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PRIME MINISTER 27 November 1989

COAL CONTRACTS

British Coal and the Generators have now reached an interim outline agreement covering the next few years. The agreement is acceptable only as a necessary expedient to allow the ESI privatisation to continue on track and to allow further restructuring of British Coal to continue apace. The agreement "buys" three years by which time the UK coal industry must be exposed to market forces rather than protected from them by administrative action.

THE AGREEMENT

The agreement commits the Generators to buy 70, 70 and 65 mt of coal from BC over the next three years. The price has been set using a two-tier structure.

- The first 40 mt will be sold at £1.85/GJ which is "supposed" to reflect the "market value" of indiginous coal.

- The second 30 mt will be sold at £1.50/GJ. This tier is "supposed" to reflect the "market value" of imported coal. The price has a minor exchange rate reopener.

- The price for both tiers will decline in real terms over the next three years. There is some protection for unexpectedly high levels of inflation.

Overall the package is an administered compromise that will last for three years. However, in order to avoid a "cliff edge" at the end of the period, British Coal must start negotiating their future (post three years) contracts immediately.

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CONTRACT NEGOTIATIONS

The reason the Generators and BC could not agree on what the market price of coal should be was because neither had experience of market forces.

The very act of trying to define the "market price" is telling. In a competitive world, the market defines the price, not one or two individual players unless they are monopolists (which is exactly the stable from which BC and CEGB management come).

The generators argued that all 70 mt should be sold to them at the marginal world price of coal (c.a. £1.25/GJ). BC argued that it all should be sold at the first tier price (£1.85/GJ) on a long term contract (10-15 years). It is no wonder the parties could not agree.

FUTURE NEGOTIATIONS

A fully competitive solution will recognise the points underlying both the above arguments and will result in a myriad of separate contracts with prices reflecting:

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- length of contract;
- size (mt) of sale;
- distance from pit;
- distance from port;
- international price availability and terms;
- freight rates;
- exchange rates;
- quality of product (including sulphur content);
- prices of competing fuels, and
- environmental factors.

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A myriad of contracts cannot be set by administrative action. Future contracts must be struck through negotiation, first for small quantities, then for ever larger quantities until all of BC's supply has been either contracted or closed.

BC should be set the target of having all of its sales under competitively negotiated contract within three years. Interim goals should be set and met. In this fashion, the "cliff edge" mentioned in John Wakeham's paper can be avoided.

CONCLUSION

John Wakeham has forced BC and the Generators into agreeing a compromise package of coal contracts. The package should ensure that ESI privatisation continues on track and that restructuring of BC continues apace. The agreement should be seen as an interim solution; it must not be seen as a model for future negotiations with BC.

The viability of the British coal industry lies in sustaining the productivity drive achieved over the past four years and in increasing the exposure it has to market forces. This is best achieved by ensuring BC negotiate all their sales on a fully commercial basis.

RECOMMENDATION

Endorse John Wakeham's package as being a good interim solution. Note that setting demanding targets for improved productivity, reduced costs and proportion of contracts struck on a commercial basis, will be necessary to avoid a potential crisis in three years' time when the agreement runs out.

GREG BOURNE