NBPQ at this stage.

MR NORGROVE

24 March 1987

BRITISH COAL - MARGAM PROJECT

Peter Walker is not exaggerating when he describes the "enormous potential benefits" of breaking the stranglehold on coal mining productivity of work practices, prescribed nationally in accordance with the 1908 Hours of Work Act and the 40-Hour 5-Day Week Agreement. It makes no economic sense to invest £90 million in the new Margam mine using the most advanced mining technology and then not to realise the full production potential of the equipment. British Coal are rightly putting high priority on transferring responsibility to local managements for devising the most productive work practices appropriate to each pit, with the miners rewarded through local productivity deals.

Arthur Scargill has chosen to defend his leadership of the NUM on this crucial issue. The signs are that he is losing the battle over Margam; South Wales miners want the investment, the work and the rewards for high productivity. Others are likely to follow as NUM members recognise the financial incentives for greater flexibility over work practices.

Even if we regard the Margam project as borderline in narrow economic terms, there is a compelling case to endorse British Coal's proposed go-ahead.

JMW.

JOHN WYBREW

002/1282

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CCBS

CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Peter Walker MBE MP
Secretary of State for Energy
Department of Energy
Thames House South
Millbank
London
SW1P 4QJ

31st March 1987

NBPR

Dear Peter,

BRITISH COAL: MARGAM

Thank you for your letter of 23 March.

I recognise the attraction of launching a new mine investment project in South Wales at the moment, especially if the prospect of 6 day working could be secured. However, the financial case for the new mine does not strike me as robust. The rate of return is not only vulnerable to the usual range of mining uncertainties, but is also particularly sensitive to exchange rate fluctuations - more so than investment in steam coal, partly because there is nothing equivalent to the agreement with the CEGB and partly because so many power stations are sited inland whereas most of the major steel works are on the coast.

I understand British Coal's argument for expecting the current international price to be maintained over the life of the Margam pit. But in normal circumstances I do not think that this would be reliable enough for the scheme to go ahead without a substantial margin in the prospective rate of return. In fact I understand that the project would not meet British Coal's own normal criteria. If geological mining risks materialised, the project's return would drop to only 3 per cent after mining risks; it would fall to zero if the current exchange rate were to hold through the life of the mine.

I recognise that the prospect of achieving 6 day working has to be set against the relatively low profitability and high risk of this project. To secure that would indeed be a prize and British Coal are of course quite right to make it a condition.

NAT IND
COAL
PT 20

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There must of course still be considerable risk that miners elsewhere will not adopt the practice readily even if it is agreed at Margam.

I am therefore not convinced of the economic justification for this project, even taking into account the prospect of 6 day working. I nevertheless recognise that there are wider potential benefits, and also that to withhold approval could be damaging to the continuing efforts of British Coal's management to improve productivity. If you judge therefore that these wider considerations outweigh the weak economic case, I would be prepared, in these exceptional circumstances, for you to approve the project.

I am grateful for your assurance that the capital expenditure would be met within the agreed capital allocation. I agree that the scope for an ECSC loan should be explored. Whether or not it or other finance is uncovered will depend on the other initiatives, being discussed between our officials, to extend BC's uncovered borrowing. I very much agree with your view that regional selective assistance should not be given to the project.

I am copying this letter to the Prime Minister, Nick Edwards, Kenneth Clarke, Paul Channon and Sir Robert Armstrong.

Yours ever,

JM

JOHN MacGREGOR

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From The Secretary of State for Wales

The Rt Hon Nicholas Edwards MP

24 March 1987

NBPM.

Dear John

MARGAM

I have seen a copy of Peter Walker's letter of 23 March to you and I am writing to register my wholehearted support for this proposal.

at Flap

Peter makes all the relevant points which demonstrate the clear case for going ahead. I would like to emphasise how important this project is to South Wales, as well as the UK as a whole.

Margam is located in an area which is experiencing a high rate of unemployment. For example, the latest male unemployment figure for the Bridgend ttwa, from which much of the workforce for the mine would be drawn, is 19.9%. The project will obviously make an immediate and significant contribution to the alleviation of the unemployment situation in the area.

Peter mentioned the radical restructuring that has taken place in the South Wales coalfield since the end of the strike. The positive response of the remaining workforce which has resulted in an 83% improvement in productivity since 1984/85 provides encouragement to our belief that the output projections made by BC are realistic.

As colleagues will readily appreciate, politically, a decision by Government to support this project could hardly come at a more propritious moment.

/ I am copying this letter to the Prime Minister, Peter Walker, Kenneth Clarke, Paul Channon and to Sir Robert Armstrong.

Yours ever

Nick

The Rt Hon John McGregor OBE MP
Chief Secretary

Nat Ind: Coal PT20.

cc BG.

SECRETARY OF STATE FOR ENERGY
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The Rt Hon John MacGregor OBE MP
Chief Secretary
Treasury Chambers
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23 March 1987

BRITISH COAL: MARGAM PROJECT

British Coal are obliged under a long-standing convention to seek our comments as to the public interest in respect of proposed new mines. We have now been consulted about the proposal for a new £90 million drift-mine at Margam near Port Talbot in South Wales. I attach a background note on the project which has been approved by the Board of British Coal and is strongly supported by the Chairman, Bob Haslam.

