PRIME MINISTER

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COAL CONTRACTS

I can now report that British Coal and the Generators have reached an interim outline agreement covering the purchase of coal over the next few years. This has been extremely difficult to achieve and I have been involved in a considerable number of meetings with all the parties. It will be most important to be able to present the outcome as a freely negotiated agreement between the parties. This minute sets out the details of this agreement and considers the implications for both the flotation of the electricity supply industry and the future of British Coal. The main elements of the deal are as follows:-

(i) The agreement covers the sale of 70, 70 and 65mt per annum of coal from British Coal to the Generators over the next three years starting in 1990-91.

(ii) There will be a two tier pricing structure with an initial breakdown as follows:-

40mt at £1.85/GJ gross at the pithead
30mt at £1.50/GJ gross at the pithead

The initial base price averages to £1.70 gross at the pithead and represents a continuation of the present price freeze that has been in operation in the current financial year.

(iii) In order to protect British Coal from unexpectedly high levels of inflation the price will be escalated each April, so that a revised price will be known before the start of each financial year. The base prices set out above will be escalated on 1 April 1990 on the basis of the year-on-year increase in the RPI minus 6% - calculated on the basis of the average of the RPI figures published in November and December 1989 and January 1990. Similar calculations will be carried out to increase the prices applicable on 1 April 1991 and 1 April 1992 on the basis of the average increase in the RPI minus 5.5% and minus 5% respectively. In each case, if the average increase in inflation is less than 6%, 5.5% or 5% there will be no change in the price.

(iv) There will also be a limited exchange rate reopener. The prices calculated above for the lower priced tier will be subject to review on a three-monthly basis starting on 1 October 1990 to take account of significant movements in the average $/£ exchange rate for the preceding six months. In the event that the average exchange rate falls outside the range $1.40/£1 to $1.75/£1 then the price of the lower tier will be increased or decreased by 50% of the proportion by which the exchange rate is below $1.40/£1 or above $1.75/£1. Thus a 10% deterioration in the sterling/dollar rate below the bottom of the band gives only a 5% increase on the lower priced tier representing less than half the tonnage. Any change in the price will be held for three months until the next review.

(v) The agreement will be presented as an interim one to cover the next three years while both sides continue to negotiate, in a less pressured environment than has been possible to date because of the timetable requirements of the electricity flotations, with a view to achieving an acceptable longer-term agreement covering at least years 4 and 5 and possibly beyond that.

This has been a difficult negotiation and represents a significant compromise by both sides. As you will recognise we had originally hoped that a longer-term solution would be possible, but that has not proved achievable. Both sides remain far apart at present on what the appropriate world related price would be for some 60mt of coal in years 4 and 5 and, in the timescale required for a settlement, it has not been possible to bridge that gap. However, with more time, there is some hope that a longer-term settlement can be negotiated on an acceptable basis to both sides, perhaps linking the final price to some agreed formula.

Presented on the above basis as an interim settlement with negotiations continuing with a view to reaching a longer-term agreement I believe that the position reached will be publicly defensible as offering something to both sides. There is, of course, somewhat more of a risk of a "cliff edge" position being reached at the end of year 3 than would have been the case for the originally conceived five year agreement, but this is something that we have to accept. The present settlement at least offers the possibility of a longer-term agreement being reached in due course. The volume commitment over the next three years will also be seen as less draconian to British Coal than widely expected. If there is any criticism of a three year deal, we will be able to say that the Generators will continue to need British coal on a long-term basis and we can say that negotiations are continuing to this end.

Implications for the flotation of the Electricity Supply Industry

The Generators have, not unnaturally, been seeking a significant reduction in the price of coal from British Coal. As indicated above it has proved impossible in the time available to reach a longer-term agreement as the parties' perception of where the price should be in years 4 and 5 were so far apart. Their differences of approach were also affected by the inherent uncertainty as to the likely movement of world oil and coal prices and exchange rates over such a period. This led the Generators in particular to focus on their exposure to risk in agreeing to fixed volumes and prices over a timescale where their contractual cover with the Area Boards was rapidly diminishing. They concluded that the risk was such that they could only contract for firm tonnages over a period where they could receive back-to-back contractual cover for the sale of the electricity generated with the Area Boards. The latter would then be able to pass the costs on to consumers in their franchise area.

We have addressed with our financial advisers how to meet the risks identified above so that the ESI flotation can proceed. Their preliminary conclusions are:-

(i) that the initial price paid to British Coal should not be unsustainably high and that there should be a continuing reduction over the period in real terms; and

(ii) that any contractual commitments made by the Generators to British Coal must indeed be matched by contracts with the Area Boards.

Given the volumes under consideration, this would require contracts with the Area Boards covering essentially all their franchise market. The initial franchise only lasts four years so we have been forced to the conclusion that contracts at the price levels acceptable to British Coal could only be sustained for three years at the most without raising serious problems for the flotation of the Generators.

