts for a quarter of its work - and for BNFL's reprocessing at Sellafield will also need to be considered. A privatised industry may take the view that it does not need the fast reactor within the foreseeable future and does not therefore wish to support a substantial research programme. This in turn could reflect on it perceptions of the need, or timescale, for recovery of plutonium by BNFL from spent fuel. Decisions on the structure of the privatised industry are also likely to have implications for the NNC's role as a nuclear supplier.

9. The existing arrangements for safety regulation at nuclear stations have been drawn up in the knowledge that the resources of CEGB's Health and Safety Department and their Berkley nuclear laboratories were available. The extent to which the arrangements may have to change, following privatisation, particularly if the CEGB were divided, needs further study. It seems likely that both the Nuclear Installations Inspectorate and the generating companies would require additional staff and that some means of pooling knowledge and skills would have to develop.

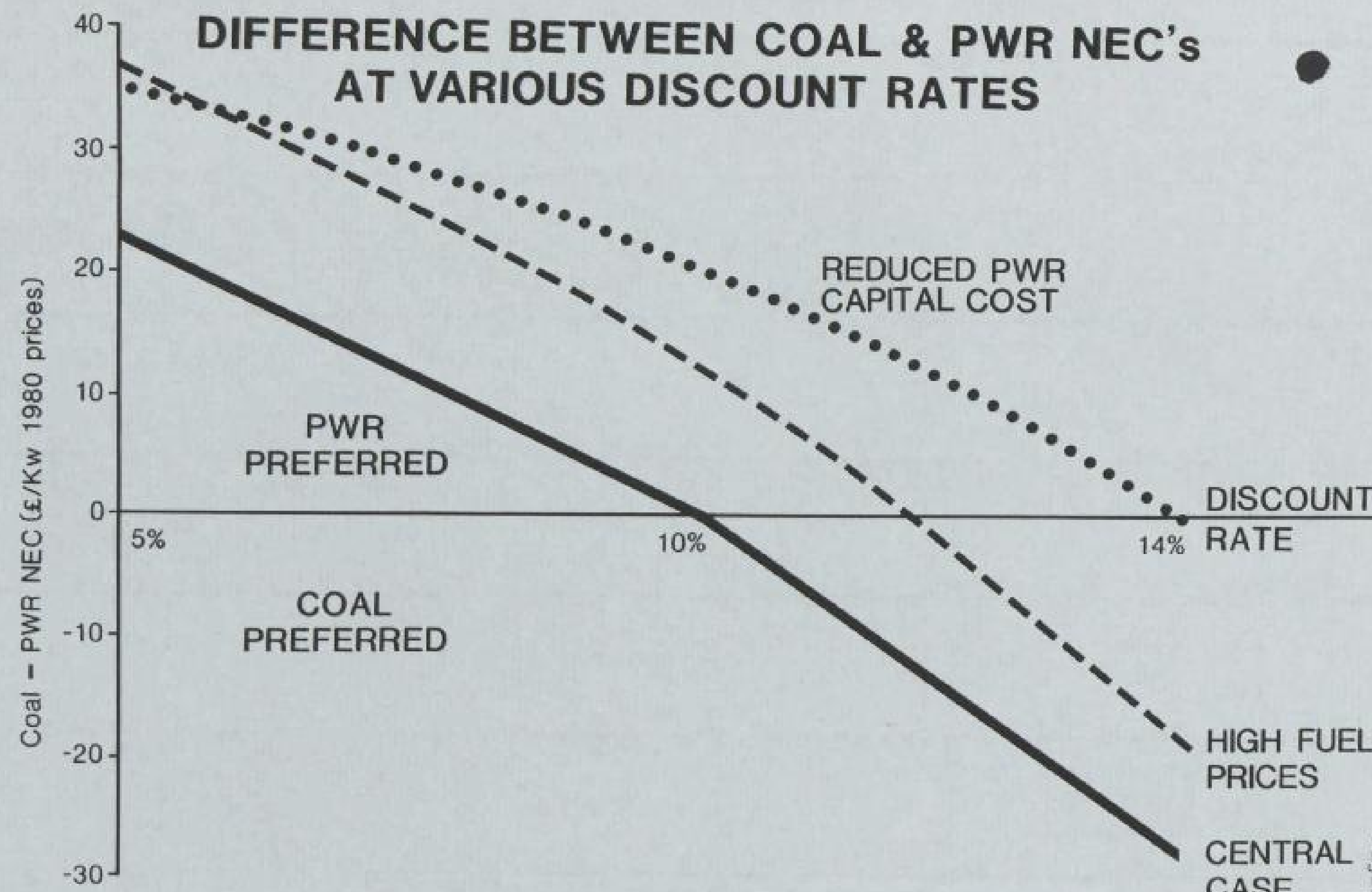

DIFFERENCE BETWEEN COAL & PWR NEC's
AT VARIOUS DISCOUNT RATES
Coal – PWR NEC (£/Kw 1980 prices)
40
30
20
10
0
-10
-20
-30
5%
10%
14%
DISCOUNT
RATE
REDUCED PWR
CAPITAL COST
PWR
PREFERRED
COAL
PREFERRED
HIGH FUEL
PRICES
CENTRAL
CASE

Figure 1C

ANNEX D

CONFIDENTIAL ANNEX D

IMPACT ON THE COAL INDUSTRY

At present some three quarters of electricity generated by the CEGB comes from coal-fired stations, and British Coal (BCC) supplies 95% of the CEGB's requirements. In 1986/87 CEGB consumed 77.0mt of coal and added 1.5mt to its coal stocks. Disposals to the CEGB of 74.9mt accounted for three-quarters of BCC's sales to the UK market. CEGB's imports amounted to only 1mt; their purchases from UK private mines and other UK private sector sources were 3mt.

Delivered Price of Imported Coal

2. The international price of coal has been falling in recent years, following the establishment of new low-cost capacity in several coal exporting countries, particularly Australia, South Africa, and lately Colombia and China. World trade in steam coal (for power stations and industry) has been growing rapidly over the last few years and now stands at around 140mtpa. The decline in international coal prices accelerated sharply last year following the collapse in oil prices, and the average price currently stands at around £20/tonne for delivery to deep water ports in NW Europe. Considerable spare production overhangs the market and there are no strong reasons for expecting a price recovery over the next few years. Transhipment and freight to shallower water British ports increases the price to about £24/tonne. Freight charges to inland power stations along existing rail and road links would vary with distance: CEGB have assessed the cost at around £10/tonne for those inland power stations most accessible to coal imports giving a delivered price for imported coal of £34/t.

