

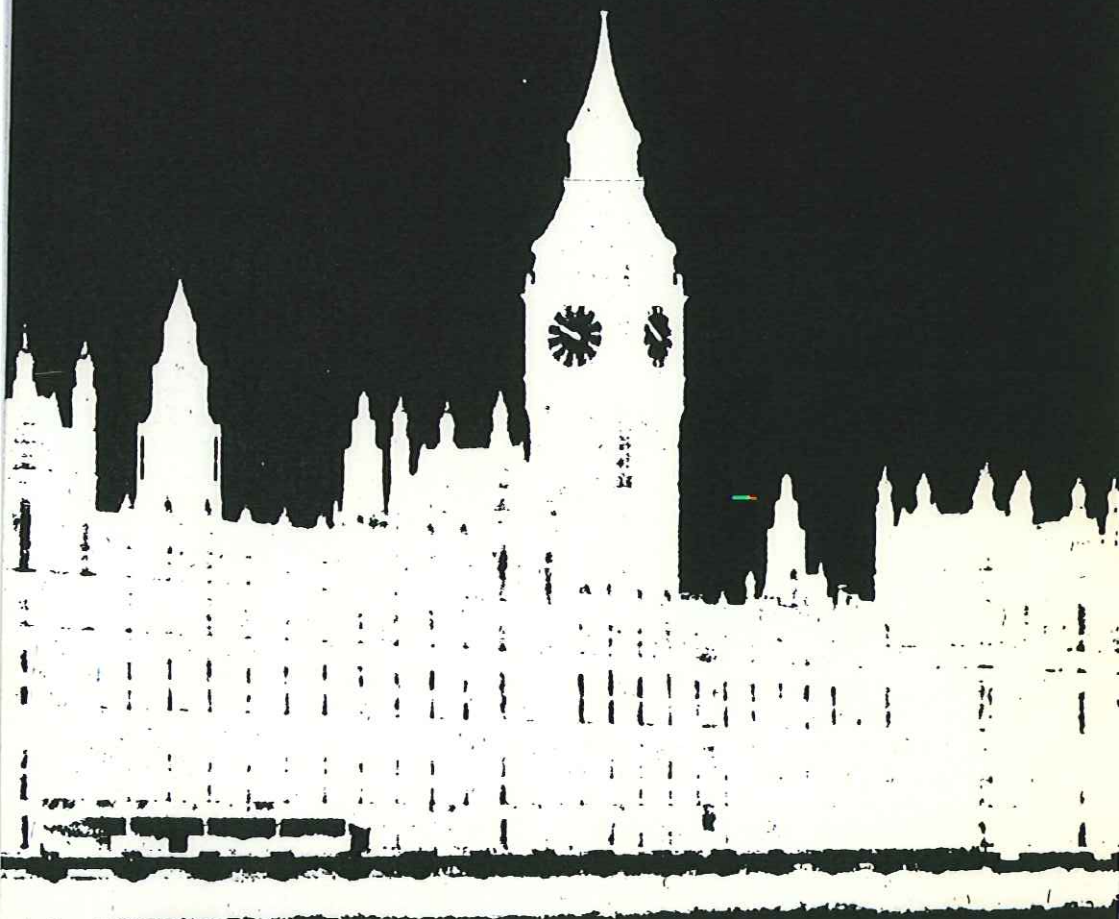


Policy Study No 85

Privatise Coal

achieving international competitiveness

Colin Robinson and Allen Sykes



CENTRE FOR POLICY STUDIES



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8 Wilfred Street, London SW1E 6PL
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Both authors write this paper in their personal capacities.

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Foreword

A number of recent publications* have discussed the case for privatising the British coal industry, arguing that it would promote competition in the British fuel market, bringing benefits not only to fuel consumers and taxpayers but to miners as well. We both formed the view, however, that there was a need for a paper which took these arguments further, quantified the achievable benefits of privatisation, and then laid out the stages by which the Government might set about privatising the industry as an important step towards a liberalised energy market. No single paper, let alone a short one, can cover all the problems or put forward a fully integrated set of detailed proposals. Our aim has been to show the broad outlines of a practicable privatisation exercise.

We are, of course, well aware of the close relationship between coal mining and the electricity supply industry and we have briefly discussed how this should influence the form of coal privatisation. A recent paper from the Centre for Policy Studies† was devoted to the privatisation of electricity supply; we intend to produce another paper shortly which will further consider the practicalities of electricity privatisation, linking it to the recommendations of the present paper.

Colin Robinson

Allen Sykes

* For instance Colin Robinson and Eileen Marshall, *Can Coal be Saved?* Institute of Economic Affairs, 1985 and Colin Robinson, *A Liberalised Coal Market?*, Lloyds Bank Review, April 1987. The House of Commons Select Committee on Energy in its report on the coal industry (January 1987) also listed some proposals which would result in more competition in the British coal market.

† Alex Henney, *Privatise Power*, CPS Policy Study No. 83, March 1987.

Why privatise the coal industry?

THE NATIONALISED COAL INDUSTRY IS NOW IN BETTER SHAPE THAN IT HAS been for many years. Closure of high cost mines and improved working methods have led to increased productivity and reduced losses. Given these welcome improvements, long held to be unachievable, it may reasonably be asked whether a good case still exists for coal privatisation. It is the purpose of the first part of this paper to demonstrate briefly how privatisation can bring further major benefits, offering the coal industry a secure and profitable future.

In general, privatisation schemes can have three principal objectives – increasing efficiency, raising revenue for the Government and widening share ownership. There is potential conflict among these objectives, and in particular between revenue raising and increasing efficiency. In the short term, the Government may see its main interest as being to raise revenue by selling an industry as a monopoly (rather than breaking it up and making it competitive). Potential shareholders may welcome the opportunity to obtain shares in a company subject to few competitive pressures. Moreover, existing management will usually wish to retain its market power but become a lightly-regulated private monopoly rather than a nationalised corporation subject to constant political interference. Finally, financial institutions generally prefer the relatively easy task of bringing well-established monopolies to market.

There are, however, few (if any) benefits to be obtained from transforming public monopolies into private monopolies. There may be some advantage in widening share ownership, but the main national benefits of privatisation come from liberalising the market. By this term we mean introducing competition throughout the industry to ensure that long term costs are minimised and maximum efficiency obtained. In some nationalised industries, it can be argued that there are natural monopoly elements which mean that only parts of the industries concerned can be made genuinely competitive. But that is not the case in the coal industry which is naturally competitive, not naturally monopolistic.

The general objective of coal privatisation should be greatly to reduce the power of monopolistic forces in the industry – British Coal's monopoly of coal production and the mining unions' power to bring

pressure to bear on a single producer. Competing sources of coal supply should be established to bring benefits to consumers in terms of lower prices and enhanced security of supply, and to the workforce in terms of more decentralised, less politicised bargaining over pay and other conditions of employment, and better paid and more secure jobs.

Such benefits could not be obtained by simply moving British Coal into the private sector as a monopoly, either with private shareholders (even assuming there were enough takers) or by handing British Coal over to its employees. Nor could they be obtained by leaving British Coal as a nationalised corporation. The competitive pressures would be insufficient, politicians and civil servants would be unable to resist interfering and the management of British Coal would inevitably spend time on political bargaining which, in a competitive market, would be employed in reducing costs. In the past, government attempts to enforce rather easy targets – generally merely to break even – on the nationalised coal industry have never succeeded. There is no reason to suppose they would do so in the future if the industry were to remain nationalised. Its management, in the absence of genuine competitive pressures, would always be tempted to ask for more time and more money from politicians on whom it could continue to exert considerable influence.

When a previously nationalised industry is opened to competition, the role of government is necessarily reduced and the emphasis is changed. Instead of constant interference in the affairs of a nationalised industry, government needs to concentrate on such matters as ensuring that competition is maintained, that the environment is protected, that energy supplies are secure and that safety standards are maintained. These are extremely important functions which are considered later in this paper.

First, however, we set out some of the specific gains which might be expected if the British coal industry is privatised in a form which increases competition in the supply of coal.

Efficiency from competition

One source of efficiency gain (productive efficiency) is the production of goods at lower total costs. To some extent, higher efficiency may be realised by selling assets to private shareholders who put pressure on management to be more efficient so that profits are increased. But liberalisation is needed to force cost reductions on producers, partly because of the pressure of competition and partly because producers

concentrate on lowering costs rather than on political lobbying. Competition also ensures a closer alignment of costs and prices (greater allocative efficiency) as cost reductions are passed on to consumers. Finally, in a competitive market, producers become much more interested in satisfying consumer wants by providing a wide variety of price and quality options. The provision of choice for consumers requires competition between suppliers.

Efficiency from private sector involvement

Efficient modern coal industries are highly capital intensive. A privatised, competitive coal industry consisting of entrepreneurial mining companies would have an incentive to make full use of equipment and to experiment with mining techniques which have proved successful in other countries. British Coal is recognised as a world leader in the development of equipment and technology for the longwall system of underground extraction. On average, however, the efficiency with which it uses that equipment compares unfavourably with other countries, even after making due allowance for British geological conditions. Increased competition, more flexible working practices, and the free movement of technical and management personnel aided by transferable pensions, would help to realise more of the potential of high cost capital equipment.

Responsiveness to customers' needs

One argument for public ownership or regulation turns on the presence of 'natural monopolies' which, if privately owned, could exploit customers because of the lack of competitive forces. However, in no sense is the coal industry a natural monopoly. Rather it is naturally competitive, since coal is a variable and geographically dispersed product. No reasonable argument can be made for leaving coal production in Britain in the hands of a single organisation. Even the total dedication of management in a huge monolithic industry, which is the very best British Coal could offer, is a poor substitute for the liberalising forces of a competitive market. To confine competition merely to a national coal monopoly and three other fuels, two of which are also monopolies (gas and electricity) is to throw away an important opportunity for further competition.

Management attitudes within British Coal have not been based upon commercial considerations, since the industry has not seen genuine competition between coal suppliers for 40 years. That is not

the fault of British Coal's management, which we recognise is trying to improve the industry's efficiency. It is the fault of governments which first created and then maintained an inappropriate structure for the coal industry in Britain. With nearly all coal supplied from the same organisation, incentive is lacking to expand the most efficient parts of the organisation (e.g. opencast production at the expense of underground production). With only one coal company and imports restricted, neither British Coal's management nor anyone else has proper performance standards against which to measure its acts and achievements. On the other hand, in order to succeed, private mining companies would have to be responsive to market requirements in terms of quality and price.

Reducing political interference, costs and subsidies

As coal mining has been state-owned, there has been continual political interference in the industry. Furthermore, commercial objectives have largely been subordinated to social aims. Production costs of coal in Britain have accordingly remained unnecessarily high and the industry has extracted large subsidies from both the British taxpayer and the electricity consumer. A privatised industry would relieve the taxpayer of most of the substantial capital and operating subsidies which the industry would otherwise continue to require, though payments to relieve the hardship consequent on restructuring the industry would need to continue. Furthermore, unnecessarily high coal prices have led to unnecessarily high electricity and other fuel prices, thus contributing significantly to the decline of British manufacturing industry and to the rise in general unemployment. Retention of a monopoly, either public or private, means continuing these penalties.

Restoration of commercial direction

The large real oil and gas price increases in the 1970s and early 1980s presented British Coal with a windfall opportunity to improve its market position. In fact, far from increasing its market share in these very favourable conditions, it continued to lose share by much more than can be explained by the greater availability of cheap gas. One of the greatest business opportunities since the end of World War II was missed. There were two main reasons. On the supply side, British Coal lacked the commercial imperative which companies operating in competitive markets have; on the demand side, customers (both the

electricity boards and industry) were fearful of increasing their dependence upon British Coal because of the monopolistic positions of both British Coal and the National Union of Mineworkers, made all the more powerful by restrictions on imports.

Since 1970, whereas production of coal in both Australia and South Africa has risen by a factor of almost three, in the protected British market it has fallen by about 25 per cent. Privatisation is needed to introduce commercial attitudes towards exploiting substantial but neglected business opportunities.

Enhanced security of supply

Security of coal supply would be greatly enhanced by the diversification of sources of supply, both at home and overseas, which a more competitive market would bring. Given their wide geographical spread, their diverse political systems and the strong competition between them, foreign coal producers would be most unlikely to take concerted action against Britain. Fuel consumers, including the electricity supply industry, would become more willing to invest in coal-fired equipment as they saw coal supplies become more secure as well as cheaper. Accordingly, the market for coal in Britain should expand.

Improved employee benefits and job security

Although, for any given output, fewer people might be employed in coal mining than if privatisation did not occur, they would enjoy much greater opportunities for increased pay and for profit sharing. A diversified, competitive industry would strive for lower costs and higher productivity, taking advantage of market opportunities both at home and abroad, so that eventually total production might well rise. The result should be greater job security, which would be both genuine and deserved because it would be based upon improved efficiency rather than the illusion of security created by taxpayer subsidies and union militancy. In a privatised industry each mine or opencast site would have the incentive to realise its full potential and the workforce would share the rewards from growing efficiency. There might also be some pricing into jobs since bigger pay differentials under more decentralised bargaining might allow some mines which would otherwise be uneconomic to operate profitably.

Opportunities for creativity

The coal industry is not only a mature industry, but one which for nearly two generations has not been subject to commercial pressure. Entrepreneurial flair is needed at all levels of workforce and management. Moreover, local managements and miners ought to be free to introduce systems and methods which are applicable to local conditions and not be constrained as at present by national procedures.

One essential point is that benefits from coal privatisation would be maximised only if the entire British energy sector were to be privatised, and in particular, electricity generation. Similar reasons to those which justify coal privatisation apply. The electricity supply industry normally absorbs nearly 75 per cent of British Coal's production. To maintain it under single ownership would significantly reduce the benefits of coal privatisation. Furthermore, private companies would be much more likely to buy and pay better prices for coal mines and reserves if electricity privatisation were certain to follow. If private coal firms had to face a sole buyer (monopsonist) for power station coal there might be few takers. Similarly if a diversified electricity generation industry had to face a near monopolist it might attract few new investors - see also Chapter 4 below. Because of the importance of electricity privatisation, and the need to link it to coal privatisation we are writing a further CPS paper on this subject to follow up the March 1987 paper entitled *Privatise Power*.

Present state, structure and financing of the industry

Reserves of British coal

Unlike recoverable oil and gas reserves, which are expected to be virtually exhausted some time next century, Britain has recoverable coal reserves sufficient to meet home consumption of coal for several centuries. British coal fields are dispersed across the length and breadth of the country and have widely varying technical characteristics. Though some coal fields are at or near the ends of their working lives, there are opportunities to extend mining into new regions. Two large developments (Selby and Asfordby) by British Coal are opening up new areas. Other coal fields are known to exist but have yet to be exploited.

