Policy towards the Nationalised Industries. Financial Control. Privatisation.

NATIONALISED INDUSTRIES

Pt 1: May 79
Pt 3: Oct 80

PART 3

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~27.10.80~~							
~~3.11.80~~							
~~4.11.80~~							
~~5.11.80~~							
~~13-11-80~~							
~~20.11.80~~							
24.11.80							
~~28.11.80~~							
~~8-12-80~~							
~~11.12.80~~							
~~23-12-80~~							
~~2.1.81~~							
12.1.81							
~~19.1.81~~							
~~2.2.81~~							
~~5-2-81~~							
18.2.81							

PART 3 ends:-

NZ5 [redacted] to Ind of 23/2/81.

PART 4 begins:-

1665 to PM (Qa 05262) of 3/3/81.

TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
E(80) 121	17.10.80
E(80) 38th Meeting, Item 2	22.10.80
E(80) 125	3.11.80
E(80) 39th Meeting, Item 2	5.11.80
E(NF)(80) 7	18.11.80
L(80) 71	26.11.80
L(80) 71 (Revise)	28.11.80
E(NF)(80) 8	11.12.80
E(NF)(80) 3rd Meeting, Minutes	16.12.80

The documents listed above, which were enclosed on this file, have been removed and destroyed. Such documents are the responsibility of the Cabinet Office. When released they are available in the appropriate **CAB** (CABINET OFFICE) CLASSES

Signed *OWayland* Date *4 August 2011*

PREM Records Team

vb

10 DOWNING STREET

From the Private Secretary

c. HMT FCO
D/IND ~~MOD~~
MOD CDL
DOE CWO
TRADE CO
D/N
Ch. Sec, HMT
Fin. Sec, HMT

23 February 1981

Nat Ind

Cable and Wireless

The Prime Minister has seen your letter to Nicholas Huxtable of 19 February. She has asked why it has been decided to sell less than 50% of the Government's shares, when it seems to her that retaining only 33% of the shares would be sufficient to continue effective control.

We shall clearly need to resolve this matter before we can give approval to the timing of your statement. Since the Prime Minister will be in the United States from Wednesday to Sunday of this week, I shall be grateful if you could let me have a note which I could put in her weekend box.

I am copying this letter to the Private Secretaries to members of E(DL), Michael Arthur (FCO), Jonathan Dawson (MOD) Nicholas Huxtable (Chancellor of the Duchy's Office), Murdo Maclean (Chief Whip's Office) and David Wright (Cabinet Office).

N. J. SANDERS

J.C. Hudson, Esq.,
Department of Industry.

CONFIDENTIAL

National Industry Policy

VLB

cc Andrew Duguid ✓
Recipients below.

10 DOWNING STREET

From the Private Secretary

23 February 1981

The Prime Minister was interested to see the recent exchanges about the role of non-executive directors in nationalised industry boards.

She is not much impressed by the kind of rules suggested in the memorandum attached to the Secretary of State for Industry's letter of 10 February. She takes the view that Ministers and their Departments should concentrate their efforts on getting the right people to fill directorships: the rest, she believes, will then take care of itself.

I am sending copies of this letter to Jim Buckley (Lord President's Office), John Wiggins (H.M. Treasury), Julian West (Department of Energy), Godfrey Robson (Scottish Office), John Craig (Welsh Office), David Edmonds (Department of the Environment), Stuart Hampson (Department of Trade), Anthony Mayer (Department of Transport), David Wright (Cabinet Office) and Gerry Spence (CPRS).

M. A. PATTISON

I. K. C. Ellison, Esq.,
Department of Industry.

VLB

Prime Minister

To note that the Treasury have agreed £145m extra for British Telecom's EFL for 1980/81. Another public sector blow.

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Sir Keith Joseph MP
Secretary of State
Department of Industry
Ashdown House
123 Victoria Street
London SW1

18 February 1981

Dear Keith,

Flag A

Thank you for your letter of 5 February about the prospective overrun on British Telecom's EFL in 1980-81.

It is disappointing that in spite of your letter of 19 January to Sir George Jefferson, in which you urged every effort to reduce the excess to the lowest possible figure, BT will not admit any possibility of containing the overrun to less than £160 million. It is also disturbing that an overrun of this order can appear so late in the year, and that a significant part of it should be accountable in terms of factors - relating to the level of stores - which have been within the industry's control.

I recognise that BT's revenues have been hit by the recession, and that prospects for effective offsetting action at this stage of the year may be limited. On the other hand, the public expenditure position as a whole is also very tight. In recognition of BT's difficulties, I am prepared to agree that its EFL should be adjusted, but I can only agree to an increase to £145 million. Can I suggest that an announcement should be made by means of an arranged PQ as quickly as possible?

I am copying this letter to the Prime Minister and Sir Robert Armstrong.

Leon

LEON BRITTAN

CF Mr Wolfson
Mr. Duguid ✓

2

PRIME MINISTER

Lord Soames and Sir Keith Joseph are in correspondence about the role of non-executive directors on nationalised industry boards. Lord Soames has in mind a more formalised increased role, whilst Sir Keith would prefer to keep matters on an informal basis.

Do you want to add to these exchanges?

MAP

17 February 1981

I think it absurd to hedge the role of non-executive directors with rules of the kind described in the DOI memo. Concentrate on getting the right directors and the rest will take care of itself. MT

2a

LORD PRESIDENT OF THE COUNCIL

Civil Service Department
Whitehall London SW1A 2AZ
01-273 4400

The Rt Hon Sir Keith Joseph Bt MP
Secretary of State for Industry
Department of Industry
Ashdown House
123 Victoria Street
LONDON SW1E 6RB

Mike

10 February 1981

12
13/2

Dear Keith,

NATIONALISED INDUSTRIES BOARD APPOINTMENTS AND THE ROLE OF NON-EXECUTIVE DIRECTORS

Thank you for your letter of 12 January and the memorandum enclosed with it about strengthening the role of non-executive directors in the nationalised industries for which you are responsible.

I entirely share your view that non-executive directors can make a very effective contribution and that it is well worth seeking ways to do so. I know how difficult it sometimes is for sponsoring Ministers and their departments to find the right men to fill vacancies on Boards. I can certainly envisage occasions when it would be very useful to tap the knowledge and advice of non-executive directors.

I am uneasy, however, about formalising this in the way suggested by the memorandum. Parliament and the public just about accept that sponsoring Ministers should not be answerable for the day to day affairs of nationalised industries; but they do regard them (rightly) as fully accountable for the appointments they make at Board level. I very much agree with what Norman Fowler and David Howell say: the choice of Board members is one of the principal ways in which sponsoring Ministers can influence the efficiency, competitiveness and general conduct of the nationalised industries. So I think we must be very careful about anything which could weaken the Minister's position and which could be seen by Parliament and our supporters to be likely to do so. In practice, I should have thought that the introduction, across the board, of the arrangements proposed in the memorandum would be bound to circumscribe Ministerial discretion. Moreover, the introduction of formal arrangements of this kind could weaken the authority of the Chairmen; and that, too, is surely not what we want.

I am not arguing against informal use in specific cases of arrangements similar to those suggested in the memorandum. For a particular industry at a particular time it might well be appropriate to tap the ideas of the non-executive directors. What I question is the desirability of introducing formal arrangements of the kind described in the memorandum and applying them to all your industries. Amongst other things, this would be bound to generate pressure on other sponsoring Ministers to introduce comparable arrangements even if they did not think them appropriate. So my advice to you would be to have a fresh look at paragraph 4.

As to Audit Committees, I again share your view that it would be right to make greater use of them in nationalised industries and to involve non-executive members in their work. It may of course be difficult to recruit non-executive members of the right quality and with the experience necessary to make a contribution to the work of Audit Committees; but this is a general problem in the appointments area and I am sure you have it very much in mind.

I am sending a copy of this letter to the recipients of yours. Like you, I should be very interested to know their reactions. I am also sending a copy, together with a copy of your letter and enclosure of 12 January to the Prime Minister in view of her interest in public appointments.

Yours ever

Christopher

SOAMES

JU

010

No A
and

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB
TELEPHONE DIRECT LINE 01-212 3301
SWITCHBOARD 01-212 7676

Secretary of State for Industry

5 ~~January~~ February 1981

The Rt Hon Leon Brittan QC MP
Chief Secretary
HM Treasury
Parliament Street
London SW1P 3AG

R.
4/2

Dear Leon,

will request if required

BRITISH TELECOM FINANCING 1980/81

John Biffen wrote to me on 18 December about British Telecom's threatened overrun of their external financing limit this financial year, and in my response on 19 January I confirmed that I was pressing BT to reduce this overrun to the lowest possible figure.

2 Sir George Jefferson assures me that, on taking up his post of BT Chairman in September, he instituted an in-depth review of BT's financing problems and took measures to make all possible savings. However, a continued increase in the depth of the recession has led to a further deterioration in BT's revenue forecasts for 1980/81. At the same time, the scope for reducing the overall level of stocks and materials awaiting installation (a problem area) has been limited by the need to maintain the increasing telecommunications network and to reduce waiting lists for the installation of telephones and other equipment. In the light of these points, Sir George advises me that the best he can hope for, with the help of strict economy, is to keep the EFL overrun at £160 million; he sees no basis on which he could offer assurance of coping with a requirement for a lower figure.

3 As Treasury officials can confirm, senior BT management is of the view that BT is threatened with an overrun of around £180 million - or even £200 million - and that it will be very difficult to hold the excess even to £160 million. We have to accept that BT's target for levels of stock and materials awaiting installation (involving a decrease in real terms) was almost certainly unrealistic. In the light of these points and what Sir George Jefferson has told me, I can see no prospect of obtaining a commitment to hold the EFL excess below £160 million, though Sir George appears ready to accept a commitment to this figure.

/4 ...

4 I must therefore reluctantly recommend that we increase British Telecom's external financing limit by £160 million, subject to a firm commitment from Sir George to hold BT's external financing during the current financial year within the revised limit. Subject to your agreement I suggest that officials should get in touch to draft an arranged PQ.

5 I am copying this letter to the Prime Minister and Sir Robert Armstrong.

Yours

Keith

-6 FEB 1981

4

Prime Minister
Nat Ind
There is some
good sense in
this letter.

T.
9/2

T/on
PM saw it (for two seconds) for Questions
N

CAW

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

5 February 1981

T Lankester Esq
Private Secretary
Prime Minister's Office
No.10 Downing Street
LONDON SW1

Dear Tim

MANAGING NATIONALISED INDUSTRIES

In case you have not already seen it, I attach a text of a lecture given by Sir William Barlow to the Royal Institute of Public Administration on 26 January. The Chancellor has a great deal of sympathy with his analysis and prescription and has asked Bill Ryrie to appraise it alongside the other work going on in this field. You may wish to draw the Prime Minister's attention to the paper indicating that we are studying it further.

Yours ever

Peter

P S JENKINS
Private Secretary

H

Nat Ind

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB
TELEPHONE DIRECT LINE 01-212 3301
SWITCHBOARD 01-212 7676

Secretary of State for Industry

5 February 1981

The Rt Hon John Biffen MP
Secretary of State for Trade
1 Victoria Street
London SW1H OET

Dear John,

will request if required

SECTION 11 OF THE COMPETITION ACT 1980: FUTURE REFERENCES

Since John Nott wrote to me on 8 December I have been considering whether we could propose some nationalised industry candidate for reference to the Monopolies and Mergers Commission. It was agreed between us that it would not be timely to refer British Telecom and that another investigation into the Postal Business would come too soon after the last reference on the London Postal Region.

2 As I understand it, British Aerospace will no longer be eligible for reference under S.11 once it is a limited company whose members are no longer appointed by me under the Aircraft and Shipbuilding Industries Act 1977.

3 This leaves this Department only with British Shipbuilders (BS) and the British Steel Corporation (BSC). You will be aware that, apart from naval shipbuilding, BS is in the fiercest international competition and I do not therefore think it would be useful to refer them to the Commission. The Corporation has a tied customer in the Ministry of Defence for naval shipbuilding but MoD are reducing their volume of orders which will involve contraction. It is thus, I suggest, inappropriate to burden BS with an MMC reference as well as the pains of contraction.

4 BSC also operates in an intensely competitive environment involving acute international competition and the question of their efficiency (or otherwise) is largely determined by reference to their success in a commercial world. Moreover, the Government are in the process of setting up joint public sector/private sector companies in the areas of overlap between BSC and the private sector. This - and BSC's programme to restore profitability - are taking every moment of BSC's senior management's time and energy, and for these reasons any reference of BSC under section 11 would be counterproductive.

/5...

5 I am copying this letter to the recipients of yours.

6 FEB 1981

Yours.

Keith.

CONFIDENTIAL

NAT Ind: Policy

SECRETARY OF STATE FOR TRANSPORT

DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

Prime Minister

To note that the Docks Board are likely to breach their EFL for 1980/81.

The Rt Hon Leon Brittan MP
Chief Secretary to the Treasury
Treasury Chambers
Parliament Street
LONDON
SW1

2 February 1981

Dear Leon.

MO

4/2

BRITISH TRANSPORT DOCKS BOARD: EFL FOR 1980-81

I think I should let you know that the British Transport Docks Board are forecasting a significant breach of their external financing limit this year; they expect to fall short by about £5m of their negative EFL £10m. I have written to Sir Humphrey Browne emphasising the importance we attach to the performance of the nationalised industries this year; the Chancellor also put this message across strongly when he met the nationalised industry Chairmen last month.

The Board have reacted promptly in response to the deterioration in trading conditions: in the face of an 84% decline in trading profit since the beginning of the financial year they have cut investment by 40 per cent and increased charges by 13 per cent. Moreover the Board's scope for cutting costs is severely constrained by the difficulty of shedding surplus dock labour so long as compulsory severance is impossible.

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CONFIDENTIAL

While I shall continue to press Sir Humphrey Browne to do what he can to achieve the maximum performance by the Board, I believe that we must accept that they will not be able to meet their EFL.

I am loth to allow such a large breach of the Board's target to pass without taking some action. A normal response might be to insist that they make good the shortfall next year. But, as I have argued earlier in discussion of EFL's, the target we have set BTDB for 1981-82 is a very tough one, and to demand more would be counter-productive; worse, it might impair their attractiveness to investors if flotation is delayed.

In the circumstances I believe it would be far preferable to agree to an increase in the Board's EFL now. I appreciate that this will be far from welcome in the light of increases in other industries' targets already agreed. But BTDB remain one of our best prospects for flotation and I think it is essential that we avoid doing anything which might prejudice this. Presentationally, I believe it would be better for the Board to meet a revised EFL than to breach the original limit.

I would therefore be grateful if you would agree to a revised EFL of £5m.

I am copying this to the Prime Minister, other members of E Committee and Sir Robert Armstrong.

James Fowler

NORMAN FOWLER

CONFIDENTIAL

10 DOWNING STREET

(1) Copy of this to – blocking out my comments – to Tolkien (Treasury)

(2) BF. 9/2

1

Prime Minister

Mr Howell wants a discussion on the N. Industry financing problem. You also suggested one. Shall I fix one up with Chancellor, KJ, DH + officials in about a month's time when the Byatt group should have got somewhere?

Yes MT

R.. 4/2

cc Mr Byatt

PRIME MINISTER

I was extremely interested to see Geoffrey Howe's minute of 16 January and the report by Treasury officials on nationalised industry financing.

I entirely share his view that there is no simple answer to these problems but I do believe that he has raised some fundemental issues on which I would welcome the opportunity for some discussion.

I welcome his emphasis on the need for inventiveness in our approach to privatisation. This is of course an area where resolution of the PSBR problem coincides with our broader political and social objectives. Certainly in my own special field I have been concerned to foster such innovative developments between the public and private sectors, and as you know I am moving forward in a number of areas and have others under consideration. Apart from the partnerships between BNOC and the private oil companies there is the gas-gathering pipeline, our intention to legislate to enable private equity to be introduced into BNOC, and our proposal to break BGC's privileged position on purchasing gas from producers which, to be worthwhile, will almost certainly involve co-operation between BGC and private firms in using the existing national distribution main. We shall also shortly be considering how to deal with BGC's appliance retail business in the light of the MMC report. Beyond these developments in the energy sector I think we have to recognise that any radical move forward may lead into areas where the net balance of advantage may be more doubtful and may bring us up against new and major problems. We agreed at E(DL) last May that there might be such possibilities for the longer term but acknowledged that no workable options could be identified at present. To address these possibilities seriously would mean dedicating a considerable effort from our constrained resources, and I therefore suggest that we should first discuss which particular areas offer sufficient prospect of success to make it worthwhile.

There is no doubt that the big prize would be to get the coal industry out of its state mould. I see this as attainable but only if we stick single-mindedly to the current strategy of policies that push NCB into profit first.

I was glad to see Geoffrey's suggestion that officials should examine further the questions at the end of the report about the possibility of devising new financing techniques which might allow some easement of PSBR constraints on worthwhile investment. The NI's themselves attach considerable importance to this, and I believe this is an area where innovation might well also suit Government interests. It may well be that wider possibilities would open up with advantage to both interests if we can switch emphasis from the PSBR to GGBR. I therefore hope the studies which Geoffrey suggests will be pursued in a positive and constructive way with a firm determination to overcome the many difficulties exposed in the paper.

DH

SECRETARY OF STATE FOR ENERGY

2 February 1981

CONFIDENTIAL

2 PP's

Nat Ind

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

2 February 1981

Private Secretary to the
Secretary of State for Industry
Ashdown House
123 Victoria Street
London, SW1E 6RB

Dear Ian,

NATIONALISED INDUSTRY FINANCING: BRITISH TELECOMMUNICATIONS

Thank you for your letter of 28 January proposing that a clause should be added to the British Telecommunications Bill to permit BT to borrow from the market subject to the agreement of the Secretary of State and the Treasury. The Chancellor is content for this to be done so that the necessary powers to borrow from the market are available to BT if it is decided to proceed with a limited experiment of this kind. As you know, the Prime Minister has recently agreed that new forms of borrowing for the nationalised industries should be examined on an experimental basis as recommended in the Chancellor's recent paper. Discussions have been going on between our Departments and BT to see whether a BT bond of a worth-while and practical kind can be devised. In accepting the clause your Minister will have to make it clear that this is on a contingent basis and that no change in the present methods of financing have been agreed.

The Chancellor has no objection to a similar power being taken in respect of the Post Office.

I am copying this letter to the recipients of yours.

Yours ever,

Peter

P S JENKINS

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB
TELEPHONE DIRECT LINE 01-212 3301
SWITCHBOARD 01-212 7676

PS/ Secretary of State for Industry

28. January 1981

Peter Jenkins Esq
Private Secretary to the
Chancellor of the Exchequer
HM Treasury
Whitehall
London SW1

P 26/1

Dear Peter

NATIONALISED INDUSTRY FINANCING BRITISH TELECOMMUNICATIONS

As you may know, our officials have been exploring further the possibility of a performance bond for British Telecommunications, following the Chancellor's minute of 16 January to the Prime Minister.

2 I understand that the merchant bank's report commissioned by British Telecommunications on the feasibility of such a bond will be completed by 13 February.

3 Should we wish to move down this road, it will be necessary to take a power in the British Telecommunications Bill to permit British Telecommunications to borrow from the market subject to the agreement of the Secretary of State and the Treasury.

4 The progress of the Bill through Committee is speeding up and we expect the relevant clauses to be reached next week; some Opposition amendments seeking to achieve the same effect have already been put down.

5 While my Secretary of State does not wish to pre-empt matters, he hopes you can agree to an appropriate amendment, on a contingency basis, being put down early next week from the Government side. In view of the urgency, we have already instructed Counsel to draft accordingly.

6 To avoid specultation about a Telecommunications bond we would express readiness, if you agree, to accept a similar amendment in respect of the Post Office when the appropriate clause is reached.

7 I am copying this to No 10, PS/Sir Robert Armstrong and Robin Ibbs.

Yours ever
Richard Riley

RICHARD RILEY
Private Secretary

CONFIDENTIAL

Top copy returned to J.H.

26 January 1981

Discussed with J.H. and agreed not to include his amendment. JL. 27/1

MR LANKESTER

NATIONALISED INDUSTRY FINANCING

not so brief in the event, 5 pars

1. I have not had an opportunity to discuss Robin Ibbs' comments with Alan Walters. Here are my brief comments with a suggested modification to the letter you have drafted to go to the Chancellor's office.

2. My feeling is that the CPRS comments are still rather superficial, because they are themselves commenting on Ryrie's paper which itself was superficial. I may be wrong - not being an expert, nor having unlimited time to think about these things - but the feeling I had from the Ryrie paper was of a group of people doing a fairly routine survey of familiar terrain and then sticking the results together with scissors and paste. I did not get the feeling of one or two brains really <u>straining</u> to get to the heart of a problem which had got to be solved.

3. For example, should we not be distinguishing more fundamentally between that part of the PSBR which relates to nationalised industry investment (investment which is at least notionally meant to generate a flow of income hopefully greater than the servicing costs of the original borrowing) and that part which simply funds expenditure for which adequate taxes have not been raised?

