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PRIME MINISTER

30th January 1992

COAL PRIVATISATION

John Wakeham has written with the latest Rothschild Report on coal privatisation.

Work is progressing apace, and we should be well placed to take the key decisions on the privatisation after the Election. Unfortunately, since the Second Report and presentation last autumn a number of factors have moved against us.

- i) The \$/£ exchange rate continues higher than the 1.60 base case assumption;
- ii) coal prices on the international market have weakened;
- iii) more gas generating capacity is now expected to be built;
- iv) the EC have tabled their proposals for a carbon/energy tax, which would increase the price of coal by 73 per cent by 2000 if implemented as now structured. Even if decisions on a tax are some way off, the threat of such a tax will impact sentiment about the future demand for coal.

On the upside, the report from the mining consultants Boyds estimates that cost reductions could be greater than British Coal had themselves estimated, bringing costs down by 31 per cent over 5 years rather than 26 per cent.

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If the higher cost reductions identified by Boyds are achieved, Rothschilds estimate that total BCC sales would be 45-50 million tonnes by 2000 without a carbon tax, and as low as 32-38 million tonnes with a tax. The \$/£ exchange rate remaining at \$1.80 would further cut economic tonnage to about 15 million tonnes.

The analysis underlines the vital importance of BCC management taking on board immediately Boyds' recommendations. Some of these would require new working practices which would need HSE sanction. The vulnerability of the industry to a carbon tax is also clear.

Given these market uncertainties, Mr Wakeham concludes that his deft touch will be all the more necessary to secure respectable contracts with the Generators. He seeks your endorsement of his acting as an eminence grise between the parties, to which you agreed in November.

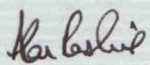
Rothschilds also report on their further analysis of the various options for the structure of the privatised industry. They sensibly rule out a Welsh Company as uneconomic, but seek also to drop the idea of a Scottish Company. They argue that giving the opencast resources in Scotland to a separate company would make the Northern English Company overdependent on National Power. They may be right, but at this stage we should not restrict ourselves to just a unitary Company or two Companies. I believe that work ought to continue on three options: one Company, two Companies, and three Companies (one being Scottish). Apart from anything else, I suspect some DE preference for a unitary company, and we should balance that by retention of the three Companies option.

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Conclusion

You will probably wish to respond to Mr Wakeham by:

- 1) agreeing to work on privatisation being pushed forward with all speed;
- ii) noting the vital importance of BCC acting on the Boyd report;
- iii) accepting Mr Wakeham's comments on the coal contract negotiations;
- iv) not agreeing to a three company option being ruled out at this stage;
- v) asking for advice on how the neutral line we are taking on the potential carbon tax can be reconciled with the impact such a tax would have on our plans for the coal industry.



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