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E(80)99

COPY NO 55

11 September 1980

CABINET

MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

STRATEGY FOR COAL

Note by the Central Policy Review Staff

1. At Monday's meeting of E Committee Ministers are due to discuss a memorandum by the Secretary of State for Energy on "Strategy for Coal" (E(80)96). In this Mr Howell foreshadows that on the basis of Department of Energy coal demand forecasts, the NCB, without taking corrective action, would be facing an increasing cash deficit against its EFLs that in 1983/84 alone would amount to nearly £1000m and cumulatively over the period 1980/84 to almost £1900m. There would be a corresponding profit and loss shortfall rising to some £200m by 1983/84. The paper puts forward possible options to reduce the excess financing requirement to some £500m in 1983/84 - principally by raising the pit closure rate by 1 mtpa to $2\frac{1}{2}$ mtpa, replacing 4mtpa of imports by home produced coal at world prices and increasing exports by up to 3mtpa; but all these would be at the further expense of NCB's revenue account which would worsen by some £50-60m in each of the years 1981/84. The paper further argues that the remaining excess financing requirement in 1983/84 could be eliminated by cuts in output at continuing pits and by reductions in capital investment, both of which the Board are currently reviewing.

2. Against this background Mr Howell's preliminary conclusion is that Ministers should persevere with the current financial strategy. This means adhering to the financial objectives announced in April, namely (i) a steadily reducing limit on external finance as set out in line 1 of Annex C1 of Mr Howell's paper (ii) a gradual withdrawal of operating grants by 1983/84 and

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(iii) the requirement on the Board to breakeven on revenue account in 1983/84 without operating grants. In maintaining this financial strategy Mr Howell recommends that Ministers ask the Board to plan on the basis of his Department's lower demand figures. However, he suggests that colleagues defer a final decision on coal strategy until the NCB has come forward with its assessment of the scope for cuts in capital investment and output.

3. The crucial factor that makes the financial strategy unattainable without adjustments is the projected level of demand. It will therefore be essential to check that the Department of Energy's demand estimates take sufficient account of changed economic circumstances; too often an under-statement of the scale of a problem elicits an inadequate response. Nonetheless it is clear that in the changed market conditions the NCB faces a situation of persistent over-capacity in the medium-term and the paper highlights the disastrous financial consequences of putting surplus coal production into stocks. It seems to the CPRS however that the financial risks associated with an imbalance in coal supply and demand are asymmetrical and one should not be unduly concerned in reducing supply too far. As Mr Howell's memorandum underlines, surplus production proves very expensive whilst CEGB's unutilised import facilities provide access to coal at world prices if for any short-term periods demand outstrips supply.

4. The rational response to the NCB's problems of over-capacity and current high cost structure would be to accelerate the rate of closure of uneconomic pits and those nearing exhaustion. The other measures cited in the paper may be necessary as a short-term expedient viz:

(i) buying out imports and increasing exports - but this could involve the NCB becoming locked into long-term uneconomic contracts;

(ii) reducing production at continuing pits - which would not reduce overheads;

and

(iii) cuts in capital investment.

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But these carry with them an economic cost and do nothing about the fundamental problem which is excess uneconomic capacity. Clearly there are limitations to a more rapid closure programme but the eventual closure of uneconomic pits is a necessary corollary to investment in new low cost capacity in order to make the industry fully competitive. Moreover cuts in strategic investment could seriously impair the long-term viability of the industry.

5. The CPRS agrees with Mr Howell that final decisions must await the deliberations of the Board. However, in view of the substantial over-capacity, the CPRS believes that the Board should be asked how an increased closure programme could be achieved, what the risks of confrontation are and how these can be minimised. Similar decisions on closures may well have to be considered for other nationalised industries in the current expenditure review. It is appreciated that for tactical reasons the Board may wish to keep pay and closures as separate issues and that timing would be an important aspect of negotiating an accelerated pit closure programme.

6. It is clear that on the basis of the Department's lower demand estimates, there is a conflict between the cash and revenue objectives of the financial strategy. It is necessary that the NCB should be provided with guidance as to which of these should be given primacy and the CPRS suggests the cash target, with the revenue objective being adjusted accordingly. In making this adjustment, however, the Board could be offered an incentive and one possibility is an agreement that the effects on the revenue account of an accelerated closure rate could be treated as "extraordinary items" after profit/loss; this would have presentational advantages since it is the requirement to break even in 1983/84 without operating grant that has received most public attention.

7. In the light of the foregoing, any final decision clearly has to await a further paper from Mr Howell. It is important, however, that this should be on the basis of robust assumptions and contain firm proposals and not a series of options. Clearly the paper should be in time to enable Ministers to take decisions in the context of their discussions of public expenditure.

Cabinet Office

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