The Delivered price of BCC Coal

3. The price paid by CEGB is governed by a five year Understanding reached with British Coal last year. Ministers have endorsed the Understanding for the period up to March 1988. The deal provides for CEGB to take 70mtpa from BCC. 12mtpa of this is at prices directly related to imports. The remaining 60mt is in two tranches - a first tranche of 47mt priced at £46.88p/tonne and a second tranche of 11mt priced at 75% of the first tranche price. By 1991 the first tranche will have been progressively reduced to 40mt, and the second tranche increased to 18mt. Prices are adjusted each November. There is a tacit understanding between CEGB and BCC that CEGB may buy additional tonnages from private UK mines and from the international market, provided that these are limited to not more than 5% of the total coal taken. This ensures that the great bulk of any incremental coal demand is awarded to BCC. The average price CEGB is currently paying for BCC coal is £41.72/tonne to which needs to be added transport costs to power stations, which amount on average to £3.55/tonne (although it varies considerably depending on distance). This gives a total delivered cost of BCC supplies of around £45-46/tonne, up to £12/tonne more than the delivered cost of imported coal.

when?

The Pressure for Change

4. CEGB claims that it could save £500-750m a year by more competitive coal purchasing from BCC and increasing imports. This claim has to be looked at carefully. If CEGB were, for example, to try to rely on imports for all of its coal requirements, this would be likely to have a significant effect upon the world price. Moreover, the infrastructure available to move large volumes of coal imports to inland UK power stations is still constrained and would take a few years to develop. A major UK supplier could in any case expect to extract a premium over the international price for coal which is available in quantity on a continuing basis, of a quality for which CEGB boilers were designed, which flows through established transport links, and is invoiced in sterling. Nevertheless, there are strong commercial pressures on CEGB to reduce the price it pays for its coal.

Given the likely persistence of a buyer's market, it seems probable that - even without esi privatisation - BCC will have been obliged to align its power station coal prices much more closely with import prices by, say, the mid-1990s.

