





PART E

Alex  
Lawson

CONFIDENTIAL

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notify REGISTRY of movement)

PO -CH /NI./0181

PART E

Begins: 29/6/88

DD: 25 years

Ends: 4/8/88 (CONTINUED)

*[Signature]* 6/9/95

CHANCELLOR'S PAPERS  
ON PRIVATISATION POLICY

PO -CH /NI./0181  
PART E



CONFIDENTIAL

FROM: W GUY

DATE: 29 June 1988

- 1. MR MOORE *DW 29/6.*
- 2. FINANCIAL SECRETARY

- cc Chancellor
- Chief Secretary
- Sir P Middleton
- Mr Anson
- Mr Monck
- Mr Turnbull
- Mrs Case
- Mrs Brown - o/r
- Mr Revolta
- Mr A M Williams
- Mr Bent
- Mr Tarkowski
- Mr Rutnam
- Mr Davies
- Mr Call
- Mr Tyrie

*Handwritten notes in red ink:*  
 What is the status of plan scheme  
 a re look at price. That is a  
 for some time price  
 of regulation.

**PRIVATISATION AND DEREGULATION OF LONDON BUSES**

This is to inform you of progress towards the privatisation of London Buses Limited, which is linked to the deregulation of local bus services in London. The issues which further planning for the privatisation is liable to raise are also discussed. A draft letter for you to send to Mr Channon is attached.

**Background**

2. LBL is a wholly owned subsidiary of London Regional Transport (LRT), the other main subsidiaries being London Underground Limited (LUL) and the Docklands Light Railway (DLR). LBL is responsible for the great majority of local bus services in the London area. Out of about 400 licensed routes in London, only about 30 are run on a commercial basis by private operators, and a further 50 are run by private operators under contracts to LRT. A programme of progressively putting subsidised routes out to tender is underway, by which private operators have an opportunity to contract to run services for LRT. LBL tend to win about half the tenders. It is intended that at the end of the day only



15 per cent of routes will be subsidised by LRT. Fare increases and operating efficiency are needed to get the remainder of the network on a commercial basis.

3. Local bus services in London are subject to the regime of 'local service licensing' which has been replaced elsewhere in GB by 'service registration'. This local bus deregulation outside London has had a mixed press but it is reckoned by DTP to be a supply side success amongst transport policies. We share DTP's view that it is high time that it was extended to Londoners.

4. On the face of the statute, the difference between 'licensing' and 'registration' of services is subtle. But in practice licensing requires a traffic Commissioner actively to satisfy himself that a proposed service is in the public interest. Processing applications may therefore involve delays if there are objections, and licences may even be refused if transport needs are reckoned to be met by existing services. Arguments about road congestion and the viability of competition can be advanced against applications.

5. The 'deregulated' alternative is a regime in which new services are more or less automatically registered unless there is evidence that to do so would positively be against the public interest. The slightly different emphasis makes a big difference in practice to the ease with which new operators may enter the market with new services.

6. The powers which enabled deregulation elsewhere can also be applied to London without new primary legislation.

#### Why not deregulate London now?

7. The DTP view, which we share, is that the fragmentation and privatisation of LBL is a necessary complement to deregulation.

8. The LBL monolith dominates the market. It is a loss maker overall. In 1988-89 it is budgetted to make a trading loss of



about £104 million. It makes losses for two reasons - first, because it is not as efficient as it could be; and second because in many cases the fares which it charges are so low that even the most efficient private operator could not make a profit at those levels unless they received a subsidy.

9. We do not want subsidies to proliferate so new operators would have to compete with uneconomic LBL fares. Deregulation would be a damp squib which would give the policy a bad name. Moreover new operators would not be able to offer bus passes giving such wide access as those issued by LBL. Neither would they be able to offer tickets acceptable also on the Tube\*, like the LBL/LUL travelcard. Also they would be at risk of even more aggressive pricing from LBL supported by cross-subsidies as well as by the direct subsidy from Government. If we tried to force LBL to encourage competition from the private sector, that would make a nonsense of the thrust to make it more commercial.

10. We therefore need to deregulate at about the same time as LBL is privatised on a fragmented basis as a number of separate companies. But to privatise does require primary legislation. You will recall that QL did not give Mr Channon a slot in the 1988-89 session despite his protest that this meant that privatisation/deregulation would not then happen in this Parliament.

11. Planning for dates is therefore 'on standby'. However there is much that can be done to prepare LBL for privatisation in the meantime; restructuring and increases in fares are essential.

### Restructuring

12. After consultation with Coopers and Lybrand, who were appointed as advisers by DTp, LBL have decided to restructure LBL into eleven separate business units. The units are defined by the garages and associated bus fleets, rather than by territories over which they run buses, although the two are to some extent linked. Business managers are being appointed to

\* If we tried to force LAT into this to the detriment of LBL, they might come up with 101 objections e.g. about revenue sharing.



prepare business plans by October this year. After study of these, DTp will decide whether the structure needs amending before LRT is instructed to produce transfer schemes to incorporate the business units as separate subsidiary companies, a process which it is intended to complete by April 1989.

13. Our concern about this is twofold: first, what will be the relationship between the successor companies after April? If they are not competing with each other, what is the purpose of establishing them so early? If they are competing, how is this competition to be organised given that they will be under common ownership? DTp officials envisage some competition amongst the successors, as well as with the private sector, for route subsidies as these come up for tender. We wonder why more pervasive competition could not be attempted, to establish a test bed for the viability of companies in relation to each other and to spur greater efficiencies, particularly in the use of property. We are not convinced that DTp have exhausted the possibilities in this area.

14. Arising from this, our second concern is that once the successor companies are established it may be difficult to do any further restructuring. But the only evidence as to suitable structures which will be available by October will be hastily prepared, and untested, business plans. We have registered with DTp officials that this also needs looking at. They say that the structure will be flexible and that there are industrial relations advantages from early incorporations. We are not convinced.

### Fares

15. Heavy price increases, of about 10 per cent per annum, are planned to bring LBL fares up to a level at which subsidized mileage is minimised and about 70-80 per cent of the route network becomes commercial. Post deregulation, competitors will then have something realistic to aim at, and there will be a basis for, without a sudden, massive increase.

privatisation



## Further Concerns

16. We will tackle questions of higher fare increases and better efficiency in the IFR. But you should be aware that Coopers have calculated that if:

- (i) LBL mileage reduced only by 15 per cent through further tendering for subsidies and post deregulation competition;
- (ii) only 15 per cent of bus mileage in London was subsidised
- (iii) fares went up by 10 per cent in real terms; and
- (iv) cost reductions of 10 per cent for operational staff and 25 per cent for administration were achieved -

then the successor companies would still be making marginal losses. LRT calculate a marginal profit, but either way it seems that it will be property which is the major drive in the sale valuations, rather than operating profitability. It will be a matter of fine judgement as to whether the more valuable central property should be disposed of separately.

17. It is the need for endowment with property which should determine the broken up structure, as operating profitability seems to be resilient to different breakup options. We shall want to see whether, once in operation, the new business units can rationalise their property needs, to allow some separate property disposals. We are pressing for a post mortem of the NBC privatisation, in particular to learn lessons about the treatment of property. DTp are not keen to do one.

18. Although operating profitability may be more or less resilient to the structure of breakup, need for operating property may not be. It could be that a different arrangement of property between the new business units could lead to a greater net



rationalisation of property needs. This would give us more flexibility to decide what to do with the surplus property. Separate disposals of at least some of it could make more sense than using it as a dowry for the privatisation of not very profitable bus operations.

### Next steps

19. We shall not, of course, be relaxed at Cooper's profit projections, and we shall press for steps to put the business units in better shape. Imminent privatisation will give the Chief Secretary more leverage in the IFR.

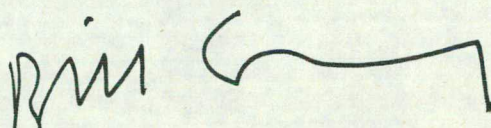
20. The main points which need to be registered with DTp at this stage are.

(i) they should not set the new business unit structure in stone until it has had time to settle down;

(ii) they need to consider how to stimulate or simulate competition between the new units (a) to get a better feel for their viability and (b) to spur greater efficiency; and

(iii) they need to consider very carefully how to squeeze out a rationalisation of the property portfolio.

21. If you agree, the draft letter to Mr Channon would serve the purpose.



W GUY



DRAFT LETTER TO MR CHANNON:

PRIVATISATION OF LONDON BUSES LIMITED

At the end of last month your officials informed mine of key decisions already taken to move London Buses Limited towards privatisation. I gather that you have indicated to LBL that you approve of the pattern of restructuring which they have proposed as a possible basis for the establishment of successor companies next April.

I do not dissent from the view you have taken of LRT's scheme for restructuring. But I do think that the best test of it will be the way in which it works in practice, and not how it is represented in untried business plans. It would be precipitate to decide the final form of the restructuring next April. Unless you see scope for restructuring the successor companies after their incorporation, I suggest it would be prudent to delay the formal establishment of successor companies until the new business units have bedded down and we have seen how they are getting on.

I think it will be important also to put the competitiveness of the new business units to the test if that is possible. Whilst it might not be easy to establish a competitive regime between them whilst they remain under the common ownership of LRT, with its various statutory duties, I do think that any moves in that direction would be helpful. A test phase of this sort should help to identify the strengths and weaknesses of the new business units and to highlight scope for rationalisation of their property portfolio.

The treatment of LBL operational property will be a difficult issue in the eventual privatisation; it was I gather difficult enough in the NBC disposals and the problem will



be much greater with LBL given the buoyancy of the London property market. We should of course aim not to dispose of the companies complete with property which a more efficient owner can cash in immediately for its alternative use value. Separate disposals of valuable property which was surplus to need should be considered. It would be helpful in this regard to be informed by a retrospective analysis of the NBC privatisation, which should be informative also in the Scottish Bus Group disposals. I think that you should arrange for one as a matter of urgency now.

