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PRIME MINISTER

19th October 1990

COAL STRATEGY

In July, the Energy Department sent us a paper with many numbers but with little true analysis of BCC's supply economics. There was also an implicit assumption, never stated, that ultimate privatisation could be as a single entity. The paper also discussed the handling of future capacity reductions in the least controversial manner. For Tuesday's meeting this paper has been rewritten in shorter form as an annotated agenda, which can be used to structure the discussion.

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 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.

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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 <u>110p per GJ</u>	15 MTPA
Cheap u/g costing below 120p per GJ	10 MTPA
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(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
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	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 cost tonnage (ii) is dependent upon the

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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. A key matter is therefore whether the present exchange rate of nearly \$2 will persist.

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

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two in Yorkshire, and one in Scotland.

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

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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.

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. Roy Lynk has also made this point (Annex A).

5. Separation of Future Reserves from Current Operations

Whichever method of privatisation is chosen, and John Wakeham is to receive a full presentation soon, 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).

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MANAGEMENT

There is talk everywhere of poor morale in a declining industry and this will continue until we have a Chairman in place who knows where he is going and how to get there. This key appointment should not be drawn from the well-worn list of establishment names. We need an ambitious strategist who will lead BCC to successful privatisation while negotiating the many people difficulties en route. I recently spoke with Roy Lynk of the UDM who emphasised the importance of new leadership at BCC which will be prepared to speak up for the industry (see Annex A).

John Wakeham is currently seeking a 'new broom' Chairman who will provide the strategic thinking on privatisation while leaving operating responsibility with John Northard, the Senior Mining Engineer at BCC and currently Deputy Chairman. He is in his '60s and production rather than marketing or finance orientated. He will instinctively push for high rather than profitable volume and displays an obsessive interest in the daily details of individual pit operations. I understand him to be vehemently opposed to private sector coal, including management buy-outs of the existing pits. Both Roy Lynk and Malcom Edwards, the monopolistic but crafty marketing director, are both strongly opposed to the handing of full operating control to Northard (see Annex B - a private and unsigned note to me from Malcom Edwards).

The new Chairman must push ahead work on regional zoning of the business so that profitable and unprofitable areas become clearly identified. There should be minimum cross-subsidisation from one activity to another at headquarter level. The blending of open-cast profits with underground, within a particular region, is a separate issue which must be

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addressed when examining the optimum route to privatisation. This was addressed earlier.

Above all the new Chairman must speak up for the industry and not simply lie low in the hope that the carbon and sulphur questions will resolve themselves. Haslam displays a strong tendency to this and it is generating contempt from management and the workforce. Other leading figures in the coal industry are trying to form a positive case for fossil fuels. As an example, I attach a letter from the Chief Executive of the World Coal Institute who recently sent me the video tape of 'The Greenhouse Conspiracy'. His argument is that the UK has an enormous competitive advantage because of its fossil fuel position and we must not allow the French and others to finesse it. (Annex C).

The management challenge is to find a way of keeping both Northard and Edwards. One way would be to divide responsibilities along American lines. Northard would be 'Chief Operating Officer' with complete responsibility for production. Edwards would be 'Chief Financial Officer' will full financial and marketing powers. Each would be co-equal and report to the new Executive Chairman. This will not make the latter's task easy. BCC needs a truly committed, every day in the office, Chairman and not a ceremonial figure. To attempt to privatise BCC with a Chief Executive like Northard, totally opposed to privatisation, and anything less at the very top would be a gift to Her Majesty's Opposition!

### 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,

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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 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.

The Department seem very confident that Scargill is a busted flush. We must be quite sure that this is not pious hope based only on his current predicament. Even if the assertion is true, and Scargill's authority within the NUM has been eroded, it does not automatically follow that he will lose his lifetime Presidency. It is certainly not clear to me whether it would be better to have a lame-duck leadership in the NUM or a Scargill replacement of greater credibility who might galvanise the militants.

