



Prime Minister

## FUTURE STRATEGY OF THE BRITISH COAL CORPORATION

I have recently reviewed with the Corporation their future strategy following the negotiation of the present 3-year coal contracts with the Generators. Considering their Strategy Review has stimulated my own thinking on the longer-term future of the industry. The implications of the Review and my proposed response to the questions raised are set out in more detail in the attached note.

The key points appear to me to be as follows:-

- a significant further reduction in the Corporation's capacity in around 1993 appears to be inevitable and we should encourage the Corporation to continue to adjust to the needs of the marketplace;
- increasing environmental pressures will continue to limit the future prospects for the industry and, in particular, any move to require the Electricity Supply Industry to meet significantly more than their proportionate share of the agreed reduction in CO<sub>2</sub> emissions, eg to counteract growth in transport emissions, would sound the death knell of the coal industry;
- at least some in the Corporation realise that the future level of their business will depend on their ability to meet the needs of a much more complex marketplace than in the past. They need to develop new skills to deal with this and the appointment of a new Chairman to succeed Sir Robert Haslam and a further strengthening of the Board will be critical factors in this.



However all is not total gloom for the industry. The key factors will be the volume and price of sales to the Generators beyond 31 March 1993. I believe that it ought to be possible in due course to negotiate new contracts for a substantial volume effectively extending the present 3-year period to 8 years in all covering the full franchise period applying to the ESI. The way to achieve this will be for the Corporation to negotiate directly with the Regional Electricity Companies to persuade them to continue their present option contracts with the Generators for electricity covering the bulk of the domestic market. The Generators should then be prepared to extend their contracts with their markets effectively guaranteed. If the Corporation can continue to improve its productivity and prove that it is a reliable supplier there must be the prospect of extending such contracts on a rolling basis thereafter.

However, the time is not yet ripe for such a negotiation as both the Regional Electricity Companies and Generators are naturally focusing their energies on their own flotations. The new Chairman of the Corporation must therefore work hard to seek to put the industry in the best position to negotiate for the future in around 1992.

You will see that we do not need to take any final decisions on these matters now, but rather to note the potential implications. I should be grateful to know whether you are content with the line I propose to take with the Corporation. I am copying this minute to the Chancellor and to Sir Robin Butler.

Secretary of State for Energy

13 July 1990



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## FUTURE STRATEGY OF THE BRITISH COAL CORPORATION

1 Following the negotiation of the 3-year coal contracts with the Generators I asked the Corporation to undertake a fundamental review of their future strategy. I recently had a presentation from them of the results of their work and officials from my Department and the Treasury have held a series of further meetings to discuss the more detailed implications of the review. This has been a useful exercise and I now need to give the Corporation guidance on some of the key issues identified by this work. Before doing so I would wish to ensure that both you and the Chancellor are content with my proposed course of action and this minute attempts to set out the relevant considerations.

2 The key issue facing the Corporation is the volume and price of future sales to the electricity supply industry in England and Wales following the end of the present contracts. You will recall that we agreed last year that British Coal should enter into contracts with National Power and PowerGen for aggregated supplies of 70mt, 70mt and 65mt over the three financial years to 31 March 1993. As well as being degressive in volume these contracts also provide for a continuous reduction in real terms in the proceeds received by the application of an inflation factor of RPI - 6%, RPI - 5.5% and RPI - 5% over the period. The present average price under the contracts in 1990-91 prices is £1.72/GJ and this is expected to fall over the period to a price of £1.56/GJ in 1992-93 in the same terms. There is no agreement covering the period beyond 31 March 1993 and serious negotiations are unlikely to start much before the summer of 1992 ie well after the Generators have been privatised.

3 The Generators' negotiating position at that time will depend on a number of factors among which are:-

- The availability and price of imported coal in sterling (this is affected both by changes in the world coal price



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which is denominated in dollars and by the level of the \$/£ exchange rate).