4. Once you say that, you start to ask more fundamental questions about the latter category of borrowing. Do we now accept an expenditure gap every year as part of the normal order of things? To be filled by borrowing which itself must be serviced by further tax or further borrowing? Or do we hark back to the original Keynesian idea that this was a contra-cyclical measure? I think there have only been one or two years of budget surplus since the war. Where is the MTFS meant to take us? What is the target - a PSBR which is the fourth year percentage of GDP? Or will it eventually be projected through to a balanced budget?

5. Even if the PSBR eventually became an NIIR (Nationalised Industry Investment Requirement) there would still be the very real

difficulty that, if the investment didn't pay off, there would be no "mortality process" by which the house of cards collapsed, as there is in the private sector. I am not therefore saying that some more rigorous thinking about what the hell the PSBR really means would solve the nationalised industry problem, but simply that it logically comes first. It might then change the nature of the problem - or at least the financing aspect of the problem. Most or all the others would no doubt remain to be solved.

6. The above thoughts may fizzle away to nothing. It may well be that Ryrie and his people have been right through this in great depth and come out the other side. But if Alan and David Young (with whom we shall be discussing nationalised industry financing in the next couple of days) think there is any substance in them, then we need to start with a more profound look at the whole PSBR* problem <u>before</u> looking at nationalised industry financing problems (though of course, looking at other aspects of monitoring and improving nationalised industry performance could go on quite independently). While I therefore agree with Robin Ibbs' suggestion of a task force, I think the task force should have a wider remit. The time when you want the largest mix of brains and experience is <u>right at the beginning</u> to ensure that you don't then plunge into solving the wrong problems. You could therefore slightly modify your letter by adding a sentence to the end of your section (ii):

> "Such a task force might start by looking at the NI financing problem, in the context of the PSBR. It could then continue, perhaps with some changes in its composition, to look at other aspects of the nationalised industry problem, eg privatisation, financial control, performance monitoring."

7. Apologies for this rather long note, but I wanted to get a few thoughts down on paper.

JOHN HOSKYNS

* You may know that Alan Peacock is doing some work on this for C.P.S.

CONFIDENTIAL

Master Wolfson
" Hoskyns.
" Walters.

Energy

10 DOWNING STREET

From the Private Secretary

26 January 1981

The Prime Minister has now had an opportunity to consider the Chancellor of the Exchequer's minute of 16 January and the paper which he enclosed with it on nationalised industry financing.

The Prime Minister has asked me to say that, while she commends the paper, it is none-the-less long on analysis and short on solutions. She agrees that officials should press ahead with the further work outlined in the concluding paragraph of the paper.

The Prime Minister's specific comments are as follows:-

i. She endorses the need for a major new initiative on privatisation where activities can be made subject to competitive pressures - success on this front, in her view, will provide the only real solution to the nationalised industry financing problem.

ii. The Chancellor should consider whether this initiative should be best left to sponsor departments, or whether some alternative should be adopted - for example a special task force with some outside participation might be set up.

iii. New forms of borrowing (on the lines of Annex C of the paper) should be examined further, although their effectiveness in attacting additional savings seems likely to be marginal.

iv. Consideration should be given to providing industries with a greater incentive to sell unwanted assets - for example by allowing them to retain a proportion of the proceeds.

/v.

CONFIDENTIAL

E. R.

CONFIDENTIAL

v. The Prime Minister was pleased to see that the Treasury and the CPRS were working on new methods to secure greater efficiency in the nationalised industries, for example by a system of efficiency audits.

I am sending copies of this letter to Ian Ellison (Department of Industry), David Wright (Cabinet Office) and Gerry Spence (CPRS).

J. P. LANKESTER

A.J. Wiggins, Esq.,
HM Treasury.

CONFIDENTIAL

1

Prime Minister

If you agree with the CPRS comments, I think it would be best if I conveyed them - in your name - at once. Otherwise, you can discuss with the Chancellor next week. (Assuming I write, can I say that the Treasury paper was well done, as I think it was?)

CONFIDENTIAL

✓ Mr Hoskyns
Mr Walters
Mr Wolfson

We are long on analysis short on solutions in both papers - but agree we must get to work at once on several of the positions & conclusions in paper.

The real answer is that there is only one solution to nationalised industry problems [illegible] denationalisation.

Qa 05228

22 January 1981

To: MR LANKESTER

From: J R IBBS

NATIONALISED INDUSTRY FINANCING

1. You asked for CPRS comments on the Chancellor's minute, and enclosures, of 16 January.

Flag A

2. Broadly speaking, we agree with the Chancellor's analysis. There is no painless way of financing nationalised industry borrowing. The best hope of optimising the use of resources lies in further competition and privatisation, where this is possible, and increased "internal" pressure for greater efficiency, where it is not. We doubt whether sponsor Departments are well-equipped to keep up the momentum on these fronts.

The Problem

3. The Government is faced with the familiar dilemma. On the one hand it wants the nationalised industries to operate as nearly as possible on a "commercial" basis. On the other hand the financing requirements of the industries must be kept within manageable bounds because of their impact on monetary growth and the PSBR.

4. The Government seeks to reconcile these objectives in setting EFLs. But there is a risk that, within a tight EFL discipline, profitable investment will be unduly restricted. In his paper, the Chancellor examines a number of proposals for dealing with this problem.

(i) Direct Borrowing from the Market

5. By itself, "putting the industries into the market" would do nothing to solve the problem, and would carry certain penalties:

- such borrowing would remain part of the PSBR;

- so long as it continued to carry an implicit or explicit Government guarantee, it would draw on funds which would otherwise go into gilt edged stock;
- any increase in borrowing would thus lead to an increase in the PSBR and either higher interest rates or greater monetary growth;
- borrowing direct from the market would be more expensive than borrowing via Government;
- it would complicate the management of public sector debt.

For all these reasons we should be opposed to "ordinary" direct borrowing in the market. It would not justify any relaxation of borrowing control.

(ii) Downgrading the PSBR

6. There might be more point in "putting the industries into the market" if the Government (and the markets) were concerned not with the PSBR but with, say, the General Government Borrowing Requirement (GGBR) which would exclude nationalised industries' borrowing on their own account.

7. The CPRS, however, sees little attraction in such a change of direction:

- the PSBR has been a main plank of the Government's economic policy: any attempt to downgrade it would be taken as a considerable change in policy;
- Ministers would be accused of "fiddling the books", particularly as they criticised the previous Government for attempting a similar move;
- there is a risk that the GGBR would be ignored, just as the TPI has been ignored: worse still, the Opposition could concentrate attention on the PSBR or the GGBR, whichever was the worse;
- so long as the Government has to treat the PSBR as a constraint, increased demands of the nationalised industries compete with other forms of public expenditure: in principle this

seems to us right, given that it is the Government which is having to reach a judgement on the relative worthwhileness of these various forms of expenditure;

- if the Government treated the GGBR as the constraint, increased demands of the nationalised industries would still, through higher interest rates, tend to "crowd out" the private sector. This seems to us undesirable unless the nationalised industries and private sector are in genuine competition.

For all these reasons we doubt whether it is worth pursuing a change of emphasis from the PSBR to the GGBR.

(iii) New Forms of Borrowing

8. We agree with the Chancellor that new forms of borrowing should be explored. Indeed this is an area the CPRS is also examining in its study on Telecommunications. The aim is to tap savings which are currently available neither to the public nor to the private sectors since this would make it possible to increase investment, without adding to the money supply. But it is a tall order. We do not want to prejudge the outcome of further work on the suggestions in Annex C of the Chancellor's paper but frankly doubt whether their effectiveness in attracting additional savings could be other than marginal. They may, of course, have other merits: for example a performance bond might bring additional pressure to bear on an industry to improve its performance.

9. In addition to the suggestions in Annex C, however, we believe there is a further option which should be examined. Some industries (eg BSC) incur substantial expenditure abroad and we should like to see an analysis of the arguments for and against financing at least part of that expenditure from overseas borrowing which would provide a new source of funds. The economic consequences are complex, but we think there might be advantage from overseas borrowing in terms of the effects on monetary growth.

(iv) Privatisation

10. The Chancellor proposes a major new initiative in which sponsoring Ministers and Departments should examine new and imaginative possibilities for privatisation. In principle we agree.

But it is just worth pausing to consider the underlying objectives, and how best to tackle them. Possible aims are:-

(a) to reduce the size of the public sector;

(b) to subject the industries to the discipline of the market;

(c) to provide immediate easement of the PSBR.

In our view, (a) and (b) above go together. We see doubtful value in privatising if the only effect is to switch (with some disruption) from a state monopoly to a private sector monopoly. The latter would equally need to be subject to Government regulation. It would compete for funds with the private sector (instead of the public sector) without a market mechanism for determining priorities. It would be difficult to write a prospectus when the future of the industry depended on regulation by successive Governments.

11. In our view, therefore, an essential ingredient for privatisation is the introduction of competition. The emphasis of the new initiative should therefore be on greater privatisation and competition.

12. How, then is this initiative to be tackled? The CPRS doubts whether the search for new possibilities should be left solely to sponsor Departments who have become, to a greater or lesser extent, advocates for and protectors of their industries. We believe the Chancellor should be asked to consider alternative approaches. One option might be to set up a task force for the purpose, to include insiders from Departments and outsiders eg with experience of merchant banking and the operation of utilities in other countries.

13. With the best will in the world, however, a new initiative on privatisation/competition will not contribute to the third aim above - to provide immediate easement of the PSBR. On this we think there may be scope for a more rapid disposal of unwanted assets - particularly land and buildings. One possibility worth considering would be to provide industries with a greater incentive to sell eg by allowing them to retain a proportion of the proceeds instead of surrendering them to the Exchequer. This may be thought

objectionable as a form of hypothecation. On the other hand it might be effective, and it offers gain both to the industries and to the Exchequer.

Efficiency

14. Where privatisation and increased competition are not possible, there is a need to step up the pressure for greater efficiency more directly. To this end the CPRS has proposed a system of efficiency audits and, as the Chancellor mentions in paragraph 26 of his paper, we are currently pursuing this proposal with the Treasury. It would be helpful if the Prime Minister could express an interest in this work since we are expecting considerable opposition from sponsor Departments.

Conclusion

15. If the Prime Minister agrees with our comments we suggest that her reply to the Chancellor should include the following points:-

(i) that, broadly speaking, she agrees with the Chancellor's analysis;

(ii) that she endorses the need for a major new initiative on privatisation where activities can be made subject to competitive pressures;

(iii) that the Chancellor should consider whether this initiative is best left to sponsor Departments, or whether some alternative should be adopted eg by a special task force with some outside participation;

(iv) that new forms of borrowing (on the lines of Annex C) ~~could~~ should be examined further, although their effectiveness in attracting additional savings seems likely to be marginal;

(v) that the merits of overseas borrowing should be further examined;

(vi) that downgrading the PSBR and direct borrowing from the market (other than under (iv) and (v) above) should not be pursued;

(vii) that consideration should be given to providing industries with a greater incentive to sell unwanted assets eg by allowing them to retain a proportion of the proceeds.

(viii) that the Prime Minister was pleased to see that the Treasury and the CPRS were working on new methods to secure greater efficiency in the nationalised industries, for example by a system of efficiency audits.

16. I am sending a copy of this minute to Sir Robert Armstrong.

JR

File

jfh

Nat Ind

BF 23.1.81

MR IBBS

Nationalised Industry Financing

You have received a copy of the Chancellor's undated minute on nationalised industry financing which came in on Friday night. The Prime Minister would be grateful for your comments before deciding how to respOnd.

I am sending a copy of this minute to David Wright (Cabinet Office).

TPL

19 January 1981

SV

10 DOWNING STREET

Mr Walters

Mr Hoskyns

Mr Wolfson

I have asked CPRS for comments. I expect the PM will want to discuss with the Chancellor.

TL. 19/1

A

Will await Dr. Ibbs comments.

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

NATIONALISED INDUSTRY FINANCING

As you know, we discussed the problem of nationalised industry financing shortly before Christmas and you asked for an early report from the Treasury on ways in which these industries could become less dependent on the Government for their borrowing. A paper is attached.

2. I think it is important to see this question in a wide context. As we are only too well aware, the nationalised industries present us with a whole complex of problems - the need for greater efficiency in cost control and better services; the need for increased competition, whether through privatisation or through diluting or ending existing monopolies; the pressure for more investment in expanding areas such as telecommunications; and, last but not least, the problem that nationalised industry financing poses for the PSBR. These problems clearly overlap to some degree; they all have financial consequences; and actions taken in one area will have implications in another. But I think that discussion and analysis need to distinguish between them.

3. I think it important as well to remember that as long as nationalised industries remain wholly owned and controlled by the Government, they cannot be subject to the disciplines of the financial markets in the same way as private sector enterprises. Nor could the Government concede them unrestricted borrowing? - the monetary effects could often prove extremely disruptive. Escape from this is in principle only possible by means of privatisation which depends on being able to identify a flow of profits which

can be disposed of in whole or in part to the ownership and control of private investors. If as will often be the case that source of profits is monopolistic, some form of regulation is likely to be needed. For those activities which, for whatever reason, cannot be candidates for privatisation, we must continue to rely on - and strive to make more effective - the present framework of financial targets and performance aims.

4. The attached report focuses, as requested, on questions of finance. I think it demonstrates convincingly that there is no simple answer to be found by just putting the industries "into the market"; and that changes to financing arrangements, unless these are accompanied by other changes of substance, can have only limited effects. Nevertheless, I think that it would be helpful to follow up the questions posed at the end of the paper. In particular, new financing methods such as a possible telecommunications performance bond might embody incentives towards lower operating costs which could contribute towards dealing with some of the other problems.

5. But the most hopeful link of progress may be a new initiative in the general area of privatisation, interpreting this more widely than we have done hitherto. One idea that is touched on in the paper (paragraphs 5-7) is to try to identify areas within the present nationalised industries where it may be possible to involve private risk capital. We need to be inventive. The monolithic character of the state corporations may have to change. Can private enterprise provide some part of the telephone service on the basis of a nationalised main network or run some trains on a nationalised rail network? It is possible that moves like this might both help with the financing and expose the entity to market pressures in a way that would be beneficial. We need to develop these ideas further, not only to cover more industries but to bring about more radical structural changes. We cannot expect the industries to

help: they are more likely to resist such an approach which will tend to loosen up existing structures. For real progress to be made, the initiative will have to be followed up energetically by the sponsor Departments.

I am sending copies of this minute with the enclosures to Keith Joseph, Robert Armstrong and Robin Ibbs.

R.I. Tolkien,

(Approved by the Chancellor and signed in his absence)

for, (G.H.)

16 January 1981

NATIONALISED INDUSTRY FINANCING

There are a number of criticisms of present methods of nationalised industry (NI) financing. The Government is concerned about the impact of the large and volatile NI requirements for funds directly on the PSBR and indirectly on its other spending programmes. NIs, sometimes, allege that Government restrictions on the PSBR and thus on their borrowing prevent desirable and financially viable investment.

2. These criticisms stem from conflicting objectives; but both have some substance. They raise some far-reaching questions affecting:

(i) the control of the money supply and the influence of NIs' borrowing on costs of finance in both the public and private sectors; and

(ii) the controls over NIs' financing and efficiency.

Most NIs are largely self-financing and at present the bulk of their external finance goes to the big loss-makers (steel, coal, rail and shipbuilding), as the figures for this year show:

	£m (estimated outturn)
Grants from the Government	1,125
Public Dividend Capital (PDC) provided by the Governmen and Loans under Section 18 of the Iron and Steel Act 1975	1,420
Net borrowing from the National Loans Fund (NLF)	975
Other net borrowing	- 385
TOTAL	3,125
Of which (announced external financing limits)	
Steel	850
Coal	834
BR	790
Shipbuilding	185
SUB-TOTAL	2559

Privatisation

3. The obvious, most direct and satisfactory solution is privatisation. The financing needs of the activity or industry are then outside the PSBR. The essential condition is that there should be a transfer of ownership and control from public to private hands, combined where needed with anti-monopoly measures.

4. Considerable progress has been made both in identifying candidates for privatisation and also in passing the necessary legislation (details in Annex A). But it has been possible only because at the outset there was a pool of obvious candidates for privatisation in the traditional sense of selling off whole enterprises or major subsidiaries. The momentum of the exercise will inevitably become slower and slower without a major new initiative to identify possibilities of a somewhat different kind.

5. Each industry needs to be looked at individually to identify (or create) areas in which private capital can be involved either in joint enterprises or in activities which, even if financed, managed and largely controlled by the private sector, would continue to be in a very close relationship with the nationalised industry concerned. In any measures of the second 'symbiotic' kind, it would be important to ensure that genuine risk capital was involved, in order to bring into play market pressures for improving efficiency.

6. A notable example of these kinds of schemes, which has got off the ground, is the gas gathering pipeline. Schemes of the second kind are being considered with merchant bank advisers for British Telecommunications. The front-runner is a proposal for the private sector to take a stake in subsidiaries set up to market handset attachments to the network but it could be extended to other types of equipment and activities. A more speculative proposal (which would involve new legislation) is to restructure the telecommunications industry to hand over further parts eg, individual regions to private companies, financed by private capital. Similar opportunities may exist in other industries eg, rail, coal or even electricity. There may need to be accompanying measures to increase competition eg, by deregulation.

7. Privatisation of this kind involves structural change in the industry and usually legislation. The industries' themselves will need to be pushed. An initiative will only succeed if it is carried forward with great determination by sponsor departments and is seen to be a matter of the highest priority; and it will demand new and creative thinking which the Treasury (or even departments) are not well-placed to provide on their own. Even then, there will undoubtedly be some NIs where this approach cannot be applied easily, quickly or, perhaps, at all. Other approaches to nationalised industry financing have therefore to be considered.

Direct Borrowing from the Market

8. Most proposals for change involve NIs borrowing direct from the market, which is the only serious alternative to the Government and NLF. NIs in many other countries, eg France and Germany, finance themselves mainly in this way (see Annex B) though subject to certain controls. Up to the mid-1950s NIs in the UK, too, had direct access to the markets, a right which could in most cases only be reinstated by legislation.

9. The arguments are considered below (paragraphs 14-26). But this change would not on its own take such borrowing outside the PSBR. The PSBR (the measure of the public sector's total demand on available savings) is no more (and no less) than the total of borrowing by the public sector. Though it affects the cost, the form such borrowing takes makes no difference, whether it is formally Government-guaranteed or not. All borrowings by the public sector bodies are by definition part of the PSBR.

Downgrading the PSBR

10. So switching ~~from~~ to market ~~to~~ from NLF borrowing would not reduce the PSBR; indeed if it led to higher borrowing it would increase it. Therefore, to ease the PSBR constraint a move to market borrowing would have to be accompanied by one major change at the very least, namely a determined and carefully presented switch of the emphasis from the PSBR (which includes all public

corporations'* borrowing) to the general Government borrowing requirement (GGBR) which includes borrowing by Government for on-lending to public corporations but excludes public corporations' borrowing on their own account.** The UK already publishes the GGBR and it is an internationally respectable concept used by other countries, many of whom do not even calculate, let along publish, a PSBR. The GGBR would include all those funds which the NIs continue to receive direct from Government, namely grants, PDC and loans under Section 18 of the Iron and Steel Act 1975; and any borrowing from the central Government (eg, the NLF) that it was judged necessary to continue.

11. Once the switch was made, the focal borrowing requirement would, broadly speaking, reflect the needs of the loss-makers but not those of the other industries. However, the GGBR would not necessarily always be less than the PSBR. Both the level, and the trend from year to year, in the impact of NIs on the GCBR would reflect the particular financing arrangements adopted, in particular the treatment of maturing NLF debt. If there were no further issues from the NLF and the NIs were obliged to refinance their maturing debt from the market, the GGBR would be considerably lower as long as it continued to benefit from repayment of the outstanding debt. Alternatively, if the industries were allowed continued access to the NLF to refinance maturing debt with only net new borrowing switched to the market, the GGBR would be less affected. Indeed, on present borrowing plans, both the GGBR - and public expenditure - would be as high or higher in the next three years than on the current presentation.

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* "Public corporations" includes a number of public sector bodies, eg Housing Corporations, New Towns, in addition to the NIs. It would have to be decided whether the changes suggested for the NIs would apply to them also.

**Since members of the present Government attacked similar moves by Mr Healey, if not very persistently, in opposition, this could be a delicate move politically.

12. It would neither be possible nor desirable to try to abandon the PSBR altogether. There are purposes for which a global measure of the borrowing of the whole of the public sector is wanted. Successive Governments have attached considerable importance to the PSBR; the media and markets have become accustomed to it, and an attempt to do away with it altogether would arouse suspicion of fiddling. In any case it would not be difficult for anyone who wanted to add the borrowing of NIs to the GGBR to arrive at the PSBR. But without seeking to drop the PSBR altogether, the Chancellor could give the GGBR pride of place in the Budget Speech, the Financial State and Budget Report and in Government statements and publicity generally.

13. The move to put the spotlight on the GGBR rather than the PSBR would need to be carefully considered in the light of the arguments below and very carefully presented if the attempt to play down the PSBR were not to lead to suspicions of manipulating the statistics. On the other hand, there would be no attempt to conceal the level of the PSBR or deny it some importance. There should be a good deal of sympathy in parts of the Press who have been critical of the way nationalised industries are treated in the PSBR and of the resulting restrictions on their investment programmes.

