NBPM at present

PRIME MINISTER 21 May 1996

PROVISIONAL AGREEMENT BETWEEN THE NCB AND CEGB ON COAL SUPPLY

The Government was right not to interfere with the negotiation between the NCB and the CEGB. But what have we got compared with expectations?

On a narrow short-term view, the fall of oil prices potentially gives electricity consumers a windfall worth up to £1 billion pa - ie tariff reductions of at least 5%. But certainly in the short-term, and probably in the long-term, the UK economy would suffer from a switch to maximum oil burn in power stations. By the 1990s, we are likely to regret a further substantial scaling down of the UK coal industry.

The stopgap deal which E(A) had in mind would have:

- given part of the windfall to electricity users in recognition of the new balance of competitive forces in the energy market;

- put part of the consequent cost on the NCB in reducing capital expenditure and making other economies;

- put part of the cost on the taxpayer in funding a larger NCB deficit.

What we are offered is close to this judicious middle course. The big difference is the long-term framework in which the deal between the NCB and CEGB has been struck.

Presentation is important both for the two industries and for the Government. We need to forestall criticism that the ESI has not fulfilled its obligation to electricity consumers. We want to signal to miners that the market for coal is under serious threat unless coal is produced more efficiently and cheaply.

Against this background, I believe that the NCB and the CEGB were right to ignore their remit to confine the negotiation to a stopgap deal. The supply of coal from the NCB to the CEGB is the world's largest contract. Both industries are capital-intensive with huge fixed assets. The CEGB's statutory obligation to minimise fuel costs is bound to be tempered by considerations of longer term supply security. With over 80% of its capacity in deep mines (which unlike open-cast mines cannot be closed down temporarily) the NCB needs a secure market for its coal. Thus, both organisations are more attracted by stability rather than the vagaries of the oil market.

Whilst the framework of the deal is presentationally helpful, the basic contractual commitment is confined to the current financial year and the next. In any case, if oil prices move outside the range $15-24 a barrel, the re-opener clause will come into play and a new deal will have to be struck. An interim deal of at most two years should fit nicely with the Government's plan for a new corporate structure of British Coal in two years' time.

Conclusion

We would recommend acceptance of the deal negotiated between the NCB and the CEGB.

JM

JOHN WYBREW

10 DOWNING STREET

Prime Minister

The Chief Secretary and Mr Tebbit are willing to go along with the proposed deal between the NCB and the CEGB. The Policy Unit are also content.

Agree not to intervene?

DCW
29/5.

Yes

MT

CONFIDENTIAL

cBG

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ

01 211 6402

The Rt Hon John MacGregor OBE MP
Chief Secretary
HM Treasury
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

NBPM.

2 June 1986

Dear Chief Secretary,

PROVISIONAL AGREEMENT BETWEEN THE NCB AND CEGB ON COAL SUPPLY

Thank you for your letter of 28 May replying to mine of 20 May.

I am glad you agree that, subject to certain conditions, we should not wholly overturn the proposals now put to us by the industries. I will arrange an early discussion with the two industries with the intention that announcements should be made in the very near future.

I shall explain to the industries that our agreement is to the firm arrangements proposed for the first two years but add, as you suggest, that there can be no presumptions beyond that date.

As regards NCB's 1986-87 EFL, I have already proposed that this should be confirmed at £730m. I shall of course emphasise to them the necessity of living within that figure.

For the later years, it is my intention, during the IFR process, to press hard on the NCB to deliver the maximum savings and this will include a rigorous examination of their capital expenditure intentions.

I am copying this letter to the Prime Minister, other members of E(A) and to Sir Robert Armstrong.

Yours sincerely,

PETER WALKER
(Approved by the Secretary of State and signed in his absence)

CONFIDENTIAL

NAT. IND: Coal: Part 19

001/1285

CONFIDENTIAL

cc BG

CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Peter Walker MBE MP
Secretary of State for Energy
Department of Energy
Thames House South
Millbank
London
SW1P 4QJ

28 May 1986

Dear Peter,

PROVISIONAL AGREEMENT BETWEEN THE NCB and CEGB ON COAL SUPPLY

Thank you for your letter of 20 May.

Like you, I am surprised that the industries have produced a provisional deal which could cover up to 5 years. Their deal is not, of course, based on any underlying economic principles. So while it may be appropriate for an interim arrangement of the sort envisaged at E(A) during a period of particular uncertainty, I do not believe it forms a proper basis for long term trading between two state industries with significant monopoly power.