- The comparative price of competing fuels eg oil and gas.
- Their desire to achieve a diversity of fuel sources including in particular their need to import certain levels of low sulphur coal to meet the sulphur dioxide emission levels set under the Large Combustion Plant Directive.

While these factors will impact both on the volume that the Generators are prepared to take and the price that they are prepared to pay, the length of the future contracts will also be of significant importance to the Corporation. The Corporation are concerned that the Generators themselves, without an obligation to supply, will have no incentive to agree to a long-term contract. However, without a reasonably long-term contract the prospects for privatising British Coal may be extremely limited. At best the Corporation conclude that if the Regional Electricity Companies see continuing advantage in price stability for the domestic franchise market and are prepared to enter into back-to-back option contracts then the Generators might be prepared to contemplate contracts running for five years beyond 31 March 1993 ie until the end of the present franchise arrangements.

4 You will recall from the work undertaken by my predecessor last summer that we had always contemplated that the volume of sales to the Generators would fall to no more than 60mt by 1994-95. The Corporation's view is that a more significant drop in volume is inevitable assuming no significant change in the present external variables. They believe that at best sales of only around 50mt are likely to be achieved to the Generators by the mid-1990s. They have considered carefully the impact that this would have on the Corporation's profitability and have undertaken sensitivities reflecting the impact of different exchange rate assumptions. Three illustrative cases examined are



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set out in the Annex and reflect the effect on the Corporation of a \$/£ exchange rate of 1.80, 1.60 and 1.40 respectively. The Annex sets out the overall surplus or deficit on the Corporation's bottomline for the next six years in the three scenarios examined.

5 In each case the Corporation's best judgement has been taken of the volume and price that would be achievable beyond year 3 of the present contracts. Case 1 examines the impact of a long-term exchange rate of \$1.80/£1 with sales to the Generators falling to 40mt in 1993-94 and the price falling from the year 3 price of £1.56/GJ to £1.40/GJ in 1990-91 prices at the same time and then rising in line with RPI thereafter. The figures show that this scenario does not yield a profitable outcome for the Corporation beyond 1992-93 even assuming a reduction in deep-mined capacity to 35mtpa and thus a significant closure of remaining high cost collieries. Case 2 illustrates an exchange rate of \$1.60/£1 with the price falling at RPI - 2% for two years to £1.50/GJ in 1994-95 and rising in line with RPI thereafter. Given the uncertainties, the figures show an industry that is just about profitable over the period, but significant losses are made in 1993-94 the year when the assumed necessary capacity reduction takes place and to a lesser extent in 1994-95. This scenario equates to continuing sales to the Generators of some 50mtpa. Case 3 illustrates the benefits to the Corporation of a weaker exchange rate of \$1.40/£1 with sales to the Generators and deep-mined production staying at 50mtpa and with the price rising to £1.60/GJ in 1993-94 and rising in line with RPI thereafter. This leaves the Corporation with healthy overall profits throughout the period and only a small projected loss in 1993-94.

6 The Corporation see little hope of future profitable sales lying above 50mtpa to the Generators. The implications of this are clear. A further significant closure round would be necessary as a result of the conclusion of the next set of contracts. As indicated earlier negotiations are unlikely to be concluded before the summer of 1992 and it is assumed that most



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of the cost of the subsequent closure round would fall into 1993-94.