Restructuring since the strike

British Coal (formerly the National Coal Board) is divided into nine deep mining Areas and the Opencast Executive. Since nationalisation, extensive restructuring has taken place, reducing the number of administrative areas to only 9 in 1986/87*; there were 48 in 1950. Small mines have been closed and new investment has concentrated on large ones which permit the use of heavy duty machines at the coal face (the favoured method being that of longwall mining). Closures of less productive mines and faces have gathered pace since the 1984-85 strike ended and the number of active coal faces is planned to fall further. The new management style has increased production and improved financial performance.

Coal production and other activities of British Coal

For a variety of reasons, British coal production has fallen steeply from over 200 million tonnes a year in the mid-1950s. During the year ended March 1986 (the first financial year of normal operations since the strike) coal production from deep mines was 88.2 million tonnes and from opencast operations 14.1 million tonnes, a total of just over 102 million tonnes; in the 1986/87 financial year just ended, deep mined

* In March 1987 the North Derbyshire and South Midlands Areas were merged reducing the Areas to 9. Statistics for the years up to end 1986 will usually relate to 10 Areas.

output was 87.8 million tonnes and opencast 13.3 million tonnes, a total of just over 101 million tonnes.

Deep mining: despite radical reorganisation and the closure of many unprofitable mines (the number of operating mines has fallen from 200 in 1981/82 to 133 in 1985/86 and fell further to 110 during 1986/87), the underground mining sector of British Coal has continued to return losses except for the last two quarters of both 1985/86 and 1986/87. These underground operating losses before interest and restructuring costs totalled £108 million in 1985/86 (see Table 1a), representing an average loss of £1.22 per tonne of deep mined coal. Preliminary figures for 1986/87 show an underground operating profit of £39 million or £0.44 per tonne.

Opencast mining: this sector, small in comparison with underground mining, is highly profitable. Mining operations are carried out by private contractors, subject to competitive tendering, and in recent years the operating profits of the Opencast Executive of British Coal have been £211 million (1983/84), £142 million (1984/85), £343 million (1985/86) and provisionally £243 million in 1986/87. The 1986/87 provisional results represented an operating profit of £18.3 per tonne, by far the most profitable part of British Coal's activity - and likely to remain so.

Other British Coal activities: these include coal processing into coke and smokeless fuel, distribution services, and consultancy. These activities are small and earn modest profits.

Reported profits

During the 1986/87 financial year (see Table 1a), British Coal reported an operating loss of £28 million after payment of interest charges. Net restructuring costs were £262 million, resulting in a total loss for the year of £290 million. The full results of the previous seven years are set out in Table 1. In considering British Coal's accounts, it must be borne in mind that most capital expenditure and nearly all redundancy costs, interest payments, deficit grants, etc. are attributable to the underground mines. These have nearly always reported an operating loss until the very small operating profit of 1986/87.

It should be noted that for years the Annual Report and Accounts of British Coal have been selective, obscure and difficult to follow, a matter complained of by some professional accountants and by the

Table 1

NATIONAL COAL BOARD/BRITISH COAL FINANCIAL RESULTS, 1980 TO 1986
(YEARS ENDING MARCH)

| | (£ million) | | | | | |
|--|-------------|-------|-------|-------|-------|-----------------------|
| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
| Operating profits (losses) | | | | | | 1986 ^(c) |
| Collieries | (122) | (107) | (226) | (317) | (595) | (1752) ^(d) |
| Opencast | 110 | 157 | 157 | 192 | 211 | 142 |
| Other mining activities ^(a) | 6 | 12 | 21 | 23 | 27 | 9 |
| Non-mining activities ^(b) | 26 | 17 | 5 | 3 | (1) | (41) |
| | | | | | | (4) |
| Total operating profits (losses) | 20 | 79 | (43) | (99) | (358) | (1642) |
| Social costs less grants ^(c) | (17) | (29) | (61) | (49) | (74) | (78) |
| Interest | (184) | (256) | (344) | (364) | (467) | (520) |
| Profit after interest | (181) | (206) | (448) | (512) | (899) | (2240) |
| Other items | 22 | (1) | 20 | 27 | 24 | 15 |
| Overall deficit | (159) | (207) | (428) | (485) | (875) | (2225) |
| Deficit grant from government | 159 | 149 | 428 | 374 | 875 | 2225 |
| Surplus (deficit) after payment of deficit grant | 0 | (58) | 0 | (111) | 0 | 0 |

(Source: National Coal Board, Annual Reports and Accounts)

Notes (a) Rents, shipping terminals, etc.

(b) Manufacture of coke and smokeless fuel, chemicals, distribution of fuel and appliances, estates and land, engineering, computer services and income from related companies and partnerships.

(c) British Coal's share of the costs incurred as a result of closing uneconomic capacity and the transfer or redundancy of employees.

(d) After crediting £340 million for strike recovery costs which substantially overstated 1986 operating profits. The 1984/85 operating loss would be similarly overstated. Auditors accordingly qualified the accounts in both years.

(e) The provisional unaudited results announced in the 26 May 1987 British Coal press release are stated on a different basis to the 1986 results. The 1986 and 1987 results are listed in Table 1a.

Table 1a
BRITISH COAL FINANCIAL RESULTS RESTATED
(£ million)

| <i>Operating Results</i> | 1985 | 1986 | 1986 <i>Restated Unaudited</i> | 1987 |
|---|---------|-------|-----------------------------------|-------|
| Mines | | | | |
| Operating profit (loss) | (1,333) | (108) | (108) | 39 |
| Strike recovery costs | (340) | 340 | - | - |
| Writedowns | (79) | (63) | - | - |
| | (1,752) | 169 | (108) | 39 |
| Opencast | 142 | 343 | 343 | 243 |
| Other activities | (32) | 23* | 43 | 76 |
| | | | | |
| Operating profit (all activities) | (1,642) | 535 | 278 | 358 |
| Interest | (520) | (437) | (437) | (386) |
| | | | | |
| Trading profit/loss (after interest) | (2,162) | 98 | (159) | (28) |
| | | | | |
| Net restructuring cost | (78) | (170) | (170) | (262) |
| Writedowns | - | - | (63) | - |
| Other income | 15 | 22 | - | - |
| | | | | |
| Overall deficit | (2,225) | (50) | (392) | (290) |
| | | | | |
| Write-back of provision for strike recovery | - | - | 342 | - |
| | | | | |
| Deficit before payment of deficit grant | (2,225) | (50) | (50) | (290) |

* Includes provision for and write-back of £2 million of strike recovery costs

(Source: derived from 26 May 1987 Press Statement and National Coal Board 1985/86 Report and Accounts.)

Select Committee on Energy in its Report of January 1987. For a nationalised industry accountable to Parliament this is regrettable and should be promptly remedied. Accordingly if we and other commentators make some errors in interpreting British Coal's figures it should not be a matter for surprise, particularly in our attempts to calculate the total cost to the nation of both British Coal and its past and present employees (many of whom are paid separately by the Government).

Present financial structure

British Coal is supported by a variety of government grants. Moreover, it has always had an easier financial target to meet than most other nationalised industries. At present it is charged only with breaking even after interest payments and receipt of government social grants (to cover premature pensions, mine closures, concessionary coal and deficiencies in the mineworkers' pension scheme). British Coal's Chairman has confirmed that the break-even target date (1987-88) set in the 1985 Coal Industry Act has had to be put back to 1988-89.

British Coal and British Rail have by far the largest External Financing Limits (i.e. government approved borrowings and grants from external sources, mainly the Government) of all the nationalised industries. Each has an EFL of over £700 million both in 1986/87 and in 1987/88: the sum of the EFLs for all other nationalised industries is only £690 million, including industries such as electricity supply which are net contributors to the Exchequer.

Government financial support for the industry is discussed more fully later in this chapter.

Private sector production

An active, generally profitable, but highly constrained, private coal mining sector is at work in Britain producing about 4 per cent of total national output from about 160 very small underground mines, 60 very small opencast sites and several small-scale discard tips belonging to British Coal. These fringe operations receive no subsidies.

The Coal Industry Nationalisation Act (1946) limits the size of mines in the private sector and allows the nationalised coal corporation to control the number of private operations by requiring those operators to hold a licence issued by British Coal, to pay royalties to British Coal, and to accept selling prices imposed upon them by British Coal.

A further activity, the recovery of coal from old mine tips, has been restrained by British Coal and yet coal from tips can be as cheap as, or on occasions even cheaper than, opencast coal. As coal tip removal both creates jobs in areas where coal mining has ceased to be a major source of employment and improves the environment, it ought to be encouraged.

British Coal can thus decide how much competition it will allow and nominate its competitors, acting as both judge and jury over the private sector. For example, the recent Joint Understanding negotiated between British Coal and the CEEGB appears to have halved, without any discussion, the quota for some of the cheapest coal available in Britain as supplied by the private mining sector. Collusion between two large public sector monopolies consequently reduced the electric power generation market for this private sector coal from 3 to about 1½ million tonnes per year. Despite having the smallest reserves (which British Coal has no interest in working itself), the smallest production units, and no subsidies, this has been a consistently profitable sector of the industry in contrast to British Coal which has nearly always been unprofitable. Its record indicates the benefits which should be obtainable from privatisation and liberalisation.

Markets

While 1985/86 was untypical in some respects (there was destocking from mines and restocking by consumers) it is the latest year for which full statistics are available. The supply of and demand for coal in Britain in the financial year 1985/86 and our estimates for 1986/87 are as follows:

Table 2
THE SUPPLY OF AND DEMAND FOR COAL IN BRITAIN

| | 1985/86 | % | 1986/87 | % |
|--|----------------|-----------|----------------|-----------|
| | million tonnes | | million tonnes | |
| Sources of supply | | | | |
| BC production | | | | |
| Deep mines | 88 | 68 | 88 | 77 |
| Opencast | 14 | 11 | 13 | 11 |
| | <hr/> 102 | | <hr/> 101 | |
| Private licensed mines and tip coal | <hr/> 2 | 2 | <hr/> 2 | 2 |
| Total BC and licensed production | 104 | | 103 | |
| BC stock reduction (increase) | 11 | 8 | (2) | (2) |
| Total BC sales | 115 | | 101 | |
| Private non-vested production | 3 | 2 | 3 | 3 |
| Imports | 12 | 9 | 10 | 9 |
| Total coal supplied | <hr/> 130 | <hr/> 100 | <hr/> 114 | <hr/> 100 |
| Analysis of demand | | | | |
| Consumption | | | | |
| CEGB | 79) | 61) | | |
| SSEB | 7)86 | 5)66 | 82 | 72 |
| Coke ovens (mainly BSC) | 11 | 9 | 13 | 11 |
| Industry | 10 | 8 | 8 | 7 |
| Domestic | 8 | 6 | 8 | 7 |
| Other markets | 3 | 2 | 3 | 3 |
| Total domestic consumption | <hr/> 118 | | <hr/> 114 | |
| Stockpiling | | | | |
| CEGB | 8) | 6) | | |
| SSEB | 1)9 | 1)7 | (2) | (2) |
| Exports | 3 | 2 | 2 | 2 |
| Total coal demand | <hr/> 130 | <hr/> 100 | <hr/> 114 | <hr/> 100 |

(Source: derived from British Coal Annual Report and Accounts, press statements and Energy Trends.)

The English and Scottish generating boards buy almost all their coal from British Coal. They are by far British Coal's largest customers. Because successive governments have acted to protect the coal industry, the CEEGB has been prevented from diversifying its supplies (for instance by importing much coal). Given the domestic protection which it enjoys, British Coal has had no incentive to consider the export of coal in significant quantity. Its costs of production (with no compelling incentive to reduce them) have for many years been well above the prices of internationally traded coal.

The Nationalisation Act

Chapter 1(1) of the Coal Industry Nationalisation Act 1946 charges British Coal with three general duties -

- (1) the duty of working and getting the coal in Great Britain, to the exclusion of any other person. There are only two exceptions to this clause:
 - (a) coal necessary to be dug and carried away in the course of activities other than mine activities; and
 - (b) the getting of coal in accordance with the terms of a licence issued by British Coal (that is, private mining).
- (2) the duty of securing the efficient development of the coal mining industry; and
- (3) the duty of making supplies of coal available, of such quality and sizes, in such quantities and at such prices, as may seem to British Coal best calculated to further the public interest in all respects, including the avoidance of any undue or unreasonable preference or advantage.

The three clauses give British Coal extremely strong powers and clearly defined duties. The use of the powers is evident: the fulfilment of the public duties is not. The British coal industry has not seen efficient development since nationalisation, nor has the public interest been furthered.

By means of its extremely strong powers, British Coal can frustrate attempts by third parties to improve the industry (and has done so). We have already explained that potential private competitors are kept out of the industry so that real competition is limited. Another example of the pressure which British Coal can indirectly exert is the fate of the recommendation made by the Monopolies and Mergers Commission in June 1983 that the statutory limit on the size of opencast

reserves worked privately should be raised to 100,000 tonnes. Even that modest proposal has been ignored by the Government.

It is not surprising that British Coal suppresses competition and frustrates external proposals for change since it was established as a monopoly by government forty years ago and has been maintained as a monopoly ever since. The habits and practices of forty years are hard to overcome.

Existing subsidies

Earlier in this chapter, in particular in Tables 1 and 1a, we touched briefly upon the 1985/86 government support for British Coal. It is helpful to consider that support more fully and over a longer period, interpreting British Coal's none too helpful Annual Reports and Accounts, and government statistics as accurately as outsiders can.

The Government's financial support is both direct and indirect. Direct support takes the form of grants made to cover losses, social costs, and redundancies. For the latest five financial years for which full data are available, these have been running at an average level of over £1 billion per year as set out in Table 3 below. 'Deficit' grants cover financial losses as they occur in each financial year. 'Social' grants cover premature pensions, social expenditures consequent on mine closures, concessionary (free) coal to miners and deficiencies in the miners' pension scheme. Redundancy payments are straightforwardly what they purport to be.

Table 3

GOVERNMENT DIRECT SUPPORT (£ million)

| | 1981/2 | 1982/3 | 1983/4 | 1984/5 | 1985/6 | 1986/87 Estimate |
|----------------------|--------|--------|--------|--------|--------|---------------------|
| Deficit grants | 455 | 386 | 875 | 2225 | 50 | 290 |
| Social grants | 93 | 134 | 270 | 189 | 513 | n.a. |
| Redundancy payments† | 48 | 81 | 192 | 202 | 566 | 540* |
| | 596 | 601 | 1337 | 2616 | 1129 | 830+ |

† Payments made by government directly which do not pass through British Coal's Accounts.

* Government Expenditure Plans, January 1987.

(Source: Energy Committee January 1987 and British Coal Annual Reports.)

Until the end of March 1987, the Government gave particularly generous terms to cover the very large redundancies between April 1985 and March 1987. These amounted to:-

- (i) a lump sum of £1000 for each year worked in the industry to those aged 21 - 49; and
- (ii) a smaller lump sum to those over 50 plus a pension payable for life.