For the longer term I think we have to look to move trading between British Coal and the CEGB toward an import parity basis. I do, however, accept your point about the difficulties of wholly overturning the proposals now before us. I would be willing to accept them on the following basis:

(a) the deal is firm for 1986-87 and 1987-88 but with no presumptions beyond that date;

(b) you are confident that British Coal will live within their 1986-87 EFL of £730 million and you will emphasise to them the necessity of making whatever savings are necessary to ensure this happens;

(c) you press hard on British Coal to deliver further savings in 1987-88 and later years. I have in mind in particular their investment programme. Our officials need to do further detailed work together on this

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I am copying this letter to the Prime Minister, other members of E(A) and to Sir Robert Armstrong.

Yours ever,

JOHN MacGREGOR

CCB6

CCB+

SECRETARY OF STATE FOR ENERGY

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ
01 211 6402

Prime Minister 2
To be aware, in advance of Treasury and Policy Unit comments.
DHN 20/5.

The Rt Hon John MacGregor OBE MP
Chief Secretary
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

20 May 1986

PROVISIONAL AGREEMENT BETWEEN THE NCB AND CEGB ON COAL SUPPLY

As agreed at E(A) (12th Meeting), I saw the Chairmen of the NCB, the CEGB and the Electricity Council in order to encourage them to negotiate a reduction in coal prices of the order of £150-£200 million during the 7 months to the end of October 1986.

Although both at the initial meetings and on subsequent occasions I made it clear that I had no authority to approve a deal other than on this basis, the industries returned to me with a provisional agreement they have negotiated covering 5 years from 1986/87 to 1990/91. Essentially, the coal industry wants a longer-term deal in order to provide stability for planning the return to viability to which it is committed: the electricity supply industry (esi) wants a longer-term deal in order to provide stability in its costs and therefore its tariffs, and because it believes it will be easier to justify accepting what could be represented as inadequate concessions on coal prices in 1986/87 if it can hold out to its customers a firm prospect of continuing gains.

It is clear that neither industry will be willing to return to the concept of a 7-month, or even a 12-month, deal. We have no statutory powers we could use to force them, but in any case, there would be real difficulties in such a course. In any shorter term deal, the esi would be bound to seek a larger price reduction in the first year. This additional burden on the coal industry could only be met by an even more extensive closure programme which would be wholly unattainable in the face of the constraints of the New Colliery Review Procedure and the pledge of no compulsory redundancies.

We must therefore consider carefully whether we can endorse their proposals. We need to reach an early conclusion, in view of the public expectations which have been built up during the negotiations.

THE PROPOSED DEAL

Details of the proposed deal are set out in the Annex to this letter. The main features are that it creates a 3-tranche, instead of a 2-tranche, structure of coal prices; and that the size of the

SECRETARY OF STATE FOR ENERGY

first tranche, which is less closely related to the price of coal on international markets, falls in each year. The deal is expressed as firm for 1986/87 and 1987/88 and as a "clear intention" thereafter. There is a re-opener clause which would allow the price of the second tranche to be re-negotiated in years after 1986/87 if the price of heavy fuel oil lay outside the range £65-£100 a tonne.

FINANCIAL EFFECTS

My officials have passed to yours the information that is available from the two industries about the financial effects of the proposed deal. The main points are as follows:

(a) Compared with the present Joint Understanding, the proposed deal will cost the NCB about £300 million in 1986/87, £380 million 1987/88 and £400 million in 1988/89. The NCB have identified substantial offsetting savings, but believe that their return to breakeven will now take place in 1988/89 not 1987/88.

(b) The esi will, of course, expect to pass the savings on to its consumers. I estimate that the savings would allow a reduction in tariffs of something more than 3% in 1986/87, and a further 1% in 1987/88.

(c) Even before their negotiations with the CEGB, the NCB had revised their plans for 1986/87 to allow for a loss of some £180 million revenue in all markets to reflect the fall in oil prices. By strenuous efforts to find cost savings, and by reducing expenditure on fixed assets from £800 million to £750 million, they expect to be able to contain their financial requirements within the provisional White Paper figure of £730 million. The proposed deal, with parallel effects in other markets, will further reduce net revenue by about £170 million. In my view, the cost to the PSBR should be offset by a further reduction in the NCB's capital expenditure of £100 million, to £650 million. Allowing for cost reductions through lower inflation and savings to public sector bodies from lower electricity tariffs, the overall effect on the PSBR should be very small - perhaps of the order of £20 million. I propose to confirm to the NCB an external financing limit for 1986/87 of £730 million.

But the public sector bodies will spend the benefit.

APPRAISAL

I see no difficulty about the proposed deal as it affects 1986/87. The full year cost to the NCB of £300 million is consistent with the range that E(A) approved (of £150 million to £200 million for 7 months); and as I have said, I believe the cost to the PSBR can be virtually eliminated.

As regards the later years it might be argued that there are dangers in a 5-year deal, given the present uncertainty in the energy market. However the fact that the deal is only firm for first two years removes much of the force of this argument.

