

FILE SW



10 DOWNING STREET

bcc: Mr. Duguid

From the Private Secretary

3 March, 1982

Dear Muir,

Invergordon Smelter: E (82) 19

The Prime Minister has now had an opportunity to study your Secretary of State's paper for E Committee on the next steps in relation to the Invergordon smelter.

The Prime Minister has minuted that she fears that the approach in this paper is not sufficiently "canny". She believes that the arrangement proposed positively entrenches the NCB's habit of averaging the price of coal and therefore perpetuating the life of the less economic pits. She considers that if that habit could be broken, and a variation in pithead prices be secured and passed on to consumers, we should be on the way to a more efficient coal industry and cheaper coal. The Prime Minister believes that simply to subsidise down the price for the purposes of restarting operations at Invergordon would get the Government into great difficulties. The Prime Minister has further minuted that, notwithstanding these difficulties, she accepts the need to keep Invergordon going.

I am sending copies of this letter to the Private Secretaries to the other members of E Committee.

Yours sincerely,

Michael Scholer

A. Muir Russell, Esq.,
Scottish Office

SW

AW



Prime Minister

(2)

I don't think

you saw this in

the folder.

Ms 4/3

PRIME MINISTER

mt

INVERGORDON

I have serious reservations about George Younger's proposals for a restart of the Invergordon Smelter. I had hoped to be able to explain this at tomorrow's meeting of E Committee but, since Hamish Gray is ill, I must attend the Standing Committee of the Oil and Gas (Enterprise) Bill at 4.30, especially since that will be the first session after the guillotine motion is announced in the Business Statement. I am therefore writing to explain those reservations.

Let me start by saying that I fully agree about the special difficulties of the Highlands and the need to restart the smelter if there is any sensible way of doing so. If this could be done and any support given under Scottish Office powers, including new legislation if necessary, I should welcome it. But George Younger's proposal to use coal prices as a means of support raises the problems set out in the CPRS paper.

First, the proposals would not only secure a restart at Invergordon but also protect Alcan, who designed these proposals, from attempts by the NCB to end their present contract for the supply of coal for their smelter at Lynemouth, Northumberland. NCB have given notice of their intention to end this disastrous contract on which they lose £26m pa. There has been no suggestion that the social case for protecting Lynemouth is anything like that for restarting Invergordon. We should simply be doubling the cost of saving Invergordon.



- 2 -

Second, as CPRS point out, there is no reason to think that it will be easier to close the smelter in five years time than it is now. I fear that if we give support, we shall be taking ourselves into providing coal below economic prices for the rest of the smelters' lives. I understand that the Scottish Office estimates of the rise in world aluminium prices over the next five years are in fact marginally less than my Department's estimates of the likely rise in coal prices. If so, we cannot expect rising world aluminium prices to reduce the burden of support for Invergordon.

Third, the proposed arrangements could not be commercial for NCB. The suggested coal price of £15 a ton (assuming that Alcan could pay that much) bears no relation to any of their costs. (At present the coal supplied to Lynemouth costs £37 a ton to produce before interest, while the cheapest Scottish deepmined coal costs £34.30 a ton). Nor incidentally is it true that the price of NCB coal to consumers overseas is lower than the domestic price. For example, the delivered price of the NCB's exported coal in Germany is £40-46 a ton.

Fourth, special low prices could be justified as long as NCB are over-producing coal. We should not however commit ourselves to arrangements which only make sense if NCB's over-production continues indefinitely, which is not our objective. They would also undermine all our recent progress in getting the NUM to accept that they must contribute to holding down production costs.

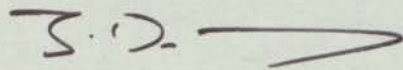
Fifth, this proposal would make nonsense of all our attempts to introduce market disciplines into energy pricing. Concessions to Invergordon could not be concealed. Other high load-factor electricity users, many in industries with a better long term future than aluminium smelting, would demand similar treatment. The political pressure on us

would be immense - and the potential costs enormous.

The suggestion, in your Private Secretary's letter of today, that NCB prices should reflect the costs of individual pits would not remove the main obstacle to faster closures, namely the strength of the NUM. It would be far more likely, I am afraid, to reduce the pressure on the NCB to make the coal industry viable as a whole by making our support appear to be not a transitional measure but aid to particular pits on social grounds. That would make closures harder to achieve.