These very generous terms secured a reduction (primarily through voluntary early retirement and voluntary redundancy) of 63,600 mine workers, 10,500 other industrial workers and 5,400 staff between the end of the strike in March 1985 and March 1987. The total manpower reduction was thus nearly 80,000. This government funded scheme has now been replaced by a less generous British Coal scheme, the main provisions of which are as follows:-

- (i) £700 for each year of service from the age of 30, with lesser amounts for each year served below the age of 30; and
- (ii) no weekly payments, only lump sum payments. The normal miners' pension scheme applies.

COMPARISON OF LUMP SUM REDUNDANCY PAYMENTS

| Age at redundancy | £ payable on redundancy | |
|-------------------|-------------------------|------------|
| | New scheme | Old scheme |
| 35 - 39 | 9,650 | 17,000 |
| 45 - 49 | 16,200 | 26,000 |
| 50 - 54 | 19,250 | 74,600* |

* Includes continuing pension payments.

The total sums spent under this scheme are included in Table 3 above.

The total of these deficit, social grant and redundancy payments amounted to £6,279 million over the five years 1982-1986, representing an annual average of £1,256 million - or approximately £6,630 per worker employed over the same period, a sum equivalent to over 75% of the total wage bill.

We do not, of course, argue that subsidies are never justified. The subsidies to British Coal, however, have by any standard been very large, and it is for the proponents of such subsidies to justify them.

There are also hidden subsidies and protective devices (such as the tax on fuel oil of nearly £8 per tonne, preference for coal in the public sector, and restrictions on imports) which have the effect of raising coal, electricity and other fuel prices as we explain more fully at the end of Chapter 3.

These direct and hidden subsidies have imposed a considerable burden on the rest of the nation. They have been paid for in lower net of tax income and higher costs, and consequently higher unemployment elsewhere in Britain. It is difficult to argue that they should be continued at anything like these levels given that there is the alternative of privatisation with liberalisation, including the freedom to import coal when it is genuinely cheaper.

Government finance

Let us now identify the government payments to the coal industry in recent years, together with the capital outlays involved. The Treasury makes payments as British Coal's cash needs arise, rather than when the liabilities occur. (These cash payments are not additional to those in Table 3 above but their timing is slightly different.) Actual cash payments, including those forecast early this year for 1986/87, are as shown below:

| 1982/3 | 1983/4 | 1984/5 (£ million) | 1985/6 | Forecast 1986/7 |
|------------------------------|--------|-----------------------|--------|--------------------|
| 773 | 922 | 1740 | 1473 | 1270 |
| Total over five years: 6,178 | | | | |

(Source: Energy Committee, 1987)

British Coal makes significant capital expenditures as it develops new mines and re-equips existing ones. These outlays and the total loans (mainly from government) for the last four years, plus the forecast capital expenditure for 1986-87 are as follows:

| | 1982/3 | 1983/4 | 1984/5 (£ million) | 1985/6 | Forecast 1986/7 |
|--|--------|--------|-----------------------|--------|--------------------|
| Mining capital expenditure | 826 | 691 | 354 | 645 | 650 |
| Outstanding loans under the Coal Industry Acts | 3710 | 4179 | 4343 | 3868 | 4070* |
| Change in loans on previous years | 282 | 469 | 164 | -475 | 202* |

(Source: Energy Committee, 1987)

* (Our estimates)

Excessive capital expenditure?

Before turning to the subject of indirect support one should consider the very large capital expenditure incurred by British Coal in recent years, and planned for future years. Too little detail is available to permit thorough examination but the levels are high by international mining standards, and it seems possible that British Coal's labour productivity improvements are in part being achieved by uneconomically high capital expenditure. Grounds exist for believing that at least part of the expenditure is uneconomic, in that the auditors qualified the 1985/86 accounts by questioning whether or not the high capital expenditures of recent years had produced assets of the value shown (fixed assets of about £4,000 million at March 1986), given that British Coal is a loss making industry and nearly always has been. We believe it is unlikely that the industry could be sold at anything like the value of its currently employed capital of around £5,400 million. We find it difficult, therefore, to see the justification for adding capital at the rate of £650 million a year. Finally, the big new mines being brought on have, by international standards, high expenditures for their planned output (Selby £1500 million for 10 million tonnes per annum, perhaps more, and Asfordby £400 million for 3 million tonnes per annum, etc.).

We doubt if a liberalised and privatised industry with international expertise would need to spend such large sums to achieve an output comparable to that of British Coal. (The end of chapter 3 explores this topic further.)

Indirect support

In addition to direct grants to British Coal the Treasury has provided indirect support via a scheme (now drawing to a close) to give incentives to larger consumers to convert from other fuels to coal. Payments have been as follows:

| 1982/3 | 1983/4 | 1984/5 | 1985/6 | 1986/7 |
|--------|--------|------------|--------|--------|
| | | (£million) | | |
| 2 | 4 | 10 | 12 | 18 |

(Source: Energy Committee, 1987)

The potential gains from privatisation with liberalisation

We begin by discussing coal imports, since increased competition in the coal market implies freer imports, and then discuss the necessary improvements to the efficiency of British coal mines.

The potential for coal imports

It is sometimes assumed that, even if significant cost reductions were achieved in British mines, domestic production would still be largely displaced by imports of cheap foreign coal (as has happened in parts of Western Europe). Were this to be true it would need careful evaluation to determine how best, how far and how fast to switch to such cheaper imports to the net national advantage. But most national production would not be displaced, since British coal enjoys considerable natural protection against imports.

Coal imports were 12.1 million tonnes in 1985/86 and 10.1 million in 1986/87. Much of this was speciality coking coal imported by BSC. The CEBG at present imports only 1 - 2 million tonnes per annum. It was not able, or did not choose, to import extra coal during the 1984/85 strike. Other consumers had no such inhibitions. Given, however, that large coal supplies are available at apparently much lower prices than domestic coal, what limits imports to the domestic market?

The CEBG, under pressure from both Conservative and Labour governments, has confined itself to taking coal almost exclusively (currently at least 95%) from British Coal, at prices which at first sight seem well above those at which imports could be obtained. To preserve some bargaining power the Government has allowed the CEBG to have token imports, typically of a few million tonnes a year. They have been delivered to its Thameside power stations which have appropriate docking facilities, usually from the three main North West European ports of Amsterdam, Rotterdam and Antwerp (the so-called ARA ports). These three ports have large modern coal handling facilities to receive bulk coal from the main overseas suppliers (Australia, South Africa, the United States and Poland), Western Europe being the main market for internationally traded steam coal. From the ARA ports coal can be trans-shipped into smaller ships

capable of entering British ports. CEGB imports have been limited not only by government imposed policy, but also by the lack of appropriate, modern coal terminals.

The steel industry (BSC) consumes 6 million tonnes a year of the higher grade coking coals, most of which it imports. It has the facilities to do so near its main blast furnaces in the Clyde (Hunterston), Teeside (Redcar) and South Wales (Port Talbot).

Other British customers, being free to import (to the extent that they are not subject to any undue commercial pressures from British Coal), took in about 4 million tonnes in 1985/86, about a quarter of their total requirements, and this proportion may well rise. Their coal imports, being modest, can be handled in numerous small ports around Britain.

What of the future? Substantial imports of coal into Britain are presently limited by the lack of large scale modern port facilities. Although such ports do exist to handle iron ore and coking coal for the steel industry, they cannot handle the volumes which would be necessary were steam coal to be imported on any large scale, particularly for electricity generation. In addition, the steel industry ports are not in general suitably located to supply the power stations. Competitiveness of imports cannot therefore be judged solely from the spot price in the ARA ports - which in mid 1987 is just below £22 a tonne. Coal must first be transferred into smaller ships before it can be landed in Britain, and must then incur extra inland transport costs. Except for Thameside, most of the large coal-burning power stations are inland, close to the coalfields. Rail or road costs to these stations further increase the cost of imported coal. Total costs added by transport from the ARA ports to inland power stations are between £5 per tonne for a few coastal stations to over £13 for nearly all others, compared with just under £5 per tonne average delivery costs for British Coal. Except for the coastal stations home-produced coal thus presently enjoys a transport cost advantage of about £8 per tonne over imports.

Thus, even if the CEGB and the South of Scotland Electricity Board were given complete freedom to import coal, major capital investments in coal terminals would be needed before they could substantially increase imports. Allowing for sites to be chosen, planning enquiries, design and construction, at least five years would pass before even one large scale coal import terminal could be built. It is also likely that increased British demand for internationally traded

coal would push up the world price for such coal. World seaborne steam coal trade is at present just under 150 million tonnes a year. Increased annual British demand of, say, 15 million tonnes would represent an increase of about 10% in total world demand for such exported coal and could well cause prices to rise. An increase of 30 million tonnes (which the CEBG suggested as a possibility to the Select Committee on Energy) would certainly raise prices.

Although international coal prices are at present very low, a number of special factors are at work. Much of the growth in coal exports in the last 10 years has come from Australia and South Africa, both of which countries have until recently had depreciating currencies. Moreover, ocean freight rates have fallen because of overcapacity in shipping. A reversal of either trend would weaken the ability of the major overseas suppliers to export coal profitably. Indeed, the recent strengthening in exchange rates of Australia and South Africa has already put financial strain on some coal exporters.

In demonstrating that large volumes of imports could not penetrate the British coal market in the short term, we are not suggesting that import restrictions do not matter. We think that such controls should be removed immediately. If they were, however, the physical and price limitations we have explained above would constrain the increase in imports for a few years. But some significant changes would start to occur. For example, the CEBG might well begin work on a large import terminal; it has investigated the economics of such a venture in the past, but who would seriously consider going ahead if the Government would not allow imports for power stations to increase substantially? As an illustration of the costs of such a facility, the Hampton Roads (Virginia) coal complex in the USA was developed in 1982 at a cost of \$120m, say \$150m now or around £100m, with an annual capacity of 12 million tonnes. Cheaper facilities may be possible if offshore floating coal terminals are feasible. The question of installing a modern coal terminal is explored further in Chapter 4.

Such a terminal would provide a useful bargaining counter in negotiations with home coal producers, whatever the actual size of imports and would probably be a justifiable investment on those grounds alone. There might also be a change in the previous CEBG power station siting policy, with more coal-fired power stations on coastal sites; indeed, this is now being considered. Thus British coal suppliers, though they would have a breathing space of a few years, would in the longer term need to aim at matching the price at which

imports could be delivered into the relevant areas of the British coal market.

Comparing the CEBG coal purchasing contract with available imports

It is worth looking in more detail at the CEBG-British Coal agreement which restricts coal imports and private sector coal supplies. Set out in Figure 1 is a cumulative cost curve per tonne of British Coal's production for the first quarter of 1986, derived from published data in the 1987 Committee on Energy report. It includes opencast mines which comprise most but not all the lower cost production. Superimposed upon it are the three coal prices the CEBG is currently paying to British Coal of approximately £30, £34 and £46.88 a tonne under a 5 year agreement signed in early 1986, called a Joint Understanding, which has provision for annual reviews. All of these are on a mine-mouth basis.

Costs of delivery to power stations are just under £5 on average. If either of the lower prices truly represented the achievable long term delivered costs of imports, and if the 1986 cost curve could not be much improved, then the long term future for domestic coal production in Britain would be bleak indeed. Neither of the conditions, however, is likely to apply. The cost curve, discussed later, can be lowered and, as just explained, coal imports could not be increased substantially in the short run.

Reasoning along these lines presumably underlies the government-condoned Joint Understanding between the CEBG and British Coal. This will be evident from Figure 2 which sets out the same information as in Figure 1 but with the annual volumes given for each tranche, that is 12 million tonnes at £30, a further 10 million tonnes at £34, and the rest (50 million tonnes) at £46.88, giving an average price of £42.28 per tonne for 72 million tonnes a year. In no way do we endorse such inflexible agreements which give no genuine choice of supplier and tend to stop the investment in terminals and changes in power station location which would occur without import restrictions. Nevertheless, if the volume and costs of the two lower tranches reasonably reflect the end-1985 cost and availability of deliverable imports - and they do not look too far out - then in 1986 the CEBG may not have had much scope to purchase its coal supplies more cheaply. The international trade in coal, however, can be expected to grow and to become increasingly competitive and import prices could even fall further. The CEBG (or its successors) needs to be able to adjust its

Figure 1
TOTAL BRITISH COAL
1986 FIRST QUARTER

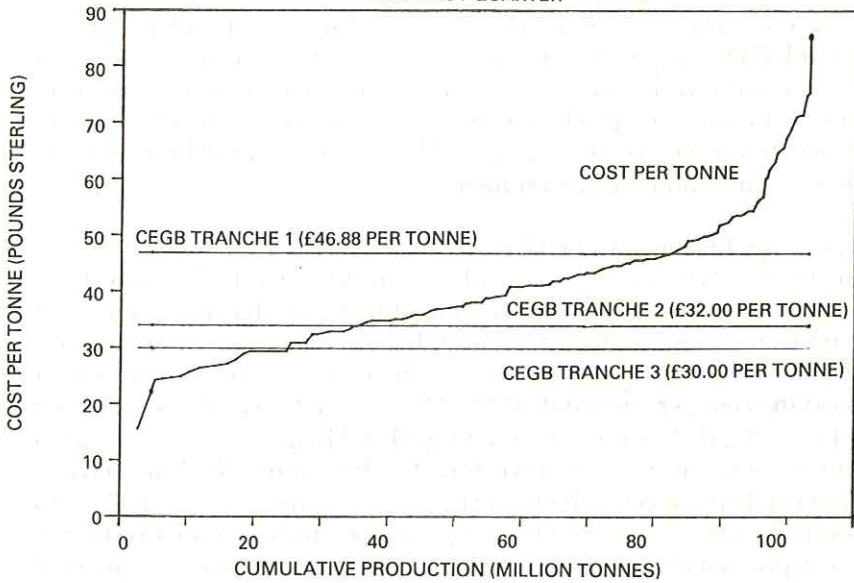
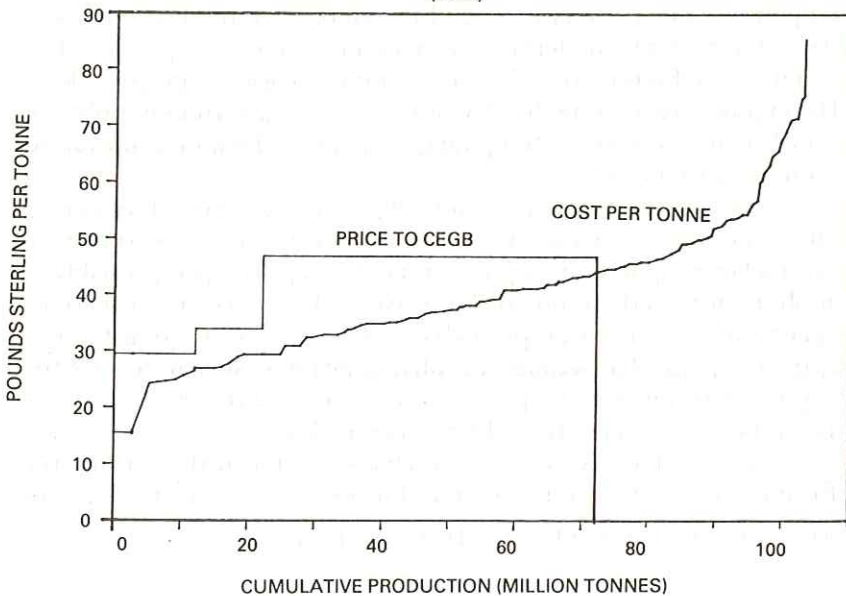


Figure 2
CEGB CONTRACT PRICE & PRODUCTION COSTS
(1986)



activities, without being hampered by import restrictions, so as to take advantage of that growing trade. Hence, the cost of British coal must be reduced considerably for it to remain competitive. Fortunately, there is considerable scope for such reductions under a liberal scheme of privatisation which would provide competitive pressures to bring down the costs of producing coal in Britain to the level of future available supplies of overseas coal. Nothing less should be acceptable to consumers and the Government.