I note incidentally that Coopers and Lybrand predict poor trading performances after real fare increases of 10 per cent and cost reductions of over 10 per cent. To my mind this argues for higher fares and higher cost reductions. You will no doubt have <sup>in mind</sup> the importance of preparing for privatisation in this way ~~on your mind~~ when you discuss LBL with John Major in this year's IFR.

I hope that you will be able to keep me more in touch with this issue in the future: my officials learned of your endorsement of LRT's plans at the same time as their bus drivers. In the meantime I should be grateful for your thoughts on the points above, which I hope you will find helpful.

[NORMAN LAMONT]



*M*



FROM: S I M KOSKY

DATE: 30 June 1988

MR DIXON

*G*

*(copy) Mr Luce  
Mr Pain*

cc:  
PS/Chancellor ✓  
PS/Paymaster General *(for my own)*  
Mr Anson  
Dame Anne Mueller  
Mr C W Kelly  
Mr Call

*Mr. Payson —  
Mr Sheridan  
heard of these  
people, please?  
J.D.*

**PRIVATISATION OF PUBLIC SECTOR PENSIONS**

... The Chief Secretary has received the attached letter from the Managing Director of the Public Sector Pension Services Limited advocating their services with a view to improving the existing public sector pension arrangements.

*P.S. They are not in the NAPP directory. Mr Sheridan, for a draft reply please.*

They would welcome an opportunity to discuss their proposals either with the Chief Secretary or officials, and the Chief Secretary would be grateful for your advice on their suggestion before reaching a decision.

*S I M Kosky*

S I M KOSKY

*Mr Sheridan*

*cc as above  
(this page only)*

*I've not heard of these people.*

*Their letter says enough to whet the appetite but nothing to describe what they have in mind. It'd be inclined to suggest that it would be helpful if they could set out more fully their observations and proposals so that the Chief Secretary can consider how their suggestions might best be handled — but I don't think we'd think a meeting just on the basis of this letter.*

*2/230  
Hatch*



# PUBLIC SECTOR PENSION SERVICES LTD.

Pensions, Mortgages, Protection and Investment

Directors

JOHN MORAHAN

B.Sc.(Hons), M.Sc., A.B.Ps.S., M.I.T.D., M.B.I.M.

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PRIVATE AND CONFIDENTIAL  
FOR THE ATTENTION OF THE CHIEF SECRETARY

The RT. HON. John Major  
Chief Secretary to The Treasury  
Parliament St  
LONDON  
SW1 3AG

28th June 1988

Dear Minister

Re: Privatisation of Public Sector Pension Arrangements.

We have recently been examining in depth the existing arrangements for Pension Provision throughout the Public Sector.

Our observations lead us to suggest that it would be advantageous to the Government and to its employees to examine our proposals for privatisation in this area.

Furthermore, we believe that we can stimulate genuine economic impact in several hard pressed regions of the country as a result of our policies being implemented.

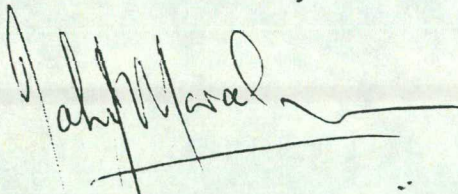
Considerable savings are possible as a result of a major privatisation exercise in this sector and I consider that the proposals we have are worthy of discussion at the highest level. I believe that the Cabinet would endorse the philosophy inherent in our proposals, and I would welcome an opportunity to discuss and explore the matter with you.



Could I be presumptuous and request a meeting with you and/or your senior advisors in order to conduct such an exploration.

I look forward to your reply on this.

Yours Faithfully

A handwritten signature in dark ink, appearing to read "John Morahan", with a long horizontal flourish extending to the right.

JOHN MORAHAN  
MANAGING DIRECTOR



FROM: MARK CALL  
DATE: 1 JULY 1988

FINANCIAL SECRETARY

- cc Chancellor
- Chief Secretary
- Sir P Middleton
- Mr Anson
- Mr Monck
- Mr Turnbull
- Mr Moore
- Mrs Case
- Mrs Brown
- Mr Revolta
- Mr A M Williams
- Mr Bent
- Mr Guy
- Mr Tarkowski
- Mr Rutnam
- Mr Davies
- Mr Tyrie

PRIVATISATION AND DEREGULATION OF LONDON BUSES

I am concerned about the delay implied in Bill Guy's minute. I'm not sure that we need to wait for privatisation in order to make some progress on deregulation. Even without restructuring we could through regulation require LBL/LUL to eliminate cross subsidies. This would clearly have to be achieved over a period of time, and would enable a partial or creeping deregulation as certain routes became viable for commercial new entrants. Furthermore, this kind of phasing could reduce the risk of the chaos that accompanied the big bang approach in a number of cities.

2. The elimination of cross-subsidies would in any event be needed for privatised bus companies to be able to negotiate their own 'travel card' type of arrangement with a state owned LUL.

MARK CALL



CONFIDENTIAL

FROM: D J L MOORE  
DATE: 1 JULY 1988

CHANCELLOR

cc: Financial Secretary  
Sir P Middleton  
Mr Anson  
Mr Monck  
Mrs Lomax  
Mrs Brown  
Mr Williams  
Mr Bent  
Mr Lyne  
Mr Call  
Ms Wheldon TSOL

*What's its other limits?*  
*Thanks. As I think you recognize, a trade is no solution. It can be what a no. As things seem a bigger share @ the expense of the individual multiplier. But I will be stops year m) to take (w) or to be kept on touch.*

*Meaning of suggestion plan 1 or 2 is when I see how wear: poor means*

**PRIVATISATION: PRICING AND WEIGHTING IN THE INDEX**

You asked (Mr Taylor's note of 15 June), following my paper of 27 May, whether the institutions' urge to get the right weighting adversely affected pricing and wider share ownership objectives in a 51% sale. We have taken some soundings on this and I have spoken in particular to Alastair Ross Goobey who, as you know, is interested in this point.

2. It seems that the institutions are indeed influenced by the aim of matching or beating the index. Pension funds and insurance companies operate some of their funds on a weighting principle, and a rough estimate is that these account for around 8-9% of all London funds. But quite apart from those who openly acknowledge that they operate in this way, many others are closet indexers. They may claim not to worry about the index but that is often untrue. Most of them are called to account for their performance - eg, by directors of unit trusts - and they are measured by the index.

3. Mr Ross Goobey says that Water and Electricity could account for around 7% of the index. If we sold only 51% and, of that, half were earmarked for the small investor, institutions would be



offered sufficient to give them a weighting of only 1¼%. Although they might not be looking for as much as 7%, insofar as they were influenced by weighting worries an artificial shortage would be created. This could bring about an increase in the price in the aftermarket which could be embarrassing to the Government.

4. There is something in this but it is not an overriding objection to 51% sales - and Mr Ross Goobey agrees with that. Some institutional expectation of shortage could indeed be helpful in stimulating interest and enabling us to get a good price. 100% sales of these industries could place too high a demand on market capacity, and would mean that we could not keep down to your objective of around £5 billion proceeds a year. If we get the pricing wrong in a 100% sale there is then no chance of making some recovery of the position in a secondary sale.

5. If we do have 51% sales, and if we see some force in weighting worries, that is a further argument for establishing the price to the institutions through a tender. Although Mr Ross Goobey agrees with tenders, he feels that institutions will still find themselves short and so the price will still be bid up in the aftermarket. But, whether or not that is so, it ought to be right that if the institutions fear a shortage they will respond positively in bidding in a tender.

6. So far as the retail investor is concerned, we can ensure through the operation of clawback and of allocation policy that they get the desired share (if they want it) at the time of the sale. If in the aftermarket the price rises rapidly, because of institutional activity, there must be a risk that more Sids will sell out than will be the case anyway. This risk would be reduced if we had formula pricing which linked movements in the price to the retail investor with that established, through a tender, for the institutions - though, as discussed in my paper of 27 May, much more thought needs to be given to whether this is a device which might be too complicated for the small investor. But even if we did not have formula pricing, the retail investor can be



tied in to some extent by bonus shares and vouchers. He will also be tied in by his own inertia and, in some cases, satisfaction at seeing the price of his shares move up.

7. Even so, we do need to look at the weighting problem, and it raises the question of whether anything can be done about the construction of the index which appears to invite the institutions to act irrationally and drive up the price to their own cost. The index is the responsibility of the Institute of Actuaries. It could be put to them that, if Water and Electricity were to be 51% sales, the index should take account of that percentage rather than 100%. They may well decide that this would be unsound and point out that other statistics (eg, earnings per share) are calculated on a 100% basis and that all market statistics should be comparable.

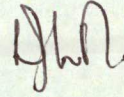
8. Nevertheless, I think we ought to follow the point up and I asked Ian Plenderleith for ideas on how this might be done. The Bank has no formal role in deciding the index, but their statisticians are in close and frequent touch with the Institute of Actuaries. As a first step he is asking his people to sound out the Institute on a technical level to get a better understanding of their attitude to dealing with 51% sales. When we have this information we can consider further whether, how and when to press for any change. But we probably should not move prematurely on this. No final, formal decision has been taken on the percentage of these industries to be sold initially. As you know, DOE are pressing for 100% for Water and I would not want to feed them with an argument - even though not a strong one - in their favour.

9. If at the end of the day, we have 51% sales and the construction of the index is not changed I think we should then take it up with the advisers to the two sales and ask them to consider how best to tackle the worry. Maybe if the point were generally aired the institutions could be talked out of behaving irrationally.



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10. To sum up, there is a worry here which we need to look at further, and as a first step I hope that the Bank of England can help. But it does not seem to me an overriding argument against 51% sales.



D J L MOORE



Ch.  
This is "NB Jessop"  
from the PQ folder!

