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CABINET  
MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

STRATEGY FOR THE COAL INDUSTRY

Memorandum by the Secretary of State for Energy and  
the Chief Secretary to the Treasury

In discussion of E(79)45\* we were asked to clarify the financial strategy outlined in that paper and to indicate alternative options.

At Annex A is a note by the Secretary of State for Energy recommending the strategy and at Annex B a note by the Chief Secretary recommending an alternative strategy. Supporting information is included in the Appendices:

- Appendix 1 - Financial effects of strategy proposed in E(79)45 (excluding enhanced redundancy and transfer terms).  
Table 1 - Effect on NCB profit and loss account.  
Table 2 - Effect on public expenditure.
- Appendix 2 - Assumptions underlying the strategy compared with NCB forecasts in Financing and Investment Review.  
- Sensitivity of the assumptions.



Appendix 3 - NCB capital expenditure programme and effect of further cuts.

Appendix 4 - NCB capital structure

Appendix 5 - Number of miners affected by closures.

We invite the Committee:

a) to choose between alternative recommendations as follows:

i) Financial strategy: either the Secretary of State's recommendation that it is not practicable at this stage to impose on the Board a strategy more demanding than that in E(79)45 be endorsed or the Chief Secretary's recommendation in favour of a tighter financial discipline which minimises demands on public expenditure, as set out in para 4 of Annex B.

ii) Investment: either the Secretary of State's recommendation that the investment programme to 1981/83 be endorsed in the usual way or the Chief Secretary's recommendation that this should be delayed until the Board have accepted the alternative strategy or, if earlier approval has to be given, it should be subject to the warning that the Board should not necessarily expect the balance of the planned programme to be approved in later years.

iii) Capital Structure: either the Secretary of State's recommendation that powers be taken in the Coal Bill to issue PDC, their use to be conditional on progress towards viability or the Chief Secretary's recommendation that the Bill should not make provision for such powers.

b) to agree that proposals for a Coal Bill for introduction in 1979/80 should now be prepared.

Department of Energy/Treasury  
12 October 1979

(D.A.R.H.)  
(J.B.)

NOTE BY THE SECRETARY OF STATE FOR ENERGY

In my previous paper, E(79)45, I proposed a financial strategy for the National Coal Board (NCB) requiring them to reach breakeven by 1984/85 on their present capital structure. How to achieve this should be a matter for them. It is not for the Government to take decisions about specific measures, such as the rate of closures.

2 I pressed the Board hard to move towards breakeven as fast as possible and rejected their first proposals because they did not go far enough. The strategy they subsequently proposed shows a saving in public expenditure compared with their forecasts during the summer. The following table shows the Board's external finance under this strategy, and the savings compared with their earlier forecast:

	£m 1979 Survey prices			
	1980/81	1981/82	1982/83	1983/84
External finance	628	597	531	434
Change from earlier proposals (savings negative)	+ 30	- 11	- 91	- 188

The increase in 1980/81 results mainly from the assumption that productivity will rise at only 2% a year. The Board earlier forecast 3%.

3 For 1980/81, the Chief Secretary recommends the figure of £598m which was accepted by the Cabinet in July but which rested on the NCB's earlier forecast of a productivity increase of 3% a year which I had already, in E(EA)(79)22, made clear was unrealistic. He has also now proposed further savings in external finance of £30m, £50m and £60m in 1981/82, 1982/83 and 1983/84. Such savings cannot be made out of current expenditure. The Committee at its last meeting recognised the political dangers of pressing for more closures, as described in E(79)45. But in any case more closures would increase the call on Exchequer financing up to 1983/84 because of offsetting redundancy and other costs. We cannot look to higher prices to produce more than is proposed in the strategy since that already assumes that if they are possible they will produce an extra contribution to self-financing. Nor can we count on lower unit costs through productivity rising at over 2% a year. The reduction below 3% of the assumed increase in productivity is only a recognition of reality.

