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CABINET

MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

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STRATEGY FOR COAL

Memorandum by the Secretary of State for ~~the~~ Energy

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1. On 16 July the Committee invited me to circulate a paper on the NCB's financial outlook, their chances of keeping within their financial strategy, and the possible costs to the Government if they were to fail (E(80)25th Meeting).

STRATEGY FOR COAL

2. Our policy for the coal industry is to develop it as a low cost competitive industry able to make an increasingly important contribution to our long-term energy needs as supplies of other fossil fuels decline. To achieve this requires both a substantial investment programme to provide new low cost capacity, and a financial strategy designed to make the industry fully competitive and reduce its need for Government support. Each is an important part of putting the industry on the right long-term basis.

THE FINANCIAL STRATEGY

3. The financial strategy agreed for the NCB last year provided for external finance limits reducing steadily in real terms up to 1983-84, and for the Board to break even on revenue account from that year without operating grant. Annex A gives the detail. As my earlier paper E(80)67 warned, the economic recession has substantially worsened the Board's market and therefore financial prospects since

the strategy was set. My Department's central estimate is that NCB disposals will fall from 119m tonnes this year to 114½m tonnes in 1983-84. Annex B gives more detail about this estimate, including detail on imports, and compares it with the current NCB estimate, made early in the year.

PROSPECTS FOR ACHIEVING THE STRATEGY

4. Annex C gives detail on the financial prospects for the Board if my Department's forecast of demand is correct. It also shows the effect of variations in cost, though these are generally less important. In summary, and considering external figures and revenue account separately, the position is:

a. External finance. Without offsetting action, lower demand increases stocks and therefore financing costs. But the Board ca take offsetting action which is desirable, such as increasing the rate of closures, and other action which is practical, but could worsen their profit and loss account, such as selling m exports and buying out imports. Such action might reduce the excess over the strategy figures to £500m in outturn money in 1983-4. The remaining excess can be further reduced by cuts in o put at continuing pits and in capital investment. The Board are n reviewing both these possibilities which, in principle, could eliminate the excess completely. But cuts which retarded the industry's progress to higher efficiency or damaged its capacity to meet our long-term energy needs should be avoided. We cannot finally judge what is sensible until the Board's work is complete.

b. Revenue account. The Board would incur a deficit of £150m in 1983/84. This could be increased by measures to reduce external finance. Because of its direct effect on the PSBR, the Board's external finance may be more important to the Government than the revenue account. Nevertheless the requirement to break even in 1983/84 without operating grant is the part of the strategy of th strategy which has most public attention. Failure to meet it wou be very damaging.





PIT CLOSURE PROGRAMME

5. The Board have already stepped up the rate of closures and say that, although they cannot count on sustaining it at more than 2½m tonnes a year, if they can get more they will. Annex C shows the EFL and revenue effects. A faster rate would of course be desirable if it could be achieved. It is however very much a matter of judgement how fast the Board can go without confrontation with the NUM. We cannot substitute our judgement for the Board's and indeed if we appeared to be responsible for closures they would be harder not easier to get. Our role is to force the Board themselves to take the appropriate decisions by holding them to the strategy. We may also eventually have to improve redundancy terms to facilitate closures. But the recent improvements were made only in June. I am not therefore making further proposals now, though I may do so if experience suggests that they are necessary.

GENERAL ASSESSMENT AND CONCLUSIONS

6. On current demand forecasts, the Board seem unlikely to achieve the revenue target, and to be able to achieve the external finance targets only by sacrificing important investment. But we must not over-react to one set of estimates. I would also ask my colleagues to consider:

- Forecasts of future demand are inevitably uncertain. If we have underestimated demand in 1983-84 by just 8m tonnes - 7% of the total - the coal surplus could be readily dealt with. For example, if, contrary to the assumptions in our forecasts, the NCB-CEGB understanding lasts until 1983-84, coal demand would then be higher by 4m tonnes on that account.

- The NCB are now working hard to keep within the strategy. Annex D gives details of their efforts. They should achieve 3m tonnes of closures this year and are taking action to reduce output at continuing pits and cut investment. These are very big changes in their attitudes since last year, and there is much to be said for giving them a fair run at their task.

