

PRIME MINISTER

20 JULY 1990

COAL STRATEGY

The Energy paper is full of numbers but little true analysis of BCC's supply economics. There is also an implicit assumption, never stated, that ultimate privatisation ought to be as a single entity. The paper is also rightly concerned about the handling of future capacity reductions in the least controversial manner. With the present Board at BCC at internal loggerheads this is wise.

There is also much talk of poor morale in a declining industry. This will continue to be the case until we have a Chief Executive in place who knows where he is going and is determined to get there. This is the key appointment and he need not necessarily be the new Chairman. The latter will, of necessity, have to be drawn from the well worn list of establishment names and is therefore unlikely to be the ambitious strategist who will lead BCC to successful privatisation. Indeed, it is possible that John Wakeham is already thinking along these lines - a 'new broom', Chief Executive operating under a part-time Chairman.

THE COAL MARKET

British Coal currently produces about 90 million tons per annum (MTPA) of which 70 MTPA is sold to power stations. Other coal markets could be served from opencast alone with a small increase in production. Indeed, the current level of deep mined output in Britain has historically been determined by the coal requirements of power stations as other uses such as steamships

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and gasworks have declined. Although the overall dependence of power stations on locally produced coal is similar in many countries with indigenous coal reserves, our heavy reliance on deep mined coal would never have come about in a free market. It has arisen directly from the economic folly of having State owned coal feeding State owned generators.

In the United States 60 per cent of power station coal comes from opencast production with much of the remainder from shallow drift mines. This is a 700 MTPA market almost entirely served from domestic sources developed as a result of market economics not State diktat. Britain is unfortunately in a very different situation with a hard road ahead as the gross distortions in our coal supply arrangements are ironed out by market forces.

COST STRUCTURE OF SUPPLY

British coal has contracts with the generators only until April 1993. After that it is on its own, and commercial life will be tough. Present production of 90 MTPA breaks down as follows:

Opencast costing below 110p per GJ	15 MTPA
Cheap u/g costing below 120p per GJ	10 MTPA
(i) Cheap coal total (below 120p)	25 MTPA
(ii) Medium cost u/g (120-160p)	50 MTPA
(iii) High cost u/g (above 160p)	15 MTPA
	90 MTPA

The 25 MTPA of cheap coal (i) should have a secure market within the UK under almost any conditions. By contrast, much of the top cost 15 MTPA (iii) will soon be gone through pit closures, although many viable mines go through high cost phases. The extent to which imports will substitute the 50 MTPA of middle

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cost tonnage (ii) is dependent upon the dollar/sterling exchange rate. As a rule of thumb, \$1.8 to the £ will jeopardise this tonnage whereas at \$1.4 it is relatively secure.

The foregoing economic facts must form the foundation of any informed debate about how to privatise British Coal.

PRIVATISATION POSSIBILITIES

1. Single Entity

It will come as no surprise that management argues for privatisation as a single entity because otherwise the industry will be destroyed through having no bargaining power against the duopsony of the two generators.

This might be the best way to maximise proceeds and future employment in the industry, but such single entity privatisation would be fiercely attacked by business economists such as Allen Sykes or Colin Marshall. They would argue that Government were repeating the mistakes of British Gas, because coal is not a natural monopoly and that at minimum a regional split of companies should be made.

2. Regional Companies

Regional splitting could provide between three and six entities producing, say, ten to fifteen MPTA where the less profitable deep-mined coal and the highly profitable opencast would be combined. There would be one for South Wales (whose natural client would be National Power), one in Nottinghamshire (UDM), one or two in Yorkshire, and one in Scotland.

A variant would be to package some of the pits according to

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which generator would be interested on the assumption that there would be some trade sales. It would however be important to sell some of the coal capacity outside the generators in order not to reinforce their electricity duopoly.