SECRETARY OF STATE FOR ENERGY

There are a number of positive features. The deal is a substantial move in the direction indicated by market signals. It can reasonably be argued that it would be wrong, in conditions of uncertainty to insist on immediately restructuring coal and electricity prices to the full extent that might be appropriate if present oil prices continued indefinitely. Any utility, even if privately owned, could well attach considerable importance to the sort of stable relationship with a supplier which the proposed deal offers. Self-evidently, both industries will be willing to defend the deal as something which they negotiated without Government interference.

CONCLUSION

Balancing these considerations, my conclusion is that we should endorse the deal for the two years for which it is firm - 1986/87 and 1987/88, whilst urging the NCB to press ahead with the necessary cost reductions underlying it, including an accelerated rate of pit closures and redundancies. For the remaining 3 years, we should note the basis on which the two industries wish to proceed and, in particular, the intention that the electricity consumer should receive a continuing benefit from the fall in energy prices. But we should make it clear that the deal should be thoroughly reviewed at the end of the two year period.

If this approach is acceptable to you and the other members of E(A), I will consult Malcolm Rifkind about the implications of this for a deal between the NCB and the SSEB.

I am sending copies of this letter to the Prime Minister, other members of E(A) and to Sir Robert Armstrong.

Peter

PETER WALKER

OUTLINE OF THE PROPOSED NCB-CEGB DEAL

1. The deal would cover the five financial years 1986/87 to 1990/91. It is firm for the first two years and expressed as a "clear intention" thereafter. (A shorter term arrangement would cause difficulties for both sides. The NCB could not offer large short-term discounts without throwing their financial recovery seriously off course. The ESI need a longer-term framework of falling prices in which to justify short term price reductions which are well below their customers' expectations.)

1986/87

2. The deal involves three tranches of coal, (compared with two tranches under the current Joint Understanding). The volumes and prices in 1986/87 are:

1st tranche: 50mt at the same price (£46.88) as under the present Understanding

2nd tranche: A new tranche of 10mt priced at £33 per tonne

3rd tranche: 12mt at an agreed import-related price of £29.50

Any tonnage above 72mt* this year will be at 3rd tranche prices. There will be no price increase this autumn, and prices will effectively be frozen until November 1987.

SUBSEQUENT YEARS

3. Beyond 1986/87 the deal relates to a steady 70mt a year, of which a growing proportion will be second tranche coal. Thus

mt

	1986/87	1987/88	1988/89	1989/90	1990/91
1st tranche	50	47	46	43	40
2nd tranche	10	11	12	15	18
3rd tranche	12	12	12	12	12
	--	--	--	--	--
TOTAL	72	70	70	70	70
	--	--	--	--	--

4. (a) From November 1987, the price of first tranche coal will rise each year below the rate of inflation, as under the present pricing formula.

(b) The price of 2nd tranche coal will be 75% of the first tranche price, provided that Heavy Fuel Oil

* Up to 72mt. Beyond that the price would be a matter for negotiation.

remains in the range of £65-100 per tonne (this is very roughly equivalent to $15-24 per barrel of crude). If it moves outside this range, negotiations on the second tranche price will be reopened.

(c) The price of third tranche coal will continue, as at present, to be related to import prices.

FINANCIAL IMPLICATIONS

5. The CEGB estimate that the deal will reduce their 1986/87 payments by £270m (8%) from around £3300m to £3028m. This is based on purchases of 72m. tonnes at a new average price of just over £42 per tonne.

6. The NCB plans were based on selling 73.5 mt to CEGB in 1986/87. On this basis they assess the loss of receipts in 1986/87 at £300m.

7. The financial implications for later years will depend on the rates of inflation and import prices fed into the pricing formulae.

ANNEX B

	Initial budget	£million Revised budget
Fixed assets	798	748
Other capital	2	2
Change in stocks	(90)	(64)
Other working capital ...	(57)	(59)
NCB (Enterprise)		20
	----	-----
Total capital requirements	653	647
Profit/(loss)	(75)	(87)
Interest	(506)	(510)
Depreciation	473	484
Sales of assets	35	39
Other	1	1
	-----	------
Total Internal resources	(72)	(73)
EFR	725	720

Mr Wiggins
although this goes beyond the terms agreed by E(A), the Treasury are likely to accept it subject to firm assurances on the ELF, & the limitation of the firm deal to 2 years. This seems reasonable to me. Mr Walker is being pretty tough on NCB capital investment this year, & it would be difficult to push them further.
IF the Chancellor does respond as above, I see no reason for the Prime Minister to intervene.

c. Mr Norgrove (No 10)

CONFIDENTIAL

CABINET OFFICE
A 5217
20 MAY 1986
FILING INSTRUCTIONS
FILE No. ....

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ
01 211 6402

cc - Mr Unwin
Mr Wiggins

The Rt Hon John MacGregor OBE MP
Chief Secretary
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

20 May 1986

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22/V

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