In the light of the above, I have concluded that the proposed three year settlement is necessary in the interests of the flotation of the ESI and that the prices agreed, while not as low as the Generators might have wished, should be sustainable and allow their flotation. If, in the event, it proves impossible to reach agreement on a longer-term basis the Generators will then be in a position to carry out a free commercial negotiation with British Coal for future supplies unconstrained by any volume limit for years 4 and 5 and beyond. This should be seen as a positive position by future investors.

Implications for British Coal

We have, of course, been concerned from the outset to reach an agreement that satisfied both the expectations of the Generators and offered the prospect of some future stability for British Coal. It has always been clear that this was likely to result in both a loss of volume as well as reductions in price. Ideally, British Coal would have wished to achieve a longer-term agreement than has proved possible and they therefore attach considerable importance to the fact that negotiations are to continue with that aim in view. Nevertheless, in the last analysis they have felt that their interests are better served by the three year agreement that has been reached rather than by a longer-term arrangement at the price levels that the Generators were prepared to concede. In particular, they would not feel able to sign up to supplying 60mt in years 4 and 5 at the prices sought. At present all parties are faced with the uncertainties of the new commercial arrangements being put in place by the privatisation of electricity and are seeking to minimise their exposure to risk. In these circumstances, it has been clear for some time that a longer-term agreement would not be negotiable in the short-term.

The agreement reached has a number of advantages as follows:-

(i) The volume profile (70mt, 70mt and 65mt) offers the prospect of minimising the industrial relations risk inherent in the necessary further rationalisation of the industry over the next few years. It will require a further closure round of some 10-12 pits in the course of the next year or so, but thereafter British Coal believe that the continuing closures necessary can, in the main, be argued on the basis of the exhaustion of the workable coal reserves. The overall reduction in manpower will still be of the order of some 25,000 or so over the next four years, but the actual pattern of job losses should be smoother over time than originally expected. As you are aware, however, some 40% of this manpower reduction would have been necessary even if there had been no loss of sales because of continuing improvements in productivity and the build up of production at pits such as Selby. While the contraction in the industry will not be easy to manage, I do not at present see any major risks of industrial action, although this can never be completely ruled out.

(ii) Such a spread-out closure programme offers the possibility of minimising the immediate job losses affecting the UDM, but it has always been clear that it will be almost impossible to shield the UDM areas completely from further closures. I shall be doing what I can to press Sir Robert Haslam to continue to assist the UDM to the greatest possible extent. In this connection, I will ask both sides to consider whether there might be some differentiation in contract prices which will benefit the flow of UDM coal to the inland power stations.

(iii) The three years will provide a breathing space to allow both sides to gain some actual experience of the new arrangements and their inherent risks. It should also be clearer where international fuel prices are going together with the £/$ exchange rate which has a significant bearing on the true value of British coal to the Generators. While I hope that a longer-term settlement will prove achievable, we must face the possibility that it may not. If in the event, in the light of experience, it turns out that the Generators' view on the level of the world related price is correct then the sooner that an orderly further rationalisation of British Coal is carried out, the better. A three year deal allows us the possibility of completing this relatively quickly after the next election, thus giving us the maximum opportunity to preserve the possibility of privatising British Coal in the course of the next Parliament.

However, the continued real reduction in price over the next three years will put significant further financial pressure on British Coal. While further more detailed work is required, initial modelling shows that, unless other action is taken, the deal will put the Corporation into a loss making position throughout the period. This is clearly unacceptable and we will need to take action to restore the morale of both the management and the workforce. Indeed, the only way that I have been able to persuade Sir Robert Haslam to accept the proposed arrangements was by assuring him that further financial support from the Government would be forthcoming to achieve this end.

I therefore regard it as vital, if this deal is to stick, that we agree to provide sufficient financial support to the Corporation to ensure that they have a more than fighting chance of achieving profitability and, hopefully, self-financing. In so doing, we must not, of course, relax for one moment the pressures on the industry to continue to improve productivity and reduce costs. I envisage as a part of the process setting demanding targets in these areas for the industry in future.

It is too early to determine the extent of support necessary, but it is essential that we agree now in principle that it will be forthcoming. I can thereafter agree the details as necessary with the Chancellor. I am clear that it should be possible to provide the industry with the necessary incentives by utilising a combination of the following:-

(i) ensuring that the write-down of asset values in the proposed capital reconstruction fully reflects the reduced prospective earnings potential of the remaining pits;

(ii) increasing the proportion of the costs of the necessary further restructuring met by Government restructuring grant; and, in the last resort,

(iii) softening the interest rates on loans on vote.

As was anticipated, the impact of the deal will add to British Coal's costs and increase public expenditure over the next few years. However, this should not be seen in isolation. The very fact that the deal puts financial pressure on British Coal reflects the benefit obtained by the ESI from continued real price reductions which should lead to higher proceeds in due course. Conversely, had British Coal not had to suffer some pain in reaching this settlement then the effect on the Generators of higher prices would no doubt have reduced proceeds disproportionately.

On this basis, I believe that this agreement is in the interests of both industries and should enable us to proceed with the flotation of the ESI. I therefore commend it to you and our colleagues.

I am copying this to John Major, Nicholas Ridley, Malcolm Rifkind, Brian Griffiths and Sir Robin Butler.

John

Secretary of State for Energy
24 November 1989