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Coal – Initial Scoping Note

I hope you will find the following comments on your August note of some assistance.

Paragraph 25

There appears to be a misunderstanding about the international market for fuel for power stations and heavy industry. International coal prices disengaged from oil prices as long ago as 1976.

After the collapse in oil prices in 1958 and throughout the 1960s, heavy fuel oil was the driving force in providing fuel to meet growing demand from power stations and heavy industry. Because of its low price and other advantages like low labour requirements and lower capital investment, heavy fuel oil supplied an increasing part of that market and coal consumption throughout the western world reduced in both percentage and absolute terms. The massive increase in oil prices in 1973/74 changed this completely and permanently. When it became clear that the new level of oil prices would hold, the oil companies reappraised their future marketing policy fundamentally and concluded that there would be little or no profit in selling heavy fuel oil to power plants and heavy industry and that they would be better to refine a much greater proportion of the barrel instead. They decided that coal would and should replace heavy fuel oil and they themselves made the largest investments in developing new low cost sources of coal which could be traded economically over long distances using their experience in low cost large vessel bulk shipping.

This major change in direction started to become apparent as early as 1976. After that, the international coal market became characterised by increasing coal on coal competition. The second oil price rise of 1979 made heavy fuel oil totally uncompetitive with coal. However, it is significant that it hardly affected international coal prices as the production of new coal mines, mainly owned by the oil companies, were then becoming available to the market. It is significant that the rise in coal prices in the early 1980s to an historic high (before and since) was caused not by the second oil price rise but by the sudden interruption to Polish coal shipments because of the Solidarity crisis.

It is important always to keep in mind that even now, less than 10% of the steam coal produced in the world is traded internationally; the rest is sold principally to power stations near to where it is produced and much of that under period contract.

International coal prices delivered to the UK in the future will be determined mainly by coal on coal competition and of equal significance, the exchange rates, not only $/sterling but Australian $/US $.

Very recent experience shows how coal on coal competition operates. Prices are in fact no longer at the level quoted in the Scoping Note -115p/120p/GJ cif UK port in large vessel. Mainly because of the active marketing of more Chinese coal in the Pacific and the prospect of more to come, steam coal prices in Europe have eased and cif prices in the UK are now returned to a level of about 105p/GJ. This in fact is in line with the forecast, which my Company made ten years ago, as a useful long term reference price.

A significant weakening of the US dollar could push prices in sterling to a higher level but the future value of the Australian dollar is perhaps even more important because Australia is the major influence on international coal prices, both steam and coking. If it were to strengthen, all international coal prices would rise at least partly to offset its greater value.

At today's exchange rates however there is every indication that a cif UK port price of ***1O5pIGJ*** enables efficient modern mines, both opencast and underground, to operate profitably and to justify the continuing investment needed to sustain capacity in this extractive industry.

Paragraph 29

The questions posed here demonstrate the confusion between current objectives. It is essential for determining future strategy to recognise that a reduction in C02 emissions per kilowatt from coal fired power stations can only be achieved if the generating efficiency of coal plant is raised. Fgd to reduce sulphur and other emissions actually reduces efficiency and increases C02 emissions.

Availability of coal plant in the UK over the next decade will be determined primarily by the demand for the power it produces. Coal generation has become very much a residuary legatee but reduced nuclear, now clearly past its peak, much higher gas prices which both deters new build and gives opportunities for arbitrage on existing gas contracts and the effects of NETA in remunerating load following plant more fairly, have all resulted in a significant increase in coal burn. Coal consumption at power stations in the UK during the first half of 2001 was 27m tonnes compared with 22.7m for the same period last year which in turn was higher than 1999. At present there is no obvious reason why coal burn at UK power stations should not settle down for the next few years at around 50m tonnes a year. If that is the now the "natural" rate of burn, then the necessary coal plant to burn it will be preserved because the generators and everyone else in the industry —want to access that part of the power market in the most economic way. The effect, however, has already been to increase C02 emissions in 2000 compared with 1999, by 2% and we can expect a further increase of the same amount this year compared with last.

Paragraph 31

The forecasts made of the capacity of existing deep mines in the 1998 Review assumed that the Selby mines would operate until 2009/10. There is now no possibility of this. Production at Selby has already fallen away and the mines are likely to close in 2004/5 even if some subsidies were to continue in the meantime.