Impact of ESI Privatisation

5. Privatisation of the esi may be expected to accelerate and intensify the pressure for import parity pricing. Privatised generators would be under stronger short term financial pressure to substitute low cost for high cost coal, and their success in doing so would be a factor at the time of their flotation. It is reasonable to assume that a privatised CEGB would seek to diversify its sources of coal in order to increase its security of supply. As a result, BCC is likely to lose a larger share of the power station market than if the CEGB had remained in the public sector, and it will have to accelerate its adjustment towards a lower cost base.

6. Whether the CEGB is sold as a single entity or is broken up into, say, four companies is unlikely of itself to affect the outcome very much. Although a fragmented industry might take a more aggressive approach towards British Coal, it would also have less clout in dealing with a monolithic supplier for its inland power stations. Moreover, splitting up the CEGB would probably take longer and so give BCC more time to get itself into a competitive position. The precise grouping of power stations into the competing generating companies could affect the overall balance of UK and imported coal, depending on the interplay of location and need for supply diversification, but the effect is likely to be relatively marginal. If the generating consortia had overseas mining interests, this too could of course tilt them in favour of imported supplies.

British Coal's Future

7. Leaving aside these special considerations, the volume of British Coal's power station business following esi privatisation

is likely to be primarily governed by five factors.

(a) The size of power station coalburn

8. CEGB currently forecast coal burn of 76mt in 1990/91, but this figure is dependent on both the rate of growth of electricity demand and the performance of nuclear power stations. It could range from mt to mt. If a privatised esi built fewer nuclear stations then coal demand might rise but this would be unlikely to have any effect by the early 1990s.

(b) Private Sector Coal Production

9. The existing private sector coal industry is too small (about 3 mtpa) and too weak to have a significant impact on the power station coal market. Even if the present statutory limitations are liberalised it is unlikely to offer more than a marginal source of supply for the foreseeable future, not least because of the environmental constraints on the mainly opencast output. Since the new planning arrangements came into force in 1984, half of BCC's applications for planning consent have had to go to public inquiry and to date only a third of these have received planning consent.

(c) Infrastructure for coal handling and transport

10. Although BSC has a number of deep water terminals capable of handling large (100,000 dwt and above) vessels, CEGB and SSEB do not. Imported coal has to be transhipped at Rotterdam and shipped to the UK in smaller vessels. At present CEGB's imports are limited to 1 mtpa; SSEB has imported no foreign coal for several years. CEGB have claimed, and BC accept, that they could step up their imports by 10mt immediately through existing ports for supply to coastal power stations; and that a further 10mt

could be accommodated within a year, still mainly at coastal power stations , following reasonably modest investment in floating terminals, principally in the Thames, Humber, and Mersey estuaries. CEGB also claims that with the necessary investment in port and rail facilities it could step up its imports to 30mt within 3-5 years.

(d) The World Coal Price

11. CEGB's entry into the international market on this scale would no doubt tend to harden world prices; but CEGB believes that the present and prospective excess capacity in coal exporting countries, coupled with the likely eagerness of coal exporters to secure the CEGB business, will limit this increase to no more than £2.50 per tonne. On the basis of today's prices and exchange rates a privatised CEGB might expect to increase its imports at competitive prices by 20 mtpa on a continuing basis; and by a further 10 mtpa if there was investment now in the necessary infrastructure. However the future movement of the world price of coal expressed in sterling terms is highly uncertain, and so therefore will be the economically viable level of coal imports.

(e) BCC's Cost Structure

12. Although British Coal's average production costs by 1990/91 are expected to be not far above the level of world market prices, the market pressures that a privatised generating industry can bring to bear, together with the Government's own objectives for British Coal, should curtail BC's ability to cross-subsidise high cost production from the profits of low-cost mines and opencast production. The size of BC's market share will depend on the structure of its production costs. It is difficult to construct a reliable supply curve for BC showing the cumulative output available as production costs rise, but the Department's best estimate is given at Figure 1D , based on 1985/86 actual operating costs.

