

PRIME MINISTER

COAL PRIVATISATION

*at flap*

Further to my minute of 27 September I now attach a copy of the revised and expanded version of Rothschilds' interim report on coal privatisation. This is a very thorough piece of work. It covers all the main issues outlined in our initial work programme, and focuses in particular on those areas where early action is needed.

At the heart of the report is the detailed economic analysis and modelling work undertaken over the last four months. This work has produced a range of base case assumptions on the projected size of the UK coal market and the share of this that British Coal are likely to secure once their current contracts with the generators expire in March 1993.

The report points to a rapid reduction in the electricity supply industry's demand for coal from 1993 onwards, caused by a dramatic increase in generation from new combined cycle gas turbine plant, increased use of heavy fuel oil, and increased competition from imported coal. This has major implications for the size of industry that we will be able to privatise. It is however important to recognise that it is market forces, and in particular the competitive nature of the electricity market with all the benefits this brings to electricity consumers, which is driving these changes. British Coal will have to respond to these market developments regardless of whether or not they are privatised.

The report predicts that the coal requirements for electricity generation will fall from around 65mt in 1992/3 to nearer 50mt by 2000. British Coal's ability to secure a reasonable share of this market will depend on their ability to cut costs and compete effectively with imports. Even if they achieve the fairly substantial cost reductions outlined in their 1991 Strategy Review then their sales to the generators are likely to decline

from the current level of 65mt to around 30-35mt by the mid 90s. A further 10% reduction in unit costs beyond the Strategy Review figures could increase the likely level of supply to the generators to nearer 40-45mt, with total sales by British Coal (including non-electricity markets) of around 50-55mt a year. (Preliminary indications from our mining consultants are that cost reductions of this magnitude whilst difficult to achieve are feasible). In both cases however there would be a very substantial contraction in the industry with the number of deep mines falling from the current level of 61 to a sustainable level of around 22 deep mines on the most favourable cost assumptions, or about 14 deep mines if they are not able to achieve the 10% extra unit cost reduction mentioned above. British Coal therefore face a further major closure programme as well as needing to increase significantly the productivity of their continuing pits.

The future size of the industry is not just dependent on British Coal's ability to cut costs, but also on the outcome of their negotiations for new contracts with the generators. There is no guarantee that the generators will agree to contract for as much British Coal capacity as appears economic under Rothschilds' modelling work. Rothschilds advise that the high fixed costs of deep mines and the consequent inability when exposed to the commercial pressures of the private sector to cope with short term fluctuations in demand means that medium-term contracts are also necessary if we are to achieve our objective of securing the largest economically viable UK coal industry in the long term. They are also essential if we are to secure a proper value for the business(es) when we come to privatisation. Achieving such contracts will not be easy and will require a constructive approach from National Power and PowerGen and the Regional Electricity Companies, and the approval of OFFER and the European Commission. Early progress is needed. Rothschilds believe British Coal will need to open up negotiations with the generators before the end of the year. If they do not the danger is that the generators will pre-empt the outcome by contracting for larger volumes of imports and hastening the closure of



British Coal capacity that would otherwise have a viable future. Rothschilds propose that the Government should assist in facilitating the process. I am awaiting advice from Neil Clarke on this but, given the need for early action and the complex range of competing interests involved, we will need to think very carefully about the role the Government should take in the process.

As I indicated in my minute of 27 September, the limited size of the industry that we are likely to be privatising does narrow down the the number of viable structural options. Rothschilds have considered a wide range of options and their analysis points to a fair degree of potential choice in the way the industry might be sold, with the eventually preferred solution likely to be one that includes one, two or three main successor companies plus the sale of some opencast assets and a few individual deep mines. Work on valuation and financial structure, and on the many political and industrial relations questions thrown up by the different options is at an early stage. I believe that we will need to progress this further before we can settle on a preferred option which in any event we need not decide until after the election. On the basis of the analysis undertaken by Rothschilds I am, however, content that we should limit further work to the one, two or three main successor company options recommended in the report.

The report also touches on a wide range of other important matters on which work is progressing well including treatment of liabilities, regulatory and safety issues, and R&D. I propose to maintain progress in these areas with a view to incorporating recommendations in a further report at the end of December.

The main areas in the current report that we need to concentrate on immediately are the key transitional issues - the need for capacity reductions and cost cutting by British Coal, and the contract negotiations with the generators. It is clear that British Coal face a mammoth task if they are to be able to reduce and reshape their business for the market challenges of 1993/4

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and beyond. They have of course already made considerable progress in improving productivity, reducing costs and capacity. The acceleration of this process will however need careful management, particularly if we are to avoid a serious loss of morale within British Coal with all the damage that could do to performance and prospects.

Given the complex and sensitive issues raised I propose that the best way of handling the report would be to arrange a presentation by Rothschilds and my officials for you and a small number of colleagues as soon as possible. We can then consider the way forward on those issues which require immediate action, as well as on the privatisation work more generally.

Finally, in view of the extreme sensitivity of the attached document, I should be grateful if you and other recipients could ensure that no further copies are taken of the numbered documents circulated.

I am copying this minute to the Chancellor of the Exchequer and Sir Robin Butler.

A handwritten signature in blue ink, appearing to be 'John' with a stylized flourish.

SECRETARY OF STATE FOR ENERGY

3 October 1991

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*in attached plates*SUMMARY OF N M ROTHSCHILD SECOND INTERIM REPORT

1. Demand for coal in the UK is forecast to fall significantly, and British Coal will lose share to imports.

	<u>UK Total</u>	<u>m. tonnes Electricity Industry</u>	<u>British Coal</u>	<u>Number of Deep Mines</u>
1990-1	90	69	90	60
1994-5	65	56	45-55]	14-22
2000	60	50	40-50]	

2. New medium-term contracts with the electricity generators need to be in place by April 1993, and should be agreed by mid-1992.

3. Cost reduction and productivity improvement are the keys to achieving a large and economic coal industry. They are fundamental to a successful outcome to the contract negotiations, and hence to privatisation.

4. Privatisation of the industry is feasible, subject to satisfactory handling of liabilities. Decisions on how to structure the new industry need not be taken at this stage, but further work should be done on three preferred options:

- i) Unitary company, floated or trade sale;
- ii) Two national companies;
- iii) Two national companies, plus Scotland plc.

Employee participation could be built into any of the above options. Cash flow valuation analysis indicates a present value of the industry of up to £2 billion.

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5. Next steps include:-

- i) BC management to push ahead with cost reduction and productivity enhancement;
- ii) Commencement of coal contract negotiations;
- iii) Detailed work on privatisation options, treatment of liabilities and outline of required legislation and regulation.

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