I hope that you and my colleagues will be able to bear these points in mind in coming to a view.

I am sending copies to the members of E Committee, the Lord Advocate, Sir Robert Armstrong and Mr Ibbs.


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

3 March 1982

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P.0669

PRIME MINISTER

Invergordon Smelter

E(82)19 and 21

BACKGROUND

flag A In E(82)19 the Secretary of State for Scotland invites the Committee to agree to negotiations aimed at reopening the aluminium smelter at Invergordon on the basis of a coal-based power station contract. His minute to you of 1 March summarises the main issues - and the political importance in Scotland of finding employment in Invergordon - but adds little to his memorandum. The Lord *flag B* Advocate in his minute of 2 March sets out the legal and European Community implications.

2. It will be impossible to enable the reopening of the smelter by covert subsidies. The question before the Committee is whether a scheme, and subsidies, on the lines proposed by the Secretary of State for Scotland could be defended against the economic disadvantages set out by the CPRS in E(82)21 and introduced without leading to unacceptable repercussions.

3. There is very considerable pressure in Scotland for action by the Government to reopen the smelter. If the Committee were to approve further negotiations on the lines proposed, the Secretary of State for Scotland would probably wish to let this be known publicly and to indicate that the Government had hopes of finding a satisfactory solution.

Proposed Scheme

4. The Secretary of State for Scotland sees no prospect of finding significant alternative employment opportunities in Invergordon for the 1500 or so people who will lose their jobs, either directly or indirectly, as a result of the smelter closure. For the reasons explained in paragraph 7 of E(82)19 he rejects the possibilities of reconstituting a nuclear power station arrangement similar to that with British Aluminium (BACo) and of hypothecating part of the hydro-electric

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system for use by the smelter. He recommends examination of the possibility of a scheme based on a contract with the National Coal Board (NCB) for coal, on lines similar to Alcan's contract for their Lynemouth aluminium smelter near Newcastle.

5. If Alcan were to take over the Invergordon smelter the main features of the arrangements are likely to be that:-

(i) Alcan would buy from BACo the assets and site of the Invergordon smelter. The price would be for negotiation but the Scottish Office think that it would be at the lower end of the range £10-20 million.

(ii) They would buy or lease from the South of Scotland Electricity Board (SSEB) a coal-fired power station which is at present largely surplus to the Board's requirements.

(iii) They would contract to purchase coal from the NCB both for Invergordon and for their existing Lynemouth plant (employing about 1150 people). On the assumption that for a viable smelting operation Alcan would not pay more than £15 a tonne for coal and that NCB's price would be based on coal export prices the subsidy, to be paid to the NCB, for the two Alcan smelters would be £22.5 million a year (for details see Annex B of E(82)19).

(iv) The contract would be for 10 or more years with some form of revision - as yet undefined - after five years.

6. Alcan UK are likely to need to drive a hard bargain if they are to go ahead. They are about to report a significant loss in their last financial year and they are dependent on continuing support from their Canadian parent company. If they were not to go ahead there are other companies in the offing (paragraph 6 of E(82)19) notably the American company Alumax. The contract with any other company would differ in that they do not have an existing coal contract for Lynemouth which could be used in part for the benefit of Invergordon.

7. The papers refer to the third UK smelter which is at Anglesey and jointly owned by RTZ and Kaisers of America. Anglesey Aluminium has a fixed price contract with the Central Electricity Generating Board until such time as Dungeness B is on stream; even then it is uncertain when they will have to pay the full operating costs. The details of this contract are not known to departments and they regard its re-negotiation as a matter between the company and the CEGB. The Welsh Office regard as unproven the claim that the CEGB are giving Anglesey an effective subsidy of £30 million a year. The main point relevant to the present discussion is that if a subsidy were to be given to Alcan for Invergordon and for Lynemouth, Anglesey Aluminium would expect a similar subsidy if their present contract with the CEGB were to terminate.

MAIN ISSUES

Size and Nature of Subsidy

8. The CPRS argue, in paragraph 3 of E(82)21, that the Scottish Office estimate of an annual subsidy of £22.5 million is too low because it is based on coal export prices. They suggest that it should be calculated on the basis either of coal domestic prices, giving a subsidy of £40 million a year, or of the electricity prices charged to other heavy users giving a range of £43-51 million annual subsidy.

