Prime Minister!

This is most unsatisfactory, for example in the continued tight restriction on private coal production.

PRIME MINISTER 4 December 1987

But agree reluctantly to allow the extension of the undertaking on the terms proposed? DRN 8/12.

BRITISH COAL/CEGB COAL PURCHASE UNDERSTANDING

May we discuss? mt

The £3bn per annum coal supply contract between British Coal and the CEGB has been described as the world's largest contract. The present Joint Understanding between the two parties was contrived under the direction of Peter Walker to shield British Coal from the full impact of the oil price collapse early in 1986. Under it, electricity consumers have been covertly subsidising British Coal. The CEGB is on record as claiming that freed to procure its fuel supplies from the cheapest sources it could be saving upwards of £500m pa.

Against this background it looks odd that, without prompting from Government, the CEGB has readily negotiated the extension of the present Joint Understanding for a further year, at prices which reduce the coal supply bill by only £60m. The present Joint Understanding is due to expire in march 1988, so the CEGB had a pretext for being tougher. Presumably the reason the CEGB has not pressed British Coal harder relates to the prospect of electricity privatisation. Lord Marshall and his colleagues are confident that electricity privatisation will be accompanied by liberalisation of the industry's coal procurement arrangements. The CEGB would rather harvest the benefits of liberalised coal supplies after privatisation than now when the sole beneficiaries will be electricity consumers.

The question you will want to consider is whether a cosy arrangement which for quite different reasons currently suits both the CEGB and British Coal should be scrapped here and now in the interest of electricity consumers. The arguments in favour of letting this sleeping dog lie for another year are not points of principle but of practicality and expediency.

It might be argued that scrapping the Joint Understanding and freeing the CEGB to minimise its fuel bill is just the shock treatment which the UK coal industry needs if all the outdated work practices and restrictions on productivity are to be abandoned. But the timing is hardly ideal. A signal of this significance could give Scargill just the cause celebre he needs to attack Walsh for the NUM Presidency and launch a campaign to defeat the Government's plans, including electricity privatisation.

Even if this is avoided, Bob Haslam's efforts to press through the further productivity improvements and cost savings needed for British Coal to break even by 1989 would lose all credibility; the psychological effect would be severely damaging. Ironically the lower-yield Nottinghamshire pits would be more vulnerable to closure in this scenario than those in Yorkshire.

In a short term context the Treasury prefers the status quo. If the CEGB were freed to minimise its fuel bill all the benefits would have to be passed to electricity consumers, whereas the additional losses incurred by British Coal would add to public expenditure and the PSBR.

Conclusion

The issue is not whether but when to liberalise coal supplies to the electricity industry. Scrapping the Joint Understanding now is likely to reduce the possibility of Scargill being defeated by Walsh. By the same token it will increase the risk of Scargill mounting an effective campaign against the Government's plans for electricity privatisation - particularly the more radical options. With little enthusiasm, we would let the deal go through.

JMW.

JOHN WYBREW

SRW

CONFIDENTIAL file

bc BG.

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

10 December 1987

Dear Stephen,

BCC/CEGB COAL PURCHASE UNDERSTANDING

The Prime Minister has seen your letter to me of 2 December about the proposal by British Coal and the CEGB to extend for a further year the main terms of the current coal purchase understanding.

The Prime Minister agrees only very reluctantly that the understanding should be renewed in this way. It is anti-competitive and only the particular circumstances described in your letter lead her to accept it. She will certainly wish to be consulted again well before November next year and before British Coal and the CEBG get too advanced with their discussions about any further renewal of the understanding.

I am copying this letter to Jonathan Taylor (HM Treasury).

Yours,

David

(DAVID NORGROVE)

Stephen Haddrill, Esq.,
Department of Energy.

CONFIDENTIAL

CJ0 :

cc BG

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

David Norgrove Esq
Private Secretary to
The Prime Minister
10 Downing Street
LONDON
SW1A 2AA

2nd December 1987

Dear David

BCC/CEGB COAL PURCHASE UNDERSTANDING

We have discussed the proposal by British Coal and the CEGB to extend for a further year the main terms of the current coal purchase Understanding. We agreed that I should write to you on this.