The scope for improved efficiency

In its *New Strategy for Coal* published in October 1985 British Coal emphasised the need to achieve competitive costs. It expressed its cost targets in a more sophisticated unit than cost per average tonne since that measure took no account of the heat value of the coal: instead it used the cost per Giga Joule (GJ)*. Mines operating at above £1.65 per GJ (about £41.25 a tonne) were judged unlikely to have a long term future, and to warrant investment other mines had to have a reasonable prospect of their long term costs being £1.5 per GJ (£37.50 a tonne) or less. These and all subsequent costs and prices in this chapter are expressed in real terms in 1987 pounds. No indication was given of the cost level necessary to meet long term import competition (if indeed that was the aim of British Coal). Given our arguments about imports, however, it appears to us that domestic coal, if it is to be competitive, must cost at most £1.4 per GJ (£35 a tonne) within 4 to 5 years, and for real long term security no more than £1.2 per GJ (£30 a tonne). A definition of relevant economic costs is given below. (Throughout we assume that it would never be government policy to allow Britain to become a dumping ground for coal imports subsidised by foreign producers).

These targets may appear difficult, but there are good reasons to believe they are achievable. As we have shown above, they do not have to be met overnight. Coal imports cannot be stepped up appreciably in the short term, perhaps not for 4 to 5 years. Although some British coal capacity may well not be profitable in the medium to long term, a reprieve is justifiable because it is physically impossible to replace the output (where destined for power stations) by imports unless and until one or more new, modern coal terminals are built.

There is, in our view, considerable scope for further raising the efficiency of coal production and for lowering costs in Britain's

*For the average quality of coal produced £1.00 per GJ is about £25 a tonne.

underground mines. Also, opencast production could be increased significantly from the present level of 14 or so million tonnes a year - perhaps towards 20 million tonnes a year. With costs already of only about £1 per GJ (£25 a tonne), opencast operations are a particularly important source of domestic coal which can withstand import competition in foreseeable conditions. Like most mining activities, opencast mining has environmental consequences, but disturbance is often short lived. Completed sites, quite rightly, have to be restored after mining to a state at least equivalent to their previous condition and in the process many are improved. Nevertheless, there is for a time considerable disturbance to local people who would be more prepared to accept mining were they given appropriate compensation. The profits from opencast mining are sufficiently large to be the source of such compensation.

The heart of the matter, however, is the scope for reducing costs in underground mines which at present are capable of supplying about 90 million tonnes of coal a year. Figures 1 and 2 show cumulative cost curves for early 1986 which are fairly flat over most of their ranges; the implication is that the amount of coal which can be produced to meet a given competitive price is rather sensitive to cost changes of about £5 per tonne (£0.2 per GJ). In the light of what we have said about import prices, considerable improvements in efficiency must be achieved before most existing and planned mines can look forward to a secure long run future.

Can underground mining costs be reduced to the figure of £1.4 per GJ (£35 per tonne) which we have suggested as a necessary interim 4 to 5 year target? Let us begin with British Coal's immediate target cut-off cost of £1.65 per GJ (£41.25 per tonne), expressed in terms of colliery costs, which include depreciation but not all overheads. Only the 14 million tonnes of opencast output and 50 million tonnes of deep-mined production were produced at costs at or below that level in 1985/86. There was a further 20 million tonnes below the top price charged to the CEEB (£46.88 a tonne) but above the cut-off point, and a further 20 million tonnes beyond that. If these costs are accurate, then the highest cost tranche of 20 million tonnes is unlikely to have a long term future. The potentially profitable *existing* underground tonnage is around 70 million tonnes (i.e. the 50 million tonnes plus the 20 million tonnes). This is the quantity to keep in mind when considering future possibilities. How much of this 70 million tonnes of underground

capacity can expect to achieve cost levels, by the early 1990s, of £1.4 a GJ (£35 a tonne), or less?

During 1986/87 British Coal achieved considerable improvements in productivity which just outweighed the estimated 10% (£4.60 per tonne) fall in its average selling price. Unit costs, which averaged £1.78 per GJ in 1985/86, fell to £1.60 in 1986/87 (a fall of 10%) and to £1.52 and £1.44 respectively for the last two quarters, although this may have been partly seasonal. For the year as a whole the underground mines made a small operating profit, before interest, redundancy costs, etc., of £39 million compared with a loss of £108 million in the previous year. Productivity, measured as output per man shift, increased from 2.72 tonnes in 1985/86 to 3.29 tonnes in 1986/87 (21%) and to 3.54 tonnes by the first quarter of 1987. According to British Coal, over half of the 21% improvement in 1986/87 productivity was due to greater use of the expensive, heavy duty coal face equipment and only 5 percentage points to closing down uneconomic mines. During the year the number of heavy duty faces increased from 88 (23%) to 119 (39%). Over the next four years this equipment is to be installed on most coal faces.

We do not wish to be unfair to British Coal's management and staff who have accomplished a great deal since the strike, but in interpreting these improvements it needs to be remembered that during 1986/87 British Coal shed nearly 38,000 workers, or 21% of its employees. If they could be shed while output was maintained, then it tells us a great deal about the inefficiencies of previous years.

In sum 1986/87 was a year of considerable productivity improvement for British Coal, but at his end May 1987 press conference the Chairman warned that the last year's progress was unusual and future annual productivity gains could be expected to settle at between 8% and 10%. This is in line with what he has been urging for sometime. If a 10% annual improvement could be maintained it would imply doubling in 7 years from the average 3.29 tonnes per man shift for the year ended March 1987 to around 6½ tonnes. However, in the forty years since nationalisation the industry has achieved productivity growth of only about 3% a year on average. To require the industry in its present structure to make a 10% productivity gain each year may accordingly be unrealistic.

Given that more higher cost mines will need to be closed (the 20 million tonnes of capacity with costs above £46.88 a tonne), and given the forecast rise in productivity in the remainder, further major

reductions in manning are inescapable. They will occur whether British Coal is privatised or not, just as they have done over the past 40 years. The only question is whether inevitable change is recognised and acted upon positively, or whether it is opposed and eventually becomes more harsh than is necessary. We argue later that man power reductions should be achieved by voluntary redundancy with generous compensation for those leaving the industry. For our part we believe the coal industry is capable of making all the necessary adaptations, but only if there is a sensible privatisation scheme. Then its future can be a secure and attractive one. The industry must be on a smaller scale, at least initially, than at present, but not so drastically reduced as is commonly imagined.

Before setting out the basis for estimates of cost reductions and efficiency improvements which privatisation could bring a comparison of underground coal mining productivity in Britain and the United States will give a useful perspective. Set out in Table 4 below is the underground output per employee of British Coal in 1985/86 and 1986/87 and similar figures for underground coal mining in the United States for 1985, the latest year for which information is available.

Table 4
BRITISH AND AMERICAN UNDERGROUND
COAL MINING PRODUCTIVITY

| | <i>British Coal</i> | | <i>USA</i> |
|--|---------------------|----------------|-------------|
| | <i>1985/86</i> | <i>1986/87</i> | <i>1985</i> |
| Production - million tonnes | 88.5 | 87.8 | 316.1 |
| Total employees - thousands | 179.5* | 141.5* | 107.0 |
| Annual coal output per employee - tonnes | 493 | 620 | 2,955 |

* *On an end year basis rather than on average during the year*

(Source: *British Coal Annual Report and Accounts*, and *The Coal Exporters' Association of the United States, Inc.*)

Only broad conclusions can be drawn from such a table because American underground mines generally have more favourable conditions than those in Britain. They are younger mines, often with thicker and geologically less disturbed seams, and are normally nearer the surface. Nevertheless, the latest productivity levels in British underground mines, measured by annual output per employee, are only one fifth of those in the United States. Clearly, the scope for

improvement in Britain is very considerable. If, as we shall discuss, the improvements brought about by privatisation were to show by the early 1990s, annual output per employee in British underground mining would by then double to over 1200 tonnes. This would still be only 40% of the 1985 American level. Because of the less favourable underground mining conditions in Britain, there is little chance of equalling United States levels of productivity. Nevertheless, privatisation should bring substantial productivity gains in the next few years, and continuing gains thereafter.

To try to determine by how much costs might be reduced in the next few years in a competitive coal market, we have examined estimates of possible productivity improvements (both by British Coal and other experts); we have considered the efficiencies achieved in overseas coal mines, making what allowance we can for geological and other differences; and we have assessed the efficiency gains which only privatisation should make possible (see Chapters 1 and 4). Our conclusion is that a lowering of costs of some 25% to 35% in real terms (that is, about £9 to £12½ per tonne) within four to five years should be achievable given the kind of privatisation proposal we put forward in Chapter 4. We would not expect the gains to stop there. Costs should fall further in the medium to long term; and the greater part of the British coal industry could be competitive in 4 to 5 years at prices of no more than £35 a tonne at the mine mouth, and at no more than £30 a tonne a few years later - which are the prices which we have suggested are necessary to match potential imports.

Turning now to the probable size of the industry on various cost and price assumptions, there are serious difficulties in making such an estimate from outside British Coal. British Coal's accounts are not very helpful and only occasionally do bodies such as the Monopolies Commission or the Committee on Energy manage to extract detailed cost information from British Coal. We have, therefore, had to piece together such information as has been published and apply both judgement and analysis.

In reaching our conclusions that by 1992 the greater part of the British coal industry can survive at £35 a tonne mine-mouth prices (for average grade coal) we have used the following procedure. We begin with the cost curve for the first quarter of 1986 derived from published data in the 1987 Report of the Committee on Energy, assuming that since British Coal supplied this data to the Committee it is both accurate and representative. The curve relates to colliery operating

costs, and excludes central overheads.

In determining the viable level of output the only relevant costs are *avoidable* costs. Thus all British Coal's historic cost depreciation is irrelevant representing as it does sunk costs. The relevant cost that is to be included is the continuing essential capital spending necessary to maintain output and cost levels. This we estimate at £6 a tonne. British Coal is currently spending £650 million per year, nearly all of it on its underground mines. Assuming that the expenditure is concentrated on the lower-cost mines (whose capacity totals around 65 million tonnes per annum), this represents £10 per tonne per year. Capital expenditure on underground coal mines in the USA is below £4 per tonne per year. Accordingly, we anticipate that an expenditure of £6 per tonne will be a reasonable estimate for a privatised industry, given the geological and other differences between the USA and Britain.

All British Coal's central overheads have also been excluded since it is evidently detrimental to close any mine that is contributing to such overheads. For the same reason the price the new owners will have paid is excluded as irrelevant to determining the optimal output.

To update the operating costs we then lowered the curve by the ratio of £1.78 per gigajoule (the 1985/86 unit cost for underground coal) to £1.5, the unit costs achieved by British Coal by the end of 1986/87; the cost reduction is almost 16%, although a greater reduction might have been justified if we had used the first quarter 1987 figures. This gives us as up to date an estimate of British Coal's cost curve as outsiders can make. This 1987 derived cost curve was then modified to give an estimated cost curve for 1992. It includes the 10 million tonnes per annum of new capacity presently under construction, and excludes those mines whose production costs are unlikely to be reduced to below £1.5 per GJ by 1992, or within an acceptable period thereafter. These estimates also assume higher utilisation of capital equipment at most mines which will require a major change towards six day working (though fewer shifts per miner per year). Without this change a significant part of underground capacity would be uneconomic. Taken together these factors give a cost reduction of at least £11 a tonne for the economic mines. All this assumes the form of privatisation set out in Chapter 4, and beginning in mid 1988.

It is important to appreciate that private owners making the relevant comparisons of marginal cost to marginal revenue might well keep mines open which British Coal would have closed. No one outside the industry can be sure what information British Coal uses in

deciding on mine closures, but it has been criticised for its use of average (rather than marginal) costs and revenues.

Before turning to the longer term implications of these cost estimates under privatisation we first consider the estimated supply and demand position in 1992.

Table 5
COAL SUPPLY, 1986 (ACTUAL) AND 1992 (ESTIMATED)
(million tonnes)

| | 1986 (actual) | 1992 (estimated) |
|--|------------------|---------------------|
| Opencast | 14 | 17-18 |
| Existing private mines | 4 | 5-6 |
| Planned new mines | - | 10 |
| Total of above | 18 | 32-34 |
| Underground mines with no likely future | 20 | - |
| Underground mines with possible future: | | |
| Higher intermediate cost | 15 | 15-5 |
| Lower intermediate cost | 5) | |
| Lowest cost | 50) | 60-65 |
| Home supply | 108 | 107-104 |
| Net imports (assuming 3 million tonnes export) | 8 | 9-16 |
| Total home supply and net imports | 116 | 116-120 |

The table is based on the assumption that there are no additional major import facilities by 1992, although they could be in place shortly thereafter if an early decision is taken – see Chapter 4.

It can be seen from the table that this import constraint and the estimated requirement of the home market for 116 million tonnes to 120 million tonnes requires 107 to 104 million tonnes to be produced in Britain in 1992. Expansion of the opencast and existing private sector, combined with 10 million tonnes per annum of new capacity should provide a total of 32 million to 34 million tonnes of low cost production by 1992. This would leave a requirement from already existing underground mines of 70 million to 75 million tonnes.

The 20 million tonnes of highest cost capacity will not be competitive. Production from some 55 million tonnes of capacity (made up of the lowest cost 50 million tonnes identified by British Coal

in 1985/86 plus 5 million tonnes from the intermediate cost category of 20 million tonnes) can probably be increased by 10% to 20% to give a further viable tonnage of between 55 million and 60 million tonnes per annum. The remaining 15 million tonnes of the intermediate category would require an average cost reduction of only about 10% from its estimated 1992 position to compete with imported coal, when further imports become possible, which as already noted might be by 1993. We believe that there is a reasonable chance for realising such further productivity improvement for most of this capacity within 3 to 5 years after 1992.

On the demand side (see the totals in Table 5) we have assumed no change or only a small increase compared with 1986; in the longer term we would expect demand for British coal to expand under private ownership, though by how much it increases will depend on economic growth and prices of other fuels.