9. It may well be accepted that it is reasonable to use export prices for, say, the next three years since over that period the NCB will have surplus production which they might as well devote to a power station supplying aluminium smelters rather than sell at a loss in export markets. But, consistent with the Government's approach hitherto to the NCB, it seems right to assume that thereafter they should aim to close unprofitable pits where practicable, to avoid locking themselves into long term contracts to sell at a loss, and to use short term export contracts only to deal with temporary surpluses. This points to calculating the subsidy, at least for the later years of the contract, by reference to NCB domestic prices even if not to electricity prices for other heavy users.

10. Irrespective of which coal price is held to be relevant to the calculations the subsidy could be higher than suggested, and of indefinite duration, because:-

- (i) It is by no means certain that Alcan would be willing to pay as much as £15 a tonne when they are currently paying only £10-11 a tonne for Lynemouth.

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(ii) It is thought that Alcan are thinking in terms of provision for relatively minor price variations after five years rather than for a major break clause in the contract and, in any event, it would be very difficult for the Government to withdraw subsidies from Invergordon five years after reopening the plant.

(iii) While the price of aluminium might rise from present levels over the next year or so (which, under the likely terms of the contract, would reduce the deficit to be financed) it is thought likely that over a period the price of coal will rise faster than that of aluminium so increasing the subsidy to be paid to the NCB for holding down their coal prices under this contract.

Thus it seems that the Government would be entering into a long term commitment to pay a subsidy of uncertain but significant size in order to reopen the Invergordon smelter. You will recall that one reason for deciding on closure last December was unwillingness to pay a subsidy of about £16 million a year without break to the year 2000. (NB. this £16 million is not directly comparable with the present subsidies under discussion since they apply to Lynemouth as well as Invergordon).

11. On top of the direct subsidy:-

(i) The Department of Industry could well be pressed by Alcan to give them grants to help with the purchase of the smelter from BACo.

(ii) If Anglesey Aluminium's contract fell through they would expect subsidies similar to those offered to Alcan.

(iii) Other heavy energy users could seek similar help.

12. The Lord Advocate has looked provisionally at whether the proposals would be acceptable in terms of the NCB's statutory powers and of European Community law. As he points out, in his minute of 2 March to you, the answers to the legal questions must depend on details of the proposals which have yet to be worked out. He considers, however, that the probability of favourable answers to the questions

of law is sufficient to make it worthwhile proceeding to work out these details if the Committee consider that the principle is acceptable.

Implications for Energy Policy and possible repercussions.

13. If the proposals were to be discussed further, it would first be necessary to clarify what should be the basis of grants to make up the difference between the coal price paid by Alcan and the price which the NCB could reasonably expect (either the export or the domestic price) and how this would fit in with the Government's objectives for NCB's capacity and profitability in Scotland (paragraph 9 above). If it were agreed that a subsidy should be paid it would be for consideration whether this could be offered under present powers. In any event, the Department of Energy might argue that a grant should be paid from Scottish Office votes rather than from Department of Energy votes.

14. It would also be for consideration what repercussions a subsidy for the Invergordon smelter might have for industrial energy pricing generally. The load management scheme which will be announced shortly will help those large users of industrial electricity willing to accept some variation in supplies, but not those users involved in continual processes. The latter could well demand similar concessions which, if granted, could be expensive and could prejudice the further review of industrial electricity prices which has now been put in hand.

15. The Department of Industry agree with the CPRS view, in paragraph 9 of E(82)21, that assistance to the aluminium industry does not merit priority on industrial grounds. There is no difficulty in securing supplies of primary aluminium and no expectation that problems of security of supply will emerge later. Thus, if a subsidy for the Invergordon smelter is to be justified and further subsidies for other heavy fuel users resisted, the case will need to be defended primarily on regional and social grounds.

HANDLING

16. After the Secretary of State for Scotland and Mr Ibbs have spoken to their papers, the Committee will wish to have advice from the Secretary of State for Energy on the implications for energy pricing policy and for the NCB in particular; from the Secretary of State for Industry on the industrial case and the risk of repercussions; and from the Chancellor of the Exchequer on the subsidy and energy pricing. At this stage, and in advance of detailed negotiations, the legislative and

perhaps
Nigel Lansmill
shd speak
before Mr Ibbs
given his
time constraint

M.S.



