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Mr. Wilson

Thank you. I agree.

Recd 26/10

cc CF file

From: R T J Wilson
26 October 1989

MR GRAY

P 03559

BRITISH COAL

1. As you know, the legislative programme for the next Session includes a Coal Bill dealing with future financial support for the coal industry. My understanding is that the Bill will be concerned narrowly with the power to give financial support to British Coal although there will be sensitive political issues underlying the use which is made of these powers.
2. The Bill will be going to L Committee on 14 November, and in the normal way they will need to check that the policy in it has received collective approval. It is arguable whether it has. All that the Department of Energy can pray in aid is a private conversation between Mr Parkinson and the Prime Minister, and one exchange of letters (attached) between the Secretary of State for Energy and the Chief Secretary which was not copied to anybody else. If, say, Mr Walker and Mr Rifkind were to complain that they had been given no opportunity to comment on proposals in which they had an interest it would be hard to gainsay them. On the other hand, we do not want to start hares running needlessly.
3. I am minded, if you agree, to suggest to the Department of Energy that the way to cut through this formality would be for Mr Wakeham to put forward his proposals, seeking the approval of L Committee, in a letter addressed to the Lord President and copied both to other members of L Committee and to members of E(A). I would be grateful to know whether you agree.

RTJ

R T J WILSON

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TC

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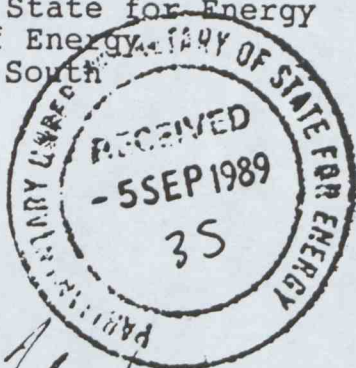


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Treasury Chambers, Parliament Street SW1P 3AG

The Rt Hon John Wakeham MP
 Secretary of State for Energy
 Department of Energy
 Thames House South
 Millbank
 London
 SW1P 4QJ

4th September 1989

SECRETARY OF STATE'S OFFICE	
TO: <i>Mr. H. H. H. H.</i>	Copies to: <i>Mr. H. H. H. H.</i>
FOR ADVICE (AND DRAFT REPLY IF APPROPRIATE)	<i>Mr. H. H. H. H.</i>
PLEASE BY: 13/9	<i>Mr. H. H. H. H.</i>
VIA <i>(R/S) (P/S)</i>	<i>Mr. H. H. H. H.</i>
	<i>Box</i>

BRITISH COAL: FUTURE FINANCIAL SUPPORT

Thank you for your letter of 28 July.

I appreciate that the outlook for British Coal (BC) is such that it may no longer be appropriate to rely on voted loans and restructuring grant to meet the Corporation's External Financing Requirement. I agree that some form of deficiency grant under new powers is required as well as an extension to restructuring grants and that you should prepare the necessary legislation. But I would be grateful for your reassurance on the uses to which we will put deficiency grant and I have reservations as to the scale and timing of reconstruction. Final decisions on these points can be taken later.

On the uses of the grant, we need to make it clear to BC that this is not a subsidy for operating at a loss. As you suggest in your letter, we should link it clearly to some proportion of payments for certain liabilities of the past, accrued in the balance sheet this year, for which BC will need to make payments in the next few years. I would hope that we could settle a profile for such grant payments one or more years ahead, to underline the fact that BC's operating losses will require the Corporation to borrow at the margin.

On the scale and timing of payments, we can not attempt a full financial reconstruction, which would produce a robust financial framework against which future financial targets can be set and financial performance evaluated. This would require a revised valuation of British Coal's assets to reflect the Corporation's current and future prospects. I think it unlikely that we will be able to carry this out reliably by March 1990. And by then BC will probably be involved in a further round of closures. It may therefore be sensible to proceed more cautiously.