COVERING RESTRICTED

FROM: JULIAN JESSOP

DATE: 4 July 1988

MR A P HUDSON

cc

- Mr Monck
  - Mr D Moore
  - Mrs M Brown
  - Mr M Williams
  - Mr Gieve
  - Ms Simpson
  - Mr Houston
  - Mr Bent
  - Mr Tyrie
  - Mr Call
  - Mr Manoranjan (CSO) 72/1
  - Mr Dickman (CSO) 72/1
- file AH1/shrak

*Handwritten notes:*  
I will see  
included  
fson  
"getting two for the roads"

- C.
1. This breaks down the figure we used in the Adam Smith speech, that 60 per cent of the 1979 State sector will be sold once the present programme was complete.
  2. They now say it will be 65 per cent.
  3. We thought the figure for Coal was rather high. See para 6 - part of it is that these are all ~~1979~~ 1979 figures, by definition, though Coal is still big.

AMH

STATE SECTOR AND PRIVATISATION

I attach at A a typed version of the figures supplied last Monday. Thanks are due to the CSO, although errors in interpretation are mine.

2. The main point is that 'around 60%' turns out to be a conservative estimate of the proportion of the State sector in 1979 that will have been privatised on completion of the current programme. Now that there has been time to refine the figures, we can justifiably say 'around 65%' will have been returned to the private sector. Correspondingly 'around 35%' will be left.

3. You may also note that the total contribution to GDP in 1979 made by the State sector has been revised downwards from 11.6% to 11.2%. The income-based GDP concept used by the CSO sums the various factor incomes, namely income from employment, gross trading surplus and rents, and then subtracts stock appreciation. Disaggregated stock appreciation figures were not available when similar calculations were last made, but they can now be deducted.



RESTRICTED

4. This adjustment is necessary because the accounting conventions of trading enterprises are different from those of the national accounts. The CSO method of 'contribution to GDP' captures the idea of economic activity much better than would simple turnover, and it should exclude any profit from a change in the money value of stocks held.

5. However, I have had to make estimates based on turnover for those now free-standing enterprises which were part of larger concerns in 1979, such as Jaguar and BS (Warships). The appendix at B illustrates how these estimates are made.

6. You also asked me to explain the British Coal contribution. The 1979 figure was 1.27% of GDP and the latest available estimate is for 1986 at 1.17%. Although there has been a major pit closure programme reducing BC's contribution, there are also important price and volume effects pulling in the other direction. In particular, productivity has improved significantly.

7. Finally, your attention is drawn to the classification of these data. The disaggregated figures are supplied in confidence by the industries and should not be distributed outside the administration. In any case the figures include a significant margin of error because some are estimates from turnover and some involve informed guesswork about stock appreciation. I would always recommend vague forms of words and rounded numbers.

8. Of course there is no objection to using aggregate figures of the type quoted by the Chancellor in his speech on Monday. It



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is also acceptable to issue figures broken down by sector, for example:

	<u>% of GDP in 1979</u>
(a) Enterprises privatised since 1979	4.4%
(utilities: BGC, BT)	2.6%)
(b) Current programme	2.8%
(electricity: ESI, SSEB, NSHEB)	1.3%)
(water: RWAs)	0.6%)
(c) Remaining State sector	4.0%
(big 3 NIs: BCC, PO, BRB)	2.9%)
<b>TOTAL</b>	<b><u>11.2%</u></b>

*Julian Jessop*

**JULIAN JESSOP**  
PEAU



APPENDIX A

The State sector is defined as the nationalised industries, other public corporations and the State-owned industrial companies. In 1979 these contributed 11.2% of GDP. This figure is calculated as total public corporation contribution less stock appreciation, making 10.5%, plus an estimate of 0.7% for State-owned industrial companies.

Enterprised already privatised:

With share of GDP in 1979:

Associated British Ports	0.06%	
British Aerospace	0.29%	
British Airports Authority	0.07%	
British Airways	0.30%	
British Gas	0.94%	
Britoil	0.12%	
British Telecom	1.67%	
National Bus Company	0.20%	
National Freight	0.12%	
Sealink	0.06%	
Rolls Royce	0.18%	
Royal Ordnance Factories	0.08%	
British Shipbuilders (Warships)	0.15%	)turnover
Jaguar	0.04%	)estimates
Others	0.15%	
<b>TOTAL (rounded)</b>	<b>4.4 %</b>	

'Others' is an estimate for small concerns such as Amersham and Cable & Wireless.

(4.4% is about 40% of 11.2%)



Enterprises announced for privatisation

British Steel	0.55%	
Electricity (E&W)	1.13%	
North of Scotland HEB	0.05%	
South of Scotland EB	0.12%	
Regional Water Authorities	0.55%	
Scottish Transport Group	0.05%	
Rover Group	0.30%	) turnover
Others	0.05%	estimate
<b>TOTAL</b>	<b>2.8 %</b>	

'Others' is an estimate for various bits and pieces such as Travellers Fare, Girobank and BREL. The estimate for Rover Group excludes divisions such as Jaguar.

(2.8% plus 4.4% is around 65% of 11.2%)

Remaining State Sector:

BBC	0.14%	
British Coal	1.27%	
BNFL	0.08%	
British Rail	0.93%	
CAA	0.05%	
LRT	0.23%	
New Towns	0.13%	
Passenger Transport Execs	0.15%	
Post Office (Post business)	0.72%	
British Shipbuilders (merchant)	0.05%	) turnover estimate
Others	0.25%	
<b>TOTAL</b>	<b>4.0 %</b>	

(4% is around 35% of 11.2%)



APPENDIX B:

Turnover estimates (examples)

Jaguar

1984 BL accounts show Jaguar contributed 14% of BL turnover in 1983. BL contributed £735m to GDP in 1979, ie 0.43% of GDP. Hence take Jaguar contribution as 0.04%

BS(Warships)

BS 1979/80 accounts shows breakdown of turnover by yard. Privatised yards accounted for 74% of the total. BS contributed 0.2% of GDP in 1979. Hence assume 0.15% already privatised and 0.05% left.





From the Minister

MINISTRY OF AGRICULTURE, FISHERIES AND FOOD  
WHITEHALL PLACE, LONDON SW1A 2HH

*Handwritten signature*

~~*Handwritten signature*~~

The Rt Hon Norman Lamont MP  
Financial Secretary to the Treasury  
Treasury Chambers  
Parliamentary Street  
London SW1P 3AG

4 July 1988

*Dear Norman,*

**COVENT GARDEN MARKET AUTHORITY**

Thank you for your letter of 23 May about the privatisation issue. I see from the replies to mine of 5 May that my proposal has raised no problems other than the ones already touched on in my letter. These are the terms of sale, the need for time for primary legislation, and the availability of finance for the exercise. We shall need to make progress on each of these before my Department can be in a position to undertake any substantial work. I am now asking my officials to arrange the meeting you suggested with yours.

I am copying this letter to the Prime Minister, other members of E(A), Douglas Hurd and to Sir Robin Butler.

*Yours etc,*

*Handwritten signature*

JOHN MacGREGOR

<b>CH/EXCHEQUER</b>	
REC.	4 JUL 1988 ✓ 4/7
ACTION	FST
COPIES TO	





FROM: J M G TAYLOR

DATE: 4 July 1988

MR D J L MOORE

cc PS/Financial Secretary  
Sir P Middleton  
Mr Anson  
Mr Monck  
Mrs Lomax  
Mrs Brown  
Mr Williams  
Mr Bent  
Mr Lyne  
Mr Call  
Ms Wheldon TSo/

**PRIVATISATION: PRICING AND WEIGHTING IN THE INDEX**

The Chancellor was grateful for your note of 1 July.

2. He has commented that, as he thinks you recognise, whatever its other merits a tender is no solution to the problem: it can only result in the institutions securing a bigger share at the expense of the individual investor. But he notes the steps you intend to take, and would be grateful to be kept in touch with subsequent developments.

A handwritten signature in dark ink, appearing to be 'JMG'.

J M G TAYLOR



*Ch. We await FOT's comments on Mr Moore's paper.*

*28  
677*

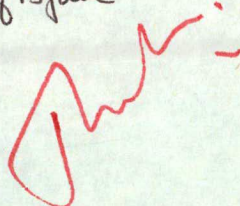
CONFIDENTIAL

- 1. MR MOORE
- 2. CHANCELLOR OF THE EXCHEQUER

From: R M BENT  
 Date: 5 July 1988  
 cc FST  
 Sir P Middleton  
 Mr Anson  
 Mr Monck  
 Mrs Lomax  
 Mrs Brown  
 Mr Williams  
 Mr Lyne  
 Mr Hayley  
 Mr Call  
 Ms Wheldon T Sol

*You asked for this note following my paper of 27 May — Mr Taylor of 15 June*

*JW 5/7*



**PRIVATISATION: PRICING**

You asked for a table, or graphs, showing how privatisation issues, post-opening, have fared in relation to the market as a whole.

2. I am grateful to Mr Hayley for supplying the attached two summary tables:

(i) the first shows the actual share prices at various intervals after flotation. Please note that the prices are adjusted to remove the effect of changes in the capital structure of the companies (eg scrip issues), and do not always correspond to the prices in the FT but instead represent the equivalent value of one share bought at flotation. Also shown in this table is a comparison with the issue price for the shares;

(ii) the second shows the performance of the shares relative to the movement in the FT all-share index over the corresponding period. Values above 100 thus represent shares performing better than the market average.