3. Individual Pits

The simplest privatisation, conceptually, would be to sell off individual pits of which there are currently 70 which will fall to below 50 by 1993. Although this might be the purist way, it would be extremely difficult to achieve. First, management and unions would be united in opposition. Secondly, it would generate the lowest proceeds. Thirdly, it would guarantee the minimum future domestic capacity plus maximum imports, because individual pits would have little or no bargaining power against the generators. Furthermore, fifty prospectuses would have to be produced at once!

4. Separate Sale of Opencast

Another proposal often toted outside the industry is to sell opencast separately. This is a difficult course because of the dual position of the State as owner of both the reserves and high margin mining profits after the contractor's share has been paid. Opencast operations produce cash profits of £300 million per annum to BCC because the system pares the contractor's profit to a minimum while leaving enormous monopoly profit with the State.

The individual opencast mines themselves are merely low reserve leases with only a few years future operation. There would be little prospect of renewing them at the same level of profitability, once current operations were sold.

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Therefore, the private sector would not pay any substantial premium for very limited periods of albeit secure cash flow.

However, if the opencast operations were blended with less profitable underground mines, then the early years' cash flow from opencast would keep the whole entity commercially viable. This would buy time for adjustments to be made to underground operations in order to ensure longer term viability.

5. Separation of Future Reserves from Current Operations

Whichever method of privatisation is chosen, and John Wakeham will receive a full presentation in the Autumn, legislation must be enacted in order to separate ownership of future reserves from the operating entities being privatised. This is true for both underground and opencast. Future resources must be vested in either the State or freehold landowners so that privatised operations, including the successors to BCC, will have access to new coal leases on the basis of royalty payments. At the moment, present and future national coal reserves are vested in BCC (with some trivial historical exemptions, like the Forest of Dean).

CONCLUSIONS

BCC should continue to reduce capacity in line with present contracts without initiating a draconian closure programme based upon current views of the post-1993 market. However, this will probably have to take place after the follow-on contracts are negotiated in 1993. With such a timetable we could aim for the completed privatisation of a slimmed down industry by 1995.

The warnings against mincing up BCC very finely for privatisation should be heeded. We should nevertheless aim at more than three

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entities (but probably less than six), probably delineated on a regional basis. Management should be encouraged to get on with internal restructuring along such lines, possibly including the integration of opencast activities within regions.

The logic of trade sales versus flotation versus MBOs could then be addressed when it is clearer what the individual entities for sale would be.

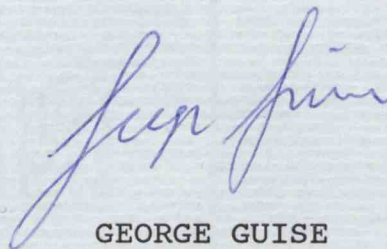
This note has not mentioned sulphur and other environmental difficulties facing the coal industry. These simply compound the arguments about the future viability of the Corporation.

RECOMMENDATIONS

1. In setting a future strategy for BCC, the commitment to privatise it after the next election must be the key objective.
2. It is now prudent to initiate work on more detailed privatisation proposals. A presentation before the end of the year should be encouraged.
3. The Treasury is rightly more pessimistic about BCC's outlook than the Wakeham paper. It will argue that sales of 50 MTPA to the generators is very much an upper limit and that all future sales commitments should be profit driven not volume driven. It therefore follows that BCC should withdraw from unprofitable markets as soon as possible.
4. John Wakeham is right to be negative about BCC's proposals for diversification overseas. While it is a nationalised industry, with a fractious management, this is a pointless diversion of effort.

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5. The general directives which John Wakeham seeks to give BCC should be supported. An unrelenting drive towards higher productivity and thus overall profitability is essential if we are to privatise this industry before the mid 90s.
6. Nothing is more important than getting the new top management structure right. If John Wakeham shows a proclivity to separate the posts of part-time Chairman and a humdinger Chief Executive, he should be strongly supported. This may be exactly the way to avoid the old mistakes.



GEORGE GUISE

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