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CABINET

MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

NCB FINANCES

Memorandum by the Secretary of State for Energy

I have already warned my colleagues that the National Coal Board face severe financial difficulties. The Board estimate their cash requirement in 1981-82 at some £1400m, about £500m more than their External Finance Limit, and their loss on revenue account at some £350m. There are two main causes of these difficulties. First, there is a substantial surplus of output over demand. Secondly, the industry is still burdened with high-cost capacity. The withdrawal of the accelerated closure programme has made it harder for the Board to tackle these underlying problems, but until they do so, the industry's financial problems will persist, if not worsen.

The longer term

2. The industry must therefore get back into balance and eliminate the high-cost capacity. I have asked the Board for their proposals for achieving this as quickly as possible. They are already taking action to reduce the surplus by raising exports and cutting back manpower. We must also reconsider

our own policy in the light of recent events. In particular, we should reconsider the size and shape of coal industry we want in the longer term bearing in mind the likely future demand for coal and the contribution which other fuels and coal imports can make. I shall bring forward proposals on these matters as soon as I can. But we must recognise that they cannot be resolved quickly. It will probably be some time before it is clear what rate of closures we can now realistically expect and before we can get proposals from the NCB in which we can have confidence. It would also be unwise to decide on a new strategy under the pressure of the next Tripartite, although the Board would like us to do so.

#### Decisions needed now

3. Some decisions however have to be taken now. NCB are now more than a month into their financial year and urgently need decisions on their EFL and capital approval. Legislation to increase their borrowing and grant limits is needed before the end of the financial year, and has been accepted as essential for next session. Decisions on this will also be needed soon. This paper contains my proposals on these matters.

#### The position of the NUM

4. In considering them, the key judgement is how we deal with the NUM. We must face the fact that they are still able to do immense damage in pursuit of their objectives. They are still intensely distrustful of our intentions and conscious of the fact that we have not yet given a full reply to their numerous, and expensive, proposals at the recent Tripartite. Their reactions are always hard to gauge in advance and, over the next year or so, will be further complicated by the struggle over the succession to Mr Gornley. My proposals are designed

to meet two objectives. One is to avoid a confrontation with the NUM which will only make it harder to get the industry back on the right course. The other is to avoid making further concession to them and to keep the industry's calls to public expenditure to a minimum. Striking the right balance between these objectives will need very careful judgement, and is bound to involve some risks. We must recognise too that the work of getting the industry back on the right course will be slow. Given the reasons for the NCB's difficulties, and the involvement of the NUM in them, there is no prospect of a dramatic improvement in the NCB's costs or financial results unless we are prepared for a confrontation.

#### The capital approval for 1981/82

5. NCB have asked for approval for capital investment of £924m in 1981/82. I propose approval for £825m thus saving about £100m. This figure would mean a sizeable cut in the investment in real terms compared with last year, but a slight increase in money terms. In my judgement, any lower figure would carry too great a risk of collision with the NUM. Details are in Annex A.

#### The external finance limit for 1981/82

6. The Board have asked for an EFL of £1406m. Taking account of the cut in capital investment proposed above, and of lower assumptions on wages and output. I propose a revised EFL of £1200m, subject to revision if necessary in the light of our decisions on energy prices. Details are at Annex B.

#### The grant structure

7. We still have to decide how to deal with the Tripartite due before the NUM's Annual Conference in July. The union will look

for progress on their shopping list and on our general consideration of the Board's finances. We have so far given them almost nothing in these areas.

8. The solution is to give some reassurance about the level and structure of grants in 1981/82, a subject of special interest to the union, so that such a reassurance could have a big effect on their attitudes. Given the state of the Board's finances, we should be largely recognising the inevitable. Moreover, grants do not increase public expenditure, which is determined by the total of external finance and not by the proportion of grants within that total. My detailed proposals are at Annex C but I would propose to introduce a single new revenue support grant to replace specific operating grants and deficit grants. It would be paid before profit and loss are struck but we would require the Board to display it in their revenue account. These arrangements would be simpler and would make clear the size of the Board's grant support. The new grant would be at a level which would enable the Board to achieve break-even by extra effort. For 1981-82 this would mean on present estimates at a level of £450-500m in addition to social grants of £100m. (We should aim eventually to settle a programme for the gradual elimination of the revenue support grant). I should like to tell the next Tripartite about the change in structure and to give them these figures for grant levels in 1981-82.

