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P.0687

PRIME MINISTER

Invergordon Smelter:
New Power Contract

E(82)31

BACKGROUND

In E(82)31 the Secretary of State for Scotland makes recommendations for a new power contract to be offered to firms interested in reopening the aluminium smelter at Invergordon. Of the two main possibilities which emerged from the Committee's discussion on 8 March, he rejects a contract based on coal prices as unlikely to be sufficiently attractive to interest firms and to be in a form immune to European Community challenge (paragraphs 12 and 13 of his paper). Instead he recommends that the contract should be based on setting aside the output of hydro-electric stations in the North of Scotland.

2. Although the details would have to be negotiated, the working assumption is that a new operator could pay no more than 1.2p a unit for power if the smelter was to be viable, compared with the minimum price of about 2.5p a unit which the North of Scotland Hydro-Electric Board (NSHEB) could justify in relation to short-run costs. It is suggested that a concessionary electricity price could be justified on the grounds that cheap hydro-electric power, which is used to meet peak demands, is available in the locality even though the smelter would be drawing on power from the system as a whole. Since the smelter would not absorb power equivalent to the full output of the hydro-electric system, concessions would also be made available to other industrial consumers in the area (paragraph 5 of E(82)31); these include oil rig platform construction yards, distilleries, and paper makers. The total cost of the concession would be £25 million a year initially, of which £22 million for Invergordon. For the reasons given in his paragraph 7, the Secretary of State for Scotland does not believe that this could be met by increasing the bills of other Scottish electricity consumers. If this is accepted, it is then necessary to finance the subsidy by means other than a direct grant which would run into Community objections.

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3. Against this background the Secretary of State for Scotland proposes:-

(i) a Bill, for introduction if possible before Whitsun and for Royal Assent in the Summer, to enable him to designate by Order those areas and categories of consumer to which the requirement on the NHSEB to avoid 'undue preference or undue discrimination' would not apply;


(ii) the writing-off of loan charges - which, it is thought, would also have to be enabled by the proposed Bill - to compensate the Board for the annual costs of the concession;

(iii) an approach to the European Commission, and at political level, to persuade them of the acceptability of the proposals.

4. If the Committee approves this approach there would be negotiations both with the Scottish Electricity Boards and with potential operators of the smelter. The Scottish Office believe that Alcan would still be interested, though this deal does not offer them assistance for their smelter at Lynemouth where their existing coal contract comes up for review in 1983 and 1986. Alumax of California and two Norwegian companies are thought to be interested. The British Aluminium Company would have to sell the site to the new operator and it is thought they might take a minority equity stake in return for continued use of the jetty which they need for shipping in supplies to their other Scottish companies.

MAIN ISSUES

5. At their discussion on 8 March the Committee were particularly concerned by the difficulty of finding a solution to the undoubted social and economic problems of Invergordon which was at an acceptable level of cost and which did not open the way to a flood of claims for similar subsidies for other large industrial users of energy and to other firms in areas of high unemployment. The Committee will now wish to consider how far the present proposal meets such objections and, if it does, whether the legislative and Community difficulties are manageable.


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Costs

6. The direct annual cost of the subsidy would be £25 million. Although the paper does not say so, a new operator would probably want a contract running for 15 years or so, and it seems implausible that he would agree to a break-clause which would allow for significant variations. Unless the gap between aluminium and coal prices narrows, the costs would rise over the years. As the Treasury have pointed out - see paragraph 11 of the paper - the cost per job saved at Invergordon would be £30,000 a year, or £20,000 a year in the short term while the NCB is reducing capacity. The Committee will wish to consider whether this level of subsidy can be defended and, in doing so, to take account also of the further costs which will arise if an effective ring-fence cannot be drawn round this contract.

Repercussions

7. If this proposed contract goes ahead, Alcan will certainly fight for a similar contract for their Lynemouth-smelter (NB. Mr John Peyton is on their Board); so too will Angelsey Aluminium if their present favourable contract folds up.

8. Other high industrial energy users would similarly bid for subsidies. Clearly the aim would be to argue that the Scottish contract was applicable only to the special circumstances of the Highlands and to the existence of hydro-schemes in the area. But this does not seem to be an impregnable line of defence. ICI, British Oxygen and other high base-load users could also claim that part of the output of a low cost power station should be regarded as dedicated to their use. Some Welsh firms could claim that their prices should be adjusted to take account of the fact of the hydro-electric system in Wales. Other firms could point out that in practice the Invergordon smelter would not actually be using hydro-electric power and that they too happened to be near a cheap source of fuel.