7 We are of course in the middle of the closure round occasioned by the current contracts. So far this year four collieries have been closed, two others have been merged and a further five either agreed or identified for closure. The number of operating collieries at present is 70. By the end of 1992-93 currently expected future closures will have reduced this number to around 58 with an overall deep-mined capacity of some 62-63mt. To reduce the Corporation's deep-mined capacity to meet an ESI requirement of around 50mt will require a further 21 closures by the end of 1993-94. This level of closures would be needed for both Case 2 and Case 3. In the \$1.80/£1 scenario in Case 1 the reduction to 40mt sales to the Generators would call for the closure of 36 collieries by the end of 1994-95. Thus under any conceivable scenario we must look towards the closure of more than one-third of the Corporation's remaining capacity in or around 1993-94. The Corporation believe that such a closure round could not be handled in the necessary timescale utilising the existing review procedure, including the IRB, and that it would not be possible to retain a voluntary redundancy policy. This problem would be exaggerated in any larger closure round occasioned by any stronger exchange rate. Closures on the scale indicated would bear heavily on UDM collieries and could call in question the continued viability of the UDM as a separate union. We have examined with the Corporation whether, given this prospect, we could seek to reduce capacity in a more steady fashion rather than on a step basis as they have assumed. However, over the next three years the Corporation is constrained by the firm volume commitment in the coal contracts. They also believe that to be in the position of constantly reducing capacity would be very damaging to morale and believe that, just as in the current case, what is needed is a justification for the adjustment in capacity. This would, of course, be provided by the outcome of the negotiation with the Generators. They therefore see the best approach as being to move to adjust



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capacity immediately the new contracts have been negotiated. Depending on any phasing of the reduction in the Generators' actual take the closures could be spread over a longer period than the 12 months or so assumed (nearer 2 years in the low output case).

8 The Corporation recognise the political implications of the likely outcome of their future negotiations as well as the implications for their own privatisation. They are seeking guidance from us as to how best to plan for the future. In broad terms the Corporation propose to adopt the following interim policies:-

- *To recognise that pressure from the Generators is likely to lead to a need to cut deep-mined production to around 50mtpa by the mid-1990s and to seek to negotiate a price that will yield the prospect of a profitable industry throughout the next contract period.*
  
- *In the light of the above:-*
  - (i) to withdraw from low priced markets (unless these provide a profitable outlet for low cost coal eg which has no other available higher priced market);*
  
  - (ii) to continue the drive to increase productivity and reduce costs;*
  
  - (iii) to seek to maximise opencast output;*
  
  - (iv) to reduce capital expenditure, concentrating on operational capital rather than investment in new capacity;*
  
  - (v) to consider possible diversification abroad; and*
  
  - (vi) to promote clean coal technology.*



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9 In general terms, I endorse their basic approach. But we must start from the position that the Corporation's strategy must create a reasonable expectation of a sustained trading profit over time. It is not possible to be definitive now about the likely volume or price associated with the next set of contracts. The Corporation's assumption of a reduction in sales to a level of around 50mt appears to me to be of the right order although it could be on the high side. However, the volume and price achievable will be very dependent on the expected path of the sterling price of imported coal with the perceived longer-term level of the \$/£ exchange rate being a major factor.

10 We do not have to reach decisions now about how to handle the likely closure implications. What we do need to do, however, is to recognise the size of the further reduction in capacity that is likely to be necessary and to form at least a preliminary view as to its political acceptability. The Corporation are hoping to achieve breakeven in the current financial year and to continue to be profitable in the next two years on the basis of the current contracts. The financial reconstruction that we are presently completing has been a significant factor in this respect by materially reducing their outstanding borrowings and thus their continuing interest burden. In the course of obtaining Commission approval for the financial reconstruction we have committed ourselves to offer no new state aids to cover future operating losses until the expiry of the present state aids Directive at the end of December 1993. Thus over the next few years we are strictly limited in what further financial assistance we can offer to the industry.

11 I can see no future for this industry unless it can run its operations on a profitable basis. I therefore believe that we should tell the Corporation that we expect it to continue to adjust its capacity to meet the needs of the marketplace to the extent necessary to maintain overall profitability. In so doing we should be prepared to continue to offer generous support for the restructuring of their operations and I believe that we



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should plan on the basis of at least maintaining our restructuring grant support at the level of 90% of such costs as is the case for 1990-91 and be prepared to introduce the necessary legislation to extend the coverage beyond the end of March 1993 in due course. Clearly the future negotiations with the Generators are vital to the Corporation's future and we will need to oversee carefully at that time both the approach and negotiating tactics of the Corporation as well as the actual outcome to ensure that this provides the basis for continued overall profitability throughout the term of the contracts. The extent of the capacity rundown required will only be able to be judged at that time. We must recognise however that, while we will be able to oversee the Corporation's actions, the Generators will be beyond our influence.