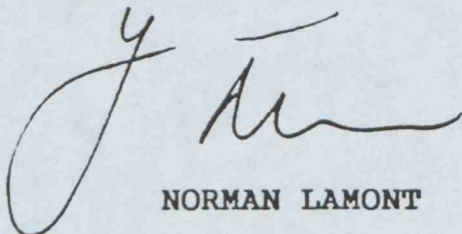
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One risk we run with any large reconstruction is giving BC a balance sheet that the Board thinks it will retain on privatisation. It might encourage them to believe that the Corporation will be privatised as one entity. You would, I am sure, make it clear that no such presumption was justified.

For the time being, our limited aims must be to reduce British Coal's debt and to achieve this through grant payments in respect of past liabilities. This then produces a degree of stability or steady reductions in its interest payments. The initial debt reduction should leave some room for BC to incur the penalty of further borrowing if it overshoot its EFL. This is little more than a stop-gap measure, while we wait for restructuring to be completed and BC's prospects to become clearer.

You list other advantages that flow from a reconstruction. I would add that a more realistic approach to investment expenditure and a satisfactory outcome to the contract negotiations are concessions you might aim for before settling the scale and timing of reconstruction. On the former, I note that BC is still spending about £500 million a year on investment. Given the very poor return it has achieved on expenditure of nearly £8 billion in 1989-90 prices since 1979-80 we will need to look for reductions or postponements in plans until it enters a more stable operating environment. While grant payments may be a useful bargaining counter with BC, all these issues are ones on which the Corporation should be cooperating anyway. We can set new objectives with its debt burden in mind; the Board should favour changes in accounting practice as much as we do; and the Board should agree not to sell coal at a loss into peripheral markets. We should not need to offer BC something for it to operate in a commercial manner.

To sum up, I agree that you should take the powers you propose for a grant limited to BC's negative reserves as at March 1990; an extension of restructuring grant; and a stream-lining of the procedures for voted loans. But we will need to present clearly the limited grounds on which the grant will be paid and plan a limited profile of payments accordingly. I suggest that we look again at the timing and scale of payments after the IFR and after our officials have made substantial progress in the discussions you propose and are able to take account of the contracts with the generators and the transitional arrangements. Meanwhile I should be grateful if my officials could be consulted about any public references to financing BC.

A handwritten signature in dark ink, appearing to be 'N. Lamont', written in a cursive style.

NORMAN LAMONT

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SECRETARY OF STATE FOR ENERGY

THAMES HOUSE SOUTH

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cc pds/pds
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Mr. Guinness
Mr. Buckley
Mr. Atkinson
Mr. Ingham
Dr. House
Dr. Metz
Dr. Heather
Mr. Holt
Mr. Wale

24 July 1989

Dear Norman,

BRITISH COAL: FUTURE FINANCIAL SUPPORT

In his minute of 14 June to the Prime Minister on Electricity Privatisation, Cecil Parkinson discussed the possible implications for British Coal. The analysis suggested that British Coal's prices to the generators might need to fall into alignment with world prices within 5 years and that the Corporation might lose 15m tonnes of sales to the ESI, leading to the need for closure of up to 25mt of deep-mined capacity - nearly a third of the present level - and a reduction in colliery manpower from the 70,000 expected by the end of this August to around 40,000.

Such a major change in British Coal's business is bound to have serious financial implications for the Corporation. As you know, a place has been reserved in the next Session on a contingency basis for a Coal Bill to address the consequences. We shall not, of course, know the precise implications for British Coal until they are further down the road with their negotiations with the generators. But it would be helpful to secure your early agreement to both the need for a Coal Bill and its broad outline so that drafting can proceed.

In the immediate future, British Coal's negative reserves are likely to rise steeply from £376m at March 1988 to around £2.5-£3.0 billion by March 1990 as a result of the need to provide for historic liabilities for hearing loss and concessionary coal. Most of this increase will occur whatever the outcome of the negotiations. Beyond March 1990, British Coal's IFR submission (which assumed that the generators would continue to take their present volumes from British Coal at prices falling only slightly