4 A further reduction in finance can therefore be achieved only by cuts in the Board's investment programme. Nearly half of this is to maintain or increase efficiency in existing capacity. Most of the rest is in major projects to create new and more efficient capacity. To cut the programme would therefore be totally inconsistent with our policy of developing a more efficient, less labour intensive industry. Because of the difficulty of catching up later on deferred projects, it would also increase our dependence, already likely to be heavy, on imports of energy towards the end of the century - costly both in themselves and in erecting the necessary infrastructure. I am sure therefore that such cuts would be against the long-term interests of the industry and the nation.



5 We must have effective monitoring of the Board's progress towards viability. In particular, we must monitor unit costs and compare them with the forecasts underlying the strategy. I have already asked the Board to submit monthly reports for regular meetings with Department of Energy Ministers. We can in this way ensure that finance for capital investment is not used to finance excessive wage settlements.

6 We need to decide the Board's capital structure. There is a strong case in principle for Public Dividend Capital (PDC) since investment in new mining capacity has a long lead time. But PDC must not be used as a soft option. I propose that we should take powers in the forthcoming Coal Bill to issue PDC, but that the Board should not actually get it until they have made progress towards viability.

7 The Board have proposed improvements in redundancy terms to make closures more acceptable to the miners. I think there is a good case in principle for such improvements, although we must also have regard to their repercussions. I am examining the Board's ideas with my colleagues mainly concerned, and will bring forward proposals as necessary. The maximum additions to public expenditure are shown in Appendix 1, Table 2. Contrary to the Chief Secretary's assumption in paragraph 4 of Annex B, the cost of any improvements eventually agreed should be added to the external finance figures which the Committee now approves if we are to avoid undesirable cuts in the investment programme.

8 I ask the Committee to:

- a) endorse the financial strategy proposed in E(79)45;
- b) approve the NCB's investment programme in the usual way (in full for 1980/81, 85% and 70% for the following years);
- c) agree that powers should be taken in the Coal Bill to issue PDC, their use to be conditional on progress towards viability;
- d) note that I am examining the Board's ideas for improvements in redundancy terms with colleagues mainly concerned and will bring forward proposals as necessary.

NOTE BY THE CHIEF SECRETARY TO THE TREASURY

### Objectives

I accept that the NCB should decide how to meet the financial target set: our task is to set them an objective which requires an improvement of public expenditure blank cheques is at an end. The Secretary of State's proposals, with their blanket endorsement of the NCB's investment programme and acceptance of their financial strategy, do not give that signal. If difficult decisions have to be taken on the industry's future, they should be taken now, early on in our Administration. It will be no easier to take them in two years' time.

### Costs and Productivity

2. The main reasons for the Board's forecast improvement in profitability in their strategy are assumptions about higher price increases, (despite the reported understanding with the CEBG to keep price increases within the national inflation rates) stock run-down and higher output at the end of the period; and accounting changes (which have no effect on public expenditure); partly offset by the assumption of a lower rate of increase in productivity, implying a rise in real unit labour costs of 1 per cent a year. There is no guarantee that the projected prices, sales and output can be achieved and no indication that the Board is tackling the root cause of their unprofitability - low productivity and uneconomic pits.

3. There must in fact be serious doubts whether the NCB's strategy will produce the results forecast. The Board have consistently fallen short of their output targets. The reduced productivity assumption from 3 per cent to 2 per cent still requires a substantial improvement compared with recent years (no average increase since 1974 despite substantial capital investment in existing pits). And the NCB's strategy assumes a real increase in miners' pay of only 3 per cent per annum.

### Public Expenditure

4. So as to give the Board the tightest financial discipline and to minimise their demands on public expenditure, I recommend that the Board's external finance requirement for 1980-81 and any increased expenditure on redundancy payments which may be agreed later for that year should be met from within the figure of £598m agreed by the Cabinet in July (ie no increase of £30m proposed by the Secretary of State). For the later years I recommend the sum of the Board's external finance requirement and any increased expenditure on enhanced redundancy payments which may be agreed later should be contained within:

	£m 1979 Survey prices		
	1981-82	1982-83	1983-84
	570	480	375

This would imply reductions compared with the Secretary of State's Proposals of some:

	30	50	60
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5. These reductions would in total match those proposed in C(79)37, though starting lower and ending higher. The Board should decide how far these savings should be achieved by cost reductions or by reduced investment. The former would be preferable, particularly since I do not accept that unit labour costs should rise further. But, if they were not obtainable, the Board should choose between reductions in the investment which supports current production and the deferment of new long term capacity. There may be risks in reducing investment but there is a possibility of surpluses of coal in the mid-1980s; and whilst deferment of new capacity might mean a few million tonnes less coal in the early 1990s, the projected switch in the industrial market from oil to coal is most uncertain in these years. Imports could in any case be increased to make up for any home deficiency.