The Margam prospect contains the last major deposit in the UK of prime quality coking coal. It is well suited in terms of both quality and location for sale to British Steel's plants at Port Talbot and Llanwern. British Coal wish to proceed with the project, subject to two important conditions:

(a) that the NUM and NACODS agreed to 6 day working;

(b) that satisfactory arrangements are made for financing, in discussion with the Government and the European Coal and Steel Community.

In my judgement the project is financially sound. The base case offers a real rate of return of 12%; and even the "worst proceeds" case, at 6.4%, offers more than the required rate of return of 5%. The output would help the balance of payments by displacing imports; and a new mine would provide an excellent showcase for the mining equipment industry.

Moreover, there are prospects of substantial benefits for both British Coal and the Government which are difficult or impossible to allow for in a financial appraisal. Since the end of the NUM strike two years ago, 60 collieries have been closed or merged; 60,000 jobs have disappeared in the pits themselves, and nearly 20,000 ancillary and non-industrial jobs elsewhere. In South Wales alone, the number

SECRETARY OF STATE FOR ENERGY

of collieries has fallen from 28 to 14, and the men on colliery books from almost 19,500 to 10,500. Against this background, Margam represents the other, positive side of the industry's restructuring; and it has great significance for both men and management. As well as demonstrating a commitment to the industry's future, the project would create 780 jobs directly, and a similar number indirectly in an area of high unemployment.

Secondly, it would be extremely beneficial to the industry's finances if it were possible to introduce more flexible working practices. Bob Haslam has publicly emphasised the need to move to six-day production in place of the five day week that has been firmly embedded in the industry for so many years. Margam is an ideal opportunity to start this process of change. As already seems clear from the South Wales NUM's decision, the unions will find it hard to resist six-day working if the effect of doing so is to block the project. The workforce at Margam will be almost entirely new recruits rather than transferees long accustomed to the traditional 5 day week. And there is the welcome willingness on the part of the local Area NUM to consider six day production in defiance of the national NUM leadership. If six day production can be agreed at Margam, British Coal have every chance of getting it accepted at other new mines; and it will put them in a stronger position to introduce it at existing pits. The potential benefits are enormous.

British Coal have confirmed to me that they are prepared to create room for this project within the capital allocations agreed in the last IFR round. However, they are subject to strict cash rationing and are having to set very stiff internal criteria for investment projects. In order to maintain those criteria, they are looking for financial support from the ECSC and the Government sufficient to raise the rate of return by rather over three percentage points. In particular they are looking for assistance under three heads:

(a) an ECSC loan with an interest rate subsidy of 3%, equivalent to 2-3m ecu for the first stage of the project with further subsidies for subsequent stages;

(b) a dollar-denominated loan for the full amount of the project, guaranteed by the Treasury but uncovered by the Exchange Guarantee Scheme (so as to offset the exchange rate risk under the project); and

(c) regional selective assistance.

The first two elements of this look straightforward - in particular, it must make sound commercial sense to finance by dollar borrowing a project so exposed to the sterling/dollar exchange rate. We should do all that we can to persuade the European Commission to provide finance on favourable terms; and we should tell British Coal that we are willing to approve dollar borrowing for the full cost of the project, subject to discussion of the details between officials.

I do not, however, believe that it would be right to offer regional selective assistance (RSA). Although it is understandable that British Coal should compare themselves with those investors in South Wales who are eligible for RSA, and that they should seek to maximise the benefits of the project to their own finances, Margam is perfectly viable without assistance from Government, and its very advantages in terms of specialised quality of coal and nearness to the market mean that it is not in close competition with projects in other Areas. In any case, since the introduction of RSA, it has been regarded as inappropriate for assistance to be offered for mainstream activities of Nationalised Industries as has been made clear in the RSA Operating Guidelines. I see no basis for our making an exception for this project.

British Coal have not reached their decision lightly. It comes at what I believe could be an important turning point in the industry's fortunes, and I very much hope that we can agree to back Bob Haslam's judgement.

I strongly believe that the politics of Margam call for an immediate and positive response. A favourable decision would have a very important impact on South Wales and also of course in supporting the realistic attitudes now developing within the NUM. I therefore seek quick and speedy approval as of course I still have to persuade British Coal to go ahead without Regional Selective Assistance.

I am copying this letter to the Prime Minister, Nicholas Edwards, Kenneth Clarke, Paul Channon and to Sir Robert Armstrong.

PETER WALKER

ANNEX

MARGAM DRIFT MINE

1. This is a proposal to develop an area of coking coal reserves at Margam on a site about 5 miles from the British Steel Corporation works at Port Talbot. Planning permission for the new development has already been obtained. The coal would be exploited by drift access and would be for supply to the British Steel Corporation works at Port Talbot and Llanwern.