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European Community implications are of secondary importance and the Committee has the provisional advice of the Lord Advocate before it; the Minister of State, Foreign and Commonwealth Office may, however, want to comment on the Community aspects.

17. The Committee is likely to recognise the strong regional and social case for helping Invergordon and the reality that apart from the smelter there is no other new source of significant employment in prospect. In considering the case for a subsidy to enable re-opening the main questions are whether it is possible:

(i) to justify a significant, partly open-ended, indefinite commitment to subsidise the fuel for the smelter;

(ii) to work out a satisfactory basis for a coal subsidy;

(iii) to reconcile a subsidy for the Invergordon smelter with present policy on industrial energy pricing and to avoid opening the way to further substantial subsidies.

18. If the Committee decide that the objections to the particular scheme put forward by the Scottish Office are overriding, you will wish to consider whether there are any alternative possibilities for re-opening the smelter. It is, however, highly unlikely that any alternatives would be immune to similar objections; no scheme will avoid substantial subsidies. If the Committee were to decide that the smelter cannot be re-opened, the Secretary of State for Scotland will need to consider when this should be made public.

19. If, on the other hand, the Committee decides that the problems of Invergordon are such as to justify assistance, you will want to decide on the next steps. Before entering into negotiations with Alcan it will be necessary to be clear on the basis for the offer of a subsidy for the price of coal. Subject to the guidance of the Committee on this point, a small group of Ministers with the Secretary of State for Energy in the lead might be invited to agree on the approach to the coal subsidy (ie Scotland, Industry, Treasury with assistance from the CPRS). If agreement could not be reached in that group the matter would have to come back to the Committee for decision. Once the decision had been taken on the coal subsidy, it might be for the Scottish Office to take the lead in the further negotiations, with the Departments of Energy and Industry, the Treasury and the CPRS in support. Further discussions would have to be


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without any commitment to eventual subsidy. The final decision would have to be taken by the Committee in the light of the report which would also advise on the legislative and Community implications.

20. If the Committee were to authorise further work on this basis, you will need to consider what the Secretary of State for Scotland should say publicly at this stage. There is a strong case for no more than a relatively non-committal announcement that the possibilities of re-opening the smelter are under consideration. It would be a mistake to indicate that the Government is optimistic on the outcome: it is highly uncertain whether a satisfactory deal could be negotiated with Alcan or any other company and the Government will not wish to arouse expectations prematurely; it would be a tactical mistake to let Alcan and the NCB think, in advance of the negotiations, that the Government is determined to re-open the smelter.

21. As an intermediate course the Committee might decide tomorrow that they wish to reserve a decision until they can consider further inter-departmental work by officials. This work is however unlikely to be productive unless officials are given clear guidance about the points which need to be clarified and on how far Ministers are prepared to contemplate energy subsidies for Invergordon, for aluminium smelting generally and for other heavy energy users.

CONCLUSIONS

22. In the light of the discussion you will wish to reach conclusions on whether:

(i) the possibility of re-opening the Invergordon smelter is ruled out and, if so, when this decision should be announced;

OR (ii) the Committee favours in principle a scheme on the lines proposed by the Secretary of State for Scotland, subject to agreement by Ministers on the level and nature of coal subsidy to be offered, and to the outcome of discussions with Alcan and other private sector companies;

OR (iii) the Committee should postpone its decision until further inter-departmental work has been done in the light of guidance from the Committee.