**RECOMMENDATIONS**

1. In setting a future strategy for BCC, the commitment to privatise it after the next election must be the key objective. It is now prudent to initiate work on more detailed privatisation proposals. A presentation before the end of the year should be encouraged.
2. The electricity supply industry must not be expected to

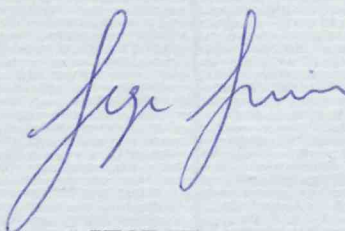
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carry more than its proportionate share of CO<sub>2</sub> reductions. If we are to give our coal industry a reasonable chance of successful privatisation, it must not be hamstrung by also sharing Transport's burden.

3. The Treasury is more pessimistic about BCC's outlook than the Energy Department particularly in view of the weak dollar. Long term sales levels of 50 MTPA to the generators should be thought of as an upper limit and future sales commitments should be profit not volume driven. It therefore follows that BCC should withdraw from unprofitable markets as soon as possible.
4. Is it sensible for British Coal to plan forward on an exchange rate range with an upper limit of only \$1.80? Even if the Treasury still considers this range adequate, we must know how vulnerable coal is above this figure.
5. 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.
6. The general <sup>directives</sup> ~~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.

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7. Nothing is more important than getting the new top management structure right. This was addressed in the previous section.



**GEORGE GUISE**

**ANNEX A - Note of Meeting with Roy Lynk**

**ANNEX B - Note from Malcolm Edwards**

**ANNEX C - Letter from Richard Tallboys, Chief Executive of  
the World Coal Institute**

## PERSONAL AND CONFIDENTIAL

FILE NOTE

8th October 1990

cc Roger Heathcote

MEETING WITH ROY LYNK ON OCTOBER 4

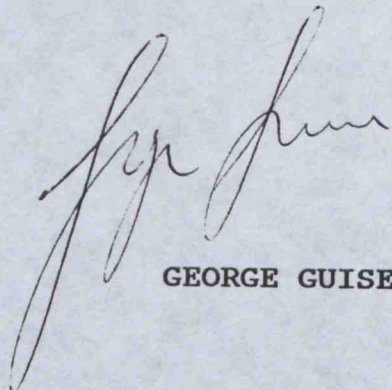
John Harris, Chairman of East Midlands Electricity, invited me to his house for drinks last Thursday to meet Roy Lynk of the UDM. The meeting was off the record, friendly and Lynk made the following points:

1. The workforce is disappointed at British Coal's negative attitude to the industry. The men are demoralised, not so much by the pit closure programme but the universal portrayal of coal as a dirty, highly polluting and antiquated source of energy. British Coal should take a positive initiative especially in view of the Middle East crisis. He suggested an advertising campaign extolling the virtues of coal as a positive national resource which does not suffer the price volatility of oil. He had also seen the recent Equinox television programme which re-examines the greenhouse warming evidence in a sceptical light. He thinks BC should be exploiting such positive signs.
2. He is worried that the arrangements following the departure of Bob Haslam will leave John Northard effectively in charge of the industry. He sees Northard as yesterday's man, with an obsessive interest in the detail of individual colliery performance but without longer term ideas for the industry. He was positive about Malcolm Edwards but fears that we shall lose him if Northard becomes Chief Executive. The new Chairman must have a commitment to coal and speak up for the industry.
3. He is positive about open cast production and strongly criticised a delegate at the Labour Party Conference who called for it to be shut down. He sees low-cost open cast as an essential mixer to maintain overall industry profitability through cross subsidisation of deep mined.