Implications of a GGBR and Market Borrowing

14. Emphasis on the GGBR and a switch from NLF borrowing would limit the extent to which decisions about NIs' borrowing (but not grants, PDC or Section 18 loans) would directly affect the borrowing statistic on which the Government placed importance. But it would raise important questions for monetary and economic policy.

(i) Implications for Monetary Control

15. The demand for funds in the economy is regulated broadly in two different ways: administrative decision in the public sector; and market forces elsewhere.

16. The boundaries of the public sector are partly historical accidents and it would be better if many public sector enterprises were in the market sector. This is the case for privatisation wherever possible. But where it is not, public enterprises cannot be shifted into the market sector and regulated by the operation of market forces alone. Being Government-owned, their borrowing is in practice guaranteed, whether formal guarantees are issued or not. Because of this, the threat of liquidation is normally meaningless and, by the same token, one of the fundamental sanctions of the financial markets is absent. At the same time, many of them are monopolies or quasi-monopolies and do not face the disciplines of competition in selling, either. For example, if either Gas or Telecomms could borrow at will in the market, it could do so virtually without limit because it is backed both by Government ownership and by a monopoly power which permits it to earn a respectable profit regardless of its efficiency. If, therefore, such industries were freed from administrative controls, they would compete for funds very unfairly with the private sector.

17. It is therefore an illusion to suppose that NIs can be subject to market forces simply by allowing them access to private sector finance. Until and unless the issues of monopoly and de facto guarantee can be resolved, the Government must control the quantity of each NI's borrowing, both to avoid crowding out the private sector and to maintain monetary control. It is for this reason that countries which have no PSBR nonetheless regulate borrowing by their public enterprises.

18. In the public expenditure context, decisions about NI borrowing are, at present, part of decisions about the borrowing of the public sector as a whole, the PSBR. If demands being made by NIs increase, then cuts must be made elsewhere in the public sector if the total of the PSBR is not to increase. If it were thought preferable to consider the amount of NI borrowing in a different context, as competing, not with the rest of the public sector and public expenditure, but with the private sector, then it would be logical to focus presentation on the GGBR. (As a corollary it would also be necessary to consider the presentation of nationalised industry finances in public expenditure.)

19. This would raise two issues. A view would have to be formed about how much NIs could borrow without unacceptable crowding out. This would require:

(a) Judgements about the value of investments made by the NIs, as compared with the private sector. If the return on NI investments was genuinely likely to be better than the return from private sector generally, there would be a case for allowing them additional borrowing and to outbid the private sector at the margin. Formally decisions about NI investment are already based on assessment of rates of return. But in practice these are difficult judgements, especially where rates of return can be influenced by monopoly pricing power. So the change would be less a matter of precise comparisons of rates of return than a broad-brush view in favour say, of more investment in telecommunications.

(b) Judgements about the monetary effects of allowing the NIs to borrow given amounts. Here the question would arise whether the monetary consequences would be different (and more acceptable) if NIs borrowed by methods different from the issue of gilt-edge stock.

20. The latter point raises some difficult questions. A variety of suggestions have been made for different techniques of borrowing by NIs, all with the purpose of permitting additional NI borrowing. Within a given PSBR or GGBR there will normally be advantage in a greater diversity of methods of borrowing. For example, there is the proposal that the telecommunications corporation should issue bonds with a yield tied to the financial performance of the corporation. Techniques of this kind involving instruments unlike conventional Government debt, should mean that wider markets could be tapped by the public sector. If so, it should be possible by this means to finance a given PSBR with lower interest rates and/or lower monetary growth. If the new instrument mobilised additional funds not previously available to the private sector, it would in principle be possible to finance a higher PSBR and more NI borrowing without higher interest rates or money supply.

21. But

(a) Would such borrowing mobilise additional savings? We have long searched for new ways of mobilising additional savings for the public sector and have not had much success.

(b) Even if not, could the extra investment be undertaken without expanding the money supply? That outcome is not theoretically impossible. But to do so the investment would have to have an unusually favourable and rapid impact on costs, incomes or inflationary expectations. It would have to be something out of the ordinary to achieve that.

Whatever the answers to (a) and (b) in practice, the risks of crowding out or adding to the money supply would mean that we should certainly have to maintain control over methods of borrowing by NIs.

22. In short

- NI market borrowing will still compete with and raise the cost of borrowing by the public sector or the private sector, and NI investment and borrowing would still have to be controlled.

- But it would be possible, in principle, to shift to a system in which it would be considered more in relation to the private sector and not traded off directly, as at present, against public expendiutre. However this would require difficult judgements.

- New methods of market borrowing might tap additional private savings. But experience to date has been unpromising (but see Annex C).

- Therefore most additional borrowing by NIs which might follow from these changes would probably be at the expense of the private sector and have to be justified as more worthwhile than the investment it would probably displace if an increase in the money supply were to be avoided - unless new proposals (perhaps some of those in Annex C and para 21(b)) can be devised which justify a positive answer to the questions in para 21 above.

(ii) The Cost of Borrowing

23. NI market borrowing would be more expensive than borrowing through the NLF. Experience in the 1950s showed that the investing public expected a higher yield from NI than Government stock. Even with a formal Government guarantee, the fact that each individual industry would issue small amounts of stock in relation to the scale of NLF (ie, gilt-edged) issues would make it less marketable and add to the cost. One of the main reasons why the NIs are currently required to borrow from the NLF (recently reaffirmed in a Treasury minute to the PAC) is to minimise the cost of public sector borrowing and the PAC would certainly criticise any additional costs. On the other hand, it could be argued that, to the extent that direct market borrowing reduced the amount of funds which had to be raised by gilt-edged sales, the cost of the latter would be reduced, so that the net overall cost of borrowing for the public sector might be little affected - though this would be difficult to demonstrate. Some NIs would also argue that direct borrowing from the market would produce psychological pressures for efficiency. This is unlikely unless the borrowing in question takes a special form which somehow embodies market disciplines which do not normally operate.

24. If a policy of this kind were adopted, there would need to be a clear decision to rebut the criticisms of the PAC on these grounds.

(iii) Implications for Control of the NIs

25. The change would risk weakening control over the NIs. There are almost constant pressures for more NI investment, some of it questionable. It is always difficult to control the expansion of their costs, particularly wages. Tight EFLs are at the moment our main defence against both. The fact that increases would add to the PSBR or require cuts in other public expenditure programmes helps the Treasury defend EFLs. In practice, it would probably be more difficult to set firm limits for the total of NI borrowing if it was controlled separately from the rest of the public sector. The rationale for the limits would be less clear to most

of our clients. The change would probably produce an impression that the Government intended to relax. Though there might be some additional worthwhile investment, the net effect could be very harmful too if control over current costs including wages was weakened.

26. This would make it the more desirable, therefore, to introduce a greater emphasis on investment appraisals by the industries as well as at the same time some new method for bringing pressures for increased efficiency in general, for example by a system of efficiency audits. The Treasury is at present working on a paper on this subject with the CPRS.

Recent Proposals

27. There have recently been a number of proposals for new forms of borrowing for NIs, inlcuding some by Mr Ian MacGregor (BSC), Mr David Young (DOI) and Morgan Grenfell. They are described in Annex C. All are intended to increase the permitted level of NI borrowing.

28. In a number of cases it was believed that because the borrowing involved was from the market and in a non-monetary form this would fall outside the PSBR. As earlier explained, this would not be the case. Nonetheless there may be features in these proposals which are worth further examination, such as the performance bond.

Conclusion

29. The problems presented by the NIs are not simply the consequences of the particular financial framework which successive Governments have arbitrarily imposed. Fundamental problems of monopoly, Government ownership and, often, the essential nature of the services provided lie at the heart of them. These are the issues to which solutions must be sought. Financial innovation will achieve little unless accompanied by other substantial changes in the framework in which the NIs operate. Further steps are needed of two kinds.

30. First on privatisation there should be a major new initiative in which sponsoring Ministers and Departments should examine their industries to find new possibilities e.g. of the kind mentioned in paragraphs 5-7; and

31. Secondly on financing proposals officials should examine further the particular ideas in Annex C (and any others) in the light of the questions below:-

(a) Can concrete and viable proposals be devised, within existing powers, by which individual NIs could in fact raise capital on the markets in ways which would not be closely competitive with gilt-edged sales; which tap new sources of savings; and/or which embody or simulate effectively the private sector disciplines of the threat of liquidation and market place pressures on costs?

(b) What would be the likely effects of each such borrowing or flotation on the money supply and on the cost of capital to the private sector?

(c) In the light of the answer to (b), could some part of such borrowing be allowed as an increase in the industry's EFL and thus of the PSBR also?

32. Thirdly, in the light of the Prime Minister's views on this programme officials should also report further on the following wider points:

(d) In what context should decisions on nationalised industries financing and investment be taken and how should they then be presented? Should a change on this be associated with a change of emphasis from the PSBR to the GGBR?

(e) Should NIs be encouraged to borrow from the markets instead of the NLF even when such borrowing was directly competing with sales of gilts?

(f) Should new powers be taken by legislation where necessary to permit market borrowing by individual industries?

(g) Should the new borrowing regime apply similarly to the public corporations which are not NIs?

HM Treasury

16th January, 1981

ANNEX A

PRIVATISATION

1. Royal Assent was given in the summer to Bills enabling British Aerospace, the National Freight Corporation and British Airways to be privatised. Their flotation waits on defence cuts and decisions on the HS146 in the case of British Aerospace; and in the cases of the National Freight Corporation and British Airways on the re-establishment of a sufficiently attractive profit record. Legislation has been drafted for the new Session to enable the British Transport Docks Board, the major British Rail subsidiaries, Cable & Wireless Ltd and the Radiochemical Centre to be privatised. The British Telecommunications Bill will facilitate privatisation by relaxing the monopoly in specific areas and providing for the setting-up of separate accounting subsidiaries. Merchant banks are currently advising on the formation of a company to hold the British Gas Corporation's offshore oil assets, with the intention of selling a stake in this in 1981-82.

2. In addition to these major items, Ministerial decisions are awaited on the sale of Sankey, the National Coal Board's builders' merchant subsidiary, and on the future of the retail gas show-rooms. Further possibilities which need to be considered are the privatisation of British Rail Engineering Ltd (the manufacturing arm of the British Railways Board) and the Open-Cast Executive of the National Coal Board. The prospects for privatising British Shipbuilders will also need to be considered.

ANNEX B

NATIONALISED INDUSTRIES AND THE PSBR: INTERNATIONAL COMPARISONS

There are wide variations in the treatment of public enterprises between countries. The following table shows the different treatment in the coverage of the public sector accounts and in the treatment of grants and loans to public enterprises in central government budgetary expenditure.

Country	Public Sector Accounts Public Enterprises	Central Government Budgetary expenditure Grants and loans to public enterprises
UK	IN	IN
USA	OUT	Partly IN
Canada	Partly IN	IN
Japan	IN	Partly IN
Germany	Mostly OUT	Partly IN
France	OUT	Partly IN
Italy	OUT	IN
Australia	Partly IN	IN
Ireland	Partly IN	IN
Belgium	OUT	IN
Netherlands	Mostly OUT	IN
Denmark	Partly IN	Partly IN

2. Undoubtedly these differences of treatment have evolved over time to reflect the legal status of the public enterprises in each country. They also reflect the fact that the range of public enterprises varies considerably from one country to another as do relationships, both formal and informal, between central government and the rest of the public sector. For example, in Germany, there are only two federal "nationalised industries" the railways and the posts and telecommunications, both of which are run as departmental agencies: other public enterprises normally take company form but may be controlled through Federal or Lander shareholdings. In France, central government includes operating subsidies and advances for capital operations of the nationalised industries but the greater part of their loan finance which is raised from the markets by loans is excluded. Even where definitions

are broadly similar the concept and presentation may vary. In the UK the most commonly discussed balance has been the borrowing requirement but in other countries discussion centres on the financial balance and no borrowing requirement as such may be published.

France

3. As indicated above the coverage of the public sector accounts is narrower than in the UK. The central administration net financial deficit comprises the central government budget and those of the local authorities and the social security system. It does not cover the nationalised industries' financial deficits. The French Government does not publish a figure for the public sector borrowing requirement either as a budget target or as part of the customary statistics on the economy and it is impossible to construct one.

4. Borrowing by the major nationalised industries on the capital market is however closely supervised by the French Tresor. Towards the end of each year, each major nationalised industry submits a programme of financing for the coming year covering borrowing on the domestic and foreign capital markets. The Tresor then prepares a consolidated list which is set against the central government borrowing requirement and projected corporate sector borrowing, together with an estimate of available resources and the market trends. The Tresor then discusses and agrees with each industry amounts and timing of borrowing for the year. This is subject to continuous review, depending on market conditions. For borrowing by nationalised industries abroad the French Government provides a guarantee for which a commission is charged. No guarantee is provided for borrowing on the domestic market, although there is clearly a strong implicit guarantee.

5. Bank borrowing by nationalised industries is not closely supervised, however it is subject to the normal credit control restrictions on bank lending as a whole. In addition certain items of capital expenditure are excluded from the central government

accounts, for example the toll autoroutes which are built by joint state/private sector companies and financed by loans raised independently on the capital market.

Germany

6. There are in Germany only two nationalised industries, posts and telecommunications and the railways. In both cases an annual budget is formulated which includes a maximum borrowing requirement for the year. This is approved by the Government after discussions between the industries, sponsor Departments and Finance Ministry. The terms and timing of the borrowing are handled by the Central Bank and, although in the industries' own names, is treated as equivalent to borrowing by the Government itself. A similar procedure is followed in the case of airports, most of which are publicly owned.

7. The system is different in the case of companies in which the state has a shareholding. At end-1979 the Federal Government had direct holdings in 88 companies. They held 55 per cent of the capital overall and more than 75 per cent in 25 companies. Indirectly, through public sector banks and other public institutions, the Government has holdings in a further 102 companies, whilst the Land Governments have similar holdings. All these companies are treated as if they were privately owned. The Government have nominees on the supervisory boards but there are no official controls over borrowing by these companies. However, the supervisory boards set limits to borrowing by the management either by stipulating a limit on aggregate outstanding borrowing or by setting an annual ceiling. In the latter case the management may have to seek permission for loans over a certain amount or the supervisory board may agree in advance the amounts and types of credit to be taken up. Although, theoretically, the Federal Government's position in influencing the borrowing of any company is very weak since the officially nominated representatives can be outvoted, the problem in practice rarely arises. Decisions on borrowing are taken in relation to the needs of the individual companies. There is no attempt to restrict the total amount borrowed by these companies as a whole.

8. Lending institutions treat companies in which the Government have a holding like any private sector company. In theory, the Government do not intervene to save a company in which it has an interest from bankruptcy. However, on occasion the banks have demanded Government guarantees for loans to such companies in trouble. In these cases Parliamentary approval has to be sought. The Government will only seek such approval where the public auditors have given their opinion that a crisis can thereby be overcome. If such an opinion cannot be obtained, the company is allowed to go bankrupt. Thus, as far as possible, companies with public shareholdings operate within the market and within the private sector. However, the Finance Ministry admit that if a very large company (say Volkswagen) were in danger of going bankrupt in the absence of Government guarantees, the pressures on the Federal Government to intervene would be very strong.

ANNEX C

NEW FORMS OF BORROWING

This note considers whether various new forms of borrowing which have been suggested could provide a useful diversification of forms of public sector borrowing. The ideas include some which have been suggested by Mr Jefferson of British Telecoms, Mr MacGregor of BSC, Mr Young of the Department of Industry and Morgan Grenfell:

i) Bonds linked to performance. A variety of proposals have been made, including one by Mr Jefferson of BT, that industries should issue bonds with yields linked in some way to the performance of the industries. (It is also suggested in the BT case that the bonds should be made available on preferential terms to employees of the corporation.) There is no suggestion that such borrowing could be regarded as outside the PSBR. But this proposal probably looks the most promising if one is looking for types of borrowing within the PSBR which would offer more diversity and be significantly different from gilt-edged, thus tapping a different savings market. This proposal is being examined further.

ii) A bond convertible into equity. The suggestion, again in connection with telecommunications, is that an unguaranteed bond should be issued which would be convertible into equity in subsidiary companies to be set up by BT in the future. This would be accompanied by a firm statement of intention by BT to set up these subsidiaries. Again there is no suggestion that this borrowing could be regarded as outside the PSBR at this stage. As a means of diversifying borrowing in advance of privatisation, it is worth considering - although it does not look as attractive as the suggestion at (i) above. It is also being examined urgently.

iii) Borrowing on the security of charges, tolls, etc paid by users of an industry's products.

This particular proposal does not seem to offer an attractive form of diversification for public sector borrowing. The main question would be where the funds would come from. If they came from banks, the money supply and interest rates would be affected directly. If they came from institutions, the borrowing could be indirectly competitive with gilt-edged and likely to influence the cost of Government borrowing.

iv) Sales of interest in future production. The suggestion is that BNOC, the Coal Board, British Gas or the CEGB could sell an interest in future production in return for a cash sum, representing the discounted value of the interest sold. This could be regarded either as a straightforward advance sale or as a form of borrowing secured on future production.

It is true that BNOC has undertaken advance sales of oil and these have not been classified as borrowing and therefore not regarded as part of the PSBR. But under this present proposal the funds would in fact come from financial institutions in a triangular arrangement. This would then be borrowing on the security of future production, rather than advance sales. Again it is difficult to see that this offers a useful extension of public sector borrowing arrangements.

v) Financing techniques based on usage. This technique typically involves a number of institutional investors forming a company, to finance a project such as a motorway, tunnel or pipeline or airport over which they retain ownership for a predetermined period. During this period they pay the ultimate owner - a Government Department or nationalised industry - a tariff and they would charge those using the project (companies in the case of a pipeline or the travelling public in the case of road or airport) a fee. This would be used to service and repay the loan and provides an element of profit. The Department or nationalised industry would retain the basic management of the project, fix the agreement with the company and monitor safety and other standards. The project would revert to the Department or nationalised industry at the end of the period.

The attractiveness of this method of finance depends upon the element of risk in the financial return i.e. the numbers and degree of competition between the users. To the extent that this exists the proposal would tap sources of savings which were not directly competitive with normal Government borrowing. If competition were very limited and the returns (on the basis of the agreed charges) certain, then the proposal simply becomes a variant of (iii) above.

vi) Sale & leaseback. A number of industries would like to raise additional finance by selling assets to the private sector and then leasing them back. Such transactions produce an initial reduction in the PSBR, i.e. the net cash inflow produced by the transaction less the first rental payment. However, in later years they add to the PSBR, because the overall cost to the public sector of the leasing is higher than conventional borrowing, partly because of the tax relief involved.

Many such proposals are frankly designed to get round the constraint of the EFL and raise additional money from the private sector for the industry. They are devices very similar in effect to borrowing on the security of an industry's assets. We do not believe that the use of this technique should, in itself, influence Ministers' decisions as to the total amount of capital which should be raised by any particular industry.

Sale & leaseback does not appear to offer an attractive form of diversification of methods of borrowing by the public sector. Much leasing is financed by the banking sector and in such cases the money supply is directly increased. In cases where property is sold and leased back, banks may not be involved, but this form of investment (probably much of it by institutions) does not seem likely to offer any advantage as compared with sales of gilt-edged stock. Generally, a substantial increase in the raising of money by nationalised industries by means of sale & leaseback could have an adverse effect on our ability to control the rate of monetary growth.

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB
TELEPHONE DIRECT LINE 01-212 3301
SWITCHBOARD 01-212 7676

Secretary of State for Industry

12.1.81

The Rt Hon The Lord Soames GCMG GCVO CH CBE
Lord President of the Council
Civil Service Department
Whitehall
London SW1A 2AZ

Dear Christopher.

NATIONALISED INDUSTRIES BOARD APPOINTMENTS AND THE ROLE OF NON-EXECUTIVE DIRECTORS

Over the past few months I have been considering how to strengthen the role of non-executive directors in the nationalised industries for which I am responsible. I also have in mind some of the criticisms which have been made in the past regarding the manner and method of their appointment as well as their somewhat general terms of reference.

2 I would like to make greater use of their experience and to encourage them to become more positively involved in the overall strategies of the industries, and in exerting pressure on the senior management to improve efficiency. I have in mind, for example, that they should be given greater responsibility for initiating the process of selecting board members, subject of course to my continuing responsibility for final approval of recommended candidates and for the formal appointments. I also wish to encourage greater participation in particular tasks including Audit Committee work. At the same time it is essential to recognise the ultimate responsibility of the Chairmen; and to support - not to appear to undermine - their position.

3 I know that the Chairmen of several of my industries share my general approach but I should now like to carry discussions with them further by sending them the attached memorandum. Before doing so, however, I felt it would be right to circulate the memorandum to you and to my other colleagues with responsibility for nationalised industries so that you may let me have your views.

/4 ...

4 I realise that some of the developments suggested may not be considered appropriate in all the industries. Given the diversity of the industries I do not believe it would be profitable to attempt to produce a uniform procedure which could be applied in every case. But before going ahead with these proposals for the industries for which I am responsible, I should like to be sure that they would not be likely to create any difficulty for colleagues in relation to their industries.