3. The following observations can be made:

(i) performance varies widely, with some notable successes (eg ABP), and some relative flops (eg RR);

(ii) the issues generally went to premia on the first day;

(iii) the share prices have generally appreciated in the period since the start of dealing by more than the market average (an average of 136.4 by April 1988 compared to an average of 115.4 on the first day), suggesting a rerating of the shares;

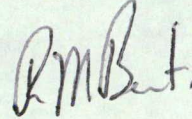
(iv) if the premia on the first days of dealing were caused solely by institutional investors trying to



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achieve their desired weighting in the shares, prices ought to fall off somewhat as the fundamentals reassert themselves. The absence of any such falling off in share prices argues against sole reliance on the institutional weighting argument;

(v) there has been no significant difference between the performance of the competitive firms and the regulated monopolies. The difference between the two shown for April 1988 in the table can be accounted for entirely by the fact that the monopolies were privatised relatively recently, and so could not be expected to show such large premia even if they were performing equally well.



R M BENT  
PE2 Division



TABLE 1

## ACTUAL PRICES (pence)

	impact day	issue price	first day	one month	two months	three months	one year	april 1988	months since impact
BAe	04/02/81	150	171	174	222	220	183	405	87
C+W	21/10/81	168	197	200	210	248	318	969	78
AMERSHAM	12/02/82	142	188	199	204	213	256	449	75
BRITTOIL	11/11/82	215	196	180	176	160	192	520	66
ABP	03/02/83	112	138	143	159	148	288	1026	63
ENT. OIL	19/06/84	185	185	182	186	194	168	375	46
JAGUAR	25/07/84	165	179	181	194	217	258	283	45
BT	16/11/84	130	173	185	204	199	243	248	41
BGC	21/11/86	135	148	151	154	165	174	180	17
BA	27/01/87	125	169	181	192	234	152	164	15
RR	28/04/87	170	228	205	209	194	-	113	12
BAA	08/07/87	245	291	277	286	252	-	257	10

## PRICE AS PERCENTAGE OF OFFER PRICE

BAe	04/02/81	100	114	116	148	147	122	270	87
C+W	21/10/81	100	117	119	125	148	189	577	78
AMERSHAM	12/02/82	100	132	140	144	150	180	316	75
BRITTOIL	11/11/82	100	91	84	82	74	89	242	66
ABP	03/02/83	100	123	128	142	132	257	916	63
ENT. OIL	19/06/84	100	100	98	101	105	91	203	46
JAGUAR	25/07/84	100	108	110	118	132	156	172	45
BT	16/11/84	100	133	142	157	153	187	191	41
BGC	21/11/86	100	109	111	114	122	129	133	17
BA	27/01/87	100	135	145	154	187	122	131	15
RR	28/04/87	100	134	121	123	114		66	12
BAA	08/07/87	100	119	113	117	103		105	10
regulated firm average (1)		100	120.4	122.3	129.2	125.8	157.9	143.0	
competitive firm average (2)		100	117.3	117.8	126.1	132.1	150.8	321.4	
overall average		100	118.1	118.9	126.9	130.5	152.3	276.8	

(1) Comprises BT, BGC and BAA..

(2) The remainder.



TABLE 2

## INDICES OF SHARE MOVEMENTS RELATIVE TO FT ALL-SHARE INDEX

	impact day		first day	one month	two months	three months	one year	april 1988	months since impact
BAE	04/02/81	100	114	113	134	132	110	85	87
C+W	21/10/81	100	112	110	117	129	141	179	78
AMERSHAM	12/02/82	100	135	141	144	147	147	112	75
BRITOil	11/11/82	100	92	86	80	72	76	101	66
ABP	03/02/83	100	121	123	130	127	211	399	63
ENT. OIL	19/06/84	100	101	100	96	98	74	108	46
JAGUAR	25/07/84	100	101	99	103	112	118	86	45
BT	16/11/84	100	129	136	142	140	151	114	41
BGC	21/11/86	100	109	104	98	99	128	116	17
BA	27/01/87	100	130	133	143	157	124	128	15
RR	28/04/87	100	123	107	101	103		73	12
BAA	08/07/87	100	118	117	115	144		135	10
regulated firm average (1)		100.0	118.6	119.1	118.4	127.8	139.5	121.8	
competitive firm average (2)		100.0	114.4	112.3	116.2	119.7	125.2	141.3	
overall average		100.0	115.4	114.0	116.7	121.7	116.4	136.4	

(1) Comprises BT, BGC and BAA.

(2) The remainder.

118.2



5/7/88

CH/EXCHEQUER	
REC.	F-6 JUL 1988 ✓ 6/4
ACTION	FST
COPIES TO	

RESTRICTED

PRIME MINISTER

**DISCLOSURE OF INTERESTS IN SHARES**

1. In May 1987 Paul Channon announced the outcome of the review of the operations of the Takeover Panel. Among the 24 measures which it identified were 4 dealing with the law on disclosure of interests in shares. Colleagues have agreed that the Companies Bill scheduled for the 1988/89 Session may contain any changes which we decide to make. The announcement said that a consultative document would be published putting forward the DTI's proposals in this area. You asked to see a draft of the document before it was published - this is attached. The draft has been discussed with the Treasury and the Stock Exchange - and shown to the Takeover Panel and the Bank of England - at official level, and although there are differences of emphasis between officials all are agreed that we should now go ahead with publishing the consultation document.

2. The Takeover review put forward its measures in the light of concern about the use of nominees in takeovers and in view of the report of the Trade and Industry Select Committee on the Westland general meetings in 1986. It was never, however, our intention to end the use of nominees by those with a legitimate wish for privacy and whose conduct does not threaten the interests of other shareholders. I do not think that we should support measures which would undermine the legitimate use of nominees unless they offered very clear and necessary benefits to the regulation of takeovers. We must also avoid imposing additional burdens on companies and shareholders which disadvantage the innocent without seriously inconveniencing those who are seeking



to abuse the use of nominees merely in order to be able to claim that we have done something.

3. We have identified three major possible changes to the law which might give effect to the Review's measures. They are described at length in chapter 4 of the document. I do not believe, however, that the arguments for taking these steps are sufficient to outweigh the disadvantages. In brief, the changes and my reaction to them are:

- (a) all those controlling voting or disposal rights would be required to make automatic declarations of their interests either at the time of registration or prior to a vote or take-over. This seems to me too drastic as well as still offering potential loopholes. It should be included in the consultative document because it is the sort of system that the Select Committee proposed. But we should be negative about it.
- (b) there could be improvements to the powers given to companies under the Companies Act to enquire into beneficial ownership of shares. Any such changes would be fairly complex and unlikely to offer a substantial advance on the present position, and should be presented in discouraging terms.
- (c) the existing 5% threshold at which those with interests in shares must disclose them to the company might be reduced: such a proposal was supported by the CBI City Industry Task Force. While simpler and more attractive than the previous two options, the balance of advantage and disadvantage needs to be looked at carefully. But we should positively support a reduction in the timescale for making the disclosure from 5 days to, ideally, one day.



4. I believe that the most important change that can be made is a non legislative one. Companies are not constrained by law from taking powers in their Articles to restrict the rights attached to shares when they receive an unsatisfactory response to an inquiry under Companies Act procedures. The Stock Exchange does, however, prevent listed companies from exercising such powers until 28 days have elapsed. It also does not allow listed companies to restrict disposal rights, which can be crucial in a takeover. I believe that The Stock Exchange should be encouraged to relax these constraints, and the document reflects this view in paragraphs 4.13 to 4.16.

5. There must always be a risk that a further scandal involving the use of nominees will result in criticism that our rejection of major legislative changes shows that we are being soft on the City. But I think it right that the consultative document should be realistic about possible changes, and it may be that the political climate since Paul Channon made his announcement has calmed sufficiently so that a reasonable case for confining ourselves to minor changes will be accepted. If the responses to the consultation exercise suggest that there is, contrary to our present view, a case for legislative measures we shall be able to reconsider our position. The important thing now is for the consultative document to be published without further delay;





the department for Enterprise

if any changes to the law, whether minor or major, are to be made we must prepare the necessary clauses for inclusion in next session's Companies Bill as soon as possible.

6. I am copying this minute to the Lord President, the Chancellor of the Exchequer, the Governor of the Bank of England, and Sir Robin Butler.

A handwritten signature in black ink, appearing to be 'D Y', is written in a cursive style.

D Y

5<sup>th</sup> July 1988

DEPARTMENT OF TRADE & INDUSTRY

DW1AFV





4366/75/JRF



Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon Paul Channon MP  
Secretary of State for Transport  
Department of Transport  
2 Marsham Street  
LONDON  
SW1P 3EB

CC: PPS, CST,  
Sir P. Middleton,  
Mr Anson, Mr Monck,  
Mr Turnbull,  
Mrs Case, Mrs Brown,  
Mr Revolta,  
Mr A.M. Williams,  
Mr Bent,  
Mr Tarkowski,  
Mr Rubnam,  
1 July 1988  
Mr Davies, Mr Call,  
Mr Tyrie.

*See Paul*

**PRIVATISATION OF LONDON BUSES LIMITED**

At the end of May your officials informed mine of key decisions already taken to move London Buses Limited towards privatisation. I understand that you have indicated to LBL that you approve of the pattern of restructuring which they have proposed as a possible basis for the establishment of successor companies next April.

I do not dissent from the view you have taken of LRT's scheme for restructuring. But I do think that the best test will be how it works in practice. I think it would be precipitate to decide the final form of the restructuring next April. Unless you see scope for restructuring the successor companies after their incorporation, I suggest it would be prudent to delay the formal establishment of successor companies until the new business units have bedded down and we have seen how they are getting on.

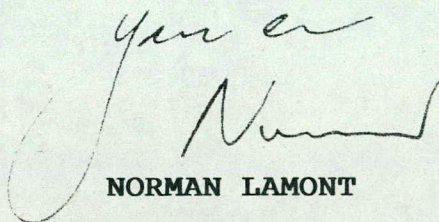
I think it will be important also to put the competitiveness of the new business units to the test if that is possible. Whilst it might not be easy to establish a competitive regime between them whilst they remain under the common ownership of LRT, with its various statutory duties, I do think that any moves in that direction would be helpful. A test phase of this sort should help to identify the strengths and weaknesses of the new business units and to highlight scope for rationalisation of their property portfolio. It might also be possible to deregulate in advance of privatisation if there were a competitive regime between the business units and if their operations had been put on to a commercial footing. This would certainly not be easy to handle but I think it is something which needs to be looked at given the delay we now face in securing primary legislation to enable privatisation.