9. The proposed form of subsidy - the writing down of loans to the NHSEB - could also have repercussions. Most nationalised industries have had to write

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down some assets recently and they and their consumers would no doubt be very happy for the Government to write off loans correspondingly so that lower prices could be charged. In particular some of the Scottish power stations which are under used or unused are in the area of the Southern Board and so consumers throughout Scotland could mount a case for benefiting through lower prices from loans written-off.

10. In short, the Committee will need to decide whether the scheme proposed by the Secretary of State for Scotland could be defended against vigorous claims for similar concessions generally and, if not, whether the repercussions were acceptable.

Legislation


11. If the Committee does decide in favour of the proposal the necessary Bill will add to the burdens this Summer on both Houses. If necessary this could no doubt be managed but the Secretary of State for Scotland may be optimistic in his judgement that the Bill would be both short and straightforward. There must be a risk that it would open up the whole debate on the Government's policy towards industrial energy pricing and the adequacy of the measures announced in the last Budget. Although the Scottish Office have professional advice that the proposed writing down of loans could be defended they could well be questioned hard as to why they are using the device of writing-off loans in order to subsidise a particular group of consumers.

European Community implications

12. As explained in paragraphs 9 and 10 of E(82)31, the Commission must be notified of the proposals which are in principle open to challenge, although it is judged that in practice the Commission could probably be persuaded to allow them. We understand that Mr Hurd will be writing today on behalf of the FCO (who will not be represented at the meeting) broadly to confirm the assessment in the paper and the Lord Advocate has commented in more detail in his minute of 19th March.

13. It is clear that the risk of difficulty with the Commission cannot be wholly discounted. You may therefore wish to ask why it is thought that the Commission would refuse to accept a direct grant but would accept the writing-off of loans which in practice is no different from giving a direct grant.

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Courses open to the Government

14. If the Committee concludes that the Secretary of State for Scotland's proposal is unacceptable, it will need to consider whether there is any alternative to making it clear, at an appropriate time, that no power contract is available on which a viable aluminium smelter at Invergordon could be based. This would have serious implications both socially and politically. The option of doing more work in the hope of finding an acceptable basis for a viable smelter is unattractive; the fundamental difficulties which have been identified in all solutions so far considered (the heavy Government subsidy involved by one route or another, the difficulty of concealing it, and the inevitable repercussions) are unlikely to be avoided in some new variant.

15. The Committee may however wish to consider whether the Government should make some offer, even if it is unlikely to provide the basis of a viable operation, to soften the impact of the unfavourable decision and to demonstrate the efforts which have been made. The Secretary of State for Scotland is opposed to this, because of the risk that such an offer might be seen from the outset to be a cynical manoeuvre. If however the Committee chose to adopt this approach, the only offer on the table is that outlined in paragraph 12 of E(82)31 under which 0.75 million tonnes of Scottish deep-mined coal would be made available each year for five years at £26 per tonne ie the export price, and the Secretary of State for Scotland would pay such grants as could properly be paid under existing legislation towards the setting up of a new smelter operation and towards any new investment. The option of an offer on these lines, inadequate though it would be, might therefore be discussed, and, if the Committee favours it, some further work would be needed to define the offer more precisely.

HANDLING

16. After the Secretary of State for Scotland has introduced his paper the Committee will wish to hear the views of the Chancellor of the Exchequer, the Secretaries of State for Energy and for Wales and Mr MacGregor (representing the Secretary of State for Industry) on the costs and likely repercussions of the proposals. The Lord Advocate can advise on the legal and Community aspects.

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The Lord President of the Council and the Chancellor of the Duchy of Lancaster will wish to comment on the proposed Bill for introduction before Whitsun.

17. In the discussion you will wish to examine the proposals under the four headings above: costs; repercussions; legislation; and Community implications.