We conclude that total coal production in Britain in the early post-privatisation period might be in the range 104 to 107 million tonnes a year, not a great deal less than in 1986 when output was about 108 million tonnes. Of this total only between 5 million tonnes and 15 million tonnes would be under threat of displacement by imports, and then only if costs of production of that tonnage could not soon be reduced by a further 10%.

Obviously, no one can be sure exactly how production would change. But our principal point is that, given the considerable potential for cost reductions, it is unlikely that, following privatisation, British coal production would be drastically reduced and replaced by massive imports. Indeed, for the reasons we have given elsewhere (the cheaper coal and the greater diversity and security of supply under privatisation), from the mid to late 1990s onwards demand for coal by British coal consumers may well expand.

Table 5 has been compiled on the basis that the British coal industry would need to be competitive at mine-mouth selling prices of no more than £1.4 per GJ, or £35 a tonne, in real 1987 pounds. While this price level is the appropriate target there is some chance, depending primarily on long distance sea freight rates and currency exchange rates, that British mines would have to meet a £1.2 per GJ (£30 a tonne) target price by 1992 to remain competitive. If this were to occur many more of the higher cost mines (representing possibly 20 million tonnes per year) would have at least temporarily higher cash costs than this, and would be candidates for earlier closure. (No mine

need be closed just because its cash costs exceed selling prices provided the costs can be sufficiently reduced to competitive levels within a few years.) The shortfall which could result from any further closures of what would be a larger category of uneconomic mines might be partly met by expanding opencast production and the small existing private mines. The remaining shortfall, however, would best be met by increased imports, assuming that such imports were physically possible. In the case of power station coal increased imports would necessitate new coal import terminal facilities, a subject developed further in Chapter 4.

Safety and environmental considerations

It is sometimes argued that, under private ownership, costs would be lowered at the expense of safety standards, which would be prejudiced by practices used (say) in America. But whether coal is in the public or private sector should make no difference to safety standards. The health and safety regulations under which the British coal industry must operate provide the highest standards in the world. The regulations are encompassed in the Mines and Quarries Act and already apply to all extractive operations throughout Britain, whether in the public or private sector. Parliament has the responsibility to ensure that appropriate changes are introduced to keep pace with new technical developments, respond to fresh practical experience, and to act as final arbiter of the rules.

The Health and Safety Executive employs Mines Inspectors who enforce the rules by regular mine visits and discussions with all levels of supervision and management. These inspectors are professional engineers with years of experience in the mining industry. The employment, training and independence of these inspectors would not be altered by privatisation. In addition all mine managers and other supervisors must, by law, pass examinations to prove their knowledge of the health and safety regulations. Privatisation of the mines would not alter these fundamental requirements.

Thus the case for rejecting privatisation for fear of falling safety standards is groundless. Well run mining companies should find that rising productivity is accompanied by improved safety, a common experience in North America.

There may also be fears that the environment would not be sufficiently protected if the coal industry were privatised. Production, transportation and consumption of coal all have impacts on the

environment which are not fully incorporated in market prices and which ideally should be a charge on the producer so that the costs used in decision making are the full costs to society. But environmental safeguards are a governmental responsibility which can and should be enforced whether an industry is in public or private ownership.

Estimating the benefits

We can now draw the threads together to make a broad estimate of the overall prize which sensible privatisation might achieve. We divide the benefits of a privatised coal market into three categories. The first consists of the efficiency and associated benefits (primarily gains to consumers) which economists would normally expect to be the result of liberalising a market which had been monopolised. Secondly, there are likely to be benefits to taxpayers who, through the agency of the government, have for years been subsidising the British coal industry. Neither type of benefit is easy to quantify, and there is some overlap between the two. We consider them separately below and indicate the likely order of magnitude of each in 1987 money values. Thirdly, there are the intangible benefits, which in the case of the privatisation of British Coal could be very substantial. The analysis assumes privatisation by mid 1988 (see Chapter 4). If it is deferred, so too would be the benefits.

Efficiency benefits

As explained in Chapter 1, efficiency should improve provided privatisation makes the coal market more competitive. These improvements would exceed anything British Coal is likely to achieve either in its present form as a state monopoly or even if it were transformed into a private monopoly. So long as the market is monopolised, costs and prices are likely to be unnecessarily high and capital expenditure wasteful, no matter how well-intentioned the management of the industry.

Accepted economic theory shows that monopoly results in deadweight losses to society (losses to consumers, not all of which flow to producers) because of the tendency for prices to be higher and output to be lower under monopoly as compared with competition. In addition to the benefit which would arise from eliminating these deadweight losses, there would be a decline in costs which inevitably tend to be excessive when competitive pressures are absent. When monopolised markets become more competitive there are at least three

sorts of cost-reducing influences. Firstly, the presence of competitors makes management and workers alike much more aware of the need to seek lower costs. Secondly, in the case of a market which had previously been in the hands of a state monopoly, reduced politicisation of the market allows management more time to spend on the search for cost savings and to waste less time on bargaining with politicians and civil servants. Thirdly, competition tends to stimulate well-directed research and development efforts which result in faster technical progress (and therefore lower costs) in the long run. In a truly competitive market, most of the cost savings are passed on to the customers of the competing private firms.

Earlier in this chapter we presented some estimates of likely production cost savings over the next few years if the coal industry were privatised so as to establish competition in coal supply. The reduction in average costs by the early 1990s, according to those figures, would approach 25 to 35 per cent (approximately £9 to £12½ per tonne in 1987 prices). Some improvements will occur under the present management, either as a state or a private monopoly, but we would not expect these, on the basis of the handicaps to efficiency of a public monopoly compared with a liberalised privatised industry, to be any more than some £5 per tonne. Thus we would argue that the short term cost reduction arising from privatisation would be of the order of £4-7½ per tonne in 1987 prices. That would be equivalent to £400-£750 million a year in cost savings over an annual coal output of around 100 million tonnes. In addition, there would be other significant gains of the sort explained above which are rather difficult to quantify, but could well be worth £100 million a year by 1992.

There would be another very valuable benefit of a more competitive coal market. For many years competition in the British energy market as a whole has been limited because of the edifice of protection which governments have erected around British Coal. With removal of that edifice, the *whole* energy market would become much more competitive. Since coal accounts for less than half British energy consumption (excluding transport fuels) spillover effects into the energy market as a whole could be quite significant. Although, even outside the transport market, there are constraints on consumers' ability to substitute one fuel for another (especially in the short run because consumers are locked-in to existing fuel burning equipment), the direct benefit from lower coal costs and prices would be multiplied by such spillover effects, resulting in lower costs and prices in all the

energy industries. Clearly, if electricity generation is also made competitive and if genuine competition appears in the gas market there would be still greater effects. We estimate that by 1992 these further benefits would be a minimum of £100 million to £125 million a year. Thereafter, these benefits would rise very substantially.

Taxpayer benefits

Estimating the direct benefits to taxpayers which could be expected from the type of liberal privatisation scheme set out in Chapter 4 is not straightforward. It is necessary to postulate the likely costs to the taxpayer if British Coal continues as a public monopoly, which in turn means postulating its efficiencies, the number of workers it will make redundant and so on. These estimates must in turn be compared with the subsidies and other taxpayer costs which will continue for many years even under privatisation, since commitments to redundant and retired workers must obviously continue. There is the further difficulty that comparisons of benefits for any single future year will differ since the industry will be changing whether it is privatised or not. It is important, however, to attempt to estimate the likely changing burden on taxpayers. We therefore give some broad estimates on a conservative basis using such information as is available to the public.

In what follows, as previously mentioned, and for reasons set out in Chapter 4, we assume the industry will be privatised in about mid 1988. For a continued nationalised industry we assume annual voluntary redundancies of around 10,000 for 5 or more years. British Coal have understandably made no statements on this subject, but their productivity targets imply these sorts of numbers. For the privatised industry we assume a further 5,000 a year, also voluntary. In both cases we assume that the Government continues to finance redundancies. Neither of us would wish to be associated with a scheme which skimmed on the payments necessary to offset the hardship which inevitably results from the transition of an old-established and regionally concentrated industry such as British Coal.

Whether under continued nationalisation or under privatisation we assume that the Government continues to fund the majority of existing and past commitments to those who have retired early, or taken redundancy. The forecast redundancies of 10,000 a year under nationalisation and the additional 5,000 a year under privatisation are not small but together they are slightly fewer in five years than those achieved *voluntarily* in the last two years. Provided that the

redundancy provisions are properly generous; that the admirable job promotion scheme under British Coal Enterprise continues (it has created 16,000 new job opportunities in the last two years and is planning 15,000 in each of the next two years) and that retraining measures also remain in place, then the transition of the industry to one that needs no government subsidies and no import protection, should be acceptable to all involved. It is, after all, the normal condition of most other industries in Britain.

As will become clearer from Chapter 4 when we discuss our recommended privatisation scheme, we urge that the Government remains the channel for financing redundancies in the early years of privatisation. This is to ensure equality of treatment and the confidence of all who are affected.

What differences would arise in government funding under continued nationalisation *versus* privatisation? In deducing the potential benefits to the taxpayer we have made the following assumptions:

- i) under nationalisation, capital expenditures will continue at the present annual level of £650 million;
- ii) under privatisation, capital expenditure will be lower;
- iii) privatisation will produce both greater and faster efficiency gains;
- iv) demand will be broadly level from the electricity supply industry and other customers (although under privatisation it could well rise); and
- v) on privatisation, the Government will receive an initial capital sum and further staged payments (see Chapter 4) which would help to offset outstanding loans to British Coal of about £4,000 million, primarily from the Government.

It should be appreciated that the existing loans are larger than any likely saleable value for the industry; so some capital write-off would be necessary.

If privatisation is effected in 1988 changes are unlikely to occur before 1989. Rather than give year by year estimates we group the four years 1989-1992 and give the expected annual average, and then give a

1995 estimate also. We accept the hope of British Coal that by 1989 it will break-even although we are sceptical about the prospects for significant profitability in later years, given long term trends in world coal prices. We also expect that the high rate of capital expenditure will need continued government financing over and above internally generated cash.

Some government payments will not differ whether the industry is privatised or not; in particular the payments which are a direct government commitment to cover previous redundancies, and other commitments made by British Coal. These combined payments are estimated to average £325 million a year over the period 1989-92, falling to under £200 million in 1995 as prematurely retired miners qualify for a normal pension payable from the normal retiring age.

We arrive at the following estimated annual costs and benefits to the Government (i.e. the taxpayer) from privatisation.

| | <i>Annual Average 1989-92</i> | <i>1995</i> |
|---|-----------------------------------|--|
| Additional redundancy costs | -£100m to -£125m | Government savings from redundancies in earlier years. |
| Reductions in investment funding (savings in the PSBR)* | £130m to £160m | Quite possibly continuing. |
| Tax revenue on the profits of private coal companies | ? | Substantial and probably rising |
| Net government/taxpayer benefits | £30m to £35m | Significant and probably rising. |

* This benefit is not a direct saving comparable with cost savings.

Thus, we expect some increase in redundancy costs in the short term which would be rather more than offset by savings in the external finance which British Coal would otherwise have needed. There would also be tax revenues from the profits of private mining companies, but these we cannot quantify. In sum, there should be a small saving to the taxpayer. Small – because we propose that the social costs of a declining workforce should continue to be met by the taxpayer. In the longer term, net benefits should increase. Privatisation would bring forward redundancies rather than increase them; thus, under continued nationalisation, redundancy payments would probably be

higher than under privatisation. At the same time, PSBR savings would continue and there would be corporation tax payments by private coal companies.

In addition to the annual net benefits which arise from privatisation it is also necessary to consider the net capital benefits. In selling British Coal, the Government will be foregoing the net cash flow each year equal to:

Interest received + profits distributed - capital contribution for capital expenditure.

While capital contribution appears here and also in the table above, no double counting is involved since net capital gains and savings in PSBR are different categories of benefit. Thus, even where there are no net capital gains, there could still be very large savings in the PSBR from the reduced capital funding demands made upon the Government.

In drawing up the benefit tables so far we have assumed that British Coal would break even by 1989 and make modest profits thereafter. We doubt if this cash flow stream is of significant value since it presumes improvements in efficiencies at rates seldom achieved by British Coal. For example, it presumes no significant set-backs, strikes, etc. Realistically, the expected future income stream under continued nationalisation could easily become negative again as it has been for most of the last 15 years. Continuing capital expenditure will also be required and is most unlikely ever to be fully recovered. If the Government attempted to sell the right to this future cash flow stream while retaining the present structure of control and management, the sum it would realise would be nominal if not negative (i.e. investors would need to be paid to assume the obligation). In contrast, if British Coal is privatised under a liberal scheme of the type recommended in Chapter 4, the Government could receive in excess of £1½ billion, and possibly considerably more in some circumstances. Hence privatisation, by increasing the value of the industry to the Government from a negligible and possibly negative sum to £1½ billion or more, creates a clear and very substantial *net* capital gain to the Government and taxpayer.

Certainly privatisation would compel the Government to write-off the difference between the capital proceeds of sale and the outstanding loans to British Coal at the time of privatisation (perhaps £4½ billion by 1988). But this is merely to recognise that much of the capital employed in British Coal, as set out in the annual accounts, is irrecoverable.

In sum, giving British Coal the benefits of any doubts about the value of its future income stream, the direct annual savings to the Government and thus taxpayers may be no more than £30 million to £35 million over the next few years, but would rise significantly thereafter. In addition there is the net capital gain of £1½ billion or more from the sales proceeds of privatisation.

Intangible benefits

There would also be important intangible benefits arising from coal privatisation, as set out in Chapters 1 and 4.

- i) A major reduction of monopolistic forces in the British coal industry leading to the gains suggested above.
- ii) Although there would probably be some further reduction in direct employment in the coal industry in the short to medium term, the rest of the British economy should become more competitive and the rise in national employment should more than offset the reduction in coal industry employment.
- iii) There would be welcome depoliticisation of an unhappy industry, and an enhancement of morale, prosperity, and security of employment for the remaining workforce and management as another major British industry became able to face international competition without subsidy or protection.
- iv) The market for coal in Britain should expand as it becomes cheaper and supplies become more diverse and more secure. Consumers would be more willing to convert to coal as the monopoly power of management and unions diminished.
- v) The economic case for nuclear power would weaken.
- vi) Exports, presently only 3 million tonnes annually, might increase.
- vii) The simultaneous privatisation of electricity will be facilitated. This is an enormous prize. Without it, investors in a private electricity industry might be hard to find, if they were left naked to the power of a monopoly supplier, with all the distortions and extortions which that might entail. For example, a 5% improvement in the value of electricity assets, worth maybe £10 billion-£15 billion would add £500 million-£750 million to the sales proceeds.

Aggregate benefits

Our broad estimates of the aggregate direct benefits from privatising

British Coal are summarised below. Since these are annual averages they are lower than the figures given earlier in the text for 1992.

