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File

bc: Mr. Pascall

19 January 1984

COAL PRICES

The Prime Minister was grateful for the note which was attached to your letter to me of 16 January, on the price at which NCB coal should be supplied to the electricity industry. She accepts that it would not be right to tackle the problem of NCB's loss-making capacity by enforcing a higher coal price on the electricity industry.

Andrew Turnbull

John Kerr, Esq.,
H.M. Treasury.

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10 DOWNING STREET

MG

From the Principal Private Secretary

Prime Minister (2)

My New Year's resolution is to convince you that it would not be right to raise coal prices above import parity as a way of ensuring that electricity prices are raised. The attached note by the Treasury sets out the arguments. I, and David Pascall, agree it is better

(i) to show NCB losses for what they are

(ii) not to concentrate the cost of supporting the NCB (and the lifestyle of miners) on large electricity users.

Agree?

AT. 18/1

Yes - especially now the electricity price increase looks like going through!

MG

cc NO

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

16 January 1984

Andrew Turnbull Esq
No 10 Downing Street
LONDON SW1

Dear Andrew,

COAL PRICES

I promised to send you a further note by officials on the price charged by the NCB for coal supplied to the CEGB. And here it is.

Yours ever,

John K.

J O KERR

Enc

PRICES FOR POWER STATION COAL

1. Until recently, the somewhat arbitrary price charged by the National Coal Board for coal supplied to the CEGB was significantly above market levels, especially at coastal power stations. (In this case, market levels are effectively determined by the cost of imports because there is no significant domestic coal production other than by NCB.) There were 3 undesirable consequences:

(a) By exercising its monopoly power to keep prices above market levels, the NCB disguised the true extent of the losses it was making by some £2-300m a year.

(b) These higher NCB costs were not fully passed on in electricity prices; the CEGB deliberately reflected only 95 per cent of coal costs in tariffs. The net result was that Electricity Boards made lower profits (indeed losses until 1982-83).

(c) The Electricity Boards saw advantage in increasing their coal imports. They had to be induced by the Government not to do so and received compensation.

2. The distortion caused by pricing coal above market levels was also undesirable in broader economic terms. For example, it ran contrary to the general policy of economic pricing for the monopoly nationalised industries which underpins the need for some presentationally difficult steps such as increasing gas prices in real terms.

3. Last Autumn the NCB and CEGB negotiated a new supply arrangement to last for four years to 1987. While conducted as a commercial negotiation, the new agreement moved to economic pricing. The key components were that:

(a) NCB coal would be priced at import-related levels from November 1983 increasing thereafter under a formula related to both import prices and the RPI.

(b) In return, CEGB agreed to take 95 per cent of its coal needs from NCB -ie accepting a restriction on the amount they would import.

The November 1983 prices were based on the cost of CEGB's existing contracts for Australian coal of about $50 a tonne (Rotterdam delivery). The result was an average increase in price of 2.7 per cent which, compared with inflation of about 5 per cent, represented a real reduction of some 2-2.5 per cent. The resulting average price of about £41 a tonne compares with current average production costs (including interest) of about £46 a tonne - giving on overall loss of some £400m a year in Historic Cost accounting terms.

4. The general expectation is for a further slight decline of perhaps around ½ a per cent a year in real terms in the price of power station coal. (But this will not necessarily lead to a fall in electricity prices of CEGB phase out the convention of reflecting only 95 per cent of coal costs in tariffs.) It would be possible for the Government to direct the NCB to introduce a pattern of real increases in the price of power station coal so as to reduce the extent of Exchequer support they require. But this would only re-introduce the associated problems which were previously encountered when NCB coal was priced above market levels. It would also give a misleading impression that the NCB's underlying financial position was improving. The CEGB would have two options:

(a) To continue their previous practice of discounting coal costs in electricity tariffs. The costs would then find their way back as a charge to public expenditure through the electricity industry's external financing requirement, leaving the PSBR neither better nor worse off.

(b) To pass on the higher costs in electricity prices. But in economic terms, it is no more desirable for electricity consumers, especially those in industry, to have to bear the cost of inefficient mines than it is for the generality of tax payers to do so. Indeed there would be a risk of simply passing on the distortion caused by the loss-making mines into distorting decisions by energy consumers about the fuel they used. There could, for example, be a further move by domestic consumers from electricity to gas - leading to greater pressure for importing Norwegian gas while leaving existing electricity assets even more under-utilised.

5. In whatever way the Government covers the NCB's heavy losses while the pit-closure programme is being pushed through, there will be an unpleasant burden for the rest of the economy. Some distortion is inevitable, but it is likely to be less pernicious if the NCB's losses are borne by the Exchequer (and hence by the economy at large) than if it is passed on to some particular area such as electricity prices. The key advantage of the economic pricing approach is that it highlights very clearly the real source of the problem - NCB's loss-making pits.

Energy price file

COAL PRICES

In a competitive market place private sector firms will aim to produce goods to meet extra demand as long as the price they receive will cover their costs and allow them to make a reasonable return on capital. Such firms cannot fix the price in the market place in the way a monopolist can. They have to take whatever price they can get.

2. The Government's policy of "economic pricing" is directed at nationalised industries which have monopoly power. The aim is to mirror what happens with private sector firms in a competitive market place - ie a price which enables these nationalised industries to cover costs and earn a reasonable return when meeting extra demand.

3. The market for coal is competitive and so automatically produces a market price which is consistent with "economic pricing". The competition to the National Coal Board (NCB) comes from imports. The market price is the price at which these imports are available. The Central Electricity Generating Board (CEGB) pays this price for the coal it buys from the NCB. This means it is paying the right price.

4. What is wrong is that, at this price, the NCB makes losses. In the private sector, a firm that made losses would have to cut its costs or go out of business. The NCB needs to cut its costs. The way to do this is to close loss making pits.

5. In brief, the real problem is not that coal prices are too low but that NCB costs are too high.

6. In economic terms the right way to handle this is to cut NCB costs. It would <u>not</u> be right to force the CEGB to pay an uneconomic high price for coal. This would put industries which used large quantities of electricity at a competitive disadvantage through no fault of their own.

7. In political terms, the aim is to focus attention on the need to close loss-making pits. This aim is best served by making the NCB's losses plain for all to see, and not by disguising the losses by forcing the CEGB to pay an unreasonable price for coal.