- The strategy was announced only in April. It was designed to last until 1983/84. To abandon it now would be damaging to the Government and imply that it was wrongly set in the first place.

- It is not clear that if we do reopen the strategy, we shall be better off as a result. It is putting great pressure on the Board to put their house in order. If it were reopened, they might suspend their efforts and use the opportunity (with the NUM's support) to press for a relaxation. Indeed the logic of the situation is that any change should be towards relaxation.

- The relationship with the NUM is at present quite good but precarious. There could be an explosion over closures. The outcome of this winter's pay claim could have important repercussions throughout the public sector. It would be most unwise to unsettle them further, at least until the pay negotiations are complete.

7. The strategy is the course most likely to keep up the pressure on the Board to get their house in order. There is therefore a strong case for perservering with it, even though on current demand estimates it seems unlikely to be achieved within their planned timescale, at least on cash and revenue together. If this were agreed, we should need to continue to impress on the Board the paramount necessity of working to the strategy and in particular we should ask them to allow for demand being at the level in my Department's estimates.

8. We cannot however make a final decision about this until the Board have finished their work on the scope for cuts in capital investment and current production. I shall therefore bring before my colleagues further proposals as this work progresses on:

i. Approval of the Board's investment programme, and

ii. the consequences for their efficiency and long-term capacity to meet our energy needs of cutting it to the extent that might be needed to keep within the financial strategy.

D A R H

Department of Energy
10 September 1980







ANNEX A

FINANCIAL STRATEGY FOR THE NCB

1. The Financial Strategy requires the NCB to operate within the following framework:-

| | £m 1979 Survey Prices | | | |
|---|---|---|---|---|
| | 1980-81 | 1981-82 | 1982-83 | 1983-84 |
| A. Grants | | | | |
| "Social Grants" | 57 | 57 | 57 | 57 |
| "Operating Grants" | 135 | 109 | 28 | - |
| TOTAL | 192 | 166 | 85 | 57 |
| B. External Financing Requirements (including grants) | | | | |
| | 613 | 570 | 480 | 375 |

2. These figures are in constant 1979 Survey Prices, and need to be revalued by the Government to actual prices. Using the same factors as in Annex C, the EFLs would become:-

| | £m Estimated outturn Prices | | | |
|---|---|---|---|---|
| | 1980-81 | 1981-82 | 1982-83 | 1983-84 |
| EFL | 834 | 874 | 810 | 697 |

3. The Board must break-even without operating grants from 1983-84 onwards, and the assumption is that they should break-even, after operating grants, in the preceding years.

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ANNEX B

COMPARISON OF NCB AND D. ENERGY FORECASTS OF NCB COAL DISPOSALS

| | 80/81 | | 81/82 | | 82/83 | | 83/84 | |
|---|---|---|---|---|---|---|---|---|
| Disposal Category | D.En | NCB | D.En | NCB | D.En | NCB | D.En | NCB |
| (1) Power stations | | | | | | | | |
| (a) CEGB | 75 | 75 | 75 | 76 | 72½ | 77 | 71 | 80 |
| (b) SSEB | 8 | 8 | 7 | 8 | 7 | 8 | 7 | 8 |
| (2) Coke Ovens | 10 | 10 | 10½ | 10½ | 10½ | 11 | 10½ | 11 |
| (3) Other Industry | 10 | 11½ | 9½ | 12½ | 9½ | 13 | 9½ | 13½ |
| (4) Manufactured fuel | 3 | 3 | 3 | 2½ | 3 | 2½ | 3 | 2½ |
| (5) Domestic Bituminous | 6 | 6 | 5½ | 6 | 5½ | 6 | 5½ | 6 |
| (6) Domestic Anthracite | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 |
| (7) Miscellaneous | 4 | 4½ | 4 | 4 | 4 | 4 | 4 | 4 |
| (8) Exports | 2 | 2 | 2½ | 2½ | 3 | 3 | 3 | 3 |
| | 119 | 121 | 118 | 123 | 116 | 125½ | 114½ | 129 |
| Import Assumptions | | | | | | | | |
| Steam Coal | 5 | 5 | 2½ | - | 2½ | - | 2½ | - |
| Coking | 4 | 4 | 4 | 4 | 4 | 4 | 4 | 4 |
| Total | 9 | 9 | 6½ | 4 | 6½ | 4 | 6½ | 4 |