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in real terms), envisaged that bottom line losses would continue until 1991-92, and that self-financing would not be achieved until 1992-93. If the outcome to the negotiations is as Cecil Parkinson described then the Corporation's negative reserves would continue to grow each year until at least March 1993; there is no prospect of breakeven within the IFR period; and debt grows to nearly £4.8 billion over the same period. These figures are necessarily broad brush, but they do demonstrate that British Coal will not be in a position to service its debt, let alone repay it. Even using to the full our ability to soften the terms of the loans it is by no means certain that British Coal would be in a position to repay the loans within the foreseeable future. Against this background I would find it difficult on propriety grounds to advance any further loans to British Coal

I therefore believe it is essential to reconstruct British Coal's balance sheet now rather than leave it until a Coal Privatisation Bill after the next General Election. Apart from the propriety problems mentioned above, I see distinct advantages in a reconstruction now. It should allow us to set new objectives for British Coal which should give a positive motivation for management, and to insist on changes to the accounting arrangements for asset valuation and proceeds which presently tend to obscure the profitability of British Coal's various coalfields. The reconstruction will of course need to be accompanied by firm commitments to reduce exposure to loss-making business if we are to demonstrate a proper basis for further lending.

Bob Haslam believes that any reconstruction must, as a minimum, extinguish the accumulated losses at March 1990. I agree with this. My preference is to extinguish this deficiency by means of a single grant rather than by means of a debt write-off. The deficiency grant route allows us greater flexibility as to the phasing of the payments. The concessionary coal and hearing loss components of the March 1990 deficiency, amounting to perhaps £1.5 billion, represent provisions for claims which will not be paid out for several years; and we may wish to phase our grant payments to British Coal in respect of these costs to match British Coal's own disbursements. Moreover a single debt write-off of perhaps £2.5-£3.0 billion would reduce the Corporation's capitalisation to well below the £2 billion minimum valuation which outside commentators have put on the business. It will not be clear until quite a late stage precisely how much of British Coal's debt it will be appropriate to back out immediately, and it therefore seems to me sensible to opt for an approach which provides for flexibility in this area.

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As Cecil Parkinson indicated in his paper, British Coal believe that such a rapid contraction in manpower can only be achieved by moving to compulsory redundancies and abolishing the IRB procedure. We shall need to explore this further. But in any event I am clear that it is not realistic to expect British Coal to bear the consequential redundancy costs without a continuing Government contribution. The Coal Industry Act 1987 allowed payment of restructuring grant up to £750m over the period to March 1992. This sum is likely to be fully committed during the course of the current financial year. We shall accordingly need to increase the ceiling substantially, perhaps ultimately to double its present level, although I am not yet in a position to offer a precise figure; and it would be prudent to extend by one year, to March 1993, the period over which our restructuring support will be available (so that it corresponds with the three year period over which the generators are expected to wind down their purchases).

On the basis that British Coal's debts are reduced by, say, £1.7 billion at March 1990, and that restructuring grant of say £350m is paid to the Corporation over the subsequent three years, I believe that there would be a reasonable basis for continuing Government lending. Our broad-brush projections suggest that British Coal should broadly breakeven and achieve self-financing after grant in 1990-91.

It will of course be important to ensure that the financing strategy is robust against further unforeseen deterioration in British Coal's prospects. For that reason, an increasing proportion of the Corporation's remaining debt should continue to be in the form of Voted Loans capable of bearing soft interest rates. The 1980 Coal Industry Act provisions governing the arrangements for revolving Voted Loans are at present rather cumbersome, I therefore also propose to take the opportunity to streamline these procedures.

My officials will of course be happy to explain more fully to yours the assumptions which underlie these projections. There will of course need to be further discussions both with British Coal and with the ECSC before we can finalise the shape of the legislation. But it would be helpful to know that you are content for me to proceed along the lines I have described.

These proposals have, of course, been discussed with British Coal. I regret that the Corporation took it upon themselves to reveal some of the details in the course of the press conference

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on their 1988-1989 Report and Accounts on 26 July. They were fully aware that the proposals had not yet been put to you and that your consent was required before any legislation could be brought forward. I have made my unhappiness at this turn of events very clear to British Coal and I must apologise for their behaviour which I hope will not detract from the merits of my proposals.

John Wakeham

John

JOHN WAKEHAM

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