It is the aim of British Coal's strategy and of the objectives set for the industry by Government, to reduce costs and make British Coal prices competitive with imports. Sir Robert Haslam has reduced costs by 23% since the end of the strike and is determined to reduce them by a further 20%. These improvements have been achieved by investment in modern mining equipment, by substantial redundancies - 31,000 left the industry last year - and against the background of a very depressed world coal market. Indeed, since April 1986 British Coal have cut prices to customers by some £500 million; the CEGB alone has benefited by over £300 million a year.

The privatisation of the electricity supply industry will lead to further major changes in the supply of coal from British Coal to the CEGB. While we cannot predict now what price the privatised electricity industry will choose to pay for British Coal supplies or what volume of imports or private licensed coal they might wish to purchase, it is clear that British Coal will remain the major coal supplier to the electricity industry. The CEGB do not expect to be able to import more than 30 million tonnes a year at most (out of the 75 million tonnes it presently takes) and the infrastructure to import more than 10 million tonnes a year is not available and would take time to put in place. (As you may be aware, the CEGB are already planning to instal coal import facilities in association with the construction of the proposed new station at Fawley. We expect an application for planning permission for this station shortly). A substantial part of British Coal's output will remain competitive with imports. This is recognised by the CEGB themselves who are prepared to defend the current coal purchase Understanding as being in their commercial interests by assuring long-term security of supply.

SECRETARY OF STATE FOR ENERGY

With the approach of electricity privatisation, both industries are aware of the need to restructure their commercial relationship and are undertaking a fundamental review. My Secretary of State has begun discussions with Sir Robert Haslam on how this can be achieved. Nevertheless there remains a real danger that the progress made so far will prove unsustainable if we try to move the industry too far too fast. Further substantial reductions in British Coal's proceeds could cause serious dislocation to the industry's finances and make Sir Robert Haslam's task of controlling the rundown in an orderly way much more difficult.

Against this background, my Secretary of State has discussed the proposed extension of the current Understanding (described in the Annex to this letter) with the Chancellor and the two Chairmen. Most of the terms of the Understanding would be unchanged. The two main changes are to reduce the price of the third (import related) tranche from £29.50 to £26/tonne and to switch 2 million tonnes of coal from the first to the lower-priced second tranche. These changes yield further savings to the CEGB of £60 million but do not affect the industries' EFLs. On this basis my Secretary of State and the Chancellor have agreed to accept the industries' proposal for a one year extension to November 1988.

I am copying this letter to Jonathan Taylor in the Chancellor's office.

Yours ever,

Stephen.

S HADDRILL
Principal Private Secretary

cc BG

CONFIDENTIAL

ANNEX

1986 JOINT UNDERSTANDING

1. Since 1979 there have been several Joint Understandings between the BCC and CEGB on coal supply. The present one was concluded in May 1986 after the collapse in oil prices early that year. It runs for 5 years, from 1986/87 to 1990/91. The Government has publicly endorsed it, but only for the first two years.

2. The Understanding provides for 3 main tranches of coal. The first tranche covers the bulk of coal supplies (47mt in 1987/88, falling progressively to 40mt in 1990/91); its price and escalation arrangements were carried over from the 1983 Understanding. The second tranche rises from 11mt in 1987/88 to 18mt in 1990/91; its price is fixed at 75% of that of the first tranche and is supposed to be broadly related to the prices of heave fuel oil and of imported coal delivered to power stations in the Central coalfields. The third tranche is fixed at 12mt pa. For the most part, its price is determined annually by reference to the price of imported coal delivered to coastal power stations, although special arrangements apply to a 4mt pa sub-tranche (sometimes referred to as the "fourth tranche") devoted to the ESI's special scheme for large, high-load industrial consumers.

3. The Understanding itself commits the CEGB only to taking 70mt of coal a year from the BCC. However, there is also a side understanding between the two industries that the CEGB will take a minimum of 95% of their coal requirements (estimated at 75-80mt pa) from the BCC. The effect of this is to limit CEGB purchases from sources other than the BCC to rather less than 4mt pa, of which in practice about 1mt pa is imported and the rest supplied by private UK sources.