The treatment of LBL operational property will be a difficult issue in the eventual privatisation - it was difficult enough in the NBC disposals and the problem will be much greater with LBL given the buoyancy of the London property market. We should of course aim not to dispose of the companies complete with property which a more efficient owner can cash in immediately for its alternative use value. Separate disposals of valuable property which was surplus to need should be considered. It would be helpful in this regard to have a retrospective analysis of the NBC privatisation, which should be informative also in the Scottish Bus Group disposals. I think that you should arrange for one as a matter of urgency now.

I note incidentally that Coopers and Lybrand predict poor trading performances even after real fare increases of 10 per cent and cost reductions of over 10 per cent. To my mind this argues for higher fares and higher cost reductions. You will no doubt have in mind the importance of preparing for privatisation in this way when you discuss LBL with John Major in this year's IFR.

I would be grateful if you could keep me in closer touch with this issue in the future: my officials learned of your endorsement of LRT's plans at the same time as their bus drivers. In the meantime I would be interested in your comments on the points I have raised.

  
NORMAN LAMONT



FROM: JULIAN JESSOP

DATE: 7 July 1988

MR A P HUDSON

cc Mr Monck  
Mr D Moore  
Mrs M Brown  
Mr M Williams  
Mr Gieve  
Ms Simpson  
Mr Houston o/r  
Mr Bent  
Mr Tyrie  
Mr Call  
Mr Manoranjan (CSO)  
Mr Dickman (CSO)

*file/gwat*

**STATE SECTOR AND PRIVATISATION**

Mr Houston has drawn my attention to a potential problem in the classification of the figures broken down by sector (my minute of 4 July).

2. Where I have added only two companies together (BGC and BT) it would be possible for BT to work out BGC's figures, and vice versa. A strict 'unclassified' number would therefore have to include at least three companies.

*Julian Jessop*

JULIAN JESSOP  
PEAU





*Handwritten signature*

FROM: J M G TAYLOR

DATE: 11 July 1988

MR BENT

cc Mr D J L Moore

**PRIVATISATION: PRICING**

The Chancellor was grateful for your minute of 5 July.

*Handwritten signature*

J M G TAYLOR





FROM: MRS JULIE THORPE

DATE: 11 July 1988

MR MONCK

cc PS/Financial Secretary  
Mr D J L Moore

**WATER AND ELECTRICITY PRIVATISATION**

As you know the Chancellor will be holding a meeting to discuss Water and Electricity Privatisation at 10.00am, at No.11 on Tuesday 19 July.

2. I am writing to confirm that you and Mr Moore will attend the meeting for the Treasury along with the Financial Secretary.

*Julie Thorpe*

MRS JULIE THORPE  
Diary Secretary



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Treasury Chambers, Parliament Street, SW1P 3AG  
01-270 3000

11 July 1988

Michelle Cameron  
Diary Secretary  
Secretary of State for the Environment  
2 Marsham Street  
London SW1P 3EB

cc: PS/Financial Secretary  
Sir P Middleton  
Mr Anson  
Mr Monck  
Mr D J L Moore  
Mrs E M Brown  
Mr M L Williams  
Mr Ilett  
Mr Bent  
Mr Tarkowski  
Mr Lyne  
Mr Tyrie  
Mr Call

*Dear Michelle*

I am writing to confirm that the Chancellor of the Exchequer will be holding a meeting on Tuesday 19 July at 10.00am, at No.11 Downing Street to discuss Water and Electricity Privatisation.

The Chancellor would like the Secretary of State for the Environment, the Secretary of State for Energy, and Ministers from the Welsh and Scottish Offices to attend, along with the Financial Secretary to the Treasury. The Chancellor has also suggested that each Minister might like to bring an Official with him and I would be grateful if all copy recipients could confirm who will be attending the meeting before Monday 18 July.

I understand the meeting is to be a continuation of the one held on 25 May and the latest paper is Jonathan Taylor's letter to Deborah Lamb of the same date.

I am copying this letter to the Diary Secretaries to the Secretary of State for Wales, the Secretary of State for Scotland and the Secretary of State for Energy.

*yours sincerely  
Julie Thorpe.*

MRS JULIE THORPE  
Diary Secretary





FROM: MRS JULIE THORPE

DATE: 11 July 1988

MR MONCK

cc PS/Financial Secretary  
Mr D J L Moore

*Julie*  
Can you pl. switch the  
venue, + include Mrs B + Mr W?

**WATER AND ELECTRICITY PRIVATISATION**

As you know the Chancellor will be holding a meeting to discuss Water and Electricity Privatisation at 10.00am, at No.11 on Tuesday 19 July.

2. I am writing to confirm that you and Mr Moore will attend the meeting for the Treasury along with the Financial Secretary.

*Julie Thorpe*

*Mr. J. Taylor e. Mr Monck*

MRS JULIE THORPE  
Diary Secretary

*As I mentioned to you I think  
the meeting should be in the  
Treasury, as was the last one. There is surely not  
room for 6 Ministers (including us 2) plus supporters.*

*Also I want Mary Brown & Nelson Williams there - if necessary  
on the back row. They will each be heavily involved in the  
follow up on Water and Electricity respectively & should  
hear Footboard. Andy goes on leave at the end of that week*

*73  
132*

*David Moore 12/7.*





Treasury Chambers, Parliament Street, SW1P 3AG  
01-270 3000

12 July 1988

Michelle Cameron  
Diary Secretary  
Secretary of State for the Environment  
2 Marsham Street  
London SW1P 3EB

cc: PS/Financial Secretar  
Sir P Middleton  
Mr Anson  
Mr Monck  
Mr D J L Moore  
Mrs M E Brown  
Mr M L Williams  
Mr Ilett  
Mr Bent  
Mr Tarkowski  
Mr Lyne  
Mr Tyrie  
Mr Call

*Dear Michelle*

Following my letter to you of 11 July confirming the details for the Chancellor's meeting on Tuesday 19 July, to discuss Water and Electricity Privatisation, please note that I have been asked to change the location from No.11 Downing Street to the Chancellor's Room in the Treasury.

I hope this will not cause any inconvenience.

I am copying this letter to the Diary Secretaries to the Secretary of State for Wales, the Secretary of State for Scotland and the Secretary of State for Energy.

*yours sincerely  
Julie Thorpe.*

MRS JULIE THORPE  
Diary Secretary





FROM: MRS JULIE THORPE  
DATE: 12 JULY 1988

MR D J L MOORE

cc PS/Financial Secretary  
Mr Monck  
Mr M L Williams  
Mrs M E Brown

**WATER AND ELECTRICITY PRIVATISATION**

I have seen your note to Jonathan Taylor and I have made arrangements for the Chancellor's meeting to be held here in the Treasury, at 10 am on Tuesday, 19 July.

2. I have also noted that you would like Mrs Brown and Mr Williams to attend the meeting as well as the Financial Secretary, Mr Monck and yourself.

*Julie Thorpe.*

MRS JULIE THORPE  
Diary Secretary





SOMMET · TORONTO · SUMMIT

Problems about proper water method  
(classical\*)

Follow up 2 diff computer methods

(Problem, too, with old method: ~~is~~ cd de script  
renormalized?)

No unit factor - better for de unit

Don't like structure on long non-local cos.

Diff eqs ratios ( $\alpha 5/100$  scale)

\*  
2 diff data 2 methods applied (Xueshi & others)  
Small number of random eqs (2 pairs)  
Water Simulations





SECRETARY OF STATE FOR ENERGY  
THAMES HOUSE SOUTH  
MILLBANK LONDON SW1P 4QJ

01 211 5038

Mrs Julie Thorpe  
Diary Secretary  
Treasury Chambers  
Parliament Street  
LONDON  
SW1P 3AG

13 July 1988

*Dear Julie,*

My Secretary of State will be accompanied by John Guinness next Tuesday to discuss Water and Electricity Privatisation at 10.00 am.

*Yr sincerely  
Philippa Jones*

**PHILIPPA JONES**  
Private Secretary



MP

FROM: N J ILETT

DATE: 13 July 1988

*I don't advise picking*

*a figure on the subject here -*

- 1. MRS LOMAX *though not an expression of*
- 2. CHANCELLOR OF THE EXCHEQUER *particularly with Finance effort*

*from DTI*  
*Re 13/7*

- cc: Economic Secretary
- Sir P Middleton
- Mr Monck
- Mr Scholar
- Mr Burgner
- Mrs Lomax
- Mr Burr
- Mr Sharples
- Mr Cropper
- Mr Tyrie
- Mr Call

*Ch/ content with PS letter as drafted?*

*OK*

*MPW 1417*

**TAKEOVER PANEL REVIEW : DISCLOSURE OF INTERESTS IN SHARES**

Lord Young's minute to the Prime Minister (6 July, attachment received 11 July) deals with part of the follow-up to last year's Review of the Takeover Panel. Lord Young proposes to publish a Consultative Document on four company law recommendations made by the Review Group. These were intended to reduce the scope for sharp practice which at present falls short of illegality. Decisions taken following the consultation would be reflected in next session's Companies Bill.

2. The main issues are concert parties and prevarication in the disclosure of the beneficial ownership of shares at crucial points in contested takeovers and on other sensitive occasions (eg Westland).

**Concert parties**

3. The Review Group thought that the law on concert parties is ineffective and should be clarified. Arguably, however, it makes little sense to decide quite how to go about this and to legislate before the dust has settled on Guinness. DTI officials appear to be convinced that it is best anyway to leave the law as it stands, and would certainly prefer not to do anything about





Mr Ridley + Sir Terry Heiser  
Mr Parkinson + John Guinness.  
Mr Grist + Aelwyn Jones.  
Mr Ian Lang + Hamish Lang.