9. We must avoid prejudging now the scale of support to the Board after 1981-82 but given the pressure on Parliamentary Counsel we also need to start drafting the legislation which will be needed before the end of 1981-82. I propose that we should legislate for the structure described in paragraph 8 with the details to be agreed between my Department and the Treasury. This structure would apply at least to 1982-83 as well, but we cannot yet take a decision about the level of support for that period.

10. The union as well as the Board have also asked for some reduction in the Board's interest burden. I do not propose any new measures on this, but only that we should make better use of the existing provision for making deferred interest loans to the Board. The effect on their interest payments would be very small. Details are at Annex C.

#### Summary

11. I therefore recommend:

- (a) The NCB's capital expenditure approval for 1981-82 should be cut to £825m.
- (b) Their EPL for that year should be cut to £1200m.
- (c) I should tell the next Tripartite that the Board's grant structure will be changed as proposed in paragraph 8 and that the levels of grant for 1981-82 should be as stated there.
- (d) Legislation should be drafted to give effect to the new grant structure, the details to be agreed between my Department and the Treasury, but without commitment at this stage on the level of support after 1981-82.

I also ask my colleagues to note that I shall bring forward proposals on longer term policy for coal as soon as practical.

Department of Energy  
8 May 1981

D.A.R.H

NCB CAPITAL EXPENDITURE 1981-82

NCB's present capital investment approval is £765m. (All figures in cash, ie 1981-82). This approval was given in Autumn 1979, and is 85% of the capital expenditure which Ministers then envisaged under the Financial Strategy.

2. NCB now seek capital expenditure authority for 1981-82 of £924m. The object of this increase is to allow capital expenditure on mining to continue at the same level in real terms as in 1980-81. The main elements of the existing approval and the approval which NCB now seek are as follows:-

	<u>£m</u>	
	<u>Existing Approval</u>	<u>NCB proposed approval</u>
Capital expenditure:		
Mining	672	818
Capital expenditure:		
Non-mining	22	20
Leasing	29	28
Capitalised interest	42	58
TOTAL	<u>765</u>	<u>924</u>

3. The key component is capital investment in mining. The existing approval implies investment in mining of £672m; the Board seek approval for £818m, which they say will maintain

last year's level in real terms. The existing approval and the level of approval now sought can be broken down as follows:-

	<u>£m</u>	
	<u>Existing Approval</u>	<u>Board's proposal</u>
New mines	155	187
Major projects at existing mines	206	255
Existing mines: smaller projects	94	98
Plant pool	105	155
Other	112	123
	<hr/> 672	<hr/> 818

4. The proposed increase in capital expenditure on mining is £146m. An analysis with short explanations is attached. About £60m would be spent on new mines and other projects which would increase NCB's capacity. A further £34m would be spent on installing heavy duty power supports which would lead to higher output - as well as lower costs - than the ordinary machinery which would otherwise be purchased.

5. The Board's case for this investment is that temporary economic recession should not lead to a reduction in investment, and that, so far as output is increased, the end of the recession and successful marketing will ensure that the extra coal can be sold. They also argue that, following the recent Tripartite meetings, both they and the Government are committed to a high level of capital expenditure to achieve the objectives of Plan for Coal and that a cut-back in investment would give further ammunition to the NUM

6. The effect of the additional investment which NCB seek would be to increase output by 1.3, 2.8, 1.7 and 1.4m tonnes over the four years from 1982-83. Although there is no hard and fast boundary between investment which increases capacity and investment which reduces costs, I have reservations about investment which would lead to increased output of coal. My current estimates of demand suggest that NCB's production may out-run UK demand for coal down to 1990, and in these circumstances it can make little sense to increase output.

7. The NUM are however keenly interested in the level of capital investment in mining. An obvious cut would be provocative and make a militant line on pay and closures more likely. I therefore propose that the NCB should be given authority for capital expenditure of £825m this year. This allows us to say that we are increasing expenditure in money terms compared with 1980-81, when expenditure was £805m. It also means an approval equal to that sought by the NCB in their Policy Review in January, so that it would be much harder for them to object to it: an important point given that, to avoid a confrontation with the NUM, the NCB will have to tell them that the approval is sufficient. But at the same time, an approval of £825m would mean a sharp cut in real terms compared with the NCB's bid, and with last year's expenditure. It would squeeze out of the

Board's plans most of the new proposals leading to increased capacity over the next few years. It would also imply a change in direction, since it would be the first time since Plan for Coal started that mining investment will have been cut in real terms.