12 While the future profitability of the industry is clearly dependent on the volumes and prices achieved in these negotiations and a significant drop in capacity seems inevitable I do not believe that it would be right to pre-judge the issue and seek to reduce capacity significantly further now in anticipation of this. Not least because it is always possible that changing external factors eg a sudden rise in the price of oil could dramatically change the future outlook for the industry. The Corporation's room for manoeuvre is limited in any event by the volume commitments in the present contracts and I believe that it would give precisely the wrong signals to the Generators if they were deliberately to fall short and thus indicate that they were not a reliable supplier.

13 However, I do expect the Corporation to be alert to the need to put themselves in the best possible negotiating position to face the Generators by eliminating some of the present cross subsidies within the industry. This will require a determined effort to withdraw from low priced export, industrial and coking coal markets to the greatest practicable extent where there is no prospect of at least matching the proceeds likely to be available from the ESI in the mid-1990s. In addition, possibilities may



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arise over the next couple of years to trim capacity below the level planned on an opportunistic basis and I would expect the Corporation to take advantage of these and to seek to meet any production shortfall by buying in coal eg from the private sector. This may require a more trading-orientated approach at the margin in future.

14 Equally we do not need to pre-judge now the position that we might take on the appropriate method of handling a further significant closure round in 1993. Following our recent discussions the Corporation are presently adopting our preferred approach for the present round and, so far, this is proceeding more smoothly than they anticipated. Assuming that this continues to be the case I am not convinced that any dramatic change in our present approach will be necessary to secure the reduction in capacity needed. I accept that the maintenance of a voluntary redundancy policy may become increasingly difficult but, until we actually have the evidence of how difficult the present round will prove to be in practice, I am not persuaded that, with suitably generous redundancy terms, the present approach, including the possibility of reference to the IRB, could not be successfully maintained in 1993 if we felt that to be appropriate at the time. We must recognise, however, that, as has been the case with the present closure round, such a decision would have adverse financial consequences for the Corporation which may call for some recompense from Government eg a possible further increase in the level of restructuring grant. We would also need to consider at the time what could be done, and at what cost, to soften the blow to the UDM.

15 I fully support the Corporation's approach in terms of the need to continue to increase productivity, to maintain pressure on cost reduction and to maximise low cost opencast production. I believe their assumptions in these areas may prove to be conservative and we need to keep up the pressure on them. I also attach importance to their seeking to achieve self-financing and a reduction in borrowing over the next three years to put them in



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the strongest financial position to face the difficulties to come. As part of our overall response to their strategic review, my intention would be to agree with the Treasury appropriate targets for the Corporation to achieve over the next three years.

16 The Corporation also argue that a logical business approach for an industry in their position, given the likely continuing decline in both volume and proceeds in their core business in the UK, would be to seek to utilise the Corporation's expertise in longwall coal mining and international marketing to diversify into overseas activities of coal production and trading. They believe in particular that the possibility of "hands on" experience in overseas projects would offer some motivation to their management who otherwise see nothing to look forward to other than the continuing decline of both their prospects and their profession in the UK. I accept that maintaining the morale of the management will be a critical factor in achieving a profitable industry in the future. However, British Coal's overseas investment record to date has not been impressive (they have a small stake in a presently loss-making operation at German Creek in Australia) and I do not anticipate that any significant increase in exposure in this area is likely to be justified. Not least because this would not sit easily with maintaining our options for privatisation. Nevertheless, I believe we should keep an open mind in this area and be prepared to consider with the Corporation any proposal that they may wish to put forward. In doing so we would need to weigh carefully the perceived benefits to management motivation against the likely industrial relations difficulties in terms of being seen to invest abroad while further closing down UK capacity.