13. Too much reliance should not be placed on the absolute values of the costs shown in this curve; and it is based on BCC's allocation of costs; but it does illustrate one key feature: the supply curve is relatively flat. Relatively small changes in the price of coal will result in large changes in the amount of UK coal production that is profitable. The Department believes that, taking into account the benefits of investment maturing by the early 1990s, around 50mt of BC steam coal production might be available at pithead costs of £30 per tonne (around £1.30/GJ) or less. This includes 12mt of opencast production, 10mt from the new Selby complex, and 3mt from the new Asfordby mine. The remaining 25mt would come from existing low-cost pits. Substantial further tonnages could, however, be available from collieries which would be only marginally loss-making at £30/tonne. Moreover there could be some collieries with even higher pithead costs which are economic because of their proximity to power stations.

Consequences for BCC

14. Against this background it is clear that full alignment with international prices by the early 1990s would require a much sharper reduction in British Coal's employment than BCC currently envisage. BCC's latest plans are based on maintaining output and sales at a little over 100 mtpa, with deep-mined output steady at 86.5mt and sales to CEGB around 74mt. Prices are expected to fall in real terms by only 1% pa. On this basis BCC expect to breakeven in 1988/89 and to build up to a profit of £115m by 1990/91. This is largely due to closure of 10mt high-cost capacity displaced by Selby and to the reduction of 35000 employees. Cutting existing capacity by a further 25 mtpa by 1990/91 could involve shedding an additional 30,000 men. Such an adjustment is likely to be particularly severe in those coalfields with relatively high costs which have hitherto sheltered behind cross-subsidisation, notably in Durham, Scotland, and Derbyshire.

15. Two general points can be made. First, opposition from the unions can be expected. If further early industrial action has to be weathered, as the price for achieving efficiency in the UK coal industry, the ability and willingness of the ESI to maintain electricity supplies and conserve coal will be crucial. Secondly, the reduction in capacity will be easier the earlier it is started. Continuation of the existing 5-year deal between BC and CEGB, which preserves an artificially high market share for British Coal, will tend to blind BC's management to the need for early adjustment.

Endurance

16. The key features of current contingency planning are at present:

(a) the levels of accessible stocks of coal, other fuels and crucial supplies at power stations;

(b) the flexibility of the generating system to replace coal with oil and gas burn, increased nuclear output, and imports via the interconnectors with France and Scotland;

(c) the flexibility of the interconnected transmission system to transfer power around the country;

(d) the extent of continued coal production and the availability of road and rail transport; and

(e) good industrial relations within the CEGB, particularly willingness to handle abnormal flows of oil and coal.

Privatisation will highlight the costs of these arrangements and their future will have to be made explicit in any prospectus.

Private sector companies would be unlikely to hold such large stocks and would be less willing to incur the very large costs of operating the system uneconomically to conserve coal. The Government has some powers under the Energy Act 1976 to direct companies to hold fuel stocks and can, in emergencies, issue orders and direction on the use of fuel. The adequacy of these powers for a privatised ESI needs to be studied further. The question of cost recovery also has to be considered. If the regulatory regime does not allow for the recovery of such costs through charges to the consumer, then they may have to be met by the Government. The technical constraints on the operation and transmission systems will also be important.

UK COAL SUPPLY CURVE

(Based on heat content of 24.5 GJ/tonne)

