Prime Minister ?
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3/6.

MR NORGROVE

3 June 1986

NCB/CEGB AGREEMENT

In his letter of 2 June, Paul Channon takes issue with the two year scope of the new agreement between the NCB and the CEGB:

"As I understand it, you envisage that we will now largely determine what electricity prices should be in 1988. If so, the difficulties of explaining such a course to sceptical - and vocal - large electricity consumers are obvious."

Paul Channon is wrong to infer that the CEGB's coal bill in 1988, and hence electricity prices in 1988, have now been fixed. The key factor is the price of oil. The re-opener clause will come into play from the end of the current financial year if the price of fuel oil falls outside the range £65-100 a tonne (roughly $15-24 a barrel).

I certainly would not bet on oil prices lying in this range by 1988. My hunch is that they could be higher.

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JOHN WYBREW

CC BG

01 211 6402

NBPM

The Rt Hon Paul Channon MP
Secretary of State for Trade and Industry
1 Victoria Street
LONDON
SW1H OET

17 June 1986

Dear Paul

AGREEMENT BETWEEN BRITISH COAL AND THE CEGB ON COAL SUPPLY

FILE WITH DN

In your letter of 2 June, you commented on the proposed agreement between British Coal and the CEGB, the first two years of which we have now endorsed.

I am grateful for your views on how you think industrial consumers, particularly the large, intensive users, may react to the agreement. However, I think your comments do less than justice to it.

As a commercial agreement, the deal had to take account of the interests of both industries; and, as I said in my letter of 20 May to John MacGregor, it can reasonably be argued that, given the uncertainty about the future of fossil fuel prices, it would be wrong to restructure coal and electricity prices now to the full extent that might be appropriate if present oil prices were thought likely to continue indefinitely. As it is, however, the benefit to industrial consumers will be greater than you assumed. As you will have seen from the announcements, the electricity price reduction will amount to 5% for monthly-billed industrial consumers and as much as 7-8% for those on contracted load terms (which includes many of the large, intensive users). This means that the 1 April increase is effectively wiped out for industrial consumers; and that the average price to such consumers will have fallen in real terms in each year since 1981 and is now some 10% less than it was in that year.

The three tranche arrangement for the pricing of coal represents a continuation and extension of the principles underlying the existing two tranche scheme whereby coal supplies are priced to compete with imported fuels at the margin, while intra-marginal supplies reflect both NCB costs and the higher costs of transporting imported fuels to inland sites. In line with these principles, the prices of first and second tranche coal in the proposed agreement remain the same as they would have been under the existing agreement (£46.88/tonne and £33/tonne respectively) while the third tranche price is set to compete with coal or oil imports at coastal sites. (It is not the case, as you assume, that the agreement increases the price of first tranche coal: the increase to £46.88/tonne resulted from the operation last November of the formula in the previous agreement.)

Under the agreement, the porportion of coal in the first tranche will fall each year, leaving a higher proportion of supplies directly competitive with imported fuels. Both the first and second tranche prices will be lower in real terms than they were at the time of the price revision in November 1984 and will subsequently fall further in real terms.

Overall, the agreement seems to me to strike a reasonable commercial balance between the two industries; and also between the taxpayer and the electricity consumer. As I said in my letter of 20 May, it is a substantial move in the direction indicated by market signals; and I pointed out the difficulties, and in fact the impracticability, of a short term deal, such as one for 12 months.

I recognise that large intensive users may still wish to pursue the possibility of special arrangements; and the industries will be considering what further might be done. I will keep you informed of developments.

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

Peter

PETER WALKER

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cc BG
cc B1

Secretary of State for Trade and Industry

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2 June 1986

The Rt Hon Peter Walker MP
Secretary of State for Energy
Department of Energy
Thames House South
Millbank
LONDON
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Prime Minister 2

2/6.

Dear Peter.

PROVISIONAL AGREEMENT BETWEEN THE NCB AND CEGB ON COAL SUPPLY

I have seen your letter of 20 May to John MacGregor, together with his reply of 29 May and Norman Tebbit's letter of 23 May.

I think that colleagues should be in no doubt that the proposal emerging from the two industries, and endorsed in your letter, will be seen as most unsatisfactory by industry. To begin with, I expect them to be unhappy about a minimum two-year structure for the relationship between the NCB and CEGB. Our past discussions, and officials' before them, have been based on the belief that something rapid had to be put together to avoid radical disruption to the NCB's plans through the CEGB switching substantially to cheaper fuel oil supplies. But it was also felt that energy markets were too uncertain for a longer-term view to be taken about the right relationship between the industries and - what matters to industrial and other consumers - the resulting course of electricity prices. As I understand it, you envisage that we will now largely determine what electricity prices should be in 1988. If so, the difficulties of explaining such a course to sceptical - and vocal - large electricity consumers are obvious.

My Departmental concern is not, of course, strictly with the relationship between the NCB and the CEGB, but with electricity prices. Unfortunately, the latter tend to be substantially determined by the former. As I understand it, it has until quite recently been maintained by your Department and the Treasury that

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electricity prices properly reflect the costs of a continuing supply, and do not contain any element of the social costs inherent in maintaining uneconomic domestic coal capacity. It has been argued that the second tranche of coal bears a reasonable relationship with the amount and price of imported coal which could otherwise be delivered to power stations capable of being supplied by imports. Similarly the price of the first tranche of coal could be defended as not inconsistent with the price of imported coal, enhanced by a notional transportation cost to inland power stations.

If that argument could be sustained a year or so ago when first and second tranche prices were some £44 and £36 respectively, it must have broken down when the second (now third) tranche falls to an import related price of £29.50, but the first tranche increases to nearly £47 (or £44½ when averaged with the new second tranche).

These are sums which industry will do for themselves. Depending on the course of oil product and international coal prices, I think we may find it increasingly difficult to argue that industrial consumers are facing electricity prices which fairly reflect market conditions and the cost of continuing supply. As your letter implies, industry is not going to be much impressed with a price reduction of only some 3 per cent, following a price increase of 4 per cent this April. I am already concerned, as you must be, with the level of complaint from industry about electricity prices in the wake of changed world energy markets.

Large users in particular may return to the charge, depending on the electricity supply industry's own plans towards this sector of the market. I think we need to reserve our position on this issue until the industries' intentions become clearer.

I recognise of course, the problem posed in your letter, that the two industries would not accede to the sort of shorter-term deal that E(A) had had in mind. I am therefore prepared to go along with the general view that something on the lines set out in your letter will need to be accepted. But I think colleagues should be under no illusions at the difficulties we shall face both in the short term and, depending on the course of energy prices, over the next couple of years in trying to make such an agreement stick. There is bound to be increasing pressure from the large and intensive users, who are likely to continue to face higher electricity prices than most European competitors. And with relevant energy prices no longer following agreed economic principles, the arguments against special treatment for this group

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would appear no longer sustainable. I therefore ask you in communicating the Government's acceptance of these proposals, to explore the industries' plans for these users and to report progress. You should also say that, while the Government notes the industries' intention that the current agreement should run for at least two years, you could not rule out the need to re-open the arrangements if the resulting electricity prices were shown to be higher than could be justified on accepted pricing principles, taking account of price comparisons across Europe. There would in any case need to be a fundamental look at the proper relationship after these two years.

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

Yours
Paul

PAUL CHANNON

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