18. There will inevitably be pressure after the meeting for a statement on what decisions the Government has taken on Invergordon. Whatever the outcome, care will have to be taken on precisely what is said; in particular, if the Committee decides in favour of the scheme it will be important not to say anything which could prejudice the negotiations and the level of the eventual subsidy. The Secretary of State for Scotland has, therefore, prepared two short statements, for use either if the Committee endorses his proposals or if they do not reach a conclusion; copies are being sent today to your Private Secretary. At the end of the meeting you might wish to read out to the Committee an appropriate form of words so that all Ministers have guidance on what should be said publicly.

CONCLUSIONS

19. If the Committee approves the Secretary of State for Scotland's proposals you will wish to approve the four specific proposals for further work in paragraph 15 of E(82)31 and to inform the Committee of what can be said publicly and immediately.

20. If the Committee decides that the present proposal is not acceptable you will wish either to call for further work or to conclude that there is no prospect of opening the Invergordon smelter. You will wish to guide the Committee on what, if anything, ought to be said publicly.

PLG

P L GREGSON

22 March 1982

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Foreign and Commonwealth Office

London SW1A 2AH

22 March 1982

From The Minister of State

Rt Hon Douglas Hurd CBE MP

MWD 132/20

24 MAR 1982

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W^{23/3}

Dear George,

I have seen your Memorandum E(82)31 of 19 March about a new power contract for the Invergordon smelter. As Peter Carrington and Humphrey Atkins are away and I will be unable to attend 'E' Committee myself, I am writing to let you have our views in advance of the meeting.

We think the Memorandum brings out the EC implications quite well. The paper rightly recognises that the aid package should be notified to the Commission (although in fact under Article 93.3, not Article 92.1 as stated). I assume of course that the aid cannot be disguised so as to make non-notification a viable option. I agree that we might have a case under Article 92.3(a) or 92.3(c), but I would not wish to give members of 'E' Committee the impression that clearing this with the Commission will be straightforward. We would rate our chances at about even. We shall therefore have to play our hand very carefully, and I would recommend informal consultations with the Commission (not formal as stated in your Memorandum) so as to establish the best way in which the formal notification could be presented. This is a standard procedure in cases of this kind.

If, therefore, it is decided to proceed on the basis of your Memorandum, I hope we can see a draft notification from your Department fairly soon which we could then discuss inter-departmentally and with UKREP Brussels, before showing it on an informal basis to the Commission. I agree in principle with your idea of a simultaneous political approach, but we can give further thought to this after we know the Commission's informal reaction to our draft notification.

I am copying this letter to other members of 'E' Committee.

✓
Covey,
Dunlop.

The Rt Hon George Younger MP
Secretary of State for Scotland
Scottish Office
Dover House
Whitehall



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Qa 05865

22 March 1982

To: PRIME MINISTER

From: J R IBBS

Invergordon Smelter

1. In his paper E(82)31[✓] the Secretary of State for Scotland sets out a proposal designed to provide the Invergordon Smelter with cheap power. This is based on new legislation to allow NSHEB to discriminate substantially in favour of large industrial consumers, and a significant adjustment in the SSEB's balance sheet to ensure that the burden of this falls on the taxpayer rather than SSEB consumers.
2. The proposal that assistance should be provided by allocating to the smelter (and other large users in the area) the low cost hydro-electric power produced in the Highlands does not allay my concern that there is no sound economic argument for this help. In countries with a large amount of low cost electricity it is entirely appropriate to devote some of it to aluminium production. But in this country low cost electricity is a valuable rare resource. If it is not going to be used (as at present) to reduce average costs and prices of electricity then it should be deployed on industrial uses of major strategic importance so as to bring substantial economic and employment benefits. Aluminium production is not such an activity. Furthermore, the very high subsidy per job will be apparent and the proposal will seem inconsistent with the Government's basic policy of encouraging economic realism. This could cause widespread confusion and resentment.
3. Three particular difficulties with the proposal are:
 - (i) it opens the way piecemeal to demands for special treatment by any intensive electricity user facing competitive difficulties related to electricity costs. (Some users would be able to argue that they are close to a source of low cost power, e.g. a successful nuclear power station; if low cost power generated in



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the Highlands can be allocated to intensive users, why cannot the same principle apply in other localities which also have economic and employment problems?)

(ii) The device of reducing the impact on other consumers by writing off assets and waiving a loan, although ingenious, is obviously artificial. The modification of the SSEB balance sheet is either appropriate or not in its own right. If the status of the power station at Inverkip is such that the assets should be written off then this should happen regardless of what is done about Invergordon. Whether or not the loan should then be waived is a policy decision. If it is seen to be as a direct result of the NSHEB discrimination in favour of Invergordon this would make it clear that the funding of and rates of return required from electricity boards are political, rather than economic. This would increase the vulnerability of the electricity pricing structure to further lobbying.