It was already obvious when the original BCC data became available to future purchasers that Selby had an uncertain future and that steps needed to be taken promptly if efficient capacity was to be created in time to take over from it. The best opportunities for doing so with the minimum planning and investment problems were the development of Thorne with a possible link to Kellingley and the linking of Daw Mill and Coventry to work the reserves of Thick Coal between the two mines. Other smaller possibilities were the combining of Rossington and Markham Main and the return of the Hem Heath mine to its full potential capacity.

All of these would have offered lower costs of production than any plan to create completely new deep mines. Of these, the development of Thorne remains a practical possibility.

At present, however, there is no willingness on the part of any of the investors to commit the funds involved to invest what is required and more importantly to wait for at least the three to five years needed for the best of the schemes to start production. The recent problems relating to the development of Hatfield are a good example of the disinclination of investors to put money into deep mines and statements by the revamped UK Coal show every sign of a business being run largely for cash.

Paragraphs 34 and 39

Despite the labour problems of the coal industry in the 1970s and 1980s, there was a recognition of the value of coal in the UK energy mix and within that of additional benefits offered by UK produced coal. Both were much diminished by the scale of the constitution of new gas fired plant. Whether that gas fired plant can be sustained in full operation in the future, let alone increased is now being seriously questioned. With the present uncertainties, there would seem to be no economic reason for adopting policies which would further reduce the much smaller share that coal currently provides in generating electricity. As the principal constraints on the future market for coal are environmental, then it is important that the environmental objectives which are embraced and implemented do not have the result of driving coal burn down uneconomically until it has been established what practical progress can be made in raising the generating efficiency of coal plant and whether sequestration of C02 is practical and economic.

Within the total consumption of coal within the UK, UK produced coal offers some advantages which in the past secured valuable premia. However, the marketing of UK coal from the early 1980s and particularly after 1986 was very much a defensive process. Tactics and timing were of key importance and when the principal UK coal producer decided to take up an extreme position at the end of its contracts in 1998, the weakness of the home producer was clearly exposed. The premia that can now be commanded by UK producers over the market are much diminished and in terms of price per tonne are probably very small now and in the future. It is important however for your final Report to recognise that a higher contract price per tonne is not the key issue for the future of UK coal production capacity. More important now would rather be a commitment by the consumer to take a stated tonnage for at least three years at a pre—determined price. This is the only way in which the significant investment can be underwritten which is essential to slow down the decline in efficient production capacity in the UK. However, as ownership of generating plant has become more fragmented and as the owners of that generating plant are more exposed to future trading uncertainties in their own market place, that all important guarantee is more difficult for them to give to coal producers. The generators' risks in the present market are instinctively passed through to the providers of the principal raw material, the fuel, and as the swing fuel, coal is placed in the most exposed position.

Paragraphs 36/37

What we have seen in the past three years is a major consolidation amongst the main exporting producers of steam and coking coal in the face of exceptionally low market prices and the threat that traders might again exercise what producers would consider to be inordinate market power. However, there does not appear to be any realistic threat of a Coalpec. Although consolidation of ownership has reduced competition at the margin, the principal cause of the big rise in international coal prices towards the end of last year was the serious problems within the US, of increasing power demand uncovered by new investment in generation and transmission and the impact on the traditional coal producers in the Eastern States of environmental restrictions, both in terms of coal quality and the operation of mines.

It is these problems that the current US Administration's Energy Programme is designed to address. If it is successful, then coal production should rise and the whole electricity system gain greater flexibility. If this happens and the exceptional and historically most unusual tight supply situation in the US power and coal markets ease, then there is no reason at all to believe that the buying power of the big utilities and the increasing concentration also amongst steel mills will not be fully a match for the larger companies now involved in the production of so much of the internationally traded coal.

Paragraph 38

With the surge in power station coal imports, now running at an annual rate of 20m tonnes, about three times the level of 2000, UK port capacity to handle large coal ships is clearly overstretched. The most important single decision to be made is the investment in the second new terminal on the Humber. It is understood that a capacity of 5m tonnes a year could be created within eighteen months to two years in return for a guarantee of as little as LiOm. This alone would virtually solve all the port and rail constraints which are now very obvious.

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