5 I am copying this letter and enclosure to the Chancellor of the Exchequer, the Secretary of State for Energy, the Secretary of State for Scotland, the Secretary of State for Wales, the Secretary of State for the Environment, the Secretary of State for Trade, the Secretary of State for Transport, Sir Robert Armstrong and Robin Ibbs at the CPRS.

Yours

Keith

CONFIDENTIAL

NATIONALISED INDUSTRIES' BOARD APPOINTMENTS AND THE ROLE OF NON-EXECUTIVE DIRECTORS

The Department of Industry has been considering how to improve the ways in which board members of nationalised industries are selected and how to strengthen the role and responsibilities of non-executive members.

This memorandum draws together current thinking within the Department. It does not represent the collective view of the Government and is put forward solely as a basis for discussion with the chairmen of the nationalised industries for which this Department is responsible. It is recognised that in several instances chairmen may have already considered, or even adopted, some of the approaches outlined; nevertheless, their views would be welcome.

1 The rôle of the non-executive director

In the private sector the non-executive director typically plays several roles in addition to furthering the interests of the company and having regard to the interests of the company's customers and employees in general in the same way as other directors. These roles may include:

- i providing outside general knowledge;
- ii providing specialised knowledge;
- iii monitoring executive performance;
- iv representing the interests of other groups or bodies;
- v providing external representation of the company;
- vi providing a balance on the Board.

In some cases these roles are formalised through participation in specialist committees whose membership varies from the exclusively 'non-executive committee' to committees involving various mixes of executive and non-executive membership.

The role and responsibilities of non-executive members in the nationalised industries are in many respects similar to those of non-executive directors in a private sector Companies Act company. They are appointed by the Secretary of State to broaden the commercial experience

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of the Board and to provide the chairman and executive members with an independent source of judgement and advice.

The Department would like to encourage greater use of the non-executives' experience, and to see them have a more positive role. Some nationalised industry chairmen already allocate specific advisory roles to their non-executive members; this is a practice which the Department welcomes.

2 Contact with Ministers

The formal and normal contact about the affairs of nationalised industries will be between Minister and the Chairman. Only in very rare circumstances should a non-executive member seek an independent direct approach to a Minister. This might arise over an exceptional issue of principle, propriety, or national interest where the normal channel of communications was, for one reason or another, not possible. Ministers would, however, like the opportunity of having a meeting, not more than once or perhaps twice a year, with the non-executive members to review progress; the chairman would normally attend such meetings. The chairman may also on occasion find it is helpful to include one or more non-executive members with relevant knowledge and experience when he meets the Secretary of State on particular issues.

3 Remuneration

Earlier this year the Government decided that the pay of nationalised industry board members should be removed from the remit of the Review Body on Top Salaries in order to provide greater flexibility in settling pay levels. The Civil Service Department is currently discussing with the Nationalised Industries Chairmen's Group, proposals for new arrangements to be introduced from 1 April 1981.

The CSD's proposals envisage a more direct role for the chairman and non-executive members in recommending members' remuneration and conditions of service. Ministers would retain their statutory responsibilities for salaries and thus recommendations will need to be approved by individual Ministers after consultation with CSD. Ministers will therefore need to be satisfied that adequate mechanisms have been established within each industry to implement the new arrangements when agreed by CSD and the NICG.

4 Appointments

Up to now the prime responsibility for selecting and appointing nationalised industry board members has rested with the Secretary of State in consultation with the chairmen. The views of non-executive members have sometimes, but not invariably, been sought. This approach has reflected the Secretary of State's statutory responsibilities for appointments to public sector boards.

In the private sector the non-executive directors often play a key role in keeping plans for succession to senior management posts under review and in securing a continuity of candidates for the board and determining their remuneration subject to the ratification of shareholders. Although the circumstances are not entirely parallel, nationalised industries chairmen may like to see non-executive members of their boards taking a more positive role in matters such as succession planning and in the identification of suitable candidates for Board posts.

Arrangements that seem worth considering are that, in future,

i each board might assume responsibility for recommending the reappointment of existing members, for identifying replacement needs, and for carrying out searches for suitable candidates.

ii this would involve review of both internal and external candidates and where necessary the use of press advertising or of professional recruitment agencies;

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iii the chairman should notify sponsor department officials (eg the Permanent Secretary) of potential vacancies at an early stage to provide the opportunity for him to contribute the names of possible candidates based on experience, or to obtain names from CSD's Public Appointment Unit;

iv the Chairman should present the Board's nomination to the Secretary of State, with alternative candidates where appropriate and the names of those considered but rejected. The Department would be responsible for clearance with other Government Departments as necessary. No irrevocable commitments should have been made prior to this stage.

v the Secretary of State, as at present, will approve the final selection in consultation, as necessary, with his colleagues and make the formal appointment in writing.

These tasks, where they involve the Board, could be entrusted to an "Appointments and Remuneration Committee", which might also be responsible for board members' remuneration and for keeping the effectiveness of internal management development programmes under review.

5 Audit Committees

Audit committees are now being considered by an increasing number of UK companies, including some nationalised industry boards. Their introduction was commended in the White Paper on Nationalised Industries, Cmnd 7131, paragraph 51, which referred to the Audit Committee recently introduced in British Steel Corporation. The Department continues to be in favour of the introduction of audit committees. Non-executive members would again predominate in membership although the finance director would be in attendance for most sittings. The board chairman and other executive members would not usually be members of this committee.

The extent of the role of an audit committee could vary considerably from industry to industry, and it would be for the board to consider its precise function in the light of current practice in the use of such

77

committees in other companies or corporations. A typical audit committee's role has been defined as follows:

- i reviewing accounting developments and changes in standards and practice;
- ii recommending financial and accounting policies to be adopted;
- iii pinpointing areas of accounting, control, or reporting difficulty and assessing their implications;
- iv approving the scope of audit work, external and internal (though it would not be within the competence of an audit committee to limit the statutory audit requirements);
- v conducting relations with auditors;
- vi recommending auditors' remuneration and their reappointment.

The audit committee has no executive powers of its own, and would report its recommendations to the board. The views of individual chairmen, both on the operation and effectiveness of such a committee where it already exists, or on the introduction of a committee, would be most helpful.

It would be normal for an audit committee, in reviewing the scope of internal and external audit work, to be requested by the board to consider whether sufficient was being done either as part of the internal audit function or by the executive management to evaluate aspects of efficiency and performance in its industry. There may also be special circumstances when, on the instructions of the board, the audit committee could be charged with the responsibility of carrying out a special duty study. Again the views of the chairmen would be welcome.

Department of Industry

December 1980

1.

Nat Ind

10 DOWNING STREET

PRIME MINISTER

WASTE IN GOVERNMENT

When you saw the Chancellor's letter of 31 December (Flag A) commenting on Mr. Nott's letter of 6 October (Flag B), you said that you would raise the matter at a breakfast. You might like to do so tomorrow morning when you expect both the Chancellor and Mr. Nott to be present.

[illegible]

12 January 1981

CF.

This was not discussed this morning. Re B/f on 26 January.

[illegible] 13.1

1. Tim
to see

2. PA.

13.i

2

Prime Minister

I asked the Treasury to let us have an explanation of the delay in submitting the report on nationalised industry financing which should have been here on 6 January. This is it.

8.i.

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

7 January 1981

Clive Whitmore, Esq.,
Private Secretary,
10, Downing Street

CF chan on Friday

14/1

Dear Clive,

In his letter of 22 December to John Wiggins, Tim Lankester asked for a report from the Treasury this week on work in progress on nationalised industry financing.

As I explained to you, the Chancellor has been discussing with officials various options for changes in the present arrangements which would make the nationalised industries less dependent on the Government for their borrowing. In addition to examining the feasibility of a variety of individual schemes which have been put forward, officials have put forward proposals for changes in the present arrangements e.g. more direct market borrowing by the industries, perhaps in new forms. These raise complex underlying issues which require careful analysis, including the impact on monetary control and the effect on the pressures for greater efficiency and lower costs exerted by the present controls. The Chancellor feels that it would be helpful to take consideration of these points further before putting a report to the Prime Minister.

We will, however, let you have a report during next week.

Yours ever,

Richard Tolkien.

R.I. TOLKIEN

Nat Ind 2

1. MR LANKESTER ✓ R.
2. PRIME MINISTER

Pt 2

John Nott copied to you his letter of 6 October (Flag A) about waste in Government. He was particularly concerned about the degree of Treasury supervision of Departmental decisions in relation to nationalised industry project proposals. Here is the Chancellor's reply, in which you will see that he is unrepentant about the amount of work the Treasury undertake, although he says he would like to see Departments better placed to discharge these responsibilities themselves. He emphasises that the real aim is to make the nationalised industries competent to reach their decisions without Government having to re-analyse proposals.

If you wish to take this discussion any further, it might be a suitable topic for breakfast talk some time. – I will raise it then.

MAP

Mr Pattison

The Prime Minister has decided that Mr Nott should continue to come to Tuesday breakfasts.

Can CF please b/f this for Monday 12 January.

[illegible]

CAW to see

BF before the first breakfast of the new series – if Mr Nott is to remain one of the group?

MAP 5/1

2 January 1981

cc Andrew Duguid

A

BF 2/XII

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

31 December 1980

The Rt. Hon. John Nott MP
Secretary of State for Trade

Dear John

WASTE IN GOVERNMENT

PE 2

You wrote to me on 6 October about the present system of vetting individual investment projects put forward by the nationalised industries. I have not replied earlier because I wanted to think carefully about the issues you raised. In the meantime there have been helpful contributions from Michael Heseltine, Norman Fowler and Derek Rayner.

I think we all agree that we cannot entirely dispense with scrutiny by Government Departments of the more important investment proposals from the nationalised industries. We need to ensure that the proposals have been adequately assessed, that they are likely to earn an appropriate rate of return and that they are in line with agreed strategies. We are also agreed that we do not want unnecessarily elaborate systems. We must strike a balance which avoids second-guessing commercial judgement and at the same time protects the interest of the taxpayer in these large investment programmes.

The key to success must surely lie in the industries themselves having a thorough and effective system of appraisal. If this is absent, no amount of double-checking by officials can provide a substitute. Unfortunately, the track record of most nationalised industries does not at present give one this confidence. We must therefore devote time and attention to improving the effectiveness of the systems operating within the nationalised industries themselves. In the short term this may mean closer involvement than is ultimately desirable. One approach, mentioned by Michael Heseltine and to which I attach great importance, is to carry out checks on whether the rate of return promised on particular projects actually materialises. Where this has been done (for example, on some British Rail investment projects),

/it has

it has identified shortcomings in the appraisal process which can then be corrected. We should ensure that this approach is more widely adopted.

The same general principle applies between sponsor Departments and the Treasury: the more thoroughly the sponsor Department plays its part the less the Treasury needs to be involved. It was the absence of appropriate economic appraisal either by the industry concerned or by your Department which was the main reason for the delays in both the examples cited in your letter. Here our officials have agreed that where Treasury approval is needed, matters should be taken as far as possible with the industry on your side before we are brought in. That seems entirely sensible to me.

Both you and Norman Fowler have suggested a revision of the limits above which projects are submitted to sponsor Departments and the Treasury. We have always been prepared to look at these at any time to ensure that no more cases are "caught" than is necessary: Departments and the Treasury need to be satisfied with the effectiveness of the industries' appraisal process, and the Treasury needs to be sufficiently informed to play its proper resource allocation role. My officials offered to raise the limits for your industries before the cases which you mention reached us but they are still waiting for proposals from your Department. I hope rapid progress can now be made.

While, therefore, we must ensure that the principal responsibility for appraisal rests with the industry, I do not think we can relax Government scrutiny as much as you suggest; but to the extent that the industries can be brought to achieve greater effectiveness themselves, the continuing role of the sponsor Department and the Treasury can be reduced.

One quite different point has impressed itself upon me, in the course of discussing these issues - particularly with those who have had to manage nationalised industries. If we are to press improvements on the industries, then departments need to be able to respond expeditiously and effectively to their proposals. It is said that this is often not possible because of the relative frequency with which people in the Civil Service move on to new jobs just at the point when they are becoming most useful.

This is, of course, one aspect of a wider question which has arisen elsewhere for example, in relation to defence procurement: suppliers to Government have complained about the need to deal with faces that change too rapidly. In

/Government's

Government's dealings with industry (including the nationalised industries) we clearly must be sure to make the best use of the expertise which can flow from continuous work in the relevant areas and not to diminish this asset by too frequent postings. This is a point which probably deserves more thorough consideration.

I am copying this letter to the recipients of yours.

GEOFFREY HOWE

CONFIDENTIAL

JS

File
cc last para
+ JH
DW

SUBJECT.

10 DOWNING STREET

From the Private Secretary

22 December 1980

cc. Master set.
cc. Nat Ind: EFL's Pt.3. Gas+Electricity Pricing

Dear Tim,

As you know, the Prime Minister held a meeting this afternoon to discuss the nationalised industries. The following were present, in addition to the Chancellor of the Exchequer: the Secretaries of State for Industry and Energy, Mr. Ryrie, Sir Donald Maitland, Mr. Croft, Sir Robert Armstrong and Mr. Ibbs.

Nationalised Industry Financing

The Prime Minister said that she was becoming increasingly concerned at the financing burden of the nationalised industries. This was proving a huge drain on the PSBR and the prospects did not seem to be getting any better. After 20 months in office, the Government had achieved far too little in terms of improved efficiency and reduced financing requirements. The Government was now being severely criticised for not having achieved more. It was essential that sponsor Departments should drive harder at the industries to get them to achieve better efficiency. In addition, she wanted the various proposals which had been put forward for removing certain types of financing from the PSBR to be carried forward urgently. She understood that the Treasury had been considering the options, including removing the Government guarantee from certain types of borrowing and sale and lease-back arrangements, for several months. She wanted a report from the Treasury by 6 January on where the review of options had got to, what further work needed to be done, and - if possible - with some specific proposals for decision.

bf 6/1/81

The Chancellor and Mr. Ryrie explained the well-known objections to removing from the PSBR financing which was guaranteed by the Government. The Treasury were trying to identify areas where the giving of guarantees could be avoided so that the relevant financing could be taken out of the PSBR. One example already identified was the gas-gathering pipeline; there were other possibilities in British Rail, the NCB and British Telecoms. In all of these areas, there were likely to be difficulties - including the need for legislation. But the Treasury would continue to pursue the various options urgently, and would prepare a progress report for the Prime Minister as requested. Sir Keith Joseph added that in the case of British Telecoms, there were a number of hopeful options; he intended to write to the chairman of the Corporation about them shortly since he would have to go along with whatever the Government decided to do.

/ Energy Prices

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Energy Prices

The Prime Minister said that she was also most concerned about the high energy prices which private sector industry were having to bear. There was nothing the Government could do to bring down the exchange rate, which was also causing increasing problems for certain industries, without undermining the monetary strategy; but she felt that more could be done to make cheaper energy available to industry. High energy prices were partly caused by inefficiency in the coal industry and electricity industry; and as she had said already, the Government must press the industries harder to bring about improvements. But many industrialists, particularly bulk energy users, felt they were being unfairly treated compared with their competitors abroad.

The Secretary of State for Energy said that his Department had been conducting an intensive review of energy pricing, and he would be bringing forward proposals for collective consideration in early January. Certain small changes had already taken place: for example, BGC were now adopting a policy for charging slightly lower prices for new contracts and the electricity industry was showing somewhat greater flexibility in its prices for bulk users. In addition, the Electricity Council had been conducting a review of the bulk supply tariff since the autumn, and this work would be completed by early January as well. Contrary to what many in industry were saying, small and medium size electricity users were not being charged higher prices than their competitors abroad; it was only the bulk users who were at a disadvantage. He had freely recognised this, and that was why the bulk supply tariff review was being undertaken. Ministers would have to consider the option of reducing bulk supply tariffs, though this would be at a cost to the PSBR. But there would be some industries who would be unable to survive even with competitive tariffs. As for heavy fuel prices, these were now the lowest in Europe - and he would let the Prime Minister have chapter and verse. The current pricing regime for gas feed-stocks was very advantageous to British industry. As regards the proposals he would be coming forward with in January, these would include the option of reducing or abolishing the tax on heavy oil and also limiting the increase in gas prices to industrial users; but again, Ministers would have to weigh up the advantages to industry against the losses to the PSBR. In short, Ministers would have to decide whether to make relatively minor changes which would be presentationally helpful, or much larger reductions in energy prices which would cost substantial amounts of money. He would include in his paper to colleagues various possible packages within the latter category.

The Prime Minister said that, against the difficult prospects which manufacturing industry were facing, it would be desirable to make some substantial concessions on energy prices; and in looking at the PSBR consequences, it was important to take into account the PSBR consequences of industries going out of business if concessions were not made.

bf 4/1/81 Mr. Howell said that he would let the Prime Minister have a paper by 4 January; and I would be grateful if his office could let me have the information on heavy fuel prices by tomorrow (Tuesday) close of play.

/ Other points

Other points

The following further points were raised:

(i) Sir Keith Joseph said that BSC's Corporate Plan was optimistic about the Corporation's market prospects. It did not include the "lower case" option, which would involve closing Llanwern and Port Talbot. Although more expensive in the short term, it was possible that the "lower case" would be more likely to make BSC competitive again; and his Department would be looking at this closely.

bf 9/1/81

(ii) The Prime Minister questioned the need for the NCB to use Hobart House as their headquarters: wasn't there a strong case on employment and other grounds for having their headquarters outside London? Mr. Howell said that their present lease was on favourable terms, but he would look into the matter and let the Prime Minister have a report.

bf 9/1/81

(iii) The Prime Minster said that she was concerned that more progress had not been made by British Shipbuilders in selling off the ship repair companies. She had been impressed by the arguments put forward by Mr. Christopher Bailey on this matter; she would like a report from Sir Keith Joseph as soon as possible.

I am sending copies of this letter to Ian Ellison (Department of Industry), Julian West (Department of Energy), Sir Robert Armstrong and Robin Ibbs.

Tim Lankester

A.J. Wiggins, Esq.,
HM Treasury.

RECORD OF A MEETING BETWEEN MINISTERS AND THE NATIONALISED INDUSTRIES CHAIRMEN'S GROUP: HELD AT NO 12 DOWNING STREET AT 3PM ON THURSDAY 18 DECEMBER, 1980

Mr Wolfson
Mr Walters
Mr Duguid

may wish to see.

J.V.
9/1

Present:

Chancellor of the Exchequer	Sir Derek Ezra
Secretary of State for Industry	Mr Robert Atkinson
Secretary of State for Energy	Sir Humphrey Browne
Secretary of State for Employment	Lord Donnet
Chief Secretary	Sir Nigel Foulkes
Minister of Transport	Sir John Hill
	Lord Kirkhill
	Sir Robert Marshall
	Sir Peter Parker
	Mr N J Payne
	Sir Austin Pearce
	Sir Frank Price
	Sir Denis Rooke
	Mr Philip Shelbourne
	The Rt Hon Lord Shepherd
	Sir Francis Tombs

In attendance:

Mr W S Ryrie	Mr Driscoll
Mr T U Burgner	Miss Lohdon

---

1. The Agenda for the meeting is attached.

2. The Chancellor welcomed the Chairmen to the first full scale meeting for some time, noting that useful progress had been made in more restricted meetings over the past year. The agreed agenda was intended to allow both sides to cover points of current concern.

Government/Nationalised industry relations

3. In a brief introduction, the Chancellor said that although Ministers and Chairmen were inevitably at odds from time to time, they had a joint interest in attaining the right outcome on matters of mutual concern.

4. Sir Derek Ezra said that the relationship had always been an uneasy one. But the Chairmen were currently particularly concerned about the tenor of Ministerial speeches on financial aspects. In recent months these had seem deliberately critical, going beyond an expression of Ministers' political views. Some Ministers had

ascribed to the industries unjustifiably a lack of reaction to the changing economic scheme and an absence of capacity for this compared with the private sector. This was unsettling for the management, whose expertise and ability was highly regarded abroad and by the private sector industries with whom the nationalised industries worked closely. He added that the industries had no objection to properly directed criticism.

5. The Chancellor said that the industries like the Government liked to be loved. Despite a plethora of studies, an effective means of operating Morrisonian nationalised industries had yet to be devised. He appreciated that the industries had genuine concerns eg, the aggregation of their borrowing with that of the Government and difficult managerial problems eg, with the unions, where Ministers wanted to strengthen their hands. For their part, Ministers were aware of a sustained off the record chorus from the industries, criticising the Government's attitude as foot-dragging. The Secretary of State for Industry added that Ministers must be free to comment on the structure and difficulties of public ownership. The Government's philosophy was one of reducing the public sector: the public had to given an objective analysis of the arguments for this. Public sector industries were less adaptable than the private sector. This was not the fault of current management; rather it was inherent, attributable to the pervasive influence of the absence of the sanction of bankruptcy, together with the powerful influence of the trades unions. The Chancellor added that not all criticism of the industries was justified eg, where pricing policy was determined by Government but Ministers were bound to take up fair criticisms eg, those identified by the MMC.