NCB: PROPOSED INCREASE IN CAPITAL INVESTMENT IN MINING 1981-82

1. NCB seek authority for capital investment in mining in 1981-82 of £818m, compared with the £672m implicit in their present authority (All figures in 1981-82 prices, ie cash).

2. The additional £146m would be spent as follows:-

i. New mines £32m

Most of this would accelerate work at Selby (£20m) and Thorne (£9m). The acceleration of Thorne would produce an extra output of 3.6mt in 1987-90. Acceleration at Selby might bring forward production earlier than the present planned date of 1983-84 - when coal seems likely to be in surplus.

ii. Major projects with capacity implications £28m

The purpose would be to accelerate projects already approved by the Board and under-way. The effect would be to produce an extra 0.6mt, 2.1mt, 0.5mt, 0.7mt in the four years from 1982-83. Coal is likely to be in surplus in all these years. The extra output, however, would probably be produced at low cost;

iii. Major projects not increasing capacity and smaller projects at existing mines. £25m

The largest part of this (£22m) is for continuing a major underground reorganisation in the Barnsley area. The main purpose is improvement in coal quality (which would lead to higher proceeds) and reducing manpower. There would, however, be some extra output, although the Board argue plausibly that the project could be justified without bringing this extra

output into the calculation. This is the project which the Board regard as most urgent; it is the next phase of a continuing major programme and any halt would be obvious to the unions.

iv. Plant Pool

£50m

£34m is for new heavy duty face supports, which cost £34m as against £11m for ordinary supports. The extra £23m expenditure would bring additional output from the same faces of 0.7mt a year from 1982-83 onwards. Provided that this additional output can be sold, the project is highly profitable. The £16m proposed for other plant pool would produce cost savings without additional output.

v. Privages

£6m

Essential work to continue production at short life pits, which cannot be closed.

vi. Other

£5m

Exploration and miscellaneous investment. No effect on production.

NCB EXTERNAL FINANCE LIMIT 1981-82

1. The NCB seek an External Finance Limit for 1981-82 of £1406. A sheet showing their detailed figures is attached.
2. The key assumptions underlying their calculations are:-
  - i) output of 126m tonnes, and sales of 120m tonnes leading to an increase of 6m tonnes in stocks;
  - ii) increase in wages of 13% from 1 November 1981;
  - iii) prices: NCB assume different increases in different markets. For CEGB, their largest customer, they assume an increase of 6.3% from 1 November, together with £15m of discounts to back out coal imports;
  - iv) capital expenditure of £924m;
  - v) existing capital structure.
3. We should not accept so large an increase in NCB's call on public funds without question. I see the following scope for reduction:-
  - i) capital expenditure: I propose a reduction of £99m to allow a capital investment approval of £825m;
  - ii) wages: I do not think that it is right for NCB to plan on a 13% increase. I suggest that their wage increase assumption should be reduced to 7%, saving £60m;

iii) prices: I would not wish to challenge the NCB's assumption that the increase in the price of electricity coal on 1 November will be only 6.3%. We want to keep to a minimum the extra costs falling on the electricity industry and electricity consumers. The allowance for only £15m of discounts to the CEGB to back out imports may be rather too low, but I would propose that the NCB should absorb any higher costs on this account without an increase in their EFL. If however we do decide that some help should be given to electricity consumers through discounts in the price of coal, the cost of such discounts would have to be added to the Board's EFL. So too would the cost of any decision to reduce the price of coke to foundries, or of moving additional coal stocks to power stations.

iv) In particular the NCB assume maximum production from continuing pits. If production could be reduced, without pit closures, stock build could be lower, and although the Board's profit and loss account would be worse, their cash needs would be reduced. The faster manpower run down would have industrial relations implications, although less serious than those of pit closures, and would need to be handled with care. I judge that it would be reasonable to require NCB to find £50m in these ways and I propose to reduce their EFL bid accordingly.

This reduction would with some rounding, give an EFL of £1200m. This is the figure which I propose.