Investment

6. We should delay approval to the investment programme until the Board has agreed this strategy. If earlier approval has to be given, it should be given on the explicit understanding that the Board should not necessarily expect the balance of the planned programme to be approved in later years.

Financial Structure

7. On present showing there is no prospect that the NCB will ever be able to meet the criterion that FDC should be issued only to fully viable industries expected to be capable over a period of paying dividend equal to interest payable on National Loans Fund advances. FDC would be a soft option and a cosmetic change concealing their true losses, already largely hidden by a combination of market protection, Government subsidies and historic cost accounts.

Enhanced Redundancy Benefits

8. The NCB's proposals for enhanced redundancy benefits would be repercussive, expensive and would not produce closures above the level assumed by the Board in their last Medium Term Development Plan. I welcome the Secretary of State's proposal not to press for them for the present.

Conclusions

9. I recommend
- a) endorsement of a financial strategy based on the public expenditure figures in paragraph 4 above;
  - b) delaying investment approval as in paragraph 6 above;
  - c) no provision in the Coal Bill for FDC.

FINANCIAL EFFECTS OF STRATEGY PROPOSED IN E(79)45  
(excluding enhanced redundancy and transfer terms)

£m (1979 Survey prices)

TABLE 1

Effect on NCB Profit and Loss Account		1979/80	1980/81	1981/82	1982/83	1983/84	
Operating Profit/ (Loss)		(65)	(28)	(1)	69	134	
Interest		(166)	(180)	(195)	(208)	(218)	
Social Grants		58	58	60	60	60	
		(173)	(150)	(136)	(80)	(24)	
Operating grants		55	20	18	11	-	} At least breakeven thereafter
Regional grants		136	130	118	69	24	
Net Profit/(Loss)		18	-	-	-	-	} zero thereafter

Conversion of 35% to 50% of debt to Public Dividend Capital in early 1981, on proof of progress towards viability, would result in the following benefit to profit and loss account:

	1981/82	1982/83	1983/84
£m available for dividend payments and allocation to reserves	65-90	70-95	70-105



## APPENDIX 1 (continued)

TABLE 2

NCB External Finance Requirements

£m (1979 Survey prices)

	<u>1980/81</u>	<u>1981/82</u>	<u>1982/83</u>	<u>1983/84</u>
1 Financial strategy proposed in E(79)45	628	597	531	434
2 (Reduction)/Increase compared with NCB forecasts for Financing and Investment Review	30	(11)	(91)	(188)
3 Level of finance implied by 'option cuts' in C(79)37	598	513	482	427
4 Increase compared with C(79)37 (line 1 minus line 3)	30	84	49	7

If the NCB's revised proposals for enhanced redundancy and transfer terms were to be agreed the additions to public expenditure would be

21	21	21	21
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## APPENDIX 2

ASSUMPTIONS OF PROPOSED STRATEGY  
(COMPARED WITH NCB FORECASTS FOR FINANCING AND INVESTMENT REVIEW (FIR))