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## ASSUMPTIONS UNDERLYING THE DEPARTMENT OF ENERGY'S FORECASTS OF COAL DEMAND TO 1982/84

1. The economic assumptions underlying the forecasts are consistent with Treasury economic forecasts.

2. The assumed rates of growth in primary energy demand are:

| 1979 | 1980 | 1981 | 1982 | 1983 | % |
|---|---|---|---|---|---|
| + 4.8 | - 6.3 | + 0.7 | + 0.6 | + 2.5 | |

3. Power station coal requirements are expected to fall over the period. But we have assumed that, with some stockbuild this year and a low oilburn, CEGB will take 75m tonnes of NCB coal in 1980/81 and that, under the 1979 understanding (see 5 below) they may find it advantageous to maintain the same coal take in 1981/82. Lower coal take by CEGB is assumed in the later years, reflecting virtually static electricity demand and the expected commissioning by 1983/84 of about 6 mtce of nuclear capacity.

4. The main differences between NCB's and the Department's forecasts of coal demand are:

   a NCB assumed in their Corporate Plan forecasts (which were made earlier this year) that the level of national output and primary energy demand would be somewhat higher by 1983 than the Treasury and the Department are now forecasting.

   b The NCB assumed that CEGB would continue to take 75m tonnes pa or more throughout the period, because of their assumptions of higher energy demand and no steam coal imports.

   c NCB assumed steadily rising industrial demand for coal. Although the Department expect some substitution of coal for oil because of coal's relative price advantage, it is thought that this will be offset by the effects of the forecast low level of manufacturing output.

5. The estimates allow for CEGB imports which are expected to be 4-4½ mt in 1980/81 and to fall in the following year to about 2½ mt reflecting our understanding of current CEGB plans. CEGB coal requirements overall are not expected to rise, and might fall in the medium term depending on the level of electricity demand and the availability of nuclear stations. Within the total demand for coal the balance between NCB and imported coal will depend on the movements in their respective prices and availability. Under the NCB/CEGB understanding concluded in 1979, each Board agreed to use its best endeavours to provide and take 75 mt coal a year up to 1984 so long as NCB prices did not rise faster than the rate of inflation. Real increases in NCB coal prices could provide a strong incentive to the CEGB to increase coal imports. Both Boards do however attach importance to continuing the understanding and, if this can be achieved, imports may remain at or about the level of 2½ mt pa.

6. Current CEGB capacity to import coal is about 6-7m tonnes a year, but CEGB are budgetting to improve ports and infrastructure so as to raise it over the next 2-3 years by a further $1\frac{1}{2}$m tonnes. With some rerouting of domestic coal supply flows, the total capacity could if necessary be further increased to some 10m tonnes. CEGB are also undertaking a number of studies of ways to increase capacity still further, including one of a dedicated new port facility, although this would take five years to construct.







EXTERNAL FINANCE REQUIREMENTS

£m (Estimated outturn prices)

| | | 1980-81 | 1981-82 | 1982-83 | 1983-84 |
|---|---|---|---|---|---|
| 1. | External finance limit | 834 | 874 | 810 | 697 |
| 2. | Further external finance required as a result of lower demand (cost of stocking surplus production and interest charges) | 70 | 263 | 575 | 982 |
| 3. | Estimated effect of corrective measures of which:- | | 140 | 295 | 460 |
| | i. increased closure of high-cost capacity from $1\frac{1}{2}$mt to $2\frac{1}{2}$mt pa | | 35 | 100 | 180 |
| | ii. Buy out imports of 2mt coking coal and 2mt steam coal by 1983-84, at a price which would leave importer no better and no worse off | | 60 | 110 | 145 |
| | iii. Increase exports by up to 3mt pa | | 25 | 55 | 95 |
| | iv. Reduce holding of stocks of stores | | 20 | 30 | 40 |
| 4. | Excess EFR after measures (i) - (iv): to be met by reduction in output at continuing pits, and reduction in capital investment (line 2 minus line ~~4~~ 3) | 70 | 123 | 280 | 522 |