Table 6
SUMMARY OF ESTIMATED AGGREGATE BENEFITS FROM 1988
PRIVATISATION
(in 1987 prices)

| | <i>Annual average</i> 1989 - 1992 | 1995 |
|------------------------------------|--------------------------------------|-------------------------------|
| 1 Annual benefits | | |
| Efficiency benefits | | |
| Lower prices to consumers, etc. | £350m - £500m | £700m plus and rising. |
| Lower prices of other fuels | £ 80m - £100 | £250m plus and rising. |
| Net government (taxpayer) benefits | £30m - £35m | significant and rising. |
| Approximate total | <u>£460m - £635m</u> | <u>£950m plus and rising.</u> |

2 Net capital benefits to government: £1½ billion plus further payments over 5 to 7 years (see Chapter 4).

3 Plus very substantial intangible benefits.

These conservatively estimated benefits fully justify the liberal privatisation scheme which we propose.

How and when to privatise

In order to obtain the substantial benefits which privatisation offers, three stages are needed. First, a preparatory stage during which a scheme is formulated. This should overlap a second stage in which the small private coal sector is liberalised, as recently recommended by the Select Committee on Energy. The final stage would be full privatisation with the sale of British Coal assets to the private sector. The second and third stages would require changes to the 1946 Nationalisation Act. Liberalisation would require that the phrase *to the exclusion of any other person* be deleted from Chapter 1(1) of the Act and that changes be made to the clauses restricting the sizes of labour forces and coal reserves. Full privatisation would require that the 1946 Act be repealed.

Preparatory stage 1

The privatisation of British Coal in order to promote maximum competition and to involve entrepreneurial skills over a wide range and size of units, poses problems not encountered on such a scale in earlier privatisation schemes. For that reason the Department of Energy would benefit from the assistance of specialists from many backgrounds, including some with experience of successful co-operatives, management buyouts, finance and venture capital, company law and good industrial relations practice. Some, of course, would need to have special knowledge of the coal industry, both in Britain and overseas, to advise on the numerous technical questions which would arise.

The Department of Energy would have three specific tasks:-

- (i) supervising certain immediate liberalisation measures;
- (ii) planning the packaging and disposal by privatisation of all the assets of British Coal; and
- (iii) setting up a new entity, for which an appropriate title might be the Crown Coal Commission, which would have the tasks of holding and allocating coal reserves for future exploration and mining (similar to the pre-Second World War Coal Commission); of administering any residual social and environmental requirements of British Coal; and of promoting competition.

After privatisation, no price regulatory body would be needed since coal prices would be determined by market forces, though if electricity generation remained a monopoly then a regulatory regime would be required to prevent the abuse of power by the CEGB in the purchase of coal. The Crown Coal Commission, however, or some similar body, should be given an overriding duty of establishing and maintaining competition in the supply of coal in Britain, including imports. The Commission would need to exist, at least in embryo form, when privatisation is being planned.

The continued running of British Coal during the transitional period while its operations are being sold poses special but not insuperable problems. One particular task deserving the attention of the specialist advisers referred to above would concern the motivation and reward of management and staff in British Coal during the privatisation planning and handover periods.

Initial liberalisation stage 2

During the initial liberalisation stage the small existing private sector should be encouraged by removing the constraints placed upon it by the Nationalisation Act, and by British Coal's interpretation of that Act. Legal restrictions should be lifted and individuals, co-operatives and private sector firms should be allowed to purchase and operate any mines planned for closure.

Removing legal constraints on the private mining sector

The constraints to be removed may be summarised as follows:

- (i) The labour force in underground mines cannot exceed or greatly exceed 30 men (although a little flexibility is sometimes allowed by British Coal). By contrast the average underground workforce in British Coal's mines was 855 at the end of 1985/86.
- (ii) In the case of private opencast mines, reserves cannot exceed 35,000 tonnes of coal, or - in the case of adjacent sites - 50,000 tonnes. These reserves are very small relative to those of British Coal's opencast operations.
- (iii) Private mines are required to pay wage rates similar to those agreed between British Coal and the mining unions, thus inhibiting employment and mining activity.
- (iv) Private mines receive only discounted prices from the CEGB. Moreover, under the Joint Understanding between British Coal and the CEGB, the latter can take only 5% of its coal (including

imports) from sources other than British Coal. Thus one monopoly has a comfortable but clearly undesirable competition-restraining arrangement with another.

- (v) Underground private mines pay a royalty of £1 per tonne to British Coal. Privately owned opencast mines pay a punitive £13.50 per tonne. Incumbent British Coal pays no royalty to anyone.

In general the private sector works reserves or remnants which are very small (or for other reasons are of no interest to British Coal) but which still make a valuable contribution to the exploitation of the country's coal reserves. Despite its severe handicaps, this small private sector has been consistently profitable. It is undesirable for it to be so constrained, as the Select Committee on Energy has recently pointed out. The Federation of Small Mines of Great Britain has also commented in its evidence to the Select Committee on Energy that the Joint Understanding between British Coal and the CEEB may be in breach of the 1951 European Coal and Steel Treaty (Articles 65 and 66). It is unwise to be at odds with EEC requirements which have the desirable aim of increasing competition.

Contract mining

During the planning period groups of workers (acting as companies or cooperatives) should be given the opportunity to mine coal at those mines which British Coal has closed or is considering closing, and at mines of a size too small to bear the overheads of British Coal. Such groups would contract to supply a given tonnage to British Coal over (say) five years at an independently determined price; and any such contracts would be binding on the privatised successors. British Coal would supply technical services and lease mining equipment to the miners at a price reflecting the costs of such support. Where mines facing closure do not interest miners or co-operatives, they should be offered by tender to private sector mining firms.

Besides helping towards full exploitation of the country's coal reserves, this method of working would offer employment for miners in areas of mine closures. When a coal company in the United States closes an uneconomic but unexhausted mine, small entrepreneurial teams of local miners welcome it. They see the closure as an opportunity to lease the seam from the company to work themselves. There is every reason to hope that British miners might wish to do likewise once a fair and reasonable scheme is devised.

The case against joint ventures

Joint venturing between British Coal and private sector companies has sometimes been put forward as a sensible interim step. Although new ideas about production, distribution and marketing could be introduced into the mining industry via joint ventures, it is doubtful whether any such arrangements would be satisfactory. British Coal, which has had a monopoly for so long, would probably show no more enthusiasm than have British Gas or the CEGB for sharing their facilities with private sector companies (despite their being required to co-operate by statute). Private investment would almost certainly be inhibited by the continued existence of a nationalised corporation, which would be seen as a subsidised competitor, and as a reluctant joint venture partner, subject to continual government interference.

Furthermore, if joint venturing were restricted to new ventures (which seems to be in the mind of most of its advocates, since they see it as a way of introducing external expertise) the short-term impact would be minimal, since it takes ten to fifteen years to plan and construct underground mines of any consequence. If, however, joint venturing is to include existing mines it could be only as an alternative to full privatisation.

Establishing joint ventures with a nationalised corporation which might soon be privatised is not attractive. Finally, any resulting friction between British Coal and private joint venturing companies could well delay or even frustrate privatisation. In sum, joint venturing may look plausible superficially but in practice would be a mistake.

Privatisation stage 3

Given the aim of achieving competition in coal supply, four features of a liberal privatisation scheme are absolutely essential. The scheme must:-

- i) provide for generous profit participation for those who remain in the industry, and adequate compensation for redundant management and employees who leave it;
- ii) attract enough of the best national and international mining expertise without which full efficiencies cannot be achieved nor the necessary, substantial capital attracted;
- iii) be compatible with a liberal form of electricity privatisation; and
- iv) be accomplished expeditiously and embrace the whole industry.

i) Generous treatment of management and workers

It is unlikely that necessary levels of efficiency can be obtained without productivity improvements of the type outlined in Chapter 3. Thus privatisation would be accompanied for a time by a declining labour force in mining. That decline has been in progress for the last thirty years, during which the number of miners has dropped from over 700,000 to only about 110,000; it has been particularly marked over the last two years (since the strike) during which period the total workforce has dropped by around 80,000.

Redundancies there will be whether British Coal continues in its present shape or whether private sector firms succeed it, since costs cannot otherwise be reduced to competitive levels. The scale of these further redundancies, however, will not be as large as is commonly expected for the reasons set out in Chapter 3, where we estimated total redundancies over the next five years as 75,000, two-thirds of which will probably occur if British Coal continues as a nationalised industry. It is desirable that redundancies should remain voluntary and be generously compensated. We strongly recommend the reinstatement of a government-funded redundancy scheme along the lines of that which stopped at the end of March 1987. Other government-funded measures to alleviate the social impact of closures and the reduction in the labour force should be continued along present lines; for example, generous retraining facilities, measures to introduce new employment in coal mining districts and help with relocation. Equally, those who stay with the industry should be given the opportunity to share in its profitability. The prospective direct gains to coal customers, electricity customers, taxpayers, and the other indirect national gains (most notably in national employment prospects) fully justify such measures.

ii) Attract the best national and international mining expertise

To improve productivity rapidly and provide the substantial capital which rationalisation will require, the terms of privatisation must attract sufficient participation of experienced firms in the private sector. For an industry whose production and capital requirements are very diverse, varied forms of ownership are more appropriate than centralisation under either a state corporation or a private monopoly. Some smaller mines might best be run by workers' co-operatives; there could sensibly be management/staff buyouts for small to medium-size operations; but the largest mines should be owned and operated by

experienced mining companies, if only because of the large capital sums and the technical and commercial knowledge required. For these mines it is best to attract four or five major private sector groupings.

iii) Compatibility with electricity privatisation

Competition in electricity generation (which, like coal, is not a natural monopoly) is highly desirable. Our general assumption in this paper is that electricity generation will be liberalised as well as privatised. If, however, the government mistakenly chooses to preserve the CEEB or a successor private monopoly, special measures will be needed. A private monopoly in electricity supply would dominate a coal industry with competing suppliers. In these circumstances a regulatory body for electricity supply would be needed to see fair play for coal suppliers before potential investors would be willing to bid for coal mines, but this would be a very poor second best for potential coal investors.

iv) Expeditious and comprehensive accomplishment

Privatisation should be carried out expeditiously to avoid a long period of uncertainty for management, employees and customers which would inhibit future planning. It should also embrace the whole industry and not leave a rump of the least efficient mines in public ownership.

The timing of stage 3 privatisation

Some people who accept the case for privatisation wish to postpone it. Leaving aside those who urge such postponement in the hope of eventual abandonment of the idea, what of those who genuinely believe that a few more years of progress under present arrangements are justified as a desirable precursor to any form of privatisation, on the grounds that it may be better to sell an industry only when it has returned to profit? This is a seductive argument with undoubted political appeal. It is, however, seriously mistaken.

Only if there were a case for privatising it whole (for instance, because it was held to be a natural monopoly, which it is not), would the profitability of the industry as a whole be relevant to the timing of privatisation. In contrast to British Gas, it is certain that higher capital sums would be raised by breaking the industry into a number of companies, rather than by privatising it as a whole (though capital raising should never be the main objective of privatisation). Indeed few might subscribe for shares even in a private monopoly if, as would be

all too likely, it persisted in the non-commercial practices of British Coal.

Delay should be avoided for two other compelling reasons. First, the process of privatisation to introduce competition in coal supply and to incorporate the best technical and commercial knowledge from the worldwide mining industry would both enhance and bring forward the gains arising from increased efficiency. Second, once a major change is identified as desirable there are strong arguments against postponing it. A long period of uncertainty would be very hard on British Coal's existing management and workers. It is for these reasons that we urge privatisation as quickly as possible, and assume mid-1988 in our analyses in this paper.

Desirable features in acceptable schemes

In addition to meeting the essential requirements set out previously, any privatisation scheme should incorporate several further desirable features.

- i) The fewer the long term subsidies granted the better. Those permitted should be only for social or environmental reasons (and, possibly, to enhance security of supply).
- ii) Any subsidies should be for specific purposes and for a strictly defined period, after which they would be subject to review.
- iii) Because of the industry's financial state, special terms may be required to ensure that the Government receives fair payment. Capital payments for coal mines could, for example, take the form of an initial sum followed by staged payments, which could be profit-related, over (say) 5 to 7 years. Such a period would allow electricity privatisation to take place and for longer term import trends to become apparent. It would also give management and workforces every incentive to maximise efficiency if a significant part of their pay and incentives were profit-related - see iv) below. If profit-related purchase schemes are considered too difficult to administer, revenue-related ones would be a possible alternative. The Government could also consider the simpler option of retaining minority shareholdings in the larger privatised companies in the expectation of capital appreciation and future sale.
- iv) Management and workers, as a condition of sale, should be offered generous participation in privatised mines by some appropriate

combination of profit-sharing bonuses and shares (or the equivalent of shares). The terms should ensure that private firms have an interest in buying the mines and running them efficiently in the long term, and that workforces have appropriate incentives, combined with long term job stability.

- v) The coal industry pension scheme should be kept in existence to retain the confidence of all in the industry, and to ensure that pensions are portable between the privatised companies. Portability - widely demanded in all occupations - is necessary to ensure management and labour mobility within the diversified coal industry. At the time of privatisation it is also essential that the pension scheme is fully funded, albeit with the right of the Government to recapture any overfunding which can be shown to exist say 7 to 10 years later. The proposed Crown Coal Commission could be charged with overseeing the pension scheme.
- vi) The Government, perhaps through this Commission, should own and allocate coal reserves. Access by all parties to such coal reserves should be free and equal. No firms of any size, from miners' co-operatives upwards, should suffer discrimination. Allocation should be on clearly-defined criteria which could include some form of competitive bidding, and commitment to given production levels, or work programmes. Economic rent should be extracted through normal corporate profit taxes, rather than through revenue-related levies such as royalties which tend to increase mine operating costs and create a bias in favour of imports.

Desirable complementary features in electricity privatisation

It is not possible to discuss and recommend coal privatisation schemes without taking into account the privatisation of electricity generation, which - like coal - should be turned into a competitive industry. Generation, unlike transmission and local distribution, is not a monopoly activity. One scheme would be to have say five to ten regional generating groups making use of a common carrier central grid (which would preferably be privately owned and regulated), and five to ten regional distribution boards (again preferably in the private sector and regulated). The regional distribution boards would be the customers of generating groups and at the time of privatisation long term power contracts would be created for most of the output of the generating stations, encouraging competition between them in

supplying the remaining needs of the Area distribution companies, with increasing competition over time.

Detailed consideration will be given to these and other possibilities in our forthcoming paper on electricity privatisation. But the essence of what we propose is, on the one hand, stable long-term power contracts to justify a proper price being paid for generating assets; and, on the other hand, the ensuring of sufficient and increasing competition to promote efficiency. Any scheme with these broad characteristics and involving competition between generating companies to buy coal supplies would make it worthwhile for any mining firms confident of their technical and commercial abilities to invest in privatised coal.

There is one more important matter to consider. This is whether there is a case for a modern coal terminal.