	<u>1979/80</u>	<u>1980/81</u>	<u>1981/82</u>	<u>1982/83</u>	<u>1983/84</u>
<u>Output assumption</u> (m tonnes)					
FIR					
Proposed Strategy	122 120	123 121	124 123	125 125	127 128
<u>Stock change</u> (m tonnes)	(2)	(2)	(1)	-	1
FIR					
Proposed Strategy	0.6 (4)	1 (1)	1 -	1 -	2 -
<u>Prices</u>					
FIR					
Proposed Strategy	Average 1.2% real pa 2% real pa *				
<u>Productivity</u>					
FIR					
Proposed Strategy	3% increase pa 2% increase pa				
<u>Wages</u>					
FIR					
Proposed Strategy	3% increase pa 2% increase pa				
<u>Real increase in earnings</u> of 3%pa					
FIR					
Proposed Strategy	to be paid for by improvements in productivity to be paid for by improvements in productivity and real price increases as above.				
<u>Unit Labour Costs</u> (derived from wages and productivity assumptions above)					
FIR					
Proposed Strategy	Constant in real terms 1% real increase pa				

SENSITIVITY OF ASSUMPTIONS  
(EFFECT ON EXTERNAL FINANCING REQUIREMENTS IN EACH YEAR)

<u>Output</u>	±£25m for each 1m tonnes by which output fell short or exceeded target
<u>Prices</u>	1% on power station coal produces about £20m in a full year
<u>Wages</u>	1% on wages bill adds about £18m
<u>Productivity</u>	Each 1% by which productivity falls below the rate of increases assumed costs about £20-£25m.

average for the period, which would, as necessary, take precedence over the condition attached to CEGB's agreement with NCB to take 75m tonnes of coal p.a. over a 5 year period, provided that prices increase no more than inflation.

## NCB CAPITAL EXPENDITURE PROGRAMME

(£m 1979 Survey prices)

	1980/81	1981/82	1982/83
New Mines (of which Selby)	85	119	149
Major projects at existing pits	(76)	(86)	(85)
Expenditure in support of production (plant and minor projects)	203	152	120
Other (Exploration, Opencast, Non-mining)	260	260	263
Leasing	40	44	48
	24	25	28
<u>Less agreed cut</u>	612	600	608
	25	25	25
<b>TOTAL</b>	<b>587</b>	<b>575</b>	<b>583</b>
of which:			
B approved July 1978	481	375	-
C approval sought September 1979	106	114	408
B and C as percentage of A	100%	85%	70%

Effect of cuts

Like any extractive industry, the coal industry needs a substantial level of capital investment simply to maintain a given level of production. Nearly half of planned expenditure is for this purpose. In addition, the capital programme aims to redress the run-down of major investment during the 1960's. The average age of existing pits is 80 years; and modernisation is needed to improve efficiency. The programme is aimed also at additional capacity for highly-productive, low-cost output.

The NCB have already accepted cuts in their capital programme of £25m a year. The Chief Secretary's proposed cuts of £200m in NCB external finance over the three years 1980/81 to 1982/83 would have a significant impact on one or more of the following sections of the programme.

Expenditure in support of present production

More than half of this is on plant (roof supports, coal cutting machines, conveyors etc) and the rest on minor projects costing less than £1m each to facilitate production and to improve efficiency. Any significant reduction would increase costs of production, eg. as a result of a higher incidence of breakdown and more expenditure on repairs.

'Other' capital expenditure comprises:

Exploration. This programme, running at about £10m a year, includes the proving of new areas of coal at existing long-life collieries and the identification of areas for new mines. It is essential if we wish to retain the potential to increase economic production. Only small savings could be obtained now and at the cost of a less complete knowledge of reserves and a less informed basis on which to plan new developments.

Non-mining. About £20m a year is planned to be invested in the NCB's subsidiary activities, chiefly in rebuilding (not expansion) of coking and manufactured fuel plants.



Opencast. About £9m a year is planned to be spent in support of the very profitable opencast production programme.

### Selby

Over £80m a year is planned to be spent on development of this 10m tonne a year mine, construction of which commenced in 1976. To restrict expenditure would be wasteful and would increase total costs.

### Major projects at existing pits

These are projects each estimated to cost more than £1m and aimed at increased efficiency, improved proceeds, extension of the lives of profitable pits that would otherwise reach exhaustion and projects to increase the output potential of profitable pits. Deferment of unapproved projects would yield some savings in 1981/82 and 1982/83, but at the cost of slowing down the pace of modernisation and at the risk of production falling short of demand in the 1990s against the main scenarios of the Department's energy projections.