6. Sir Derek Ezra noted that generalisations were often at the root of difficulties. Sir Francis Tombs added that there had been very biased comments of a general nature by individual Ministers, equating all borrowing by the industries with subsidy. The Minister of Transport said that it was important to recognise the differences between the nationalised industries eg, between service industries like rail and manufacturing industries like steel. Mr Dearing added that the workforce would look to management to defend it against criticism: this could be dangerous if it led to criticism escalating in a destructive way.

7. Sir Denis Rooke said that he could not agree that the private sector was inevitably more efficient. The nationalised industries had played their part in creating new businesses and responding to the market. Sir Derek Ezra added that the CBI's medium term review of the economy would note good performance of public sector industry in purchasing policy.

Financial framework

8. Turning to the second item on the agenda, Sir Derek Ezra said that the Chairmen wanted to add a third topic under this heading - the impact of the financial framework in relation to the economic crisis which was leading to serious problems for some industries.

a) Outcome of Ryrie Group

9. On the outcome of the work of the Ryrie Group, Sir Francis Tombs said that this had been positive and helpful. He valued highly the open-minded approach taken by the Treasury. The revised presentation agreed for the Financial Statistics and Budget Report (Red Book) should clarify misunderstanding about the purpose and extent of the industries' borrowing. The change in rules for borrowing from the NLF had been a major break-through and further work was in hand on variable interest loans and direct access to markets within EFLs. The Chairmen attached importance to the code for operation of EFLs and would want to discuss this. A set of rules was necessary to replace the cobbled up ad hoc solutions adopted at present. In return the industries had agreed to more frequent, and he hoped better, forecasts of their borrowing needs. More progress had been made in the past year than for the previous seven or eight. The Chancellor agreed that useful work had been done and that outstanding items should be pursued quickly. His 4 August statement went a long way towards meeting the Chairmen's wish for better, clearer rules on EFLs; officials would be ready to look respectfully at anything the Chairmen's Group put forward.

b) Impact of the Recession

10. Turning to the impact of the recession, Sir Derek Ezra said that changes in the economic outlook over the past 12 months had given the

industries' markets a new dimension. Financial objectives agreed 12 months ago were no longer valid. There was a need for a total rethink and painful adjustments which could require additional financing. Funds might be needed for additional redundancy payments or the costs of accelerated closures. Individual industries would be taking up these points with their Departments. The <u>Chancellor</u> commented that the industries were in the same position as both the private sector and the Government. He echoed what Sir Derek had said about a total rethink and painful adjustment but the amount of additional finance available was limited for all. Although this was less than the industries had wanted, the Government had increased provision for nationalised industries in 1981-82 by £800 million in recognition of the effects of the recession.

c) <u>Further issues, including private capital</u>

11. <u>Sir Derek Ezra</u> said these further issues were how the industries got their finance, whether this counted against the PSBR and to what extent the industries' cash problem would be eased if they could borrow from the private sector. The Group were thinking about this problem. Given the different financial position of individual industries, it was not easy to distil a common position but they would put forward propositions in due course. Sir Denis Rooke would take the lead in this.

12. The <u>Chancellor</u> emphasised that the Government were most anxious to find a way forward which would avoid the conflict of interest between the Government and industries. But a solution would need to take account of the reality of the implicit guarantee and to satisfy the Public Accounts Committee about the cost of finance outside the NLF. Joint activities with the private sector eg, the gas gathering pipeline offered an attractive way forward and other paths were already being charted. <u>Sir Denis Rooke</u> commented that the myth of PSBR definition was a fence which stopped sensible practical schemes going ahead. There was something wrong with the definition if industries had to sell their souls to meet it. The Group would be putting forward a number of proposals. If the Government rejected them they would be cutting off their nose to spite their face.

13. The Minister of Transport pointed out that in his group of industries progress was already being made in different ways by the National Freight Company, the British Transport Docks Board and British Rail subsidiaries. There was no question of any of those Chairmen selling their souls. The Secretary of State for Energy added that imaginative solutions were needed which confronted the Chancellor's basic problem - the need to reduce the PSBR.

14. Sir Francis Tombs commented that privatisation of fringe activities did not tackle the central issues which were the failure of present definitions to discriminate between borrowing to finance capital and revenue expenditure and the way in which the PSBR was linked with a notion of control. Sir Peter Parker added that there was no dearth of new ideas around or of major projects eg, electrification of the railways which could be identified. The Chancellor commented that it was as easy to increase problems by this route as to diminish them. Mr Ryrie said that it was important to keep in mind the purpose of the exercise. This was not simply to create another form of borrowing or one in direct competition with Government borrowing. Simple financial devices were not answer. What was needed was far reaching structural changes whereby genuine risk capital could be involved in market situations.

15. The Chancellor said that the initiative lay with the industries to follow up some of the ideas which had been floated for involving private capital but Ministers were prepared to examine the proposals which the Group put forward.

Pay

16. Invited to open the discussion, Sir Peter Parker said that the industries shared the Government's view of the importance of the public trading sector in achieving lower settlements. The absence of a single common figure in fixing EFLs was a helpful recognition of its differing degree of importance for pay negotiations between industries. The industries knew how important it was to fight for single figures. Ministers might like to know that the Chairmen's Group had set up a working party to update their earlier report on longer term pay issues: the results should be available in the Spring.

17. The Chancellor said that there was no national or public sector pay policy in terms of precise figures. Where the Government was directly concerned as employer in the public services there had to be a cash limit on the public expenditure concerned. For the industries, he suggested a reasonable expectation was increases comparable to those in the parts of the private sector most open to international trading conditions. The Government was crucially concerned to get settlements as low as possible, bearing in mind that three fifths of the UK's loss of competitiveness since 1978 was due to high wage costs. 6 per cent was not unreasonable in the light of experiences in the period 1951-1964 when increases also averaged 6 per cent, of which 3 per cent was inflation and 3 per cent growth.

18. Lord Shepherd said that it was important to hold the line on fringe benefits, holidays and sickness as well as on straight rates of pay. Sir Austin Pearce suggested that more needed to be done to get lower settlements in the financial services sector and to counter the unions' feeling that they would make good any restraint now when the upturn came. Mr Dearing added that if the industries were to take a tough line, which they all agreed they should, they would expect understanding in relation to the costs involved.

19. In reply to a question from the Chancellor about how the perception in the market place of the coal settlement as 13 per cent might be altered, Sir Derek Ezra said that he was reluctant to intervene explicitly, although he had done what he could to ensure that other employers knew and could use the full story. Sir Francis Tombs said that full time union officials knew the position: the difficulty was shop stewards in local negotiations.

Board Members Pay

20. Sir Denis Rooke reported that the Group had made progress in their discussions with the Civil Service Department but were still concerned about three things. First, that Ministers should be fully committed to the market philosphy underlying the new system. There was no point replacing the TSRB by new administrative rules. Second, they did not understand why the starting point for the new rules had to be current rates of pay. The Government ought to accept the analysis underlying the last TSRB report, allow the

industries to move towards implementing it and only begin the new system of structural reviews at that stage. Otherwise the industries would be merely duplicating the work of TSRB. Finally they had suggested that Board Members should be paid as executives of the corporation concerned, with their pay determined through remuneration committees subject to the veto of the Secretary of State concerned and with a small fee as board members equal to that paid to non-executive Directors. Sir Derek Ezra said that despite these concerns, they welcomed the progress which had been made.

21. In reply the Chancellor emphasised that the Government were moving to unhook the industries and enable the market to breathe.

Conclusion

22. In conclusion, the Chancellor thanked the Chairmen for a useful exchange of views.

DEPARTMENT OF TRANSPORT
2 MARSHAM STREET
SW1P 3EB

MINISTER OF TRANSPORT

With the Compliments of the
Minister of Transport

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Nat Ind

DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

MINISTER OF TRANSPORT

The Rt Hon John Biffen MP
Chief Secretary to the Treasury
Treasury Chambers
Parliament Street
LONDON
SW1

8 December 1980

Dear John,

Thank you for your letter of 5 December about the composition of British Rail's 1981/82 External Financing Limit.

attached ~~copy requested~~.

I am sure you are right in your view that the announcement in relation to the grant needs to be handled with great care. We must certainly avoid any impression of yielding under pressure either from the Unions or from the Board. I already know that the claim for grant, subject to any final views taken by the Board itself, contains an assumption that the next fares rise will be brought forward to September 1981. This is an assumption which I am anxious to stop in its tracks.

Peter Parker has a very difficult hand to play with the Unions, and the latest resolution by the NUR marks an attempt by them to start bargaining directly with the Government. That we must at all costs avoid. Here again, the right course must be for us to announce our decisions as we take them and in our time, and not to wait for pressure to be built up.

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For these reasons, we must I am sure go for a quick announcement. I will of course see that the text is cleared with the Treasury.

I am copying this letter to the Prime Minister, Sir Keith Joseph, David Howell and Sir Robert Armstrong.

Yours ever.

Norman

NORMAN FOWLER

Nott hd

DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

MINISTER OF TRANSPORT

The Rt Hon Sir Geoffrey Howe MP
Chancellor of the Exchequer
Treasury
Parliament Street
LONDON SW1

6 December 1980

Dear Geoffrey.

WASTE IN GOVERNMENT

In his letter of 6 October to you John Nott suggested that the way we deal with nationalised industries' investment projects belied our Manifesto commitment to interfere less with the management of the industries. I agree that we need to scrutinise this area of government activity, as others, to ensure that we are not causing unnecessary work. Some of the industries consider that the control over investment should be relaxed altogether; that there should be no scrutiny of projects, and (since the EFL is now the paramount constraint) no separate investment ceilings. I do not think I would go as far as that. The problem is one of striking a balance between interfering unnecessarily and exercising our responsibilities for bodies providing vital public services and spending large sums of public money.

I can see three legitimate reasons why, as the Minister with statutory responsibility for three industries, I should expect my department to look at their major investment projects. First, I need to ensure that major projects are consistent with the role and objective of the industry, particularly where a public service is being provided. Here the best method is to agree long term strategies with the industry, after which we need to check that individual projects are in line with those strategies. At the very least we need to be sure that we look at new projects which might extend public sector activities, or which are overseas ventures by traditionally home-based operators.

Second, because nationalised industries have, in the last resort, to be bailed out by the Government if they become insolvent I cannot afford to be indifferent to the returns and risks involved in major investments for which borrowing is required. Certainly I should expect to consider very carefully projects which are so large that their success or failure can effect the future course of an industry's financing requirements. But I should want to do so in such a way as to reinforce rather than weaken, the Board's internal disciplines.

Third, I think industries which are permanently unprofitable are a special case. As providers of large sums of taxpayers' money to some of the public service industries we need to ensure so far as possible that we get value for money: investments cannot always be judged solely by commercial criteria. I shall continue to need to look at major investment in BR's passenger business, the results of which directly affect the grant which I pay them.

It is a matter of judgment where to draw the line. My department have an opportunity to see all BR projects costing over £3.5m, though they do not vet all of them. For the smaller transport industries the level is £1m or less. These levels are reviewed from time to time to ensure that only the most significant projects have to be submitted. I am inclined to think that the present limit on BR projects is too low. My officials will be in touch with yours about that.

John Nott also raises the question of Treasury involvement. I agree that it is important not to blur the distinct and different responsibilities of Treasury Ministers and of those who sponsor nationalised industries, and I should expect the Treasury to be concerned with nationalised industry investment projects only if they had significant national expenditure implications. Thus in my field the Treasury are involved with the question of whether there should be substantial increases in railway electrification, but not with individual projects for the replacement of railway rolling stock. I take the view that provided you and your officials are confident that a sponsoring department and the industries have adequate arrangements between them for vetting investment, you would expect to be consulted only on particularly important projects. I am not aware of any problems in operating in this way so far as my industries are concerned.

Copies of this letter go to the members of E Committee and to Sir Robert Armstrong and Sir Derek Rayner.

Yours ever

Norman

NORMAN FOWLER

CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon Norman Fowler MP
Minister of Transport
2 Marsham Street
London SW1

5 December 1980

Dear Norman.

BRITISH RAIL: COMPOSITION OF 1981-82 EXTERNAL FINANCING LIMIT

I wrote to you on 24 November agreeing that the ceiling for BR's grant in the coming calendar year should be increased by £20 million within the EFL announced for 1981-82. Together with the increase of £3 million in respect of costs arising from a closure of their loss-making parcels business, the Board's grant ceiling for 1981 would be £23 million higher next year and their planned level of borrowing correspondingly lower.

Since writing I have viewed with concern recent developments on the railways which have culminated in a threat of strike action by the NUR if the Government does not increase its assistance to British Rail. One specific demand being made by the NUR is that the Government increases BR's grant. There have also been suggestions that the NUR is considering joining with the miners and possibly the steelworkers in a joint approach to the Government aimed at increasing levels of Government support, backed up by the threat of industrial action.

In these circumstances, I think it would be a mistake to announce an increased grant ceiling for BR. I appreciate that it represents no more than an adjustment within a given EFL and that, in itself, it could serve temporarily to defuse the position on the railways. But the wider repercussions may be severe. However carefully we present the change in the grant ceiling as an unexceptional adjustment within a given EFL, the NUR are bound to seize on it as a response to their campaign. This could well encourage them to press the other demands they are making; and I am concerned that it may encourage the unions in other loss-making nationalised industries to adopt a similar approach.

On this basis I must ask you to postpone indefinitely any announcement about the increased grant ceiling for British Rail. I am not at this stage suggesting that we should reconsider the increase itself (although this we may have to do if matters do not improve and an announcement is required for operational reasons.) Alternatively, there may come a time when the change we have agreed could be used to help resolve the difficult position which is emerging. I am sure however that we should for the moment wait until the situation becomes clearer before contemplating any announcement.

I am copying this letter to the Prime Minister, Sir Keith Joseph, David Howell and Sir Robert Armstrong.

Yrs

John

JOHN BIFFEN

Top Copy: Econ Pol, PE12 Public Expenditure

H. M. TREASURY

Parliament Street, London SW1P 3AG, Press Office: 01-233-3415
Telex 262405

Nat Ind

24 November 1980

NATIONALISED INDUSTRIES: EXTERNAL FINANCIAL LIMITS

As indicated in the Chancellor's statement today, the Chief Secretary to the Treasury, the rt. hon. W J Biffen, MP, today announced the External Financing Limits for the nationalised industries for the financial year 1981-82.

In a written Answer to a Parliamentary Question by the rt. hon. Sir R Graham Page, (Crosby) the Chief Secretary announced the figures for individual industries exluding British Steel, whose limit will be announced later.

The text of the Parliamentary Question and Answer is attached.

PRESS OFFICE
HM TREASURY
PARLIAMENT STREET
LONDON SW1P 3AG
01-233-3415

181/80

The rt hon Sir R Graham Page:

To ask the Chief Secretary to the Treasury what limits have been set on the external financing of the nationalised industries for the financial year 1981-82.

The limits are as follows:

Nationalised Industries' External Financing Limits 1981-82*

		£ million
National Coal Board		882
Electricity Council & Boards		-210
North of Scotland Hydro-Electric Board		32
South of Scotland Electricity Board		77
British Gas Corporation		-390
British National Oil Corporation		-360
Post Office	(Post & Giro	16
	(Telecommunications	180
British Airways Board		101
British Airports Authority		14
British Railways Board		920
British Transport Docks Board		-5
British Waterways Board		32
National Freight Company		7
National Bus Company		75
Scottish Transport Group		17
British Shipbuilders		150

These limits have been set, following consultations with the industries concerned, on the lines set out in my Rt. Hon. Friend's answer on 4 August 1980. (Hansard W.A. col. 41-42).

Notes

*No figure is included for British Aerospace on the assumption of a sale of shares in a successor company in 1980-81, or for the British Steel Corporation where a limit will be announced in the light of their Corporate Plan expected shortly. As in the past the forecast for BNOC does not represent a limit. The limit for the British Gas Corporation is before the imposition of the proposed Gas levy.

Notes for Editors

External financing limits (EFLs) are "a form of cash limit" for individual industries. They control the amount of finance (grants and borrowing) which an industry can raise in any financial year from external sources. They are thus the difference between very much larger flows of revenue and expenditure, both current and capital. As last year, the limits are being set in the autumn so that the industries can take them into account in wage-bargaining.

2. The White Paper on the Government's Expenditure Plans (Cmnd 7841) emphasised (page 55) the particular uncertainties attaching to the figures for the nationalised industries for the later years because their revenue and expenditure, like those of private sector companies, depend on trading conditions. As the Chancellor explained in his statement, the limits represent an increase of £620m on the White Paper figures reflecting the impact of the recession at home and abroad. To keep to these figures the industries have been asked to make substantial economies of more than £800m. (Both figures are at "1980 survey prices" - roughly £800m and over £1,000m in cash respectively.)

3. The Chancellor of the Exchequer set out on 4 August 1980 (Hansard WA col 41-42)the Government's approach to setting and administering EFLs. This will apply to the figures announced today. The statement made clear the role which EFLs play in the control of public sector borrowing. It also said (as did the April 1976 cash limits White Paper) that since the nationalised industries are trading organisations with large flows of expenditure and revenue, the EFLs cannot be immutable; but that equally there can be no presumption that a financing deficit would be met, as happened before 1976, by a further injection of external finance and went on to define in broad terms the circumstances in which the Government would be prepared to consider adjusting EFLs.

cc A. Duguid

Nat Ind

CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

R 21/11

Rt Hon David Howell MP
Secretary of State
Department of Energy
Thames House South
Millbank
London SW1

20 November 1980

Dear David,

PERFORMANCE AIMS FOR THE NCB

Thank you for your letter of 27 October in which you reiterate your opposition to publishing a performance aim for the NCB this autumn.

filed on Nat Ind: Gas + Electricity Pricing, Pt 3

I note from paragraph 3(b) of your paper on industrial energy pricing, E(80)128, that you propose to "consider a performance aim for the NCB early in the New Year when we have reviewed their financial strategy target as it is important not to set them inconsistent targets".

On the basis that you accept the principal of a performance target for the NCB, I am prepared with considerable reluctance to accept the timetable you suggest in your paper to E Committee provided that the delay would not cause too much difficulty for colleagues in their relationships with their nationalised industries. We cannot be put in the situation where other industries use the delay in setting the NCB's aim as an excuse for backtracking on their aims.

You will no doubt be asked when the aims are published for the other industries why no aim has been published for the NCB. I think our reply here must be that consideration is still being given to the precise details of a performance aim for the NCB and it will be published early in the New Year.

I am sending a copy of this letter to members of E Committee, the Secretary of State for Scotland, the Minister of Transport and Sir Robert Armstrong.

John Biffen

JOHN BIFFEN

DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

MINISTER OF TRANSPORT

COMMERCIAL IN CONFIDENCE

Prime Minister

For information

T P Lankester Esq
Private Secretary to
the Prime Minister
10 Downing Street
LONDON
SW1

19 November 1980

Dear Tim,

I am writing to let you know that British Railways Board and Brostroms are announcing this evening that they are discussing arrangements to bring together their companies, British Rail Hovercraft Limited, and the privately owned Hoverlloyd with a view to establishing a joint operating company for cross-Channel hovercraft services. This follows failure by French interests to follow through negotiations involving Hoverlloyd, the French hovercraft operator and two French banks.

If the talks succeed, that should be a helpful step towards privatisation. No commitments will be entered into by BRB until my Minister has considered a worked-up proposal. I attach a background note.

I am copying this letter to Private Secretaries in interested Departments: John Wiggins, Treasury, Stuart Hampson, Trade, Ian Ellison, Industry, George Walden, FCO and Brian Norbury, Defence.

Yours,

Anthony Mayer

R A J MAYER
Private Secretary

COMMERCIAL IN CONFIDENCE

MERGER OF CROSS CHANNEL HOVERCRAFT COMPANIES

BACKGROUND NOTE

The Railways Board's wholly owned subsidiary, British Rail Hovercraft Ltd (BRHL), is beginning merger negotiations with the rival hovercraft operator Hoverlloyd which has been on the market for over a year. The intention is to establish a joint operating company for cross-Channel hovercraft services. At present there is no intention to include the third operator, the French Railways, in the new company.

Separately the prospects of the two companies are poor. In 1979 they both made a loss before interest and tax. Joint operation offers considerable economies of scale and is the best hope for continued operation on the Channel of British hovercraft. Without a merger, closure of both services is a real possibility.

This proposal does not affect the Board's and Government's intention of introducing private capital into BRHL (enabling powers will be contained in the forthcoming Transport Bill). On the contrary, if negotiations are successful and are accepted by Ministers the Board's interest in the resulting company should be more attractive to private risk capital than is BRHL itself.

The Railways Board have been told that no public money will be made available ~~for~~ to launch the proposed company, and that it must not constitute an extension of the public sector.

The British Hovercraft Corporation are known to favour the rationalisation of hovercraft services, since this is expected to generate future orders. They have been informed of this proposal by BR who hope that they will be prepared to take a share in the new company. This would reduce public sector involvement.

Finally, there are monopolies implications, and if negotiations are successful the Director General of Fair Trading will have to decide whether to recommend referral to the Monopolies and Mergers Commission

Department of Transport
17 November 1980

Commercial in Confidence ANNEX

FACT SHEET

	BRHL	Hoverlloyd
Owner	British Railways Board (100%)	Brostrums, Sweden (100%)
Routes	Dover - Calais Dover - Boulogne	Ramsgate - Calais
Fleet	Stretched Super 4s x2	SRN4 MkII x 4
Capacity (each craft)	416 passengers 55 vehicles	280 passengers 37 vehicles
Financial Results		
Operating Profit £m (before interest & tax)		
1978	(2.2)	0.6
1979	(0.8)	(0.4)

Brackets denote loss.