NATIONAL COAL BOARD  
GROUP FINANCING REQUIREMENTS AND SOURCES OF  
FUNDS FOR 1981-82 (AT OUTTURN PRICES)

<u>CAPITAL REQUIREMENTS</u>	£m
Fixed assets	924
Other Capital Expenditure	7
Changes in Working Capital	
Stocks	223
Other	(98)
<b>TOTAL CAPITAL REQUIREMENTS</b>	<b>1,056</b>
<u>METHODS OF FINANCING</u>	
Profit/(Loss)	(255)
(Less) Interest	(371)
Depreciation	261
Sales of Fixed Assets	14
Other Capital Receipts - from Government	1
<b>TOTAL INTERNAL RESOURCES</b>	<b>(350)</b>
Government Grants (Existing Arrangements)	267
NLF Borrowing: Gross	1,285
(Less) Repayments	(134)
Foreign Borrowing: Gross	60
(Less) Repayments	(106)
Other Borrowing (Net)	22
Leasing	12
<b>TOTAL EXTERNAL FINANCE</b>	<b>1,406</b>

OPERATING GRANTS TO THE NCB

Need for Operating Grants

1. In the absence of grants, NCB would simply show losses on their Profit and Loss account each year, which would then accumulate on their balance sheet. Given the likely size and persistence of NCB's losses I do not regard this approach as tenable. It would be clear that the Board could not break even by any effort, so that the duty to break even, which is the only financial discipline which has had any influence over both the Board and the unions, would be devalued. The industry would accumulate further borrowings to cover these losses, and to pay interest. An accumulation of deficits would call into question the propriety of further lending from the NLF, and so might force us into changes in the Board's financial structure.

2. I believe therefore that we should continue to pay grants up to a level which would enable the Board to break even while requiring them to make some contribution by way of cost reduction and increased efficiency. These grants should not be open-ended but should be fixed in advance each year and, as soon as possible we should again set NCB the objective of eliminating their dependence on operating grants within a set period.

Form of Grants

3. The choice is between grants ostensibly tailored to some specific purpose and a general grant. At present, NCB receive two small specific grants, paid under arrangements which we inherited from the last Administration (to assist additional coal burn by SSEB, under an arrangement which will run out in 1983 and to

support the cost of holding stocks of coke, under an arrangement which expires in 1982). The rest of NCB's operating grants take the form of an explicit Deficit Grant, shown as such on their main profit and loss account, after they have first struck a profit. ("Social Grants" which are paid to recompense the Board in whole or part for various sorts of expenditure in connection with pit closures or manpower redeployment are not intended to improve the Board's accounting results and are not in question here).

4. I should wish to retain this general approach. It is essential that operating grants should be provided in the simplest possible way on the face of the Board's main Profit and Loss account, in order to bring home clearly both to the industry and to the public the amount of support they receive. I do not think, however, that we need insist on the present name "Deficit Grant" or on the requirement for the Board to strike their profit before the Grant. Both are resented by the industry and have proved ineffective as a means of public education. I believe that a token concession would help us with the NUM, without materially preventing us from getting our point across to the public. I therefore should propose that the present Deficit Grant should be replaced by a single "Revenue Support Grant" which would appear on the Board's main Profit and Loss account after interest and tax but before extraordinary items and before the Board struck their balance for the year. The amount of this grant would be fixed before the start of each year at a level which required a realistic contribution from the Board by way of reduced costs or greater efficiency if they are to break even.

5. This solution will not necessarily be welcome to the Board or the unions. They have proposed a multiplicity of specific grants, exploiting existing ECSC rules to the full (coal stocking aid, coking coal production aid), supplemented as necessary by some form of "Regional Grant". I do not think that we should accept this

approach, which would blur the public presentation, suggest that the coal industry had some sort of "entitlement" to such grants, and make it harder to taper them off as the Board's financial position improves.

6. NCB have also put forward proposals for a new capital structure under which their interest liabilities would be much more flexible. I have some sympathy with the general argument for more flexibility but I do not propose any radical change to meet the NCB's representations. I should prefer instead to make full use of the power which already exists to make loans on deferred interest terms. This, however, would mean accepting the deferment of repayments of principal as well as interest, and allowing payments of interest deferred not to count against the Board's EFL. The cash effect, however, would probably not be large - about £10m in 1981-82 increasing by £25m pa thereafter - and we must accept that it would fall well short of satisfying the NUM. I shall discuss with the Chief Secretary whether advances out of the National Loan Fund should continue to be the main form of financing for the NCB.