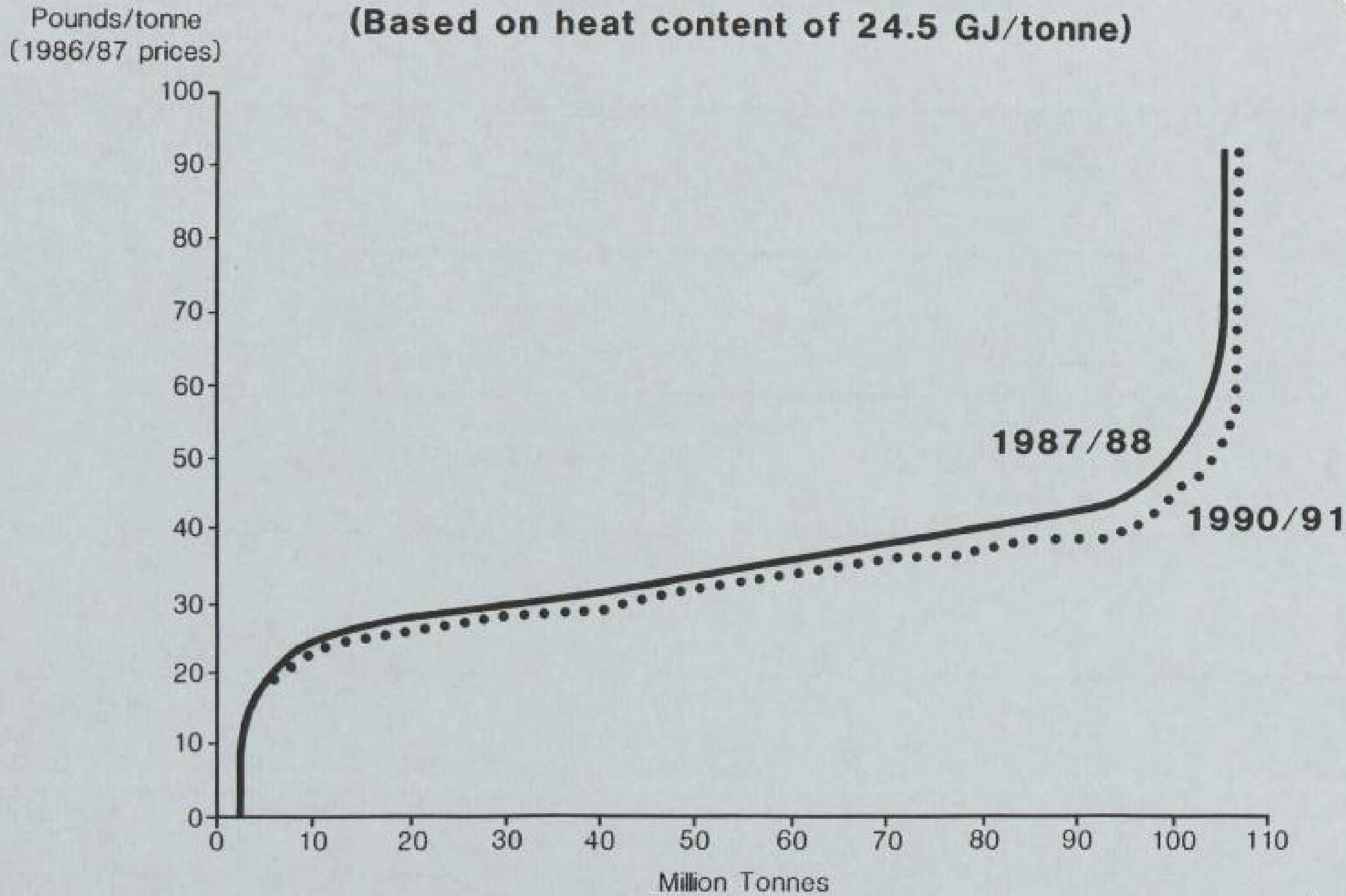


Figure 1D

ANNEX E

ANNEX E

TECHNICAL CONSTRAINTS

The Integrated Generation and Transmission System

The construction of the 400KV transmission system in the 1960s completed the development of a national grid which had earlier been based on 275KV and before that on 132KV. It allowed the CEGB to achieve considerable economies by increasing reliance on fewer and larger generating units operating on base load, with units with higher running costs following the peaks and troughs of demand. The ESI had 283 power stations in 1946; 122 were closed between 1973 and 1987; and the CEGB now has 82 operating stations. Of these stations, 12 large coal plants accounted for some 60% of electricity supplied. The 10 commissioned nuclear stations and 6 of the older coal stations accounted for another 25% of supply. However the CEGB would acknowledge that the scope for achieving further reductions in power station numbers is now limited. Moreover, with a generation deficiency in the South, which must rely for supply on large coal-fired stations in the North Midlands, there are heavy flows of power in the 400KV inter-regional transmission system from the North Midlands to the South which have implications for the reliability of supply in the South of England.

Minimising Cost

2. The CEGB operates the transmission and generation system together with two basic aims: to minimise cost; and to ensure that the system does not fail. To minimise cost, a procedure broadly on the following lines is adopted, making considerable use of computer programmes:

(a) at regular intervals, the CEGB's National Control Centre ranks plant in merit order of marginal operating cost; future daily demand is estimated, and future plant use is predicted on the basis of cost ranking and total demand; fuel is then centrally purchased and allocated to stations;

(b) every day, the ranking of plant and demand forecasts are updated; the technical constraints on power flows to prevent the system failing are taken into account; and National Control issues instructions to Area Control Centres on the plant to be used the next day. The following day these instructions are modified continuously to meet actual demand and to prevent the failure of the system.