17 On the question of clean coal technology, the privatisation of the Generators and the increasing financial pressure on the Corporation means that it is now appropriate to consider the balance of funding between Government and industry for future R&D. My Department will be reviewing this area in detail over the next 12 months with British Coal and others with a view to



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producing an agreed future R&D strategy for clean coal technology. I hope that, once any necessary public expenditure implications have been cleared with the Treasury, my Department will be able to publish this strategy during next summer.

### Privatisation

18 Overall the longer-term prospects for the industry are bleak. In the present circumstances there is unlikely to be any justification for significant investment in new mines. This, taken together with the likely necessity of a further significant reduction in capacity in around 1993 and the anticipated further reduction in capacity resulting from natural exhaustions by around the turn of the century implies a continuous decrease in the productive capacity of the industry. Coupled with the increasing environmental constraints both on SO<sub>2</sub> and CO<sub>2</sub> emissions which will restrict future markets for British coal this does not offer an encouraging prospectus for the sale of the industry. The prospects for the sale of the industry could become impossible if the ESI was required to meet significantly more than their proportionate share of the agreed reduction in CO<sub>2</sub> emissions eg to counteract growth in transport emissions.

19 We are, however, committed to privatising the industry after the next general election and work is proceeding to that end. As you know, we are operating under the constraint that there should be no public discussion of the method of privatisation or of the proposed future structure of the industry. Nevertheless, I have asked my officials to give me a presentation in the autumn of how we now see the options in the light of the above. We are also working with British Coal to identify how best to deal with the "technical" issues involved, eg vesting the ownership of the coal in the Crown, the future licensing regime and the responsibility for historic liabilities including subsidence and abandoned workings etc, so that we will be in a position to move forward swiftly after the next election.



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Conclusions

20 I believe that the Corporation's strategy review has taken us a significant step forward and represents the most realistic appreciation of the difficulties facing the industry and the likely necessary response that we can expect from the present management. While a significant further reduction in capacity appears likely to be necessary this does not need to take place until after the next election and, if handled carefully, should not put any insuperable barriers in the path towards the privatisation of the industry. I see the review as the start of a continuing process rather than as an end in itself. I am keen to find a successor to Sir Robert Haslam of stature and one of his first tasks would be to revitalise the Board and to bring a fresh mind to these considerations focusing on putting the industry in a position from which it can be successfully privatised. I therefore intend to ask him to update the strategy review and I would then wish to review the position thereafter on an annual basis.

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Annex

Case	Exchange Rate \$/£1 at 1990-91 prices	Deep-mined Production 1994-95 mt	Additional Colliery Closures	ESI Price £/GJ at 1990-91 prices
1	1.80	35	36	1.40 year 4
2	1.60	50	21	1.50 year 5
3	1.40	50	21	1.60 year 4

**TRADING PROFIT/(LOSS) AT OUTTURN PRICES - AFTER INTEREST BUT BEFORE NET COSTS OF RESTRUCTURING**

Case	<u>£m</u>					
	90-91*	91-92	92-93	93-94	94-95	95-96
1	96	64	(8)	(291)	(143)	(125)
2	96	75	33	(101)	(31)	19
3	96	90	55	33	183	276

**OVERALL SURPLUS/(DEFICIT) AT OUTTURN PRICES - AFTER RESTRUCTURING GRANTS AT 90%**

Case	<u>£m</u>					
	90-91*	91-92	92-93	93-94	94-95	95-96
1	80	33	(67)	(371)	(149)	(130)
2	80	44	7	(154)	(42)	14
3	80	59	29	(20)	172	271

\* budget figure