On the following variations in assumptions the excess external finance required (line 2) becomes:-

| | 1981-82 | 1982-83 | 1983-84 |
|---|---|---|---|
| i. 2% pa increase in labour cost/tonne instead of 1% assumed in line 1 | 289 | 625 | 1062 |
| ii. No increase in labour cost/tonne | 248 | 542 | 925 |
| iii. 3% pa increase in other operating costs (instead of 2% pa assumed in line 1 | 280 | 614 | 1048 |
| iv. 2% increase in labour cost/tonne, and 3% pa increase in other operating costs | 306 | 664 | 1131 |
| v. No increase in labour cost/tonne but 3% pa increase in other operating costs | 265 | 581 | 991 |

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£m (Estimated outturn prices)

| | | 1980-81 | 1981-82 | 1982-83 | 1983-84 |
|---|---|---|---|---|---|
| 1. | Planned revenue results | B/E | B/E | B/E | 35 |
| 2. | Effect of lower demand | (14) | (41) | (96) | (200) |
| 3. | Benefit of deferred interest | 0.5 | 2 | 6.5 | 15.5 |
| 4. | Revenue results, without measures to correct EFR | (13.5) | (39) | (89.5) | (149.5) |
| 5. | Estimated effect of measures to correct EFR: | | | | |
| | i. Increased closure of high-cost capacity from $1\frac{1}{2}$mt to $2\frac{1}{2}$mt pa | | (18) | (11) | (1) |
| | ii. Buy out imports of 2mt coking coal and 2mt steam coal | | (14) | (21) | (24) |
| | iii. Increase exports by up to 3mt pa | | (13) | (25) | (35) |
| | iv. Reduce holding of stocks of stores | | 1 | 2 | 3 |
| 6. | Effect of measures | | (44) | (55) | (57) |
| 7. | Revenue results after measure in line 6 but before revenue effect of cuts in investment and production | | (83) | (144.5) | (206.5) |

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On the following variations in assumptions the revenue results in line 4 become:-

| | | 1981-82 | 1982-83 | 1983-84 |
|---|---|---|---|---|
| i. | 2% pa increase in labour cost/tonne (instead of 1% assumed in line 1) | (65) | (100.5) | (232.5) |
| ii. | No increase in labour cost/tonne | (24) | (56.5) | (92.5) |
| iii. | 3% pa increase in other operating costs (instead of 2% pa assumed in line 1) | (56) | (128.5) | (215.5) |
| iv. | 2% increase in labour cost/tonne but 3% pa in other operating costs | (82) | (178.5) | (298.5) |
| v. | No increase in labour cost/tonne but 3% pa increase in other operating costs | (41) | (95.5) | (158.5) |

Note: figures in brackets are negative.

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ANNEX D

## ACTION ALREADY UNDERTAKEN OR UNDER CONSIDERATION BY NCB TO KEEP WITHIN THE STRATEGY

1. Acceleration of closure rate to an expected 3m tonnes this year.

2. Reduction in labour costs by more selective recruitment, improved deployment of manshiifts following lower absence rates, and reduced levels of overtime.

3. Detailed examination of the scope for savings in operating expenditure at collieries, including cut-back of purchases of materials and equipment, especially at high-cost pits.

4. Action to match quality of coal supplied more closely to customer needs and maximise revenue, especially in the coking coal market.

5. Cuts in overhead expenditure, including H.Q. staff.

6. Reduction in costs and increased profitability of opencast operations at existing authorised sites; critical examination of cost structure and proposed operation of future opencast plans.

7. Improvement of profitability of ancillary activities, including house sales and increased rents.

8. NCB have already secured an additional 1 mt of export sales in 1980 and are considering a further million tonnes.