(iii) It would be difficult to limit this major subsidy to the Invergordon smelter. In view of the points in (i) and (ii) above it will be hard to argue that the assistance to Invergordon related solely to the local availability of hydro-electric power. Both Lynemouth and Anglesey are in areas of high unemployment, and are likely to be able to deploy substantial backing for special treatment.

4. I am sending a copy of this minute to Sir Robert Armstrong.

for E folder

From: THE PRIVATE SECRETARY

Prime Minister

MS 22/3



NORTHERN IRELAND OFFICE

GREAT GEORGE STREET,

LONDON SW1P 3AJ

Michael Scholar Esq
10 Downing Street
LONDON SW1

22 March 1982

Dear Michael

Mr Prior has commitments in Belfast tomorrow and therefore regrets that, provided the Prime Minister is agreeable, he will not be attending tomorrow morning's meeting of 'E' Committee.

Yours sincerely
Mike Hopkins

M W HOPKINS

PRIME MINISTER

INVERGORDON

1. The E papers speak of a subsidy of £25 million per annum for 15 years = £30,000 per annum per job (assuming 890 jobs lost).

2. But deduct

- (i) £9 million per annum NCB saving, arising from reduction of NCB's need to export excess coal at a loss (see para 7(c) of E(82)31).
- (ii) £3 million per annum lost revenue for British Rail
- (iii) £6 million per annum in extra unemployment benefit

3. This brings the net cost down to £7 million per annum immediately = £7,900 per annum per job (assuming 890 jobs lost); or £4,700 per annum per job (assuming 1500 jobs lost).

4. This calculation makes the subsidy look far less daunting. But it takes no account of

- (i) the costs of similar subsidies elsewhere - e.g. for Lynemouth and Anglesey;
- (ii) the general and hidden economic costs which giving this 'wrong signal' would generate.

MCS

Content for Mr MacGregor to represent

Mr Jenkin (in N America)?

22. Marbh 1982

MCS 22/3

Prime Minister



(1) Given the Press interest I imagine you will want to agree a form of words at E tomorrow.

(2) I doubt whether those below will appeal to you. May I

SCOTTISH OFFICE

WHITEHALL, LONDON SW1A 2AU

suggest alternatives:

Michael Scholar Esq
Private Secretary
No 10 Downing Street
London SW1

(A) "The government have today decided to go ahead as far and as fast as possible, with the aim of assuring the future of the Invergordon smelter on the basis of a power contract related to hydro-electricity costs."

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smelter on the basis of a power contract related to hydro-electricity costs."

Dear Michael

INVERGORDON

(B) "The government have today considered a proposal to base a new power contract for the Invergordon smelter on hydro-electricity costs. This is a highly complex issue, and the government is seeking further information before reaching

When we spoke this morning about Invergordon you asked for two draft statements for possible use tomorrow by the Prime Minister, one if my Secretary of State's proposal is accepted and another should it be deferred. The following paragraphs have been approved by Mr Younger:-

(A) Statement if proposal accepted

There is now a substantial measure of agreement within Government on the basis of a new power contract for the smelter. Some details remain to be finalised but we will shortly be ready to make an announcement.

a decision."

MUS 22/3

(B) Statement if decision on proposal deferred

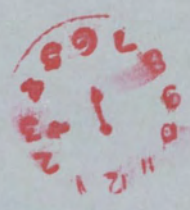
The Government have today considered a proposal to base a new power contract for the Invergordon aluminum smelter on the hydro-electric resources of the North of Scotland Hydro-Electric Board. Without a power contract we are unable to start negotiations with potential operators for the re-opening of the smelter. The complexities of the proposal make it necessary for the Government to seek further information before reaching a decision. They have therefore agreed to discuss the proposal again when this information is available and officials have been instructed to report back to Ministers as a matter of urgency.

I am copying this letter to Bernard Ingam and to David Moore in the Cabinet Office.

Yours ever,
John Wilson

JOHN S WILSON
Private Secretary

SCOTTISH OFFICE
POSTAL TELEGRAPH OFFICE



22 MAR 1982