### Unapproved new mines

The programme provides for a start on 10m tonnes new mine capacity. Deferment would carry a substantial risk of output falling short of demand in the 1990's as general industry seeks to reduce dependence on increasingly expensive oil. But a start on each new mine is, in any event, dependent on Government endorsement and the Secretary of State for Energy will consult colleagues in due course as appropriate.

### Conclusion

A significant cut in the investment programme, which is aimed at lower cost, more productive and less labour-intensive capacity, would be contrary to our policy of making the industry economic and competitive; and reducing long-term capacity would increase our dependence on imports of energy towards the end of the century: a dependence which is in any case likelt to be heavy. New mines will still come forward for individual approval.

Investment should be geared to our central estimates of long-term requirements, with resort, if surpluses should develop in the meantime, to a more adequate level of stocking, to securing a higher level of closures (which would be more easily attainable in conditions of surplus) and, if necessary, to reducing opencast output.

## NCB CAPITAL STRUCTURE

### Public Dividend Capital

Methods of minimising risk of PDC becoming a 'soft option'

1 Policy should be that issue of PDC would be dependent on satisfactory progress towards viability.

2 Legislation could provide that further tranches of PDC, after the initial conversion of a portion of debt, should be subject to affirmative resolution after consideration of a statement by the Secretary of State about the Board's progress towards viability and the prospects for payment of dividends.

3 The Financial Target for the NCB should describe the objective of break-even as though interest were paid in full on loan capital without any conversion to PDC having taken place. Thus the issue of PDC would not permit the Board to relax their efforts to achieve break-even by cost reduction, closures, higher output etc.

4 Either, the Board could undertake (as they have offered to do) to aim to pay a dividend of not less than 5% in the period to 1983/84 on any PDC now issued

or the issue could be analogous to a participating preference share which would oblige the Board to pay a minimum fixed dividend and also permit payment of a higher dividend if profits allowed.

### Benefits of PDC

Alternatives to conversion of a portion of existing debt (para of Annex A) could be to restrict the issue of PDC to new major capital expenditure or to expenditure on new mines. The corresponding benefit to the profit and loss account would be (roughly):

	£m (1979 Survey prices)		
	<u>1981/82</u>	<u>1982/83</u>	<u>1983/84</u>
for major new expenditure only	45	65	90
for new mines only	20	35	50

### Alternative to Public Dividend Capital

An alternative to PDC would be voted loans on which interest would be deferred for a specified period comparable to the construction period of major projects. An enhanced rate of interest would be paid subsequently to take account of the interest deferred. If deferment of interest were to apply to all projects on which interest is now capitalised (ie those estimated to cost more than £5m and to take longer than 2 years to complete), there would be no additional benefit to profit and loss account but the Board's need for external finance would be reduced by the following amounts:

	£m			
	<u>1980/81</u>	<u>1981/82</u>	<u>1982/83</u>	<u>1983/84</u>
	30	40	50	60

MEN AFFECTED AT ANNUAL CLOSURE RATE OF 1½m TONNES

(Total number of men affected over the whole period to 1983/84)

	<u>Total Manpower</u> (end June) 1979	<u>Men made</u> <u>redundant or</u> <u>transferred</u>	<u>%</u>
Scottish	21,000		
North East	33,800	1,200	6
Yorkshire	65,200	6,100	18
Midlands	62,400	3,300	5
* Western	23,200	2,800	4
South Wales	27,300	3,000	13
		3,500	13
Great Britain	232,900	19,900(see note)	8½
<u>* Western</u>			
Lancashire	8,640		
North Wales	1,250	490	6
Cumberland	980	550	44
Staffordshire	12,320	980	100
		1,000	8
Total Western	23,190	3,020	13

NOTE:  
Of the total of 19,900, the NCB estimate that 9,300 could be transferred to other jobs in the industry:

	<u>Short distance</u>	<u>Long distance</u> (ie to Yorkshire and Midlands)	<u>Total</u>
1½m tonnes	6,900	2,400	9,300

It is not possible for the NCB at present to indicate the regional distribution of the source of the men who could be transferred long distance.