P.G.
P L GREGSON

3 March 1982

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3 March 1982

ALAN WALTERS

PRIME MINISTER

INVERGORDON SMELTER

MS

1. I agree with the main recommendations of the CPRS paper. Invergordon should never have been built and will never be economic. It would be best, on economic criteria, to close it forthwith.
2. You believe, however, that we must keep it open in order to maintain employment. I think it can be shown that if Invergordon requires a subsidy per worker of more than £10,000 per annum, it is likely that maintaining it open will reduce the level of employment generally. Although of course, maintaining it at Invergordon.
3. Assuming Invergordon is to stay open, however, I think it would be worth while considering extracting a quid pro quo. I suggest that as a condition of Government support you require the Invergordon Smelter to cut labour costs next year by 10%^{nominal} and each year thereafter ensure that labour costs rise by the rate of inflation less 3% or more. This would be the condition for continued Government support. It is, in the nature of a long-run productivity agreement.
4. The advantages of extracting this agreement are that you could present the Government subsidy in a much better light politically to your supporters. At least we will get something back for our hand-outs. I believe that also it is necessary to have a limited period over which this applies and I would suggest that it be extended only for, say, four years to 1986/87. The details, however, can be worked out later.
5. The other advantage of this approach would be to bring pressure on wage rates and productivity. The fact, however, that the reduction is imposed on the wage bill enables the workers and management to settle how it is to be distributed between redundancies on the one hand, and reductions in wage rates on the other.
6. Presentationally this would be best achieved as an initiative by, or at least agreement with, the workers. This would be their "contribution to survival".

AW

3 March 1982

ALAN WALTERS

CONFIDENTIAL



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Qa 05851

To: MR SCHOLAR

3 March 1982

From: J R IBBS

Invergordon Smelter

1. I told the Prime Minister on Monday evening that the CPRS note on the Invergordon Smelter concluded that there was not a sound case on economic grounds for the proposals put forward by the Secretary of State for Scotland. She asked whether we had any positive suggestions.
2. The CPRS has had further discussions with Scottish Office officials and, among other possibilities, has explored whether assistance for the Smelter could be provided as some form of 'social grant' in order to avoid the problem of blatantly subsidised electricity prices. We have been unable to find any satisfactory proposition of this kind.
3. In the circumstances the CPRS would regard general help for the Invergordon area of the kind agreed by Ministers at the time of the closure decision in December as the most appropriate. In view of the high cost per job of the support envisaged in the Secretary of State's proposals such assistance might be on a very generous scale. It could, for example, include special assistance for starting small businesses, although there are limitations to the extent to which this is feasible in such an area. It would not in the short term offset the obvious immediate consequences of closure.
4. I am sending a copy of this minute to Sir Robert Armstrong.

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3 MAR 1982

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COMPTROLLER

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B (2)
Prime Minister
MS 2/3

PRIME MINISTER

INVERGORDON SMELTER: PROPOSALS FOR A RESTART

I have considered with officials the legal questions arising from the proposals by the Secretary of State for Scotland to be discussed by E Committee on Thursday 4th March.

The proposals involve difficult questions of domestic and Community law. A great many details of the proposals remain to be worked out and the answers to the legal questions must depend on what these details are. For example, much will turn on the terms on which the coal-fired power station is made available by the SSEB and the coal is made available by the NCB. I consider that the probability of favourable answers to the questions of law is sufficient to make it worthwhile proceeding to work out these details if colleagues consider that the principle is acceptable. I should be glad to advise further on the details in that event.

I am copying this to those who will be attending the E Committee meeting, to the Attorney General and to Sir Robert Armstrong.

my C

MACKAY OF CLASHFERN
2nd March 1982

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SCOTTISH OFFICE
WHITEHALL, LONDON SW1A 2AU

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Prime Minister

INVERGORDON SMELTER: PROPOSALS FOR A RESTART

MCS 1/3

The paper I have circulated for the meeting of E Committee next Thursday shows that the issues are complex. I thought it might help to say briefly why the issue is of so much concern to me.

When we discussed the proposed closure of the smelter in December we were unable to accept the terms which BACo had indicated for keeping the plant going. The smelter accordingly closed at the end of December with the direct loss of 890 jobs.

As I feared this closure has provoked a degree of bitterness unparalleled even in Scotland. In contrast to Linwood, Singers or Massey Ferguson, where the job loss was many times greater, Invergordon is relatively isolated. New industry on the scale of the smelter is virtually impossible to attract in anything like a reasonable timescale. The knock-on effects are extremely serious for a wide range of small business in the area, for British Rail's services in the north of Scotland and for the coal industry. The Highlands have had more than their share of disasters over the generations, and no doubt this helps to account for some of the intensity of feeling. We are coming to be regarded as the Government that "lost" the two major projects which had been brought to the Highlands as a result of Government policy in recent years: the other was the pulp mill at Fort William which closed in 1979. The implications of this are serious for the Highlands economically; politically they could be disastrous for us as well.