Another important aspect of cost minimisation is the central direction of plant maintenance, since this affects not only the ability of the system to meet demand at or near minimum cost but also the power flows which can provoke system failure.

Avoiding System Failure

3. To avoid system failure, and to ensure that it delivers usable power, the CEGB needs to manage a number of features of power transmission:

(a) frequency: if demand is not precisely met by supply, the frequency of the supply system as a whole will drop from the standard 50 cycles/sec as generators give up rotational energy to meet the shortfall. Conversely, if demand drops below supply, the frequency will rise. The limits within which frequency can move are set by regulation at ± 1%, though the CEGB's aim is to limit changes to ± 0.4%.

Larger changes can affect the operation of electrical equipment and the power stations themselves. The system therefore has to be managed continuously to ensure supply and demand do not drift apart. The pumped storage station at Dinorwig with its ability to provide power at very short notice, is important in the control of frequency. If the Grid were to be separated from generation, there would be a strong case for separating Dinorwig as well, since this would ease many of the problems of frequency control.

(b) voltage: when load is low, it is a characteristic of the transmission system that voltage will rise unless lightly loaded circuits are switched out, which inevitably reduces security of supply. Unchecked, rises in voltage can cause damage to plant connected to the system. Conversely, voltage tends to fall when load is high and power flows are strong. Unless foreseen and prevented by appropriate system design and operation, voltage collapse on the transmission system could occur which would inevitably lead to widespread power cuts. This is an important feature of managing the UK transmission system which is characterised by heavy North-South power flows which, if uncontrolled, could lead to conditions of voltage collapse and hence power failure. This can, of course, be prevented by appropriate system design, the use or addition of reactive compensation equipment, and by correct system operation, including the operation of power stations, sometimes out of merit order, to influence system voltage rather than simply to produce power. The CEGB lays some emphasis on the last option, as an argument for running transmission and generation together.

Separate operation of the transmission system would be likely to change this emphasis and it would be important to assess the costs involved.

(c) system stability: sudden disturbances, such as a fault on an overhead line or the failure of a generator, can cause the transmission system to become unstable. Roughly speaking, such faults cause sudden changes in the electrical output of the machines connected to the system, generators get out of step with each other, and oscillations can be set up on the system, causing further tripping out of equipment under the automatic protection system or the need to switch out circuits for their own protection. So the transmission system not only has to be designed to meet stability requirements, it also has to be operated to ensure stability. At present, the CEGB checks the risk of instability in its daily planning and, if necessary, adjusts the scheduling of generators to avoid problems and to allow for transmission lines out of service. Since instabilities are a potentially major source of supply failures to consumers, it would be important to ensure that any separation of the Grid from generation provided a means of ensuring the minute-by-minute stability of the system.

Integrated Operation

4. Any approach to transmission which involved separating the transmission and generation systems would have to capture these operational features through contractual relationships, and it would be important to ensure the new system worked before the sale to the public took place. It would also be important to ensure that the principal benefits of the co-ordinated planning of transmission and generating investment

were not lost. The siting of plant will be important to the operation of the transmission system. Whilst power station sites are being sought in the South of England, the flows on the North-South interconnectors will, for many years, remain high. The capacity of these 400KV circuits can be increased and the CEGB is currently studying the amount and allocation of reactive compensating equipment to be installed in the South so as to extend the power transmission capability of the existing circuits. The provision of additional parallel North-South 400KV circuits is, of course, an obvious alternative, but the difficulty in obtaining consent for suitable wayleaves cannot be over-estimated.

Constraints on Competition

5. The finite capacity of the transmission system may also place constraints on unfettered competition in the supply of electricity. This can be illustrated by the trivial example of splitting the CEGB into companies representing its Area Grid Control regions, with regional portfolios of plant. Even if the company in the North-East, say, was the cheapest producer in the UK, there would be a technical constraint on increasing the flows of power from that company through the transmission system, since this is connected to the remainder of the system in England and Wales by only one 400KV double circuit. As mentioned above, there would be considerable difficulty in obtaining consent for additional line routes and substations. Technically the constraints would be the same if a power company had stations on a portfolio (rather than a Regional) basis, but the effect on each company would obviously depend on the portfolio.

IT8.7/2-1993
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