PST.

Mr Monck

Mr Moore.

(Mrs Brown)

(Mr Williams)

- To sit in  
back row, with  
P3.



concert parties in next session's Companies Bill. Lord Young rather skates over this issue in his minute, but paragraph 4.32 of the Consultative Document admits in a rather convoluted way that action will be taken if it should "become apparent" that action is necessary, though the Government "do not, at present, take the view that it has been established that the existing concert party provisions are defective". This admission reflects pressure from the Treasury at official level to toughen up the Consultative Document.

#### Disclosure of shareholdings

4. Lord Young says (paragraph 3 of his minute) that the Consultative Document discusses and is minded to reject three changes to the law. The first was suggested by the Select Committee on Trade and Industry, namely that beneficial owners must automatically declare their interests on registration or before significant votes. Lord Young rightly says that this is too stark. But he also opposes reducing the threshold at which shareholders must disclose their interest below the present 5% to 1% (in line with the current Takeover Code), though he does endorse a reduction in the timescale for declaration from 5 days to one. And he does not want to use the law to give companies better powers to restrict voting rights on shares whose ownership is unclear. He prefers to rely on the Stock Exchange changing its rules.

5. Lord Young therefore proposes to press the Stock Exchange to allow companies to make their own rules, in their articles, to restrict voting rights at 7 days notice where companies suspect the ultimate controller of shares is not responding properly to the existing (Companies Act) procedures which companies use to require significant shareholders to reveal themselves. At present, the Stock Exchange require companies to wait for 28 days before acting, and are very reluctant to reduce this period. Treasury officials have already argued that the Exchange should be told that if they do not change these rules voluntarily the Companies Bill will have to override them. Lord Young says in his minute that the Stock Exchange should be pressed to change their rules. But the text of paragraphs 4-13 to 4-16 of the Consultative Document conveys this message in very discreet terms only, and argues against legislation.

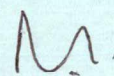


**Assessment**

6. The Consultative Document is weaker than we would like. However, it is not the end of the story; we can have a further go at the DTI when the time comes to decide policy. As Lord Young says, the political climate has changed since last year; he hopes to get away with rather more modest proposals than his predecessor would have done when Guinness was in the headlines. It is also relevant that the Takeover Panel is on the up at the moment, due in part to skilful public relations by the Alexander/Beevor regime, and the time is not ripe to pick a fight about the regulation of takeovers. Also, the Consultative Document is already very late. Treasury officials commented on virtually the same text back in April, so it is difficult to escape the conclusion that the DTI would not be sorry if further delays ruled out the possibility of immediate legislation on any of these points.

7. I understand that Bank officials will be recommending the Governor to acquiesce in the publication of the Consultative Document in its present form, but to put on record similar reservations to our own.

8. No 10 have asked for comments from the Treasury and the Bank. On balance, therefore, I think a response which invited Lord Young to redraft key bits of the Document would be a bit over the top. But it would be wise to record the Treasury's difference of view on the policy. So I attach a draft Private Secretary letter.



N J ILETT



CONFIDENTIAL

MOIRA

DRAFT LETTER FROM: ~~PRINCIPAL PRIVATE SECRETARY~~TO: Paul Gray Esq  
10 Downing Street**DISCLOSURE OF INTEREST IN SHARES**

The Chancellor has seen a copy of the Secretary of State for Trade and Industry's minute of 6 July to the Prime Minister, and of the Consultative Document which Lord Young proposes to publish.

The Chancellor appreciates that there is no requirement to take policy decisions at this stage and that time is now very short if these consultations are to be reflected in next session's Companies Bill. He notes also that it is in any event likely that the lessons of the Guinness affair will have a significant bearing on the questions of "concert parties" and disclosure of interest in shares with which the Consultative Document deals, so any conclusions at this stage may be provisional. That said, the Chancellor would have preferred the Consultative Document to indicate a rather more positive determination to strengthen the law on "concert parties".

The Chancellor welcomes the proposal to shorten the timescale for the declaration of interests



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above 5%. And he agrees with Lord Young that pressure should be brought on the Stock Exchange to allow companies to restrict voting rights where a satisfactory response to legitimate enquiries by the company is not received within 7 days, as opposed to the present 28 days. If the Stock Exchange is not prepared to do this voluntarily, the Chancellor thinks that it may be necessary to override them in legislation. The message might be put rather more firmly in the consultative document itself, and should certainly be conveyed to the Exchange separately.

However, the Chancellor would not wish to press Lord Young strongly to make further amendments to the Consultative Document at this stage, given the timing constraints and that there will be opportunities to discuss the policy after the consultative period.

I am sending copies of this letter to ~~[Private Secretaries to Lord Young, the Governor and Sir Robin Butler.]~~

Neil Thornton (DTI),  
Trevor Wooley (Sir Robin Butler's office)  
and John Footman (Bank).

Alison  
Smith (Lord  
President's office)

MPW





2 MARSHAM STREET  
LONDON SW1P 3EB  
01-212 3434

My ref:

Your ref:

The Rt Hon Nigel Lawson MP  
HM Treasury  
Parliament Street  
LONDON  
SW1 3AG

CH/EXCHEQUER	
REC.	14 JUL 1988
ACTION	Mr DJL MOORE
COPIES TO	EST. SIR P. MIDDLETON Mr ANSON, Mr MONCK, Mr M.E. BROWN, Mr M.L. WILLIAMS, Mr ILETT, Mr BENT, Mr TARKOWSKI, Mr LYNE, Mr TYRRE, Mr CALL.

14/7 14 July 1988

*Dear Nigel*

FLOTATION STRATEGY

Following our meeting in May, Schrodgers have been considering the feasibility of floating the water industry before summer 1990 thereby enabling us to sell both the water and electricity supply industries in this Parliament.

Their paper "Strategy for the Privatisation of the Water Authorities: Recommended Method for Simultaneous Flotations" (copy enclosed) concludes that the "two tier" approach proposed by Schrodgers would enable all the individual water utilities to be floated simultaneously in autumn 1989 while meeting in large part our objectives for wider share ownership and for proceeds. It is however, as they stress a high risk strategy with a price to be paid for both speed and wider share ownership.

*looked*

Under the proposed "two tier" offer structure, there would be a package offer whereby the institutions and high worth individuals would be offered a package of shares from each WSPLC at a single composite price. There would also be separate offers of shares in each WSPLC directed at the retail market, in particular at customers and employees. Schrodgers provisional judgement is that 100% of the equity should be marketed with the separate offer taking place approximately four weeks after the package offer. This would enable relative share prices to be set in the market. The separate offers could be priced to allow the retail investor as good a premium as that offered to the institutional investor.

*more don't put*

Schrodgers stress however that the proportion of equity offered for sale, the timing of the two offers and the extent and nature of the under-writing would need further consideration in the light of market research on the source and nature of demand and of the more detailed financial assessments. As their paper notes, one of the strengths of their approach is the flexibility it offers for tailoring packages to meet our objectives.

I have also seen the Department of Energy's and Kleinworts' proposals for selling the electricity supply industry via a distribution share and option card - there have been some useful exchanges between our officials and our advisers on the two



approaches but this needs to be taken a great deal further if we are to have a credible and defensible rationale for the approach or approaches adopted for the two industries.

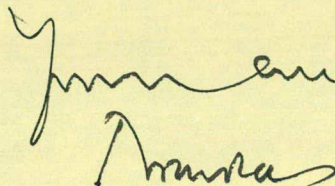
I have already suggested the directions in which more work is needed both on the nature of demand for the water industry securities and on the logistic legal and proceeds aspects of simultaneous flotation on either method. At this stage however, I am convinced by Schrodgers' work that simultaneous flotation of the ten WSPLCs in autumn 1989 is feasible. Schrodgers' best judgement at this very early stage is that there would be a cost in terms of proceeds from simultaneous flotation as compared with batches, although only of the order of 5%. Our brokers, Rowe and Pitman, however, believe that simultaneous flotation would achieve higher proceeds than batches. Either way simultaneous flotation is a high risk strategy as it is novel and it imposes considerable demands both on the water authorities and on my Department.

To secure simultaneous flotation which, I suggest, should remain our objective despite the associated significant costs and risks, we must simplify the operation in every way we can. I would need to secure clear and detailed undertakings from the water authority chairmen on their management and co-ordination arrangements. I will be looking to the business managers to ensure Royal Assent to the Bill before next summer's recess.

I suggest therefore that Cecil and I tell our respective industries that we are prepared to work on the basis of simultaneous flotation of the water industry in November 1989 with the electricity supply industry following in summer 1990 and thereafter. We should stress however that we are commissioning further work on the exact methods to be used. It would be extremely helpful to me to have your views as soon as possible on the level of proceeds you are looking for from water, as opposed to other sales, and their preferred timing, as this is a key constraint in any development work.

We would avoid any public commitment to a particular offer structure (including on partial sales) until more detailed advice is available on the logistic, legal and demand aspects. Our objective should be to take (provisional) decisions on methods before the end of the year. By then we should have a more secure basis on which to decide what approaches to adopt for water and electricity.

I am copying this letter to the Prime Minister, Cecil Parkinson, Peter Walker, Malcolm Rifkind and Norman Lamont; to John Wakeham because of the legislative implications and also to Sir Robin Butler for information.



NICHOLAS RIDLEY



CONFIDENTIAL

FROM: D J L MOORE  
 DATE: 15 JULY 1988

CHANCELLOR

cc: Financial Secretary  
 Sir P Middleton  
 Mr Anson  
 Mr Monck  
 Mrs Lomax  
 Mr Sedgwick  
 Mrs Brown  
 Mr Williams  
 Mr Hibberd  
 Mr Mowl  
 Mr Bent  
 Mr Lyne  
 Mr Call  
 Mr Tyrie

*Many Plans.  
 We will need to  
 discuss when we  
 know more about where  
 we stand on fleet &  
 water.  
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**PRIVATISATION PROCEEDS**

This note brings up to date PE's assessment of possible proceeds from 1989-90 onwards. It is a companion piece to my note of today on Water and Electricity privatisation.

