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PRIME MINISTER

I attach a copy of Rothschilds' third interim report. The structure of the report is broadly along the lines of their second interim report copied to you under cover of my minute of 3 October, although the analysis is more sophisticated and detailed. In particular the report incorporates the advice from our US mining consultants, Boyds, on the scope for cost reductions and a more up-to-date assessment of the impact of developments in the electricity market on coal demand and price.

The report is more pessimistic than its predecessor. This is because the dollar has not strengthened as expected, coal prices have weakened, the amount of gas-fired generation is likely to be greater than envisaged last year and commitments to reducing carbon emissions through a carbon tax are becoming firmer, or are at least perceived to be so. Rothschilds now predict that, in the absence of carbon stabilisation, National Power and PowerGen's demand for coal will fall from 65mt in 1992-93 to 50-55mt in 1994/95 and 45-50mt by the year 2000. Total UK demand would be 10mtpa higher than this. These figures are 5mtpa lower than in the second interim report due to the extra gas-fired generation. If carbon stabilisation measures are phased in over the period 1995-2000, then total demand could be 10-20mtpa lower by the turn of the century.



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British Coal's sales will depend on production costs and the competitive position of imports. Boyds have concluded that 10% additional unit cost reductions are achievable over and above those foreseen in last year's British Coal Strategy Review. If 70% of the potential savings envisaged by Boyds are achieved by British Coal over the next 5 years then the Corporation's sales to the England and Wales generators could be in the range 30-35mtpa later in the decade, with possible sales of 10mtpa to other markets. With around 15mtpa being produced from British Coal opencast mines these market opportunities could be produced from 14-17 deep mines. If effective carbon stabilisation measures are introduced only 9-12 deep mines would be needed by the end of the decade. These figures are all on the assumption of a \$1.60 = £1 exchange rate. If the current rate of around \$1.80 = £1 were maintained then imports would increase and the deep-mined industry would be reduced to a handful of collieries.

Since our meeting on coal privatisation on 13 November I have considered carefully how best to take the process forward between now and the General Election. We agreed at our meeting that the Government should play a carefully defined facilitating role in the negotiation of medium term, market based, coal contracts with the generators. I remain of the view that such contracts are the best means of achieving our objective of securing the largest economically viable coal industry.

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To provide a sound basis for privatisation of British Coal, the Corporation need to secure contracts with the generators for not less than 35mtpa from April 1993 for 5 years (possible tapering thereafter) at a contract price of £1.45-1.50/GJ. This is not achievable without direct Government influence. Neil Clarke opened negotiations with the Generators before Christmas and is currently negotiating coal flows from groups of collieries to the power stations. He plans to table an opening price shortly. I propose to encourage National Power, PowerGen and British Coal actively to negotiate contracts along the above lines. I believe the key to securing British Coal's future in the medium term is to encourage the Regional Electricity Companies (RECS) to indicate to the generators that, in the interests of stabilising the price of their electricity, they would be prepared to enter into 5 year contracts to buy the electricity generated for the tonnages secured in the coal contracts. This would reduce the exposure of the generators and the RECS to adverse exchange rate movements and volatility in the world price of coal. The Director General Electricity Supply, Professor Stephen Littlechild, is a key participant in this process. He may need to be persuaded that such an arrangement is the optimum approach to achieving both the Government's and his objective of lower coal prices feeding through to lower electricity prices to consumers.

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The third interim report predicts that without any Government involvement a more likely outcome of the negotiations between British Coal and the generators would be fixed price contracts for perhaps only 20-25mtpa from April 1993 for a period of only three years and at a rather lower price. The generators would meet their remaining requirements through annual contracts reflecting short-term market prices. This would present difficulties for the coal industry since prices for these short-term supplies would be unlikely to be at economic levels for the deep mines until the full potential of cost reductions predicted by Boyds had been achieved. In order to meet the objective of retaining the largest possible economic industry we would need to consider ways to oblige and assist new owners to keep this tonnage open for a minimum period whilst the Boyd proposals were implemented. This policy would reduce proceeds and might introduce industrial relations problems since we would be privatising loss making collieries with particularly uncertain futures.

The third interim report also considers in detail the options for the structure of British Coal after privatisation. The report concludes that a separate Welsh company is not viable since its sales would be wholly dependent on a single National Power power

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station. There is also little commercial merit in a Scottish company which would be unlikely to add diversity of management approach in the deep mined sector (with only one deep mine) and would worsen the dependence of the Northern Company in England and Wales on National Power. I am therefore of the view that a three or more company option should be ruled out. This would leave the choice between one or two companies until after the election when the outcome of the contract negotiations will be known.

On regulation and legislation issues good progress is being made. Rothschild's third interim report recommends the adoption of an open-access regime designed to facilitate competitive access by third parties to coal reserves currently controlled by British Coal. My officials have prepared a first report on Regulation which I have sent to the Chancellor of the Exchequer. My aim is to introduce the main privatisation legislation early in the 1992/93 Session. In order to achieve this objective, work on preparing the Bill must be carried forward speedily in the coming months and substantial progress must be made before the election.

I see the next steps as urging the generators, RECS and British Coal to settle the new coal contracts as soon as possible, progressing regulation and legislation matters and commissioning further work from our advisers on structure. Consideration may

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need to be given to whether, if we agree to rule out a structure involving three or more companies, I should inform Neil Clarke. This would assist him in deciding on changes in group structure in readiness for privatisation. This would of course need very careful handling at this sensitive time. The advisers will also need to carry out further analysis of liabilities including an assessment of buying out existing concessionary fuel entitlements.

I am pleased to be able to report that all the above work has been carried out by officials and advisers to time within very demanding timescales. We are now substantially in a position to take decisions following the election. However, once the election is past we will need to move very quickly to privatise the industry before economic pressures force the closure of capacity which given more time to adapt could become competitive. I am convinced that only through rapid privatisation can the full potential for unit cost reductions identified by Boyds be realised and the industry's longer term future secured.

In conclusion, I would be grateful for your agreement to rule out further analytical work on a structure involving more than two coal producing companies; press on with the work on preparing the

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privatisation legislation and take action to ensure that the generators and British Coal settle the future contracts as soon as possible.

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 this minute or of the security coded documents circulated.

I am copying this minute to the Chancellor of the Exchequer, the Secretary of State for Trade and Industry and the Cabinet Secretary.

A handwritten signature in blue ink, consisting of a stylized, cursive name.

SECRETARY OF STATE FOR ENERGY

24 January 1992

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