The case for a modern coal terminal

In Table 5 in Chapter 3 we set out the estimated coal supply position for Britain in 1992 assuming privatisation and the need to sell coal at no more than £35 a tonne at the mine-mouth. The suggested imports might be 12-19 million tonnes, assuming exports of 3 million tonnes. If the level of competitive prices were to fall to £30 a tonne, the need for import capacity could rise to 20 to 25 million tonnes a year. In the light of these potential requirements it is appropriate to reconsider the case for a large modern coal terminal. It is clear that the British coal industry, made up as it is in large part of deep multi-seam mines, many of which are more than 25 years old, and some very much more, is unlikely to be capable of supplying the whole British market economically. Imports are therefore an essential element in a liberalised market, particularly if the demand for coal expands. Accordingly, we believe that the case exists now for the CEB together with the SSEB to plan a new coal terminal of say 15 million tonnes per annum capacity. For the reasons set out previously it might be four years or more before such a terminal could be operational but it may well be needed by the early 1990s.

Commencing to plan and build a new terminal now would have several purposes. It would make clear to both the British coal industry and the electricity supply industry that the interests of coal and electricity consumers were henceforth to be paramount. Second, it would sharpen the concentration of all involved in the British coal industry to have to meet international competition without operational subsidies (social subsidies are a different matter) within four to five

years. Third, even if the coal terminal is not fully utilised when first built – or even after many years, depending on the efficiency of the British coal industry – it would be an invaluable insurance policy for the CEEB (or its private sector successors). At a cost of say £100 million to £150 million (or cheaper, if a floating terminal is feasible) it would be a sensible investment to ensure keener prices on an annual coal purchase outlay of several billion pounds. Fourth, it would enhance security of supply by protecting against a future oil crisis, a nuclear shutdown or a future coal strike in Britain.

For all these reasons, most of which apply whether or not coal is privatised, we consider the Government should lift restrictions on CEEB and SSEB coal imports and ensure that they plan and construct a large new coal terminal.

The choice of schemes

Three forms of privatisation merit examination:-

- i) privatising British Coal as a monolith;
- ii) offering all mines, both opencast and underground, for sale on an individual basis, subject to tender; and
- iii) offering the existing British Coal Areas for sale by tender.

The advantages and disadvantages of these methods need to be considered against the list of essential and desirable features set out earlier in this chapter.

i) Privatising British Coal as a monolith

This scheme is the simplest form of privatisation and might be expected to meet least internal resistance from managers and employees; it would bring the fewest pressures for uncomfortable change. The disadvantages are so many, however, that it is very debatable whether it would be any better than leaving British Coal in the public sector.

It would merely mean replacement of an unnecessary public monopoly of coal production by an unnecessary private monopoly. The scheme would be against the interests of customers and taxpayers; it would not enhance national employment prospects, and it would prevent the rapid injection of private sector technical, commercial and management expertise. Above all, it would fail to add a competitive spur to the industry. Moreover, the privatisation of electricity would be

handicapped, since the scope for lowering electricity costs and for increasing the security of coal supplies would be reduced.

There are still further drawbacks. If coal were to be privatised in its entirety, there might well be no public interest in buying shares in a company which in recent years has almost always lost money, which would have an unchanged management and workforce, very large capital requirements, and no certainty of long term profitability. Individual shareholders are hardly likely to be interested, nor could they be advised to invest, particularly as they would have little control of management. These objections would also apply to corporate investors since a consortium of companies would need to be involved, and it is hard to see the attractions of joining such a consortium. Any attempt to sell off British Coal as a monolith would either attract too few takers, or result in an unreasonably low price for the Government. For all these reasons privatising British Coal as a monolith should be firmly rejected as a serious option.

A variant of this scheme, which has been suggested, is the selling of British Coal in its entirety to its existing management and workers – the so-called ‘co-partnership scheme’. This has superficial attractions because, it is argued, it would create higher morale amongst managers and workers, or at least cause less resentment and fewer difficulties than other schemes. While this might be true initially, it is unlikely that the reaction would be lasting because it achieves so few of the essential and desirable points listed previously. From the Government’s viewpoint it is very unlikely that any significant capital sum could be raised from the co-partnership approach; the industry would probably have to be given away. This in itself is not sufficient reason for rejecting the scheme if it could meet all the other criteria of successful privatisation. But it does not. There would be only minimum pressure to rationalise the industry either quickly or thoroughly. There would be no input of the external management and the technical and commercial expertise which the industry so badly needs.

Subsidies might have to continue, perhaps indefinitely unless overtaken by other forms of privatisation. Without competition within the industry, without improvement in the diversity and security of supply, demand for coal would continue to decline. The industry thus privatised might have great difficulty in raising the large capital sums needed for rationalisation and new mines. The Selby mining complex, for instance, has a capital cost of £1,500 million for 10 million tonnes per annum of capacity while Asfordby will cost £400 million for 3 million

tonnes per annum. Further, a monolithic, co-partnership privatisation scheme would largely negate the gains to be expected from complementary electricity privatisation. That is a particularly serious drawback.

Co-partnership raises other basic problems, and in particular how the worker ownership is to be inaugurated and how it is to be provided with the financial stability to survive. Presumably, the proposal would require that each working miner would be offered a share and corresponding voting rights in either British Coal as a whole or his particular Area Board. With the latter, basic problems would arise in that the miners in the high cost areas (who face the most insecure future) would be given low value shares, whilst those in the low cost areas facing a secure future would be given shares that were highly valuable.

Under either option the decision taking would be dominated by caucuses of miners and unions with little or no experience of commercial management and caught between their desire for job security (based on continuing cross-subsidisation) on the one hand, and on the other hand their need to come to terms with losses, and with the necessity for commercial viability. Such complications would be incompatible with the decisive and strong management essential if the industry is to survive without subsidies and in competition with imports – the tests which privatisation must meet to be justified.

We conclude that if the industry were privatised as a monolith the outcome would inevitably be a flight of both management and finance from the industry leading either to collapse or to restoration of public ownership. If privatised under co-partnership but on an Area rather than national basis, the initial gross inequities referred to above would be compounded by a rapid flight of management and capital from the weaker Area boards leading to their early insolvency.

In summary we believe co-partnership to be one of the least sensible forms of privatisation. It would appear to be unfeasible both managerially and financially. It would probably fail and require rescue. It is hard to see that it is better than leaving British Coal in the public sector in its present form.

ii) *Privatisation of individual mines*

This scheme has much more in its favour. It would ensure great pressure to achieve efficiencies, and would be of interest to a wide range of firms and existing managers and workers. It could lead to

major improvements in efficiency and would have some significant attractions for customers and taxpayers.

The difficulties of privatisation on an individual mine basis, however, are formidable. The technical and legal problems involved in drawing up prospectuses for 100 or more mines and other businesses would be a huge task resulting in such long delays that its accomplishment would always be in doubt, bringing uncertainty, and causing dissension within the industry. Fears of job losses would be increased. Subsequent problems of industry rationalisation by the amalgamation of groups of mines to achieve optimal exploitation of reserves would be considerable. This kind of scheme would not attract, and might well deter, the involvement of the national and international private sector, so vital to achieving efficiency and securing the long term prospects of the industry. Efficient world-scale coal mining companies are usually much larger than all but the very largest of British mines. If a mining group or consortium were interested only in a substantial investment (in, say, 10 to 15 million tonnes per year of capacity) it might be discouraged by the trouble and expense of bidding for say 20 to 30 different mining units in order to achieve a sufficiently interesting and viable set of say 10 to 15 mines. Clearly, then, this route could lead to the failure to sell a large number of mines despite their reasonable long term prospects, leaving them on the Government's hands. For these and other reasons, the Government might fail to realise a proper capital sum from the exercise and, worse still, fail to establish the industry in its most economic long term form. In sum, although this approach has advantages over privatising the industry as a monolith, its drawbacks loom so large that it can hardly be considered a serious option.

iii) *Area board privatisation*

There is some advantage in working, as far as possible, with existing organisations. The last two years have seen increasing devolution to Area management in the coal industry with encouraging results. There already exists a complete or near-complete management team in each area charged with putting it, as far as is possible, on a commercial stand-alone footing. It is, therefore, sensible to build upon this organisation and loyalty by privatising British Coal initially on an area basis. Subsequently, there would be further reorganisation leading to the variety of producing units which, as explained earlier, should be the eventual aim of coal privatisation.

Of all the approaches to privatisation, initial privatisation by area is the most likely to provide the necessary motivation and to maintain morale among existing managers and employees. It would give them the prospect of remaining, in the first place, in a structure similar to the one in which they were already working and would provide the best chance of continued employment with increased security and attractive profit incentives. Managers and employees would be less opposed to rationalising or closing unprofitable mines since they would automatically be considered for transfer to other mines within the area.

It would be much easier to produce the nine or so prospectuses which would be involved in the offer of Areas for sale than the scores of prospectuses which would be required for individual mines, since legal problems involved in defining the precise limits of individual mines and their associated reserves would be avoided. By privatising initially on an area basis, the units would be of a size which could be expected to attract large, experienced companies able, certainly for medium and larger mines, to achieve the necessary levels of efficiency. As mentioned, most modern coal companies are of a size much closer to existing areas than to individual mines. Under this scheme each area would, in the first place, be formed into a 100% owned operating subsidiary of British Coal. Employment contracts would be transferred to these subsidiaries with no diminution in rights, terms of employment, or entitlements to pension.

One relevant question is whether the opencast mines should remain as a unit or be dispersed amongst the areas in which they lie. The case for keeping them together and privatising them as a unit is strong. The opencast sector is certainly the most profitable part of British Coal and could be expected to find ready purchasers. On the other hand, it would reduce the attractions of many areas if they did not contain opencast operations. Many coal companies in other countries operate both underground and opencast mines. Since it is desirable to make it possible for all areas to be privatised speedily and to hold out the prospect of profitability for each one of them (without which private sector participation would not occur), it would appear sensible to allocate opencast operations to the relevant areas in the first phase of the privatisation exercise, and to study the question of management integration. Set out in Table 7 are the area operating profits (losses) for the financial year to end March 1986, calculated on the basis that opencast mines are distributed to the areas in which they

lie. The table shows that six of the then ten areas (South Midlands has now amalgamated with North Derbyshire) would have been profitable in the financial year 1985-86 with opencast mines included, as opposed to two which were profitable with deep mine operations only.

It is of considerable importance that the management and employees in all areas have equal and compelling financial incentives to support privatisation. The provision of such incentives (investment opportunities, profit sharing etc) should indeed be one of the conditions for bidding. While this will reduce the sales proceeds of all areas, particularly in the more marginal ones, it is both equitable and essential.

If some areas appeared to involve disproportionate risks or levels of management effort before they could become viable they might prove unsaleable in isolation. It may therefore be necessary to consider making it a condition of sale that these are acquired by bidders purchasing the more strongly viable areas. This would provide greater opportunities for job relocation. These are matters for careful investigation during the privatisation planning period.

Area managements, with the help of British Coal headquarters, would provide for the Department of Energy (or directly for the proposed Crown Coal Commission) both technical and cost information on individual mines during the preparatory stage of privatisation. Provision of this information would give potential investors reasonable time to judge how much to bid for areas; payment, as we have explained, could be made under some kind of staged scheme. Where mines seemed to have little hope of a profitable future they might have to be put under a commitment to close before privatisation - in other words, they would be excluded from the areas for which bids would be asked.

To provide continuity and to give a minimum revenue to attract investors, it would probably be necessary to keep in being for a limited period existing arrangements under which areas supply power stations (the CEGB and SSEB) at certain guaranteed volumes and prices; there could, for instance, be a tapering provision (both volume and price would taper) which would reduce over a defined period the proportion of an area's output which was sold in this way. As this tapering period drew on, more and more competition would be introduced into the sale of coal. Full competition would exist from the beginning in the supply of coal to consumers other than the CEGB and SSEB, i.e. a quarter of all coal produced in Britain.

Table 7

AREA OPERATING PROFITS (LOSSES), YEAR ENDED 31.03.86
Including re-distribution of opencast profits to deep-mine Areas

| AREA | Underground | | Opencast | | Profit/(Loss) (£ millions) | Total tonnes produced | Profit/(Loss) (£ millions) | Profit/(Loss) (£ per tonne) |
|------------------|--------------------|-------------------------------|--------------------|-------------------------------|-------------------------------|--------------------------|-------------------------------|--------------------------------|
| | tonnes produced | Profit/(Loss) (£ millions) | tonnes produced | Profit/(Loss) (£ millions) | | | | |
| Scottish | 4.3 | (46) | 2.6 | 56 | | 6.9 | 10 | 1.4 |
| North East | 9.5 | (34) | 2.8 | 88 | | 12.3 | 54 | 4.4 |
| North Yorkshire | 13.9 | (61) | 0.0 | 0 | | 13.9 | (61) | (4.4) |
| South Yorkshire | 12.5 | 11 | 1.5 | 31 | | 14.0 | 42 | 3.0 |
| North Derbyshire | 6.2 | (26) | 1.4 | 28 | | 7.6 | 2 | 0.3 |
| Nottinghamshire | 18.7 | 97 | 0.0 | 0 | | 18.7 | 97 | 5.2 |
| S. Midlands | 6.2 | (17) | 2.7 | 71 | | 8.9 | 54 | 6.1 |
| Western | 9.4 | (27) | 1.0 | 12 | | 10.4 | (15) | (1.4) |
| South Wales | 6.6 | (65) | 2.1 | 57 | | 8.7 | (8) | (0.9) |
| Kent | 0.5 | (3) | 0.0 | 0 | | 0.5 | (3) | (6.0) |
| TOTALS | 87.8 | (171)* | 14.1 | 343 | | 101.9 | 172 | 1.7 |

* before strike recovery costs - see Tables 1 and 1a

(Source: National Coal Board Report and Accounts)

During the bidding procedure, the Crown Coal Commission or the Department of Energy would need to guard against collusion and to ensure that the basis for a genuinely competitive industry was established. There would probably need to be limits placed on the number of areas for which a company or a consortium could bid. A general prohibition on owning more than one area would probably be unnecessary; nevertheless the ownership of two of the larger areas might be regarded as competition-restricting. It would be for the Commission or the Department to judge the merits of each situation on the basis of the bids they received.

Privatising on an Area basis would be only an initial (though an important) step which should not be allowed to preclude a wider spread of ownership of mining operations of different sizes. Once the areas were in private ownership, further changes in the structure of the industry would be desirable leading to the diversified structure which would be the objective of privatising individual mines (see ii above). These changes would quite probably come about naturally as the new owners decided that some of their operations should be sold off - for instance, to managers wishing to buy out, to other firms in the private sector, or to groups of miners wishing to set up co-operatives. Were such changes not to occur, it might seem appropriate for the Coal Commission or the Department of Energy to step in to encourage some divestment in the interests of developing competition in an industry where operations of many different sizes should be able to flourish. We would not rule out some combined ownership of power stations and associated coal mines during this second phase, assuming that electricity generation was being privatised and liberalised at about the same time as coal, subject to the provision that there should be no significant diminution of competition.

To sum up, although there are several ways in which privatisation could be achieved, no road towards a fully liberalised coal market will be easy after forty years of nationalisation. However, the approach outlined above (and it is only an outline) seems to us a reasonable basis for discussion since it appears capable of bringing about the major benefits inherent in a much more efficient British coal industry, providing secure jobs and holding out the prospect of long term expansion in output.