2. Annex A shows the provisional timetable for the Water and Electricity sales and an estimate of total proceeds from them, divided into equity and debt. It also shows what the debt proceeds might be if repayments were to start the year after privatisation and they were then spread equally over 10 years; in practice of course the terms will be for negotiation. All these estimates are very provisional and uncertain, and the Annex explains the doubts over Electricity in particular.

3. Using these tentative figures Annex B shows possible proceeds from items in the pipeline, from the second instalment of Steel (another uncertain figure), and from equity instalments from 51% Water and Electricity sales. You will see that these add to:-

1989-90	90-91	91-92	92-93
4950	4700	4400	2550



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With the addition of debt repayments on the Annex A assumptions that would give a total of almost exactly £5 billion in each of the first three years. The shortfall in 1992-93 could be supplemented by secondary sales, eg, British Telecom.

4. Annex C shows the outcome with 60% sales of Water and Electricity. On this basis the total before any debt is close to £5 billion in each of the three years. There are attractions in this assumption. We may find that debt repayments will be deferred longer than assumed here. It would be more appealing to the Water and Electricity Chairmen because it would take them away from the 51% brink. Indeed, for Water and for Electricity Distribution the advisers will probably want at least 60% sold for reasons explained in the separate brief.

5. So it is clear, on the figures we are currently using, that to meet your aim of keeping down to around £5 billion a year we should continue to assume partial sales of Water and Electricity in the order of 50-60%. 100% sales would take us to £8-9 billion in each of 1990-91 and 1991-92.

6. Mr Ridley still wants a 100% sale of Water, and DOE may propose that 50% of total proceeds would be in the form of debt and deferred, rather than the £3 billion out of £8 billion which we have assumed. If so, that would add to the Annex B and Annex C totals by the amounts shown at the bottom of the tables. Of itself this change would take us to around £5½ billion in the first year and to about £5 billion in each of the 2 following years, and to more if there were also debt repayments in the period. But even if those totals were acceptable to you, we cannot see any credible rationale in selling 100% of Water, with all the doubts and worries over that sale, and only 51% of the Electricity industries.

7. Now that BT and the Regulator have agreed on the Telecom price formula there will be no MMC reference unless Lord Young decides otherwise this month. Without a reference, and other things being equal, we would be free to sell a further holding in



Telecom in the summer 1989 gap. The minimum reasonable sale would be, say, £1½ billion out of our remaining holding of of around £7½ billion. We could not sensibly spread these proceeds over as long as three years. We would therefore be adding, say, £600 and £900 million to each of the first two years.

8. Although it is not essential to take a decision until much later this year, the aim of constraining proceeds to around £5 billion a year, and possibly the need to make way for Building Society flotations next summer, point to not going ahead with Telecom in summer 1989 unless you thought it of overriding importance to take the opportunity for another wider shareownership sale and possibly to try out tender techniques in advance of the main sales. You may prefer, however, to hold back on Telecom and to use it as an insurance if it turned out that Water could not be done in November 1989. It could also be held in reserve for an early post-Election sale in 1992-93. (It could not be done for 12-18 months from around summer 1990 because of the duopoly review.)

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9. As further background I attach as Annex D a note by EA2 on the implications of the financial forecast for privatisation sales. As the note points out, there are enormous uncertainties in the assessment. Apart from the Building Societies, there may not be strong competition from private sector companies for new equity finance. If this reflects a judgement that the market appetite for equity is weaker it bears out the case for prudence and going for partial rather than 100% mega sales. It is suggested that new Building Society issues may help privatisations by rekindling interest in share ownership. If there are to be such issues we want them in 1989 ahead of the November Water sale and the subsequent heavy programme of Electricity sales.

### Conclusions

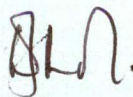
10. On our present very tentative estimates, in order to keep to around £5 billion proceeds a year:



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i. both the Water and the Electricity sales must all be 50-60% though we need to keep open the option of something more if the estimates were to change substantially;

ii. a Telecom sale in summer 1989 would take us considerably over the £5 billion ceiling, other things staying equal, and you might prefer to hold that sale in reserve for either November 1989 or for 1992-93.



D J L MOORE



## ASSUMPTIONS

		Equity	Debt	Total fbillion
November 89	Water	5	3	8
Summer 90	E/Dist	5	2	7
Autumn 90	CEGCO	7	0	7
January 91	Scot/Elec	2	1	3
Summer 91	GENCO	5	1½	6½
		-----		
		24	7½	31½

Note the totals, and the split between debt and equity, are still very provisional and uncertain estimates.

Equity

Annexes B and C give estimates for receipts from equity instalments. They are particularly uncertain for electricity in England and Wales. The present calculations are necessarily based on a wide range of assumptions, and the results are highly sensitive to some of them. For example, Kleinworts are assuming that tax relief will be available for nuclear provisions, without which the equity value of CEGCO could be lower by some £2 billion. Kleinworts also envisage that potential nuclear liabilities are capped at projected levels (DEN are not yet ready to put proposals about the support package necessary for nuclear liabilities and provisions; they are still collecting data. Clearly, however, tax relief for the provisions raises a number of difficult issues, notably its knock-on effect for other industries, eg, provisions for oil platform abandonment). The estimates assume that fuel cost reductions are retained by CEGCO and GENCO, and they could be worth up to £0.75 billion on proceeds. They also take present electricity price levels as their starting point, and assume that initial contracts will be priced accordingly. But the area boards are

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arguing that competitive prices could be substantially lower (up to 30%, although this figure has a negotiating element). We will of course be wary of arguments implying a substantial write down of the CEEB's assets, but the prospects of a write down when initial contracts come to be renegotiated could still damage proceeds substantially. On top of all this, we can envisage the usual tension between the Government and its advisers over the dividend yield/PE on which to sell the industries, with the advisers arguing that they should be presented as high yield low growth companies.

We are also waiting for a new estimate of Water proceeds and for advice on the assumption for the split between debt and equity.

Debt

It will be for negotiation over what period the debt will be repaid. But if debt repayments were to start the year after privatisation and if they were spread equally over 10 years the figures would be:-

	89-90	90-91	91-92	92-93	Total £billion
Water	-	300	300	300	3
Dist	-	-	200	200	2
GENCO	-	-	-	150	1½
Scot/Elec	-	-	100	100	1
	-	300	600	750	

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BT)*



PROCEEDS : Water and Electricity sales of 51%

	89-90	90-91	91-92	92-93	
Total in the Pipeline	2450	100	100	100	
Gas Debt	400	750	350	-	
Steel (2nd Instalment)	1100	-	-	-	
Water	1000	750	750	-	
Distribution	-	1100	700	700	
CEGCO	-	1500	1000	1000	
Scottish Electricity	-	500	500	-	
GENCO	-	-	1000	750	750
					in 93-94
TOTAL pipeline + new equity	4950	4700	4400	2550	

Possible additions

Debt	-	300	600	750
B Telecom	600	900	-	-
Water (if 100% sale and £4 billion equity rather than 51% of £5 billion equity)	600	450	450	-



## PROCEEDS : Water and Electricity sales of 60%

	89-90	90-91	91-92	92-93	
Total in the Pipeline	2450	100	100	100	
Gas Debt	400	750	-	700	
Steel (2nd Instalment)	1100	-	-	-	
Water	1200	900	900	-	
Distribution	-	1200	900	900	
CEGCO	-	1600	1300	1300	
Scottish Electricity	-	550	650	-	
GENCO	-	-	1200	900	900 In 93-94
Total pipeline and new equity	5150	5100	5050	3900	
Possible additions					
Debt	-	300	600	750	
B Telecom	600	900	-	-	
Water (if 100% sale and £4 billion equity rather than 60% of £5 billion equity)	400	300	300	-	



**THE BACKGROUND TO PRIVATISATION: INVESTORS AND FINANCIAL MARKETS  
1989-91**

**Summary**

The June forecast presents a picture which is reasonably comfortable for future privatisation issues. The forecast has a gradual recovery in the equity market. Real equity prices rise through the period, though they are still below the pre-crash level in 1991. Stock market turnover recovers and surpasses average pre-crash levels in 1989. But the value of new equity finance by companies remains below the levels of recent years. In one way this relatively low level of new equity issues by companies could be seen as helpful to prospects for privatisation sales, but insofar as it reflects a well founded view that the equity market is likely to remain fragile it is not particularly encouraging. In general it is unlikely that confidence in a firm and rising equity market will be as strong as in the pre-crash period. Potential holders of equities will be more conscious than they were earlier in the 1980s of the possibility of sharp capital losses.

2. Companies' issues are not usually targeted at individual investors. Building societies will probably begin to come to the market during this period with personal savers as their main target. But only the top five or so societies could command capitalisations of sufficient size to offer serious competition to privatisation issues, and not all these societies will choose to incorporate. The extent of adverse effects for privatisation issues from the number that do so choose will depend on the overall strength of the equity market.

3. There is a large net redemption of gilts over the forecast period. The institutions will therefore be forced to have higher shares of other assets - probably including UK equities - in their portfolios. This will help privatisation sales.