Department of Transport

17 November 1980

CONFIDENTIAL

FILE

Copied to Nat Ind: Policy. Pt 3

bc: John Hoskyns
David Wolfson
John Vereker
Industry

10 DOWNING STREET

From the Private Secretary

5 November 1980

Nat Ind.

Original and BF action on ~~Public Sector Pay~~: Pt 3

Dear John,

Public Sector Pay: Monitoring Report

The Prime Minister has now read the latest Monitoring Report which you sent over with your letter of 31 October. She has commented that this is an excellent Report, and she would like to discuss it - and subsequent Reports - with the Chancellor. She has no objection to your producing the Report on a three-weekly basis rather than fortnightly at least for the moment.

On individual issues in the Report the Prime Minister has the following comments:

i) Handling of nationalised industry pay. She asked whether all sponsoring Ministers have informed the chairmen of their nationalised industries that the Government is looking for single-figure settlements?

ii) University technicians. She believes that this case provides a further argument for getting an early announcement on the pay element for next year's cash limits.

iii) University teachers. She has commented that the Government must resist the 13% offer proposed by Committee A.

I should be grateful for a note on the first point above, and no doubt the Chancellor will take up the question of University teachers' pay further with the Secretary of State for Education as necessary in the light of the Prime Minister's comment.

I am sending copies of this letter to Richard Dykes (Department of Employment), Jim Buckley (Lord President's Office), Gerry Spence (CPRS) and David Wright (Cabinet Office).

Yours ever,

Tim Lankester.

John Wiggins, Esq.,
HM Treasury

CONFIDENTIAL

Ref. A03447

PRIME MINISTER

Nationalised Industries: External Financing Limits 1981-82

(E(80) 121 and 125)

BACKGROUND

When E discussed E(80) 121 on 22nd October it was agreed that each sponsoring Minister should consider further the measures necessary to achieve the EFLs for 1981-82 listed in column 2 of Annex A to E(80) 121 - equivalent in total to additional provision of £500 million at Survey prices - and that the Committee would then discuss these measures together with the further cuts which would be necessary to bring down the additional provision for the nationalised industries to the £300 million assumed in the papers now before Cabinet (E(80) 38th Meeting, Item 2).

2. The Chief Secretary's present paper (E(80) 125) reports that agreement has been reached on the first stage - that is, on the EFLs listed in column 2 of the Annex to E(80) 121 - on all the industries other than electricity, gas, rail and air-ports. These exceptions are however highly significant, and mean that the present additional provision required is £757 million (see the table in paragraph 3 of E(80) 125).

3. This is £457 million in excess of the figure of £300 million now before Cabinet, which is already under strong attack from non-nationalised industry Ministers resentful of making cuts in their programmes to finance the excess requirements of the nationalised industries. Moreover, this additional £300 million is on top of £470 million more approved in July and of a further £300 million increase in reserve now being provided to allow for end-year flexibility in nationalised industry EFLs.

4. The Chief Secretary proposes, in paragraphs 6 and 7 of E(80) 125, that the £457 million excess should be eliminated either by selective cuts or by across-the-board cuts equivalent to 9 per cent of the proposed level of fixed investment, though with the industries free to decide for themselves how to make this cut.

5. The discussion of the options for dealing with gas and electricity will inevitably overlap with that on industrial energy pricing, which is the next item on the agenda.

HANDLING

6. After the Chief Secretary has introduced his paper, you may wish to remind the Ministers responsible for nationalised industries of the need for them and their industries to face up to very painful decisions in order to make the necessary contribution to the overall public expenditure exercise.

7. I suggest that you then take the four industries where there is not even agreement on the first stage of the cuts; and that you then go on to the general question of whether the balance should be found selectively or across the board.

Electricity

8. The Treasury propose, for England and Wales, an EFL of minus £221 million. The Secretary of State for Energy advises that, with allowance for further reductions in capital expenditure and for efficiency savings, it should be minus £100 million.

9. He points out that the EFL is highly vulnerable to the miners' pay settlement. This could lead to a higher settlement than the 10 per cent at present assumed for pay in the electricity industry; and could also have a major impact on coal prices which represent 50 per cent of the revenue costs of the CEGB.

10. If alternative economies cannot be found the difference between the two EFLs under discussion represents the yield from an extra $2\frac{1}{2}$ per cent average tariff increase next April on top of the 12 per cent already assumed. If Scottish price increases are to be kept in line with 12 per cent in England and Wales the total EFLs for the Scottish Boards will be £127 million rather than £108 million as proposed by the Treasury.

11. The question before the Committee is, therefore, whether they are prepared to countenance tariff increases of around $2\frac{1}{2}$ percentage points higher next April (i.e. $14\frac{1}{2}$ per cent rather than 12 per cent) in order to yield a further £140 million in Great Britain. There would be a strong likelihood that the industry would blame the Government for this increment in the tariff increase. On the other hand there remains the possibility - provided the NUM settlement is within bounds - of finding other savings before the tariff increases are finally determined.

Gas

12. The Treasury propose minus £399 million: the Secretary of State for Energy proposes minus £309 million.

13. The Treasury's proposal was based on a domestic price rise of 27 per cent in April 1981. The Secretary of State for Energy recommends that it should be based on an April increase related to the going rate of inflation and a 10 per cent increase in the following October. He identifies but does not support two other ways of bridging the gap:-

17-10

(i) £30 million from retaining BGC's present assumption of a 17 per cent increase next April but recognising that lower inflation would make possible a tariff increase of less than 10 per cent later in the year and lower increases in BGC's costs: the Committee will no doubt wish to press the Secretary of State on why this is unacceptable.

(ii) £60 million from a combination of manpower cuts of 5,000, split between contractors and BGC employees, and reducing profitable investment: clearly unattractive in many ways but no different in kind from many of the cuts being pressed upon Departmental programmes.

Rail

14. The Minister of Transport proposes £945 million compared with the Treasury's £888 million.

15. The Minister has already persuaded the Chairman to revise his pay assumption down from 10.7 per cent to 8 per cent and to find substantial other savings. He judges that the excess of £57 million could be eliminated only by a 10 per cent cut in investment or by bringing forward the next fares increase currently planned for November 1981.

Airports

16. The difference here is relatively small - £21 million against the £16 million sought by the Treasury.

17. This arises in part because it is now judged to be unrealistic, in the face of the current legal row with the airlines, to increase landing fees by the full amount needed to meet the financial target. The gap could, however, be narrowed, by a more satisfactory pay assumption than the present 14 per cent. Each 1 per cent off would yield £0.5 million. 0.5

Other Industries

18. Sponsoring Ministers were able to agree with the EFLs proposed by the Treasury for the other industries. Unless any Minister has any particular points on these industries it should not be necessary to discuss them.

Further Cuts

19. If none of these reductions is made a cut of £457 million at Survey prices will be required to get down to the £300 million assumed in the Cabinet papers. The choice posed by the Chief Secretary, in paragraphs 6 and 7 of E(80) 125, is between selective cuts and across-the-board cuts on all industries equivalent to 9 per cent of the proposed level of their fixed investment, but with the industries free to select how to find these sums.

20. If all the reductions discussed above were made the gap would be reduced to £200 million with the choice between selective cuts and across-the-board cuts of 4 per cent of investment.

21. Selective cuts are likely to work only if there are major contributions from the larger industries including electricity, gas and probably rail. In view of the difficulties already identified in the paper this does not seem to be a runner. If so, this points to an across-the-board cut of whatever level necessary to bridge the remaining gap. Unless the Committee is prepared to accept whatever tariff increases might emerge from this decision, they will wish to invite sponsoring Ministers to report back on how the cuts are to be achieved and to do their utmost to ensure that the weight is put on cost savings, and lower pay settlements (unrealistic pay assumptions do not help), rather than on tariff increases.

CONCLUSIONS

22. In summing up, you will wish to remind the Committee that the final decision on the aggregate cuts rests with the Cabinet, as with other public expenditure proposals. Subject to that you will wish to record decisions on:-

(i) Those EFLs in dispute - namely, electricity, including Scottish electricity; gas, rail, and airports.

(ii) How any remaining gap above the £300 million assumed in the Cabinet papers is to be bridged:

<u>either</u> selectively and, if so, identifying the industries,

<u>or</u> across the board by a percentage sufficient to bridge the gap and with whatever reservations the Committee feels necessary on tariff increases.

23. You might also invite the Chancellor or the Chief Secretary to report orally to Cabinet on 6th November on the position reached.

RTA

ROBERT ARMSTRONG

4th November, 1980

Nat Ind

CONFIDENTIAL

Qa 05173

To: MR LANKESTER

From: J R IBBS

Nationalised Industry EFLs 1981/82

1. In E(80)125 the Chief Secretary reports that sponsor Ministers have now identified measures by which they are prepared to reduce the total of EFLs to a figure of £757m. above that agreed by Cabinet in July. For his part, the Chief Secretary is prepared to accept an excess of £300m. The gap remaining is therefore £457m.

2. To bridge this remaining gap the Chief Secretary proposes further across-the-board cuts equivalent to 9 per cent of investment programmes. It would, however, be open to sponsor Ministers to vary the severity of the cuts between their industries and to reduce current costs, rather than capital investment, if that is practicable.

3. Given the commitment of Ministers to contain public expenditure, and the difficulties already inherent in the Chief Secretary's proposals for reducing other public expenditure programmes, it is difficult to argue that the scale of cuts proposed for nationalised industries is disproportionate. We should, however, like to make two points:

(i) In principle it is undesirable to make pro rata, across-the-board, cuts since these cannot be expected to yield an efficient and rational distribution of resources. We therefore think Ministers should be urged to use to the maximum possible extent the discretion to vary the severity of the cuts between their programmes, and to put maximum emphasis on cutting current costs and improving efficiency.

(ii) The scope for variation between industries may be limited in the short term. But the problem is likely to recur next year and we would strongly urge that Departments should begin to formulate a strategic medium-term plan for allocating capital resources between different industries. Such a plan should entail an ordering of priorities in investment programmes, giving preference to those industries expected to be the most profitable and which will contribute most to the infrastructure of the economy and its efficiency. Other industries (probably steel and shipbuilding) would have to be given low priority. Some of these might have to pursue a policy of minimising their financial requirements, and cutting costs even if this would lead to partial closing down of the industry. It would be far better to end up with fewer industries all of which are vigorous and successful by world standards than with a wider range of activities none of which is outstanding and some of which remain in chronic difficulty and a drain on the Exchequer from sub-optimal planning and under-investment.

4. I am sending a copy of this minute to Sir Robert Armstrong.

JR

4 November 1980

Nat Ind

MAP

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

3 November 1980

M. Pattison, Esq.,
Private Secretary,
10, Downing Street

Dear Mike

WASTE IN GOVERNMENT

You will recall that the Secretary of State for Trade wrote to the Chancellor of the Exchequer on 6 October about the degree of detailed scrutiny by the Treasury on the major Investment Projects of nationalised industries. This was particularly in connection with the Civil Aviation Authority, but the point made was a general one. This letter is to let you know that this subject is still in play; we are proposing to including it on the agenda for a meeting on 10 November with Sir Derek Rayner about the role of the Treasury expenditure divisions and I will keep you posted of any developments.

Yours ever

Peter

P.S. JENKINS

CONFIDENTIAL

B/C

10 DOWNING STREET

From the Private Secretary

31 October 1980

British Aerospace Flotation

The Prime Minister has now read your Secretary of State's minute of 23 October on the above subject, and the Chancellor of the Exchequer's letter of 30 October.

The Prime Minister very much hopes that it will be possible to vest on 1 January with a view to flotation in January or February. She has noted that there are a few issues which still have to be resolved with the Treasury. But as soon as decisions on defence spending have been taken, she hopes they can be resolved. She would like the further discussion which is planned for E(DL) Committee to take place as soon as practicable so that agreed proposals can come forward.

I am sending copies of this letter to John Wiggins (HM Treasury), Brian Norbury (Ministry of Defence), Jim Nursaw (Attorney General's Office), the Private Secretaries to other members of E(DL) and to David Wright (Cabinet Office).

TPL

Ian Ellison, Esq.,
Department of Industry

CONFIDENTIAL

JS

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

30 October 1980

The Rt. Hon. Sir Keith Joseph, MP.,
Secretary of State for Industry

Dear Keith

BRITISH AEROSPACE: VESTING AND FLOTATION

You sent me a copy of your minute to the Prime Minister on 23 October about the timing of the British Aerospace flotation, a subject which was discussed in E(DL) later that day. I have three comments on your minute.

(a) I am as keen as anyone to see a successful privatisation, and I share your regret that the plan for a flotation in November has had to be dropped. But the doubt about future Defence orders, on which the November plan has floundered, was not in fact an entirely unexpected shoal. It came up in a discussion I had with Adam Butler in June, when he took the view that the chances of bringing off an autumn flotation were less than evens. And the Chief Secretary's initial proposals for PES reductions - admittedly more modest than those subsequently sought - were tabled in Cabinet in July.

The Dept. of Industry disputes this interpretation Th.

(b) I do not dissent from your wish, subsequently endorsed by E(DL), to float early in the New Year, but I see a risk of a further shipwreck on precisely the same shoal. Unless we should decide otherwise, our decisions on particular expenditure programmes would not become public until we issue the White Paper, and if your merchant bank advisers are inclined to see an earlier announcement in respect of Defence as a pre-condition for a flotation in January, I think they must be told that it may not be met. Moreover, their suggestion that the prospectus should reflect the maximum impact on BAe which might result from the public expenditure decisions affecting MOD, rather than their actual impact, seems bound to depress still further the likely proceeds from the flotation. You will wish to be sure, before proceeding with the Offer for Sale, that they would be sufficient and defensible.

/(c) If the

(c) If the route to a flotation in late January or February was clear, I would, as you mentioned, be content to vest the company on 1 January. However, as I explained in my letter of 8 July to Adam Butler, I am unconvinced of the merits of vesting if flotation is not an immediate prospect. The closing sentences of your minute imply that some doubt would remain as to whether the Government would exercise effective control after vesting. I am clear that if the company were to remain in 100 per cent public ownership for more than a very short period it would be absolutely essential that full control, at least as effective as that operated at present, should be maintained. The control mechanisms that would be adequate for an interim period, and were thought adequate for the NFC because Norman Fowler then and now expects privatisation in 1981-82 to go ahead, would be quite inadequate for BAe Ltd., if it were to remain wholly Government-owned throughout the lifetime of this Parliament, as you say would probably be the case if we were in practice unable to float early next year. The scale of BAe's business, investment plans, and future capital requirements greatly exceeds those of the NFC.

In sum, I am sure that E(DL) was right to postpone a decision on vesting date: the prospects for an early subsequent flotation must be clarified before such a decision can be taken.

I register point (a) simply in order to set the record straight. Points (b) and (c) will no doubt be subsumed in further discussion in E(DL) as your planning develops.

Copies of this letter go to the Prime Minister and the other recipients of yours.

GEOFFREY HOWE

DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

MINISTER OF TRANSPORT

CONFIDENTIAL

The Rt Hon John Biffen MP
Chief Secretary
HM Treasury
Parliament Street
LONDON SW1

30 October 1980

Dear John.

NATIONALISED INDUSTRIES' EXTERNAL FINANCING LIMITS 1981-82

Following the discussion at E Committee on 22 October, I have had further discussion with Peter Parker on the forecast in E(80)121 that BR would have an external financing requirement of £765m (at 1980 survey prices) for 1981-82, which would be £102m above the current provision of £663m. I have now seen your letter of 29 October about the EFL for 1980-81.

The need for operating economies and productivity improvements has been the dominant feature of my discussions with Peter Parker, and they are pressing ahead. Over the two years 1980 and 1981, they will have cut back operating expenses in real terms by £50m and the numbers on the payroll by 4000, without bringing into the reckoning the 4,500 jobs that will go on closure of the collected and delivered parcels business and the further cuts to which I refer below. To conserve cash this year, the Board have held back some £20m of investment. And, as you know, I have warned Peter Parker that new investment next year must depend on the Board's ability to generate the money.

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Following last week's discussion at E Committee, I have now secured Peter Parker's agreement that he will go for a pay settlement at 8% and will budget accordingly. The real battle has still to be won next spring, and it will be harder to win if other industries which settle earlier do so at higher figures. But I am sure that we have now carried this with Peter Parker as far as we possibly can at this stage of the pay round.

Faced with further traffic losses, the Board have now concluded that they must carry the search beyond operating economies and secure reductions in maintenance expenditure. I warned my colleagues in September that there were already serious grounds for concern that maintenance, particularly of the track, may already have been cut back too far. There is, at least, now serious risk of a deteriorating service as it becomes necessary for the railway management to impose speed restrictions for reasons of safety, and that would of course have a consequential effect on revenue.

I have also discussed further with Peter Parker the prospects of additional sales of assets, in particular the hotels. The timing of that sale must depend on the state of the market, but we will keep up the pressure.

Thus, since September I have secured the specific economies I envisaged, and a bigger reduction in the pay assumption, at a time of worsening business prospects. I judge that we can now reduce BR's external financing requirement next year by some £60m at 1980 survey prices or £80m at ourturn prices. I therefore propose that their EFL should be set at £945m.

To go below this would mean two things. It would mean bringing forward next year's fares increase from November to September at the latest - an option which Peter Parker is naturally bound to consider, but which I feel strongly we should avoid forcing on him. It would also mean halting new investment starts for the whole of the year. This would have a large knock on effect on the private sector suppliers, as well as weakening the pressure we had contrived to put on the Board towards better financial performance. To my mind, the disadvantages of these options far outweigh the advantages.

I should add two things. The first is that Peter Parker is as well seized as we are of the need to keep within this year's EFL, and is doing his utmost to achieve that. As a result of further traffic losses, the Board now forecast an overshoot of £45m in 1980/81. The Chairman expects to be able to pull that back by measures he has already identified to some £25m to £30m, and hopes to go further. He is personally more firmly committed than most nationalised industry chairmen to the importance of the EFLs as a management discipline, and he is naturally anxious to limit as far as he can the problems that any overshoot will cause for him next year.

The second point is that week by week the risks of serious industrial unrest on the railway are increasing. The unions are now being pushed much harder than at any time since Beeching. Opposition to the closure of the C&D parcels service is building up. As part of the necessary economies, the Board have decided to close the freight line through the Woodhead Tunnel. They will be telling the unions of their decision to close the BREL works at Ashford. They are moving to the point where they will impose marshalling yard closures without further consultation.

Peter Parker and his Board are now making a determined attack on a number of long standing problems. This is necessary, but we attach no less importance to getting a pay settlement next year well into single figures. We must therefore take care not to put the Board in a position that they would regard as untenable.

The proposals in column 2 of Annex A to your paper (E(80)121) did not involve any further reduction in the EFLs for the other nationalised transport industries. I have seen the chairman of the National Bus Company again, but I must confirm what I said at the meeting on 22 October that further reductions on these small industries would have disproportionately damaging consequences.

A copy of this letter goes to the Prime Minister.

NORMAN FOWLER

01-211-6402

Rt Hon John Biffen MP
Chief Secretary
Treasury Chambers
Parliament Street
London SW1

30 October 1980

Dear John

ELECTRICITY SUPPLY INDUSTRY (ENGLAND AND WALES): EFL 1981/82

It was agreed at E Committee last week that we should consider further the measures necessary to achieve the EFL's for 1981/82 listed in Column 2 of Annex A to E(80)121. The figure for the Electricity Council and Boards is -£221m, though the industry themselves are arguing for an EFL in the range of -£20m to -£50m. I have reviewed the position with Tombs and England.

Tariffs and Financial Target

As you are aware, the industry's forecast sales both for this year and for 1981/82 have been revised downwards substantially. Nonetheless, in 1980/81 they still expect to achieve, on a lower sales volume, the same CCA return (0.9%) as was originally planned. The consequence is that tariffs are now closer to full economic levels than was envisaged when the industry's financial target was agreed, and the Council think it unjustifiable, on the lower sales figures, to stick to the originally agreed target 'path' of a CCA return of about 2% in 1981/82. Indeed, they consider that they would not be justified in going for a tariff increase based on more than a 1% return. From their LRMC calculations they believe that this would bring them to within about 5% of full economic pricing, which is consistent with what was envisaged when the financial target was set.

On present forecasts, a 1% return would result in an overall tariff increase of 12% (about 2% less for quarterly billed customers, who will be over-charged for fuel costs in 1980/81, and about 2% more for monthly billed customers, who through fuel cost adjustment pay the increased cost of fuel as it is incurred). A CCA return of 2% would require an overall tariff increase of about 16% (again, less for quarterly, and more for monthly billed, including industrial, customers). It would also take the industry to approximately 100% of full economic pricing. This would mean a very much sharper real price movement than that implied in the target when it was originally set. The industry would resist this.

Capital Expenditure

Against this background I have once again pressed the industry for further economies throughout the whole organisation, including all aspects of administration, and further reductions in capital expenditure, in an effort to see their contribution raised without resort to such price increase.

