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PRIME MINISTER

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ELECTRICITY PRIVATISATION - "MANAGING THE TRANSITION"

Cecil Parkinson's paper "Electricity Contracts, Prices and Proceeds" addresses the contractual and commercial arrangements between the various successors of the Electricity Supply Industry (ESI), their customers and British Coal.

The recurrent theme is "managing the transition", - from the nationalised, corporatist and protectionist world which the ESI, British Coal and some major consumers have grown to love, to the realities of competitive and market forces.

Cecil Parkinson is asking colleagues to endorse his general approach which is to:

- * promote competition immediately;
- * ensure domestic and commercial customers see price increases in line with inflation (they may reduce);
- * privatise successfully;
- * provide transitional arrangements requiring:
 - (a) British Coal to move to a competitive environment;
 - (b) large industrial customers to pay competitive, market-related prices for their electricity.

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This is a laudable, highly competitive approach. It removes most market distortions immediately, the remaining few within 5 years and leaves only the Non Fossil Fuel Obligation after that time.

Proceeds are reduced because monopoly profits are reduced through introduction of competition.

I believe you should endorse the general approach emphasising your wish to improve the extent of competition, minimise possible distortions and limit any transition period to 5 years.

PROBLEM AREAS

The paper discusses four problem areas:

- (a) prices to industrial customers;
- (b) British Coal's transition to competitive pricing;
- (c) flotation prospects and proceeds; and
- (d) independent generators.

One very significant problem however, which is discussed briefly in the body of the text and the annex, is

- (e) the cost of nuclear power and the consequent size of the nuclear levy.

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(a) Prices to industrial customers

Some large industrial customers have been cross subsidised by the other consumers and the taxpayer (via deficit grant to British Coal) to such an extent that they have paid little more than the fuel costs for their electricity.

Moving into the competitive world could bring price increases of 25% for large users and up to 60-70% for energy intensive users such as ICI.

Such a large change, if it occurred immediately on privatisation could be damaging both economically and politically. DEN have thought of several ways of ameliorating the change, some of which however imply permanent distortions in the markets. These include continuation of the QUICS arrangement with British Coal and applying the nuclear levy on a "transmission and distribution basis".

These distortions should be rejected.

The most promising way forward is to phase in the nuclear levy over a 5 year period with the levy based on the value of sales.

The political downside will be explaining why domestic and commercial customers pay the full levy but industrial users do not. There are also EC "subsidy" implications. Neither of these hurdles are insurmountable.

Industrial customers are likely to protest vociferously about the price rises they will receive. The media must be handled well to ensure that these price rises are not read across to the domestic and commercial sectors where prices will remain constant or even fall.

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(b) British Coal's transition to competitive pricing

The ESI will be able to purchase fuels anywhere. They will want to keep a core domestic supply of coal and buy some coal on the world market.

In the absence of transitional arrangements, BC would suffer reductions in volume and price to such an extent that they would have to reduce capacity by closing mines beyond the level economically sustainable in 5 years time.

The proposed transition mechanism, calls for the generators to "buy their way out" of their current undertakings. A fixed sum, declining to zero over 5 years, would be paid to BC. The sum would be the difference between the BC coal price and the world market price.

The proposed mechanism is workable and probably acceptable to BC. It has the advantage of distancing the government from the restructuring process caused by market forces.

An alternative would be for the government to pay an equivalent, "lump sum restructuring grant" now in lieu of the 5 year declining generator payments. Although from an economic point of view this is probably more attractive, it exposes the government to all the "blame for pit closures".

Department of Energy will be bringing forward proposals to ensure that the small private sector operations do not disappear as volume is reduced. A paper will be forthcoming next week.

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(c) Flotation prospects and proceeds

The package of measures ensures flotation. However, proceeds under the competitive environment are reduced to:

	<u>£ billion</u>
Area Boards	6 - 7½
National Grid	1½
National Power	
- Fossil	2¼ - 3
- Nuclear	N/A
PowerGen	<u>1½ - 2</u>
TOTAL:	11 - 14

You should note that no figure is available for the nuclear component of National Power. It will be very low.

Flue Gas Desulphurisation (FGD) retrofit programmes also depress the price of the generators. The paper points out that with this being the case, then essentially the taxpayer pays for the retrofit rather than the customer. However to reverse this situation we would have to put selective restrictions on competition and distort the market.

I believe you should rule out such distortions.

With increasing environmental pressure throughout the '90s, the least polluting plants will become more valuable and will be able to charge more. Prices will eventually go up and the customer will eventually pay. Spreading FGD costs as an overhead is probably the best way forward.

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(d) Independent generators

The emergence of independent generators is by no means certain. They will be squeezed between current overcapacity and future building of PWR capacity.

That said DEN have suggested measures to encourage an initial tranche of about 1½ -2 MW of capacity before vesting. I believe you can welcome these measures.

Recommendations on (a) - (d)

The package put forward by DEN on points (a) - (d) is workable. I believe you should:

- endorse the general approach;
- place emphasis on increasing competition, including encouraging new entrants;
- insist on minimum distortions, and in particular ruling out distortions favouring large industrial customers and distortions aimed at protecting individual power stations with FGD;
- limiting any transitional arrangement to 5 years.

DEN need to work on implementing this package without delay.

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(e) Nuclear levy and building programme

In September 1987 at Chequers, when DEn Energy presented their first major analysis of the way forward for privatisation they stated quite clearly that nuclear costs would eventually be comparable to fossil fuel costs, and therefore that nuclear power would become a competitive source of energy. At the time some, such as George Guise, were very suspicious of this estimate and frankly considered it far too optimistic.

By October 1988 the Secretary of State's paper on privatisation and nuclear power indicated that generation costs of electricity from the present nuclear stations would be about 4.2p/KWh compared with 2.9p/KWh for fossil fuelled plant.

Now in June 1989 we are being told that electricity from current nuclear power stations could cost as much as 7p/KWh compared with 2.6 to 2.7p/KWh for fossil fuel based load power - 2½ times greater. In this case, nuclear levy works out at £1,750 million per year.

The major reason for this is a revision of the costs of de-commissioning and waste disposal.

In September 1987 CEGB had made provisions of £2.5bn for decommissioning and waste disposal for their existing nuclear stations. This figure had risen to £3.4bn by October 1988 and I am now led to believe that they could be as high as £11bn. Clearly the Department of Energy has been misled by CEGB.

With these figures finally coming out, they contradict the manifesto commitment to develop abundant, low cost supplies of nuclear electricity. I do not believe we can be confident that these figures will not get even worse. As a result with constant revision, it is very difficult to trust the CEGB figures for PWR's

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Recommendation

- (a) We need a paper from Cecil Parkinson in the near future explaining the reasons for the rising costs of nuclear power over the past two years and the likely trend in future.
- (b) As nuclear costs rise, so does the size of the nuclear levy. This will be difficult to present.
- (c) In order to contain the total growth in nuclear costs it is worth thinking about the possibilities of phasing the building of PWR's over a slightly longer period. I believe that it is time to reconsider the prudence of proceeding so quickly with 4 PWRs. A slower, phased approach would not only provide more opportunities for finding the "true" cost from "open" accounts but would result in lower electricity prices.



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