Probable sales proceeds from privatisation

One final matter of importance remaining to be discussed is the

potential sales proceeds from privatisation. It is not possible to be precise on this matter because it depends on so many factors, but it is important for us to indicate the likely range of sales proceeds. We do this under the following assumptions:

- i) British Coal is privatised in mid 1988 by initial Area by Area (including opencast sites) sale to private sector companies.
- ii) The privatised coal industry would need to be competitive with imports at the equivalent of £35 a tonne at the mine-mouth (in 1987 real terms) by 1992, and will be producing the 1992 output set out in Table 5 of Chapter 3. This assumes achieving the efficiency improvements which underlie the Table 5 estimates.
- iii) The electricity generating industry is privatised on a competitive basis so that the CEB and SSEB are no longer the sole purchasers of power station coal.
- iv) There are tapering coal contracts in price and volume terms (as set out earlier in this section) between the areas and the CEB and SSEB, and those coal contracts would be assumed by any private sector successors to these entities.
- v) Redundancy payments post-privatisation would be funded by the Government.
- vi) Managers and employees would be given generous profit participation incentives in the privatised companies on an equitable basis to encourage acceptance of the new industrial structure.
- vii) Purchase prices would consist of an initial capital sum and further profit or revenue related payments over the subsequent five to seven years.

Given the conditions noted above we would expect the aggregate initial capital payment to be around £1,500 million, possibly more, and the subsequent annual profit related payments over five to seven years to be in the range of £150 million to £300 million.

Clearly the initial proceeds will depend on the area prospectuses, the enthusiasm of the management and employees of British Coal, and the perceptions of potential private sector purchasers. The further staged annual payments will also depend upon productivity achievements, and the price and availability of imports. We hope, however, to have indicated the orders of magnitude which could be involved.

It is hardly necessary to add that these purchase price estimates,

and indeed the whole future of the industry, turn upon the industry establishing reasonably harmonious industrial relations.

This in turn requires a generous profit participation scheme for those who remain in the industry and who could, therefore, expect a more prosperous and secure future. Those who leave the industry must, as we have consistently urged, be treated generously to secure voluntary redundancy. In addition, full support must continue to be given to the creation of new jobs and retraining in those areas affected.

Summary and conclusions

Objectives of privatisation

In this paper we have set out to show the benefits to the nation from coal privatisation on a competitive basis, and how and when this should be done. The main aim of privatisation should be to make the British coal industry internationally competitive within five years. This vitally important objective is achievable only under an efficient privatisation scheme of the form outlined in this paper.

The record of nationalisation

The British coal industry has not realised its potential. Since nationalisation in 1947, when British Coal was given the almost exclusive right to mine coal in Britain, it has been a monopoly high-cost producer, from which the electricity industry has been required (by successive governments) to purchase virtually all its coal supplies. As a consequence, electricity costs in Britain have been unnecessarily high, contributing to the decline in manufacturing industries and thus to the rise in national unemployment. Despite oil price rises during the 1970s and early 1980s, British coal production dropped and market share was lost to other fuels. Only a small, restricted, but nonetheless efficient and consistently profitable private sector is permitted to operate on remnants of coal and the recovery of coal from colliery tips. Its achievements point to what privatisation could achieve.

Despite a captive market and supported prices, British Coal has made losses for much of its history and has required large subsidies from the taxpayer. Between 1981 and 1986, government financial support has totalled £6.3 billion, i.e. over £1.25 billion a year on average - a sum equivalent to over three-quarters of British Coal's average wage bill. The net effect of this is an industry which, despite the considerable and praiseworthy improvements of the two years since the strike, has in its present form no serious prospect of viability - i.e. of supplying coal at internationally competitive prices. This condition is not the fault of British Coal's management and employees: it is inherent in its public monopoly structure which causes all major policy and investment decisions to be politicised by management, employees, unions and government, with minimal long-term accountability or the need to meet the critical tests of commercial reality. Accordingly, in its present

form, it will not achieve anything approaching its full potential. The same will be true if it is privatised as a monopoly: it will remain an economic drain on the nation, and the value of its future contribution is likely to be negligible, if not negative. The introduction of competition under a sensible scheme of privatisation would offer a far superior alternative to all involved.

Criteria for privatisation

Coal production is not a natural monopoly and the introduction of competition within the industry will ensure that coal is supplied both as efficiently and as cheaply as possible. However, to reverse the decline of the industry and to ensure competition, fundamental changes to the structure of the industry will be required. These changes must ensure a permanent improvement in the industry's efficiency, and this should be a primary aim of privatisation rather than maximising the sales proceeds to government, as has been the case with some other major privatisations (e.g. British Gas). In fact, privatising the coal industry on a diversified rather than a monolithic basis will also realise the maximum sales proceeds since the industry will be much more marketable on this basis, and accordingly investors will pay greater sums.

An effective privatisation scheme has certain essential requirements. These are that the scheme must:-

- i) realise the identified major benefits;
- ii) provide both for generous and attractive profit participation for all who remain, pension arrangements at least as good as the present ones (with full transferability within the industry), and generous compensation for redundant employees with continued job creation and retraining schemes;
- iii) attract sufficient of the best national and international mining expertise needed to raise efficiency, and also attract the necessarily large sums of capital required in this capital-intensive industry;
- iv) be compatible with a liberal form of privatisation of electricity generation; and
- v) be accomplished expeditiously and embrace the whole industry.

All these critical points are fully developed in the main body of this paper but a few important observations are worth repeating. Privatisation can and must be made attractive to present and future

management and employees. We estimate that if British Coal is to achieve its stated productivity targets of 8% to 10% improvement a year, some 10,000 voluntary redundancies and retirements will be required in each of the next five years. To reach the higher efficiency targets which are required for the industry to be internationally competitive within five years, a further 5,000 voluntary redundancies a year would be required over the same period, a total of 75,000 over five years. This needs to be compared with the 80,000 reduction in manpower achieved voluntarily in the last two years. If the redundancy arrangements remain as generous as those of the past two years (one of our most important recommendations), we believe that those extra redundancies will be achievable without demoralisation or hardship.

We also stress the need to link coal privatisation to electricity privatisation. The electricity industry purchases over 95% of its coal requirements from British Coal (equivalent to over 75% of British Coal's annual output). Accordingly, to privatise electricity generation on a competitive basis, (which is the only way to maximise efficiency) but to leave it to the mercies of a high cost monopoly coal supplier, will greatly lessen its attraction for investors. Conversely, if coal is privatised on a diversified competitive basis it will attract few if any investors if 75% of its output is bought by two customers who are the monopoly suppliers of electricity. Accordingly, the privatisation of the two industries should be planned simultaneously and executed as near to the same time as possible. These are points which we shall cover fully in our forthcoming CPS paper on electricity privatisation.

Favourable impact of privatisation

It is often feared that the impact of privatisation and the consequent need to be internationally competitive would result in a massive closure programme and consequent redundancies. Our estimates, based on our researches into the achievable efficiencies of the British coal industry under privatisation (which probably requires mine-mouth selling prices of £35 a tonne in 1987 money values to be internationally competitive), give a very different picture. By 1992, the output from existing underground mines (now 90 million tonnes per annum) is likely to be in the range 70-75 million tonnes per annum plus a further 10 million tonnes per annum from new capacity due on stream in the next five years. If the total British market for coal remains static at today's level of around 115 million tonnes per annum (though

indeed with the lower prices and greater diversity and security of supply under privatisation the market could well expand) imports will amount only to around 12-19 million tonnes per annum compared with 10-11 million tonnes per annum today.

Due to the lack of modern coal terminals it would be physically very difficult to import more coal by 1992, however economic such imports might be. For this and other reasons we urge that the Government should encourage the CEEB and SSEB to build a 15 million tonnes per annum coal facility which could be in place within four to five years. In addition to demonstrating that the interests of coal and electricity consumers are henceforth to be paramount, such a terminal would enhance the security of supply of Britain's energy by protecting against a further oil crisis, a nuclear shutdown, or a future coal strike. In short it is needed primarily as an insurance policy. While it would permit a near doubling of imports from (say) 1993 onwards, the 15 million tonnes per annum of underground capacity which would be displaced by such imports would need only to reduce its 1992 production costs by just over 10% to remain competitive at coal prices of £35 a tonne. Such a cost reduction could well be achievable under privatisation in a further few years beyond 1992.

Benefits of privatisation

Much of our paper is devoted to the critical issue of estimating the net benefits to be derived from privatisation as compared with continuing British Coal as a monopoly. These benefits turn upon the comparison between the performance of the industry under privatisation and monopoly. We believe our estimates are realistic but conservative, and sufficient for basic decision-making. Assuming early privatisation, the benefits (see Table 6) can be set out under three categories:-

- a) the tangible annual benefits to consumers and taxpayers, after financing generous redundancy payments (net benefits of around £450 million to £650 million in the years to 1992, rising to at least £950 million by 1995, and more thereafter);
- b) the net capital receipts from privatisation (estimated to be at least £1,500 million as an initial down payment and a further £150 million – £300 million per annum on a profit related basis over the next five to seven years); and
- c) the very substantial intangible benefits which may be summarised as follows:-

- i) A major reduction of monopolistic forces in the British coal industry leading to the gains suggested above.
- ii) The gains to the rest of the British economy, plus the rise in national employment prospects resulting from cheaper coal and electricity, should more than offset the further modest reductions in direct coal industry employment.
- iii) There would be welcome depoliticisation of an unhappy industry, and an enhancement of morale and prosperity, together with security of employment for the continuing workforce and management, as another major British industry became able to face international competition without subsidy or protection.
- iv) The market for coal in Britain should expand as supplies become cheaper, more diverse and more secure. Consumers would be more willing to convert to coal as the monopoly power of management and unions diminished.
- v) The economic case for nuclear power would weaken.
- vi) Exports, presently over 3 million tonnes annually, might increase.
- vii) Finally, there is the substantial prize of facilitating the simultaneous privatisation of electricity.

How best to privatise

Three main schemes with some variants have been examined:-

- a) privatising British Coal as a monolith;
- b) offering all mines for sale on an individual basis; and
- c) a two phase privatisation, first of the existing areas including opencast activities, and second by further rationalisation once privatised, leading to a competitive diversified coal industry.

The first objection to privatising British Coal as a monolith is that privatisation would have to be delayed until British Coal is seen to be earning sustainable profits such that its heavy capital expenditures (presently £650 million a year) would be acceptable to its new owners. It could be years before this happened, if it ever did. There are other serious objections.

Monolithic privatisation is not viable since without introducing some new senior management – possessing great commercial and financial expertise – the industry would almost certainly be unsaleable to private investors. It would be unable to secure the major financial

resources which rationalisation requires. Sale of the industry to the existing workforce (the so called co-partnership scheme) would be even less viable since the latter would be even less capable of securing access to financial resources. The management structure would be weakened so as to preclude the essential rationalisation which the industry must achieve if it is to survive.

Joint ventures between British Coal and private sector companies are similarly unattractive and cannot be recommended.

Privatisation of mines on an individual basis is more attractive since it would be of interest to a wide range of firms, existing managers and employees and should introduce major efficiency improvements. It poses, however, formidable legal and technical problems in drawing up prospectuses for over 100 different mines and the delays could run into years, demoralising the industry in the process. Equally seriously, it might result in too many small companies which would reduce its attraction to the international mining companies whose experience, management and financial resources are vital to rationalisation. It could also result in many mines finding no purchasers, leaving the Government with an unprofitable and demoralised rump of the industry. For all these reasons it is not a serious option.

This leaves the third scheme: privatisation on an Area-by-Area basis with tapering, medium term contracts between the Area Boards and the CEEB and SSEB or their successors. This offers the best prospects for speedy privatisation, and the sale of the whole industry in units of viable size. This would achieve the maximum gains in efficiency by attracting sufficient technical, managerial and financial resources. It would hold out the best employment and profit sharing prospects for management and employees, and obtain by far the highest sales proceeds for the Government. For all these reasons, we believe that Area-by-Area privatisation is the best option. Indeed, it is the *only* worthwhile one.

The timing of privatisation

The best time for privatisation deserves careful consideration. Many who favour privatisation in principle wish to postpone it in practice. Partly this stems from fear of management, employee and union opposition which should be dealt with by generous compensation to all who are made redundant (a much smaller number than has commonly been feared). There is also the argument for awaiting the arrival of profitability. We consider, however, that there is no need to

wait until British Coal achieves long term viability, if it ever does, because that is a requirement only if it is to be privatised as a monolith, an approach which we reject as undesirable, indeed unworkable.

Delay should be avoided for two other compelling reasons. Firstly, the process of privatisation to introduce competition in coal supply and to incorporate the best technical and commercial knowledge from the worldwide mining industry would both enhance and bring forward the gains arising from increased efficiency. Secondly, once a major change is identified as desirable there are strong arguments against postponing it. A long period of uncertainty would be very hard on British Coal's existing management and workers. It is for these reasons that we urge privatisation as quickly as possible, and have assumed mid-1988 in our analyses in this paper.

The ultimate justification for privatisation

The ultimate justification for privatising the British coal industry is that it offers the early prospect of a strong and viable industry at a level of output similar to that of today. In contrast, continued nationalisation holds out the prospect of the industry dwindling to a fraction of its present size over the next decade while continuing to need large and probably increasing subsidies. In such conditions the livelihoods of both management and employees would be under continuous threat, as would be the security of coal supply to the nation. The demand for coal would accordingly fall.

It follows that privatisation with competition is in the interest of both the nation and those employed in the industry. Privatisation would increase efficiency, lower costs to the point where the industry could compete internationally without subsidies or protection and, by enhancing the security of supply, should expand the market for coal in Britain. It should be seen not as the destroyer of the British coal industry, but as its saviour.

Glossary

| | |
|------------------|---|
| Longwall mining | the method by which most coal is mined in British underground mines. A cutter-loader travels along the coal face (or wall) delivering coal onto an armoured face conveyor for subsequent transfer to the mine's main coal transport system. |
| Giga Joule (GJ) | a measure of the energy content of coal. Coal of average quality contains about 25 Giga Joules per tonne. |
| Mine-mouth price | the price of coal at the mine, excluding any transport charges to the consumer. |
| BSC | British Steel Corporation. |
| CEGB | Central Electricity Generating Board. |
| SSEB | South of Scotland Electricity Board. |
| ESI | Electricity Supply Industry. |
| ARA Ports | the ports of Amsterdam, Rotterdam and Antwerp. |
| Steam coal | coal destined for steam raising; most British coal is of this type. |
| Coking coal | coal destined for conversion to coke. |
| Deep mines | underground mines. |
| Opencast mines | surface mines. |
| EFL | external financing limit. |
| Liberalisation | the introduction of competition throughout the British coal mining industry to reduce long-term costs and increase efficiency. |
| Joint venture | a suggestion frequently made that coal mines should be jointly owned by both British Coal and private-sector companies. |