Taking first capital expenditure, an accelerated review is due to be completed by early in the New Year. This is being conducted stringently. Senior CEGB management for instance are rejecting projects put up from within the organisation which, while seen as producing a good return, are not regarded as of paramount importance. Some 80% of CEGB expenditure is of course on committed projects including Heysham II. Around three quarters of expected Area Board expenditure is for the provision of new supplies to consumers or for the reinforcement of the system, including reinforcement necessitated by power station closures. The industry insist that there is little room for further economy without taking decisions with wide and immediate implications for employment in the private sector.

As I said in my letter to you of 13 October (not to all), it would not make sense to delay the three AGR stations already under construction; they will enable large fossil fuel savings to be made, apart from adding to diversity and security of supply. The three oil-fired stations will, when completed, bring cost savings through displacing older, low efficiency fossil-fuelled stations in meeting the peak. More important, this would have to take second place to EFL requirements if I thought it would yield a net gain. But to stop work now would leave vast nugatory expenditure (£650m on Ince B and Littlebrook, for instance), on which interest would have to be paid, and there would also be cancellation charges too. There are strong economic and employment reasons for continuing with the pumped storage scheme at Dinorwic; similar arguments about interest and cancellation charges apply. Abandonment of the completion of Drax would leave nugatory expenditure of £250m. It would have severe implications for the power plant and mining industries. The project is linked with the Selby Coalfield. The Government is contractually committed to compensations payments for advancing Drax. When we were in opposition we did not divide the House against the Bill providing for these payments to the Board. Stopping work on Drax would thus have side-ranging political and industrial consequences. The Board also consider their site industrial relations policies at Drax as a test-bed for improving construction times on future nuclear sites. A deliberate delay would be disastrous for these policies, which are aimed at improving construction performance. We reviewed Heysham II, and Torness in March and decided that it would be right for the Board to proceed with them. The arguments have not changed; we see the need for a more diversified and economic electricity supply; the industrial capacity to meet the need for future nuclear power stations has to be sustained, and until it is clear whether PWRs can be built in this country, after the public inquiry starting in 1982, AGR orders are the only way to sustain it. The consequences of delay for private sector employment could be very damaging indeed. I attach a list of the main firms involved. They in turn provide orders and jobs for many smaller concerns.

I have impressed on Tombs and England the need for the most rigorous economy in capital expenditure. While one cannot be certain until the industry's review is further advanced, I believe that there is scope for some reduction, and I shall be pressing this hard. But I see no realistic prospect that net capital cuts large enough to bring us to an EFL of -£221m could be achieved without important reversals of policy and severe damage to private sector employment.

Efficiency savings

I have also emphasized to the two Chairmen in the strongest terms the need for efficiency savings and absolute economy in adminstration and general expenses which form less than 2% of turnover. They said that the industry were acutely aware of this need, not least at a time of falling demand. All elements of cost were under close scrutiny. Manpower reductions are planned. The closure of 3.4 GW of older plant will result in staff reductions of between 3,000 and 4,000. The CEGB are planning a 5% reduction in headquarter formations staff. Staff travel has been reduced, as has repair work on office buildings. Expenditure on repair and maintenance of plant is being limited, as is provision for materials stocks, stores and spares. More risks generally are being taken on the system itself in the search for economies.

Pay

The industry have reduced their pay assumption from an earlier 15% to 10%, year on year. I stressed the very great importance we attached to low pay settlements in the public sector. Tombs pointed to the influence likely to be exercised by the miners' settlement.

Fuel cost

The industry will not know until January how much they will have to pay for their most important single input - coal. They are maintaining pressure on the NCB to keep to the understanding with the CEGB which calls for coal price increases not to exceed the rate of inflation (and which is held by both Boards to have a moderating influence on NUM wage claims). On this basis, the national average fuel price for 1981/82 of 4500p/tonne assumes a January coal price increase of 15% and a subsequent increase of 12%-13% in November 1981. I need hardly emphasize the link between the two NUM settlements expected in 1981 and these coal price increases. The January 1981 increase is particularly important. If the coal price increase were below 15%, this might give the industry confidence to reduce their fuel price assumption which in turn could be expected to have a beneficial effect on tariffs.

Fuel stocks

Since colleagues raised the question of fuel stocks, I took this up with Tombs and England. I am bound to say that in view of the uncertainty at this time of the year about the level of stocks in the spring, I see little profit in making necessarily arbitrary assumptions about movements during 1981/82. And we must not forget that the next NUM settlement is in November 1981; summer stockbuild in 1981 could be vital. Here again, the January 1981 coal price increase is of crucial importance. The CEGB have made it clear to the NCB, in the interests of the negotiations with NUM, that if, because coal goes up by more than general inflation, the understanding between the two Boards is broken, they will wish to make a significant reduction in their coal-take. This would of course have implications for the NCB's EFL which we would need to discuss. But I see no grounds at present for assuming that fuel stock reductions can contribute to an improvement in electricity's EFL, though this is something to which we shall need to return.

Conclusion

We are seeking to set an EFL for the industry while there are continuing uncertainties over major assumptions. In particular the industry just does not yet know for sure what it is going to have to pay for NCB coal (which amounts to about 50% of CEGB revenue costs) and cannot know for a while yet. Such variations could make a sizeable difference to the whole EFL arithmetic. And while they have accelerated their review of capital expenditure, accurate figures will not be available before January. In any event reductions of more than about 5% (which will in themselves be difficult enough to achieve), would involve decisions with wide reaching consequences for private sector industry and employment. The scope for savings in other directions is always there but however vigorously pursued can only yield limited sums. Management in the industry are already under great pressure to cut costs. The position on CEGB purchases from the NCB will need to be reviewed in the light of the January NCB price rise.

In present circumstances, as we know them at this stage of the year, I see no prospect of agreeing on any realistic basis to an EFL of -£221m without an overall tariff increase from 1 April 1981 in excess of 12%, and one which would result in much faster movement towards economic pricing than was envisaged when the financial target was set.

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This would be resisted by the industry and involve a heavier burden for the consumer than we agreed last year.

Assuming that the industry are able to make further reductions in capital expenditure, and making allowances for further efficiency savings, I consider that the industry's EFL could be improved from the -£20m to -£50m which they are currently offering to at most -£100m. This would be without raising tariffs beyond an overall 12%. It does not make any specific provision for temporary assistance to industrial customers. If to secure wider objectives it is, nevertheless, decided that a higher tariff increase is required we must be clear that the industry would protest and there could be severe criticism from customers generally. Starting from the -£100m mentioned above the achievement of the -£221m which you have suggested could mean a further overall tariff increase of about 2½% next April. (In broad terms, each 1% on the tariff benefits the EFL by about £50m.)

It may be argued that an EFL of -£221m might be fixed now in the hope that subsequent favourable changes in basic assumptions (eg lower fuel costs) will avoid the need to set tariffs at a higher level than the industry themselves think justified. This would be ill-advised. Some of the industry's assumptions may in fact turn out to be optimistic.

I am copying this letter to the Prime Minister, to E Committee colleagues, and to Sir Robert Armstrong.

Yours ever

David

D A R HOWELL

CONFIDENTIAL ANNEX

COMPANIES PROVIDING COMPONENT PARTS FOR AGR'S

Babcock Power (boilers and pipework)
GEC (turbines for Torness)
NEI, Clarke Chapman (boilers)
NEI, Parsons (turbines for Heysham II)
Taylor Woodrow Construction (civil engineering)
MacAlpine (civil engineering)
Balfour Beattie
Whessoe (pressure vessel)
James Howden (gas circulators)
Aitons (pipework)
Capper Pipe Company (pipe erection)
Darchem (pressure vessel insulation)
NICL (pressure vessel insulation)
Mather and Platt (fire protection)
James Scott (cabling)
N G Bailey (heating and lighting)
Strachan and Henshaw (fuelling machines)
Union Carbide UK (graphite)
Tube Investments (boiler tubes)
Fairey Engineering (fuel)
Crown House (cabling).

Nationalised Policy

DEPARTMENT OF TRADE 1 VICTORIA STREET LONDON SW1H 0ET Telephone 01-215 7877

TL

From the Secretary of State

CONFIDENTIAL

The Rt Hon John Biffen MP
Chief Secretary
HM Treasury
Treasury Chambers
Parliament Street
London, SW1P 3AG

29 October 1980

Dear John

NATIONALISED INDUSTRIES' EFLs 1981/82

I am writing to follow up our discussion in E Committee last week about the implications of your proposals for the nationalised industries for which I am responsible.

British Airways

For British Airways the position is already uncomfortably, perhaps unrealistically, tight: their original bid of £154m at out-turn prices assumed a profit margin for 1981/82 about which they are far from confident; it also assumed a reduction in capital expenditure virtually to the level of their inescapable contractual commitments; and, as you know, they cannot raise their prices at will, indeed they have had to lower them in several areas to fill their existing capacity. These three factors together make further adjustments in their EFL virtually impossible. If we attempt to set a limit that is lower than this bid we shall not only fail to achieve a corresponding reduction in the PSBR, but we shall also damage the credibility of our EFL control for the future.

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From the Secretary of State

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One aspect of BA's forecasts for next year which we discussed at E Committee last week was the pay assumption. At my request my people have reworked the assumption on the basis of a single figure settlement (9%), which, because of planned staff reductions, would represent an increase of only 3.5% on the airline's pay bill - well within the range of public sector pay increases we have in mind. I do not think it is realistic to expect BA to reach a settlement more favourable than this, unless we are prepared to see a shutdown and a much higher out-turn of the EFL than I am proposing.

How is it possible then to reconcile the bid for £154m with the EFL of £125m listed in Column 2 of Annex A to E(80)121.

I recommended to you several weeks ago a leasing arrangement to bridge the gap, and our officials are in touch about the classification of an operating lease for the purposes of the PSBR. I am bound to say that there has been little progress on this constructive suggestion which was calculated to solve your problem (without any adverse consequences for monetary policy). If, of course, we have published the £125m EFL and then find that a lease is impossible the airline will have a limit some £30m short of the minimum level they require to meet their contractual commitments to purchase aircraft.

I must make it clear that, in my best judgement, I have offered the maximum possible without destroying the EFL. If you go lower I believe the limit will be breached involving adverse consequences for the whole system.

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From the Secretary of State

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British Airports Authority

I have now discussed the BAA bid in some detail with their Chairman. As you know, the position here is complicated by two writs served by the airlines which seek, inter alia, an injunction to the effect that we have been acting ultra vires in setting the BAA a tough financial target (which I insisted on last year) involving an increase in their CCA return on net assets from 2% last year to an average of 6% over the next three financial years (this is equivalent to a return of about 25% on a pure historic cost basis). We shall, of course, defend the action vigorously but we must recognise that there is no explicit statutory basis for such a target. If the courts find in favour of the airlines, the implications for the financing of other nationalised industries (eg the energy industries) which have been set similar demanding targets without an explicit statutory basis, would dwarf the amounts of money at stake in the case of the BAA.

Details of the BAA's bid have already been made public in a submission to the Select Committee on Trade and Industry, who may seek evidence from the Department in the new session on the final outcome of this EFL exercise and its justification. The issue will certainly be discussed in detail in the court action over BAA charges where the airlines will point to any arbitrary reductions in the EFL as evidence that the Government is deliberately seeking to exploit the Authority's monopoly position in the market in order to push up charges.

I have already agreed in our earlier bilaterals to a substantial reduction in BAA's EFL equivalent to over 10 per cent of their investment programme in return for an addition to British Rail's EFL in 1982/83 and thereafter to cover the cost of the Victoria-Gatwick rail link. This would bring the EFL to £21 million at out-turn prices. I am prepared to defend such a large reduction in profitable investment

From the Secretary of State

CONFIDENTIAL

even though it will mean, for example, delaying construction of a second terminal at Gatwick by at least a year and thus make the case for development at the Stansted public inquiry more difficult. But I am not prepared to defend any further reduction below that level merely to punish the BAA for assuming that it cannot increase its prices next April by 5 per cent over the current rate of inflation. This would be a perfect gift for the airlines' legal case and is totally unrealistic at a time when one of the writs from 18 airlines not only involves a proposed withholding from 1 October of the large additional charges imposed last April but also seeks a court injunction against any further increase in charges next year while the current litigation is undetermined. There is therefore a possibility that this legal action will prevent <u>any increases</u> in charges next April, let alone a further 5% real increase. I cannot therefore agree to the further deduction of £5 million which your officials have made in arriving at the figure of £16 million proposed in Column 2 of the Annex to your paper.

The E Committee discussion also touched on the pay assumptions the Authority had made in early September when it submitted its revised EFL bid. I have now impressed upon Mr Payne our determination that pay settlements in the public sector should be in single figures. He has agreed to keep the final settlement as low as possible but has pointed out that, unlike most other public sector bodies, the Authority's pay settlement last year was kept well below the current level of inflation and its ability to repeat this success for a second year will clearly be restricted. The numbers of staff and the amounts of cash involved are small; a settlement at 7 per cent would yield a saving of £3 million. But the critical factor will be the level of settlements achieved elsewhere in the public sector, particularly in British Airways and the Civil Service, and Mr Payne has therefore

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From the Secretary of State

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agreed to delay the Authority's pay settlement as late as possible in the pay round. And I must bear in mind that if the airports are closed down there would be a major adverse impact on the EFL of British Airways.

I am copying this letter to the Prime Minister, all other members of E Committee and to Sir Robert Armstrong.

Yours ever

John.

JOHN NOTT

CONFIDENTIAL

Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon Norman Fowler MP
Minister of Transport
Department of Transport
2 Marsham Street
London SW1P 3EB

29 October 1980

R. mho

Dear Norman,

BRITISH RAIL: 1980-81 EXTERNAL FINANCING LIMIT

You wrote to me on 21 October setting out your latest assessment of British Rail's financial position. We will be returning to the figures for 1981-82 in E Committee next week; this letter is concerned with the prospect of a breach in BR's revised EFL for the current year.

You suggest in your letter that despite the further economies which BR are seeking, the prospect is for the Board's revised EFL to be exceeded by £30 million. I believe we ought to be pressing the Board harder to achieve the savings necessary to offset this prospective excess requirement. I appreciate that it is your intention to deduct any overshoot from next year's EFL but, as our discussions in E have illustrated, we will face problems enough in keeping the Board within the financial provision we have in mind for next year without adding to their problems in this way. Indeed, I doubt it is realistic to expect the Board to meet next year's target unless the importance we attach to the financial objectives we set them is driven home this year with every ounce of emphasis we can muster.

More importantly, the prospective overshoot presents us with immediate problems in relation to the very tight public expenditure position in the current year. The unallocated contingency reserve is under intense pressure largely because of the combined claims of the nationalised industries. It is not clear whether room exists to accommodate further claims of this nature without our having to reappraise the position elsewhere. I do not see why the British Railway's Board should force us into this position without at the very least setting out for us the options which would enable them to meet their revised EFL so that we can judge between those and the alternative courses open to us to offset the prospective breach within the existing overall total of public expenditure.

I appreciate that BR have already made economies and that they face the difficulties posed by a network fixed in size in seeking further savings. But in the current circumstances, BR should be shaking out their entire organisation in a search for savings and improved efficiency, just as companies of all sizes are being forced to do in the private sector where it is not possible to shelter from economic pressures. One would expect, for example, a new urgency to be injected into initiatives such as the productivity discussions with the unions which began after the last pay settlement but the evidence seems to suggest that this is not occurring. In short, it seems we are faced here with the epitomy of the general problem posed by nationalised industries which are aware that the sanction of bankruptcy does not apply to them and which consequently are reluctant to accord our financial objectives sufficient priority when they conflict with what they perceive as the proper role of their industry. I have to say that evidence of this sort of attitude on the part of BR is evidenced all to clearly by their recent advertising campaign in which they seek to attribute all the shortcomings of the railway to a simple lack of money; and in the reports which have appeared recently in the press about the possibility of BR producing their own "White Paper" arguing the need for a more flexible, and in effect easier, financial framework to enable them to meet <u>their</u> objectives.

In these circumstances I do not think we can accept that a further breach of BR's EFL is inevitable. I believe we should ask the Board to set out the options which must exist to offset this excess; that in the interim we should insist on a complete moratorium on new capital expenditure (which has not been severely cut back so far); and that we should make it clear to the Board that if they wish to protect their capital investment programme it is up to them to produce the operating economies necessary to live within the financial provision we have set for them. One of the options I would expect to see displayed by the Board would be a significant increase in sales of assets which are currently projected at a level little more than that envisaged at the beginning of the financial year.

I have asked my officials to keep me closely in touch with further developments. The time may be approaching when some blunt talking with the Board is necessary if there is to be any prospect of retrieving the position not only this year but also in the coming year when the outlook is for a tighter rather than more relaxed financial environment.

I am copying this letter to the Prime Minister.

Yours

John Biffen

JOHN BIFFEN

Nationalised Industries.

cc Mr Angel

01 211 6402

TL
27/10

Rt Hon John Biffen MP
Chief Secretary
H M Treasury
Parliament Street
LONDON
SW1

27 October 1980

Dear John

You wrote to me on 16 October about performance aims for the National Coal Board.

I do not disagree about the need to put the Board's finances on a sound footing but when we discussed coal strategy last month at 'E' we firmly agreed to consider the whole strategy in the New Year. This will also have the advantage of avoiding further complication of the pay negotiations now about to start between the NCB and NUM. Since if we decide to set any performance aims they must be consistent with the strategy, I am sure you will agree that their appropriate form can and must be worked in with the strategy itself.

I say this because we have all agreed that the principal means of putting the Board on a sound footing is the financial strategy which we laid down for the Board last year. If successful, this will achieve a substantial turn round in the industry's position. Achieving it will be a task of the utmost difficulty, especially given the decline in the market for coal since the strategy was set. I know however that the steady pressure of the strategy is already producing changes, which were badly needed, in the NCB's attitudes.

Against this background, I am anxious to do nothing to complicate or jeopardise the achievement of the strategy, to divert the Board's attention from it, or to give them excuses for failing to achieve it. Giving them an uncoordinated performance aim runs these risks. If we want to press the Board to take the increasingly painful decisions needed to stay within the strategy, we should only impose further tests and checks on them which dovetail with the strategy settled. This would not be the case if we gave them performance aims which were inconsistent, as you acknowledge they could be, with achieving the strategy. To achieve the strategy, with its emphasis on cash, we may have to press them to cut investment further, or cut production at continuing pits.

These measures could increase costs and make the performance aim difficult or impossible to achieve at the same time. You say that in such circumstances the Board could argue that their failure on the performance aim was because of Government action elsewhere. But this is exactly the position I want to avoid getting into: one in which the Government appears to impose conflicting objectives on the industry, and in which the Board can blame us for having failed to achieve what was expected of it.

I would add one other point. You say that the Board could keep within its external finance requirements by passing on excessive costs to its customers by excessive price increases. This does not reflect their real position at all. The market is weak because of the economic recession and indeed the Board's biggest problem now is how to keep within the strategy in spite of the fall in the market. The strategy, with its emphasis on cash, makes it of paramount importance to the Board to maintain demand so as to avoid stocking and the need for cash which it involves. Excessive price increases are therefore just not a practical possibility.

I am sending a copy of this letter to the recipients of yours.

Yours ever

Da

D A R HOWELL

JU

CONFIDENTIAL

Prime Minister

There is a dispute with the Treasury on this (see Flag A). I think the best thing would be for E(DL) to consider the Treasury points - Sir Keith is reconciled to this; but I can say that you want this done quickly.

Agree?

I hope we can vest on 1 Jan with a view to flotation Jan-Feb. We shall be dealing with the Treasury matters this week not

Lasting Tory Commitment (possibly ... months)

R 30/x

PRIME MINISTER

BRITISH AEROSPACE FLOTATION

When I spoke to you on Tuesday, I explained the critical position we have reached in our attempts to float British Aerospace. I am now writing to set this out in more detail, and to indicate how I believe we should proceed.

2 We had planned to float British Aerospace in November, and preparations for this date were far advanced. At a late stage, however the Department was warned of the scale of the changes in defence expenditure proposed by the Chief Secretary as part of the public expenditure review. In addition to whatever measures are necessary to compensate for the probable overspend by the Ministry of Defence this year, the Chief Secretary in his initial, and not necessarily final, proposal to Francis Pym has sought a reduction in defence expenditure of £400 millions in each of the survey years. Past experience shows that when substantial changes to the defence budget are made they tend to result in the defence equipment budget, which constitues approximately 40 per cent of the total, bearing a disproportionate share of the load. Any agreement to proposals for defence expenditure of the scale suggested by John Biffen would almost certainly therefore have a significant effect on British Aerospace. We could not simultaneously issue a prospectus based on the prospects for the business as now known and be considering substantial changes to the defence budget which would be likely to affect BAe severely. As promoter and sole vendor of the company we are under the same legal requirements to disclose our intentions towards the company we are selling as any other vendor; the extent and importance of the Government's

/dealings ...

dealings with British Aerospace make these requirements particularly onerous and significant. The Attorney General has confirmed the previous legal advice we had received, requiring full disclosure to our advisers and appropriate disclosure thereafter to the prospectus.

