Prime Minister

The CPRS note attached is a useful summary of the issues.*

TL 12/10

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P.0118

MR LANKESTER

cc: Sir Kenneth Berrill
Mr Downey
Mr Vile (with enclosure)

STRATEGY FOR COAL

The joint paper by the Secretary of State for Energy and the Chief Secretary, Treasury on coal strategy, due to be discussed in E next Wednesday, will be available tonight (Energy Private Office are sending you a copy direct).

in the folder TL.

2. The paper now contains the information necessary for Ministers to reach conclusions on these issues though, because of a fundamental disagreement between Mr Howell and Mr Biffen it is in substance two papers with a covering note pointing to the differences. It is thus not a particularly easy paper to read and the CPRS have it in mind to circulate a "collective brief" for Ministers on E which should ease the handling problem. I attach a copy of the present draft of the CPRS paper which the Prime Minister might care to read alongside the paper itself should she have time this weekend.

P Le CHEMINANT

Cabinet Office
12 October 1979

* I think E Committee would do better to base the discussion on the CPRS note than on the Ministerial paper. The covering note on the Ministerial paper which should spell out the differences between Mr Biffen and Mr Howell is not much help. TL.

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E(79) COPY NO

12 October 1979

CABINET

STRATEGY FOR THE COAL INDUSTRY

Note by the Central Policy Review Staff

1. In considering E(79) , Ministers may find it helpful to have a note bringing together

(a) the main assumptions underlying the strategy recommended by the Secretary of State for Energy.

(b) the points of disagreement between the Secretary of State and the Chief Secretary.

(c) some of the main issues which will need to be considered.

2. Assumptions

These are set out in Appendix 2 to E(79) .
Perhaps the most significant are:

- 2% p.a. increase in productivity
- 3% p.a. increase in real earnings.
- 2% p.a. real increase in prices.

3. Points of Disagreement

(1) Recommended limits on external finance

£mn

	1980-81	1981-82	1982-83	1983-84
Secretary of State	628	597	531	434
Chief Secretary	598	570	480	375
Difference	30	27	51	59

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(2) The Secretary of State proposes that the following capital expenditure programme (set out in Appendix 3 of E(79)) should be approved on the normal basis:

£mn 1978/79 Prices

1980-81	1981-82	1982-83
587	575	583

The Chief Secretary recommends that approval should be delayed until the Board have accepted the financial limits he has proposed under (1) above.

(3) The Secretary of State recommends taking powers to issue Public Dividend Capital. This is opposed by the Chief Secretary.

4. Issues

(1) Are the assumptions realistic? In particular

- are there solid grounds for believing that productivity will rise by 2% p.a.? Output per man year has been static in recent years at levels lower than in the early 1970s. If zero growth continued, trading losses could rise by, say, £200 mn a year by the fourth year (loss of 8 mn tonnes of output at over £25 a tonne). This, of course, would dwarf the differences shown in paragraph 3(1) above.

- even if the assumed 3% p.a. increase in real earnings is reasonable on average, how would it affect the financial targets if (as seems possible) much of it is bunched into the coming year? If the miners' settlement was, say, 20%, the additional shortfall could be £50 mn next year and probably more thereafter.

- there are at least two questions on the prices assumption

  (a) is the Board's assumption of a 2% increase p.a. in real prices compatible with their agreement (see footnote to Appendix 2 of E(79)) to sell two thirds of their total production to the CEGB at a price indexed only to inflation? The amount at stake is over £35 mn in the first year, £70 mn in the second and so on.

  (b) the agreement with the CEGB apart, is there not more scope to raise coal prices than the 2% assumed, given the likely rises in oil and gas.

(2) <u>Is there a case for PDC?</u>

Mining companies normally depend substantially on equity finance. This might suggest that new investment should be financed partly through PDC. But the case for converting existing debt seems much more doubtful. It would certainly improve the appearance of the NCB's accounts but, with little or no prospect of dividends, is it any different from a write-off of capital debt?

(3) <u>How will the strategy be enforced?</u>

Given the uncertainties involved, there is clearly a risk that breakeven will not be achieved by 1984-85 on this prospectus. What, then, are the Government's options?

(i) take no disciplinary action and allow the cash limits to be broken. This would discredit the cash limit system and should, we think, be ruled out.

(ii) as the Secretary of State suggested in E(79)45, press for a faster phasing out of uneconomic capacity, perhaps with substantial changes on the Board. It is doubtful if this would significantly improve the financial position, at least in the short term. The proposed closure rate is in any case well above that achieved in recent years.

(iii) capital investment could be cut. But if the cut had to be substantial this would have damaging consequences (see Appendix 3 to E(79)).

(iv) prices could be raised by more than the 2% p.a. in real terms assumed. But in paragraph 3 of Annex A to E(79) , the Secretary of State proposes that revenue from higher prices should only be used as an extra contribution to self-financing (i.e. that it should be used to finance investment, not revenue costs).

i.e. they should not be used to pay higher wages ?

The CPRS suggests that if these rules on price (revenues) were adhered to, the financial limits could not be enforced and the cash limits would break. This would be unacceptable. It would be better, in the CPRS' view, to allow the Board to use the proceeds of higher price rises to offset losses (as with other nationalised industries) so that the consequences of excessive wage increases and lack of productivity growth are brought home sharply to both sides of the industry. If this course were adopted there would be a much yes better chance of living within the Chief Secretary's financial limits. To reinforce the Board's bargaining position, the Government could consider making it clear that it would place no obstacles in the way of imports.

5. Conclusion

The CPRS recommends that Ministers should consider the questions raised in paragraph 4 above before settling the specific issues set out in the joint paper by the Secretary of State and the Chief Secretary.