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4. He is saddened by the departure of young men from the industry. As soon as there is any suggestion that a colliery might close, miners take their money and run (I resisted the temptation to ask him whether he thought that the Government was being over generous!).
5. He mentioned Bilthorpe arguing that the Government should spend £40 million of R & D money for the development of fluidised bed combustion in combination with 'gas topping'. He was supported by John Harris. I said that this sounded like near market development which should be financed by industry rather than the taxpayer because it was not basic research. Neither disagreed with this but they are both still anticipating some generous support from British Coal!
6. He complained that British Coal would not help him to recruit members from the NUM. In some instances UDM pamphleteers were being dismissed by British Coal for trying to recruit in the NUM heartlands. He also claimed that BC did not respond positively to industrial proposals initiated by the UDM and hid behind legal points that they cannot deal differently with one union from another. He did not go into detail but his general gripe is that British Coal are too sympathetic to the NUM and will not assist his Union to undermine it.

For my part, I explained how our Policy Unit works as an independent source of advice to the Prime Minister in parallel with Whitehall Department. I thanked him for his insight into current issues but emphasised that British Coal and the Department of Energy were the correct channels for him to argue specific issues. He promised that he would respect this.



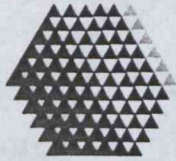
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JHN is the senior mining engineer in the industry. He has provided valuable service to both Macgregor and Haslam in the rationalisation of the industry but his achievement relates to the past. He has been good at solving an important but narrow range of problems. The techniques for solving these are now well established. He has no idea how to tackle the problems which face the industry now.

Some of his drawbacks which are already obvious are:

1. He has a narrow traditional mining background made worse by a vast grasp of detail.
2. He has no ability to think in strategic terms.
3. He is a poor manager of top staff - everyone is treated like the undermanager reporting on the morning's face performance.
4. He has had virtually no experience of the world outside coal production. He has zero knowledge of the commercial coal business. He played no part in the negotiation of the coal contracts.
5. He was the main protagonist of the proposal to set aside the Independent Review Body and announce a list of some 20 pit closures all at once. This he helped argue through the DEN for it to be finally rejected by the PM.
6. He is vehemently anti private sector coal. He strongly opposes cooperation through BCC buying in private coal or through leasing of mines which BCC wishes to close and will so engineer any offer of the latter to ensure rejection.
8. His appointment would be regarded by Lynk as " a real step backwards". He has an old fashioned management dislike of the men getting above themselves and that includes any kind of UDM backed buyout scheme.
9. He is an unimaginative negotiator and this is particularly true when dealing with Ministers and the DEN.
- 10 He would fight hard to retain the present finance director and would not make the best and obvious choice for head of marketing.

JHN's appointment would reinforce all BCC's traditional weakness of excessive introversion and lack of response to change in the outside world at just the time when radical change in the attitude of the industry is unavoidable and needs to be managed effectively by the top team at BCC.



ANNEX C

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10th September 1990

Mr G Guise  
Policy Unit  
No. 10 Downing Street  
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*Dear Guise*

I thought you might be interested to glance at the last two pages of the enclosed article. It is articles such as this, together with much other material written by scientists and which now seems to be coming more to attention, that creates scepticism on the part of many regarding the whole global warming scenario.

I find equally interesting the enthusiasm on the part of mainland Europeans in the Community to do all they can to discount the natural advantage that the United Kingdom has with its substantial resources of fossil fuels. It is easy to see why the French and certain others would be very happy to make it difficult for the United Kingdom to make maximum use of its fuel reserves when, apart from french nuclear interests, other countries have to import the greater part of their energy, much of it natural gas. I do hope that the European community talk of large carbon taxes is not going to simply become a way of reducing Britain's natural advantage over our continental partners. There does seem to be a trend towards giving the newly industrialising countries an opportunity through cheaper energy, from COAL, as well as through cheaper labour.

I do hope that the BBC Channel 4 programme "The Greenhouse Conspiracy" has been widely seen at Downing Street!

*Regards*  
*Richard*

Richard G Tallboys  
Chief Executive