3 I understand that as a Cabinet we shall not be taking decisions on public expenditure until the very end of this month at the earliest. Because of the uncertainty the Chief Secretary's proposals cause, we have been forced to abandon the prospects of a November flotation, and have therefore fallen back on the next opportunity, which arises in January/February. Our financial advisers on the flotation, Kleinwort Benson, have identified two ways of quantifying in the prospectus the effects of the possible cuts on British Aerospace. The first would be to ensure that they are minimal. In practice, the only means this could be guaranteed would be by largely exempting the defence budget from the effect of public expenditure cuts, which the Chancellor regards as - and I accept to be - impracticable. The second is to attempt to quantify or at least set an upper limit to the likely damage to BAe's business of any cuts in defence expenditure and to make this information public in the prospectus. Kleinworts believe this approach should be possible, provided:

(i) Ministers had announced the general scope of their decisions on public expenditure including the general magnitude of any reduction in defence expenditure;

/(ii) ...

(ii) the prospectus included an appropriate passage indicating the effect on British Aerospace of those spending reductions. This might be on the lines that the effect should not be more than an annual loss of profit of £X millions. /The figure could, for example, be £6-8 millions, roughly equivalent to loss of sales of £60-80 millions a year/; and

(iii) the Government was prepared to accept the consequences for its net receipts, which will be reduced both by the reduction in the market capitalisation arising from the fall in profits and by the need to ensure that the new company starts off its life with adequate capital resources.

In order for this to be possible, the Ministry of Defence must set upper limits, in the light of any expenditure decisions taken by Cabinet, to the consequences for their business with British Aerospace; and must do this in time for British Aerospace and our financial advisers to assess the effects on the company in terms that enable an appropriate statement to be made in the prospectus. To meet the timetable of a January/February flotation, this will require work to start at once on this, and conclusions will be needed by the end of November. I do not pretend that any of this will be easy to achieve; if we are to succeed at all, it will require us to give high priority to bringing off the flotation, and demonstrating on a number of fronts our political will to do so.

/4 ...

4 Time is very short. Both British Aerospace and Kleinworts have warned me in strong terms that early next year is almost certainly our last chance of bringing of a flotation within the ? life of this Parliament. If we delay further, political uncertainty and the risk of re-nationalisation without compensation will loom ever larger in investors' minds. Our chances of succeeding at all with British Aerospace will therefore be dealt a crippling blow unless we act now. We are already under attack for not being able to privatise shipbuilding; last week we announced the impossibility of early action on British Airways; unless we are resolute in our determination, we shall have at best to postpone, for some considerable time, the flotation of British Aerospace, which has been widely recognised as the front runner in our privatisation programme. If this were to occur, the political credibility of the Government would suffer acutely; and we should forego the benefits to the PSBR to which privatisation of British Aerospace will give rise (excluding the net receipts arising from the sale, these should be nearly £200 millions over 1980/81 and 1981/82).

5 I believe it of the utmost importance that we should not allow this to happen unless we are absolutely forced to accept defeat by uncontrollable circumstances, as could arise if British Aerospace's results deteriorated sharply. I therefore think we should attach high priority to dealing with the obstacles to a flotation caused by the present uncertainty over defence expenditure, on the basis set out in paragraph 3 above. There is, in addition, a particular decision that can and I believe should be taken now:

/before ...

before we can float the company, we must vest in it the present business of the statutory corporation. We should have to do this on 1 January 1981 for a flotation in January. I believe we should now decide to go ahead with the vesting on 1 January. A public decision to do so will be seen as a commitment to our privatisation target; it will help British Aerospace in a number of important preparations for the eventual flotation; and it will do much to revive British Aerospace's support for the flotation (they attach great weight to an early decision on this, and would not take our intention to float seriously unless we demonstrate this commitment). There are of course arguments about the exercise of control over the company while it remains wholly-owned by Government. But we have already faced these with the National Freight Corporation, where vesting occurred on 1 October against a flotation date that is some time off, and should do so again with British Aerospace. Geoffrey Howe, when I discussed British Aerospace with him, was content for us to take the step. This is just the sort of issue where we must show our determination to press ahead, if we are to succeed.

6 I am copying this to Geoffrey Howe, Francis Pym, Michael Havers, members of E(DL) and to Sir Robert Armstrong.

KJ

K J

23 October 1980

Department of Industry
Ashdown House
123 Victoria Street

Nat Inds

10 DOWNING STREET

Prime Minister

We will need to look at each industry's EFL carefully so as to avoid the inconsistencies of last year (eg. pay assumptions of 5% for BSC and 17% for BR in last year's figures).

The Policy Unit will be doing a note.

JL.

20/10

Ref: A03304

CONFIDENTIAL

PRIME MINISTER

Nationalised Industries Financing
(E(80) 121)

BACKGROUND

The purpose of the meeting will be to take provisional decisions on the total financing requirements of the nationalised industries in the Public Expenditure Survey period, and in particular on their External Financing Limits for 1981-82 which will be announced in November. It will however be for Cabinet to take the final decisions on these figures in the context of their discussions, beginning on 30th October, of the public expenditure programme as a whole.

2. It was agreed in the summer that an additional £470 million (1980 Survey prices) should be allocated in each year to the nationalised industry programme to cover the general deterioration in their prospects, and in particular the problems of the loss making industries. These sums have to be covered by offsetting savings on other public expenditure programmes.

3. In E(80) 121 the Chief Secretary reports that he has not had detailed discussions on 1982-83 and 1983-84. These will take place when 1981-82 is settled but, in the meantime, his firm assumption is that there will be no further increases for the nationalised industries beyond the £470 million allocated to them in each year.

4. His paper focuses therefore on 1981-82. The figures are summarised in Annex A which shows that the original bids made by the industries were £1,270 million in excess of a baseline inclusive of the £470 million already transferred to them. This increase is mainly attributed to the effect on their markets of the recession.

5. Following discussions with the sponsoring Departments and the industries the Treasury concluded that the increase of £1,270 million could be reduced to £500 million, (a reduction equivalent to £1 billion in cash). The savings would be found by a combination of low assumptions for pay, further cuts on capital investment and in some cases higher and earlier tariff increases. They have not all been accepted by Departments.

6. The Chief Secretary now proposes that this additional bid of £500 million should be further reduced by at least £200 million. He proposes, in his paragraph 10, that this should be achieved either:-

(i) by an across the board cut in each industry's financing requirement equivalent to 4 per cent of their investment programme; or

(ii) by selective cuts on electricity, telecommunications and rail as shown in paragraph 10(ii).

To offset the full £500 million would need cuts equivalent to 10 per cent of capital investment.

7. As the Chief Secretary explains in his paragraph 6, the industries are responsible for their own inflation assumptions, although they discuss them with Departments. Their GDP assumptions from 1979 to 1981 may still be optimistic. If this is so, and their turnover is less than they are expecting, it could more than offset any assumptions they are making which might turn out to be pessimistic - e.g. on interest rates.

8. The Committee will want to look in particular at the approach to pay assumptions discussed in paragraphs 7 and 8. With the one exception of the British Airport Authority, Departments have 'talked down' the industries to assuming 11 per cent or less for settlements in the wage round ending 31st July 1981, with a majority at 10 per cent or less (in some cases the increase in earnings will be slightly more). The Chief Secretary advises against imposing lower assumptions on the industries, since this would be tantamount to imposing a pay norm. The important point here is that in choosing not to intervene the Government would not be blessing the particular assumptions made. But the industries need to be encouraged to settle at lower levels; the tighter the EFLs the stronger should be the pressure on them to do so.

9. The risk in looking for further savings, and from setting very tight EFLs, is that the industries will end up cutting further into productive capital investment - with, among other things, effects on private sector employment - and going for higher and earlier tariff increases. This is a point which the Committee will need to bear particularly in mind in looking through the options and prospects for each industry.

HANDLING

10. After the Chief Secretary has introduced his paper you might remind the Committee that, to the extent that cuts are not made, the burden of finding off-setting savings will fall on other public expenditure programmes. These are already under acute pressure, partly because of the £470 million a year already switched to the nationalised industries. Further savings will also have to be made if room is to be found for provision for special employment measures and further industrial support which the Committee discussed last week. There is a strong case for reducing the excess to at least the £500 million proposed by the Treasury and indeed for looking for substantially more than this - at least the £200 million proposed by the Chief Secretary.

11. You might then take the industries in groups, with each sponsoring Minister commenting on those for which he is responsible, and explaining the scope for cuts and any particular points which he thinks should be highlighted on tariff increases and pay assumptions. At Annex B to E(80) 121 there are useful notes on each industry with the key figures and assumptions highlighted. At the end of the discussion the Committee will wish to form a judgment on whether savings should be found by across the board cuts or by a selective approach.

Secretary of State for Energy (and Scotland - Mr. Younger will be represented by Mr. Fletcher)

12. Subject to any further across the board cuts, it has already been agreed that the EFL for coal should be £882 million. This makes no specific provision for pay, but Mr. Howell thinks that it will be a tight limit.

13. For electricity the pay assumption is a settlement of 10 per cent. In England and Wales it is assumed that to meet the financial target (a real rate of return of 1.8 per cent on average from 1980-81 to 1982-83) there will be a $16\frac{1}{2}$ per cent tariff increase in April 1981 - not $18\frac{1}{2}$ per cent as in the Annex - following the increases of 17 and 10 per cent in 1980-81. In Scotland the working assumption is 15 per cent from April 1981. Any concessions to help industrial consumers - as discussed in the paper on energy pricing, E(80) 120 - and any reduction in the financial target, as I understand the Electricity Council have now suggested, would considerably add to the difficulties of making the savings.

14. In particular the Secretary of State for Energy will wish to comment on the proposal in paragraph 10(ii) of the Chief Secretary's paper that, as a contribution to the further savings of £200 million, the electricity industry should cut a further £60 million off investment and raise another £60 million by sale of 2 million tonnes of coal stocks abroad.

15. The pay assumption for gas is 10 per cent. As their contribution to bringing the total bids down to an excess of £500 million it is assumed that domestic gas prices would have to be increased by 27 per cent in April 1981 or by a two stage increase in the year. The proposed £10 million concession to industrial users taking out new firm contracts - see E(80) 120 - would have to be offset.

16. The BNOC savings would have to be found by investment cuts. Their salary bill is too small to be relevant (any increases would be subsumed in their general provision for administrative expenditure which they assume will rise by 14 per cent).

Secretary of State for Industry

17. For telecommunications an 11 per cent pay settlement is assumed and a 10 per cent tariff increase in Autumn 1981. The Secretary of State for Industry will wish to comment on the possibility of a further £60 million investment cut - paragraph 10(ii) of the Chief Secretary's paper.

18. The assumption for Posts are a 10 per cent pay settlement and a 15 per cent tariff increase in October 1981.

19. Decisions on Steel will be deferred until the end of the year when the Chairman will be putting forward his proposals.

20. Shipbuilders will have been dealt with in discussion of E(80) 112, subject to any across the board cuts applying to BS. If, as now seems highly likely, British Aerospace is not privatised in 1980-81 provision will have to be made for it, and this will add to the overall difficulties.

Secretary of State for Trade

21. A 10 per cent pay award is assumed for British Airways.

22. The British Airports Authority are assuming a 12 per cent calendar year settlement for 1981 and 15 per cent for 1982. Against the background of the current legal battle with the airlines over landing fees, the Secretary of State for Trade is likely to argue against the Treasury's assumption that fees will be increased from April 1981 by inflation plus 5 per cent in order to achieve the Authority's financial target. This is an important issue in its own right, but the £5 million cash at stake is relatively small in the context of the present discussions.

Minister of Transport

23. The main question is over British Rail, where the proposed EFL is £888 million assuming a 10.7 per cent pay settlement and a 17 per cent price increase in November 1981. In view of the current pressures on the board, and of the well-publicised criticism of the effect on the network and services of cash restrictions, the Minister is likely to argue strongly against the proposal in paragraph 10(ii) that British Rail might contribute a further cut of £25 million.

24. I doubt whether the Committee needs to discuss in any detail the smaller transport industries which are all assuming pay settlements of 10 per cent or less.

CONCLUSIONS

25. Final decisions on the EFLs, and on the provision for the nationalised industries in 1982-83 and 1983-84, will be taken by Cabinet. In the light of the discussion of the individual industries you will however wish to record the Committee's provisional conclusions on:-

(i) whether it is agreed that savings sufficient to bring down the 1981-82 excess of £500 million should be assumed;

(ii) whether this excess should be further reduced by £200 million, as proposed by the Chief Secretary, or by some other sum;

(iii) how these further savings should be achieved - equality of misery with an X per cent cut across the board or by selective cuts from named industries;

(iv) whether it should be assumed that there will be no further additional provision in 1982-83 and 1983-84 beyond the £470 million in each year already agreed.

26. If it is agreed that selective cuts should be made, I suggest that the Chief Secretary should not be asked to identify these in further bilateral discussions. He has already had extensive discussions and managed to get only so far. What seems necessary now is a specific instruction from the Committee that sponsoring Ministers should go to particular industries to find named sums and that they should report the outcome within a week. Subject to discussion, the candidates would be those Ministers and industries in paragraph 10(ii) of the paper.

27. In the meantime, and in the light of discussion, the Chief Secretary would make provisional assumptions for additional provisions for the nationalised industries in 1981-82, but not in the two later years, in putting his report to Cabinet on the public expenditure programme as a whole.

RA

(Robert Armstrong)

21st October 1980

CONFIDENTIAL

DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

The Rt Hon John Biffen MP
Chief Secretary to the Treasury
Treasury Chambers
Parliament Street
LONDON
SW1

21 OCT 1980

Dear John

E COMMITTEE 22 OCTOBER: NATIONALISED INDUSTRY EXTERNAL FINANCE LIMITS 1981-82

I thought that I should write to you before tomorrow's meeting of E Committee on how I now see the situation with British Rail.

The Board's latest forecast, as it emerged towards the end of last week from their preparation of next year's budget, shows a further deterioration of their financial position this year and next. In the current year, it now appears almost certain that BR will be unable to keep to the revised EFL of £790m. Freight business prospects have continued to deteriorate over the last month. BR have made significant reductions in their operating costs (given that the size of the system is substantially fixed) and are seeking more, but the prospect is for an overshoot of some £30m. I have already told the Chairman that any excess on the EFL must be financed by holding back commitments to new investment.

CONFIDENTIAL

CONFIDENTIAL

For 1981-82, BR now forecast an external finance requirement of £765m (at 1980 survey prices) - £102m above the current provision of £663m. This is incorporated in your paper for E Committee as the revised EFL bid. This forecast assumes a wage increase of 10.7%, which is consistent with the assumptions for most other industries; a continuing drive for economies; and a real fare increase in November 1981. Work done in my Department, however, suggests that the Board's revenue forecasts may well still be too optimistic, and that there could be a further shortfall of perhaps £50m.

I am naturally extremely concerned about these developments. I saw Peter Parker yesterday, and again impressed upon him the very difficult public expenditure situation we face and the need for maximum possible economies. He, of course, accepted that, and has himself already put in hand a rigorous examination of the budget and of what further action is open to the Board. This will take a little time to carry out.

In the circumstances, I am sure that you will agree that it would not be right to settle finally on BR's EFL until we have a more solid basis of information on which to do so. I shall be pressing ahead with the Board as quickly as possible, and will write to you again at the earliest possible moment.

But I am bound to say that, given the serious deterior in the Board's revenue prospects, I do not think that it would be realistic to make a cut on the present provision for next year as you propose in paragraph 10 of your paper.

A copy of this letter goes to the Prime Minister.

Yours ever,

Norman

NORMAN FOWLER

CONFIDENTIAL

Qa 05158

To: MR LANKESTER

From: J R IBBS

EFLs for 1981/82

1. In E(80)121 the Chief Secretary asks for a decision on which of the approaches to selecting further reductions in EFLs for 1981/82 should be adopted.

2. My view is that alternative (i) an across the board cut would be a damaging approach and should be avoided.

3. Of the selective cuts which the Chief Secretary lists as part of alternative (ii) I would be concerned about the £60m. investment cut for Post Office telecoms because the work which the CPRS has been doing in this area indicates that, because of the opportunities for new growth sectors in the broad field of information technology, it is important to ensure that modernisation of the basic telecommunications network is not delayed. I understand that the Secretary of State for Industry believes that he can find the required £60m. saving by means (further privatisation) which avoid an additional investment cut. I think this is the right way to solve the problem.

4. I am sending a copy of this minute to Sir Robert Armstrong.

JRI

21 October 1980

CONFIDENTIAL

21 October 1980
Policy Unit

PRIME MINISTER

NATIONALISED INDUSTRIES' EFLS 1981/2 - E, WEDNESDAY

1. Paragraph 9 of the Chief Secretary's paper proposes that £200m of the £500m residual increases in NI's EFLs should be recovered. Given the public expenditure position, should we be aiming for more - possibly the whole £500m?

2. Although now reduced, the pay assumptions for the NIs remain far too high. On the one hand we have a proposal for 6% on the public services; on the other we have the best examples of hard-pressed manufacturing industries in the private sectors settling well within single figures. Against this background, there can be no case for loss-making nationalised industries (or inefficient ones whose losses are disguised by high prices) assuming that they will pay 10% more this year. We understand that 1% on the total NI pay bill is worth approximately £125m.

3. Of course, the Treasury are very reluctant simply to write down more favourable pay assumptions, only to find that the savings are not in the event achieved. The answer to this can only be that they must be achieved and that if they are not, the industries will have to adjust their own investment programme accordingly. But surely it would be better to make this clear than simply to resort to investment cuts. Nationalised industry chairmen should be told to make it crystal clear to their own employees that pay assumptions are very low and that anything exceeding that will strike at their own industry's future.

4. Ministers should be ready to use whatever influence they can with NI chairmen, without, of course getting identified with the process of negotiation itself. Ideally, perhaps, we should leave this entirely to the NI board themselves. But we submit that this principle is a luxury we cannot afford if it means pay assumptions of 10% plus - which in turn could easily mean outturns substantially higher still.

CONFIDENTIAL

5. There may also be a <u>psychological</u> case for all NIs to start in single figures, as a position consistent with recession and the need for pay to be less than the going rate.

6. I am copying this minute to Geoffrey Howe, Robin Ibbs and Sir Robert Armstrong.

JH

JOHN HOSKYNS

CC Mr Burgess
Nat Industries

CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

R
14/10

Rt Hon David Howell MP
Secretary of State
Department of Energy
Thames House South
Millbank
London SW1

16 October 1980

Dear David,

PERFORMANCE AIMS AND THE NATIONAL COAL BOARD

Ministers agreed in E Committee in June (E(80)22nd Meeting, Item 2) and re-affirmed in E(NF) in July (E(NF)(80) 2nd Meeting, Item 1) that each industry should be set, by the Autumn, a performance aim in terms of cost per unit of output. Since that discussion Departments have been in touch with their industries and I understand that progress is being made on most fronts. The aim now is for the matter to be discussed in the interdepartmental committee on Nationalised Industry Policy in the first few days in November followed by a paper to Ministers in the hope of then publishing agreed performance aims shortly thereafter.

Your Department has approached the gas and electricity industries about their performance aim and progress is being made. But I understand that despite E Committee's decision, which was applicable to all the nationalised industries, your Department has steadfastly refused to make any progress whatsoever in developing an aim for the National Coal Board.

I am told that your Department's firm view is that giving the NCB a performance aim would be inexplicable and would only complicate the achievement of the Government's main policy objective for the industry, the attainment of its financial strategy. I cannot accept this. The purpose of a performance aim is to provide a benchmark for assessing a nationalised industry's performance in controlling its costs or its level of service to its customers, or both.

If the NCB was to meet its financial strategy and keep within the external financing requirements laid down for it, there could be no guarantee that thereby it would have controlled its costs. It is quite conceivable - indeed likely on past performance - that the Board would have kept its external financing requirement within bounds by passing on excessive costs to its customers through excessive price increases. A properly constructed performance aim would show whether the Board was in fact acting in this way and would help bring pressure to bear on it to control its costs.

I accept that it is conceivable, as your Department have pointed out, that a performance aim could in certain circumstances conflict with the requirement in the Board's financial strategy to keep its external financing requirement within set limits; one obvious example is if cuts in investment prevented the implementation of measures to increase efficiency necessary to meet the performance aim. But if this happened, the Board could legitimately argue that their failure on the performance aim was because of Government action elsewhere.

In short I strongly believe that the performance aim regime should apply to the NCB. That industry has a great capacity for generating inflation; it is very relevant here that labour costs amount to almost 50 per cent of its operating costs. A performance aim would provide a systematic means of focussing attention on the Board's control of its costs, including its labour costs. And I can see no good argument which could be put forward publicly for making an exemption of the Coal Board - to do so would not be understood and would weaken the whole policy.

I therefore ask that you should urgently put in hand action to fulfil the remit of E Committee and prepare proposals for performance aims for the National Coal Board.

I am sending a copy of this letter to the Members of E Committee, the Secretary of State for Scotland, the Minister of Transport and Sir Robert Armstrong.

Yrs.

John Biffen

JOHN BIFFEN

PART 2 ends:-

HMT to Ind 9.10.80

PART 3 begins:-

CST to S/S Energy 16.10.80