2. The main aims for the proposed project would be:

(i) to contribute to profitability in South Wales by developing the only substantial untapped reserves of prime coking coal at present known in the UK;

(ii) to displace coking coal imports and in doing so to provide employment in South Wales to mitigate the effects of the rundown of the coal industry there;

(iii) to recapture for British Coal part of the BSC market, while giving BSC a dedicated source of supply very close to their two South Wales plants. In 1981/82 British Coal supplied 63% of the 8m tonne BSC market; this year it will be some 34%.

3. The new Mine is estimated to take some 4.5 years to construct at an estimated cost of £79.9m (December 1986 prices) equivalent to £89.8m at outturn. The project prospectus is based on production on 6 days per week. It assumes initial output of some 0.75 tonnes in year 5, with full output of 1.2m tonnes occurring in yar 6. At this level there are reserves to support a production period of 16 years. The manpower requirement is 780, and a similar number of jobs are likely to be generated in support services, etc.

Assessment of Mining Proposals

4. British Coal stress that the project has been carefully planned in detail over some considerable time. Inherent in any major mining proposals of this nature are a number of physical mining risks. The particular risks which British Coal have identified in this project are as follows:

(i) Physical Access - The reserves are almost surrounded by major geological barriers which have previously made drift access appear difficult and costly. New geological techniques - high resolution seismic surveys developed for South Wales - have made it possible to design low risk drift access which will avoid the geological barriers.

Drivage of twin 3000 metres long drifts at average progress rates of 25m/week to access the reserves is critical to the timing and ultimate cost of the project. Valuable experience has however been gained at Betws Drift recently and by the proposed use on a competitive basis of outside contractors on continuous operation.

(ii) Mining Performance - The project provides for mining the coal by two full retreat shield supported faces using the most modern available equipment on 6 days and 26 machine shifts per week. This implies an output per machine shift at a sustained rate of over 700 tonnes per machine shift - which some of South Wales Area's faces are already starting to record. The project assumes output per manshift of 7.52 tonnes.

5. The majority of the manpower required for Margam will come from the ranks of new adults in the Margam catchment area with a small number of men who have continued to live in the catchment area offered the opportunity to transfer from adjacent collieries to form a nucleus of experienced labour. Thus, despite the recent closures of Cwm and Nantgarw collieries, the manning of Margam can be accomplished without major difficulty.

Assessment of Markets

6. British Coal consider that any decline in the total UK market for coking coal will fall mainly on imported coal, and that their own sales will continue to be constrained not by the overall market need, but by the tonnage they can produce at internationally accepted quality standards. The present total market for coking coal in South Wales is about 4 mtpa most of which is taken by BSC's works at Port Talbot and Llanwern. Given that the combined outputs of Marine (which will be the only existing coking colliery - producing inferior qualities - likely to be still operational in the early 1990s, when Margam would be coming into production) and Margam itself, together with limited tonnages of opencast coking coal, will only amount to about 2 mtpa, there should be no problem in accommodating Margam in the market.

7. The Margam reserves are Rank 301B prime 'medium volatile' coking coal of excellent quality comparable with the best on the international market. It is the only remaining deep mine reserve of this type of coal in the UK. BSC have confirmed the suitability of the predicted specification for the Maragm coal and that it would fit in to their supply pattern in replacement for imported coal provided its price is acceptable.

8. British Coal sell coking coal to BSC at prices aligned to the delivered price of comparable imported coking coal plus a small premium of around 2% for security of supply. At present, international coking coal prices are extremely low - a figure of $53 per tonne has been used in the calculation converted to £35 per tonne on the basis of a sterling/dollar exchange rate of $1.52. At current dollar prices, British Coal report that higher cost Australian, US, and Canadian export mines are experiencing financial difficulties. There is a distinct possibility of closures which would reduce the extent of the oversupply in the market: this, together with the prospect or firmer demand, should serve to maintain and, other things being equal, strengthen international prices in the longer term.

Financial Assessment

9. British Coal's central estimate of the financial outcome to the project is set out below:

Proceeds per Gigajoule	£ 1.26
Operating Cost per Gigajoule	£ 0.97
Operating Profit	£10.4m
Profit after Interest	£ 0.3m
Net Present Value when discounted at 10%	£10.8m
DCF Yield	12.2%

10. This central estimate, reflecting the risks at paragraph 4 above, incorporates an allowance for a delay of six months in completing the project and a 10% increase in capital cost, together with a 5% shortfall in output and a 5% increase in operating costs. The cash flow assessment incorporates ongoing routine capital expenditure totalling some £25m over the 16 year production period assumed in the cash flow.

11. British Coal have also pointed out that a 10% deterioration in the sterling proceeds would reduce the 12.2% DCF yield to 6.4%. Such a deterioration in sterling proceeds could arise either because of a long-term rise in the sterling/dollar exchange rate to nearly $1.70, or because of a decline in the dollar price of international coking coal. For the reasons set out at paragraph 8 above British Coal believe that a fall much below current dollar prices is unlikely.