My task in explaining what has happened is made extremely difficult on two counts. First, the closure certainly cannot be blamed on the workforce or the management at Invergordon. Industrial relations and productivity were good. The problem lies squarely with the terms on which electricity was made available, and although Government were not party to the contract this is widely and justifiably regarded as a matter in which Government has major responsibility. Secondly, although it is the Highlands with their hydro power which have the cheapest indigenous electricity supply in Britain, people see that the other two large aluminium smelters continue. Invergordon was linked to the nuclear station at Hunterston B; it failed because the £8m-£10m which Government paid annually by way of subvention to the power contract was not enough. Anglesey Aluminium is estimated to receive a subvention from other CEBG consumers of around £30m a year and Alcan at Lynemouth have power based on a contract with the Coal Board which, if similar terms were available to Invergordon, would certainly make it viable also.

Prime Minister

(Written before me

Secretary of State knew of

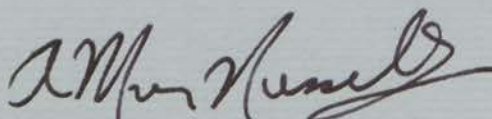
your comments on his E paper.)

I consider it essential to get the Invergordon smelter restarted. A number of companies have shown interest in taking over the plant, but they cannot negotiate terms with BACo until we are in a position to offer a power contract which could make its operation viable. I recognise the difficulties; but the arrangement set out in my paper, which is based on a coal contract, seems to me to offer the best chance of success. The proposals put forward by Alcan have particular attractions since their existing coal contract provides enough to cater for 40% of Invergordon's needs in addition to those of the smelter at Lynemouth. There are break clauses in this contract: the first occurs in December 1983. The continued operation of the Lynemouth smelter depends critically upon any adjustment to the terms which may then be negotiated. This is crucial to the proposed restart of Invergordon also as would be the terms on which the additional 60% of Invergordon's supplies could be obtained. The implications for other industries must be considered, but I do not believe that my scheme will weaken our general position on power costs. The massive facility at Invergordon was only built because special arrangements were made for its power supply and its consumption of electricity is in a different league from any other industrial user in Scotland. To make special arrangements for a new owner seems entirely justifiable.

I recognise too the NCB's difficulties over the price of the coal required. But we are already exporting surplus coal from Scotland at prices below the domestic selling price. The surplus is likely to be particularly acute for the next 3 or 4 years while Peterhead power station burns liquid gases from the North Sea; it is likely to continue thereafter since the Torness nuclear station is scheduled for start up in 1987. It seems to me much better to use British coal to keep one of our own industries in existence rather than export it abroad to our industrial competitors at a price which is not available in the home market, that way we give them energy on terms which we deny ourselves.

The Lord Advocate is considering the legal and EC implications of the course I propose, and I will arrange for his advice to be available to the Committee.

I am sending copies of this minute to those who will be attending the E Committee meeting.



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

SCOTTISH OFFICE
1 March 1982



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ACTION

CONFIDENTIAL

Prime Minister

2

A very difficult solution

THIS DOCUMENT IS THE PROPERTY OF HER BRITANNIC MAJESTY'S GOVERNMENT

E(32)19

I fear we are not being 'carry' enough

COPY NO 2

26 February 1982

This arrangement positively exacerbates the WCB's habit of covering the rule of cost

CABINET

to a very awkward problem.

and therefore keeping in the position. If we can break that habit and secure a variation in

MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

rule at pit-head, select those to consumers, we should be on the way to greater efficiency & cheaper coal.

M/S 26/2

INVERGORDON SMELTER: PROPOSED RESTART WITH A NEW POWER CONTRACT

Memorandum by the Secretary of State for Scotland

It is to subsidize down the price for this purpose felt

us into difficulties. I accept the need to keep Invergordon going

but don't like the suggested route.

1. This paper reports on the situation following the closure by British Aluminium (BACo) of their smelter at Invergordon. It describes discussions which have been held with aluminium companies interested in taking over the smelter in order to restart it, explains the issues involved in a possible new power contract which could make the smelter operation viable and seeks the agreement of colleagues to the steps which would be necessary to put such an arrangement in place.