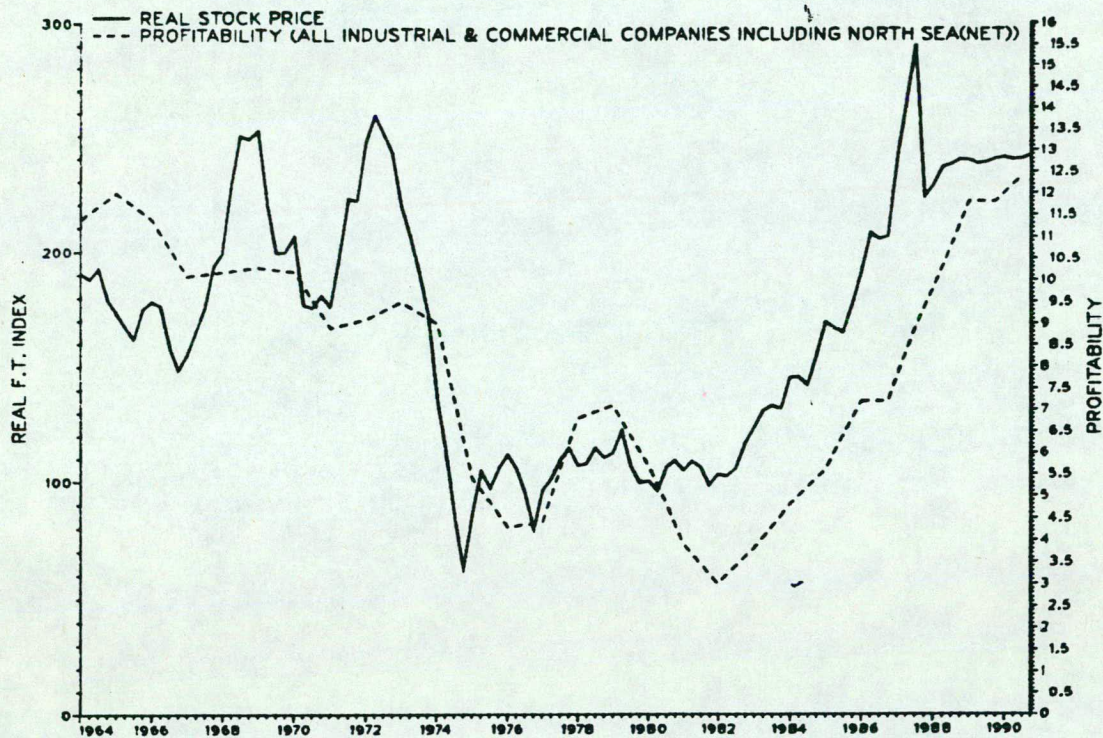


4. It goes without saying that the margin of error around these judgements and the specific figures is enormous. The forecast can therefore give only limited guidance on the likely prospects for privatisations sales.

### The equity market

5. The forecast has a gradual rise in real equity prices in line with the past and future rise in the rate of return.

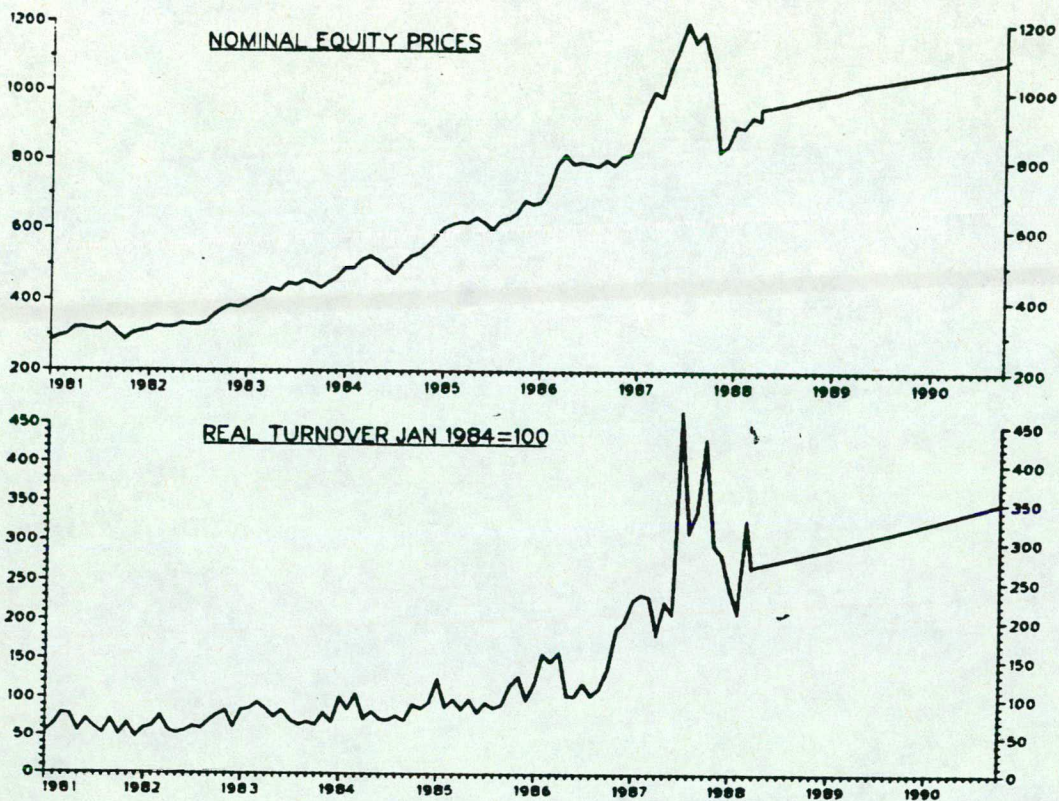
**CHART 1 : REAL EQUITY PRICES AND THE RETURN ON CAPITAL**



6. The forecast has pre-crash levels of turnover volume regained by end-1989. Certain technical factors, notably the introduction of SAEF (automatic execution) and TAURUS (automatic settlement) may play a part in this, as may further development of retail outlets such as Barclayshare, especially for individual investors.



CHART 2 : EQUITY TURNOVER

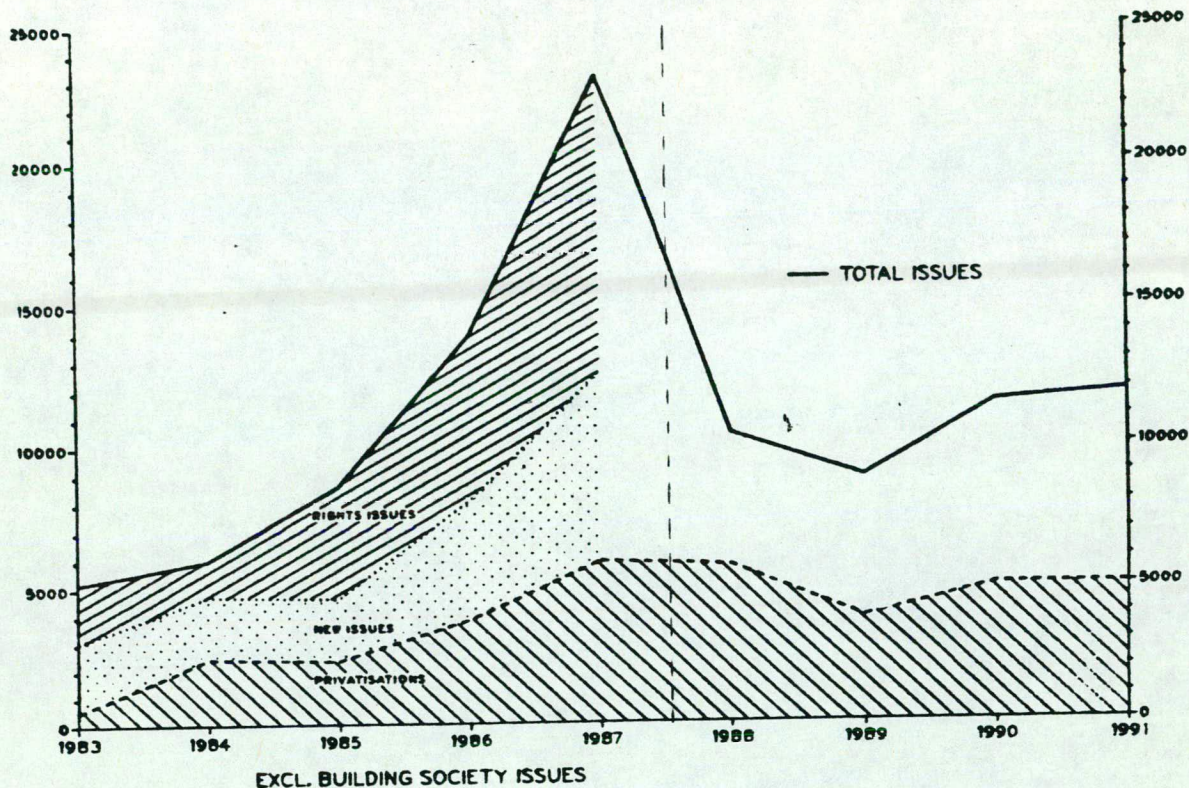


New issues by companies

7. The forecast envisages a small increase in new equity issues by UK companies, although these do not regain the exceptionally high levels of 1986 and 1987. One reason for this is that the cost of finance, as measured by gross dividend yield, is so much higher - companies now need to pay greater dividends per unit of new equity capital raised, since equity prices have fallen and dividends risen over the last year.



CHART 3 : UK EQUITY ISSUES



### Building society flotations

8. Building society flotations could add substantially to total new equity issues over the next few years. Because these will be targeted to a large extent at members they are likely to be close substitutes for large privatisation issues that would be attractive to the small investor. But not all the societies will choose to incorporate - at least one (the Nationwide-Anglia) has publicly stated that, for the meantime, it will retain its current status - and the incorporations that do occur are likely to want to avoid the period around privatisations. The forecast did not attempt to quantify building society equity issues, but should the top five societies excluding the Nationwide, all choose to incorporate and to become capitalized on the stock exchange it might result in up to around £5-7 bn. of new issues. The issues may actually aid privatisations, by rekindling interest in share ownership



especially if shares are issued free or at a large discount), and since most small investors will probably only have share accounts at one or two societies, are unlikely to result in investor satiation. For non-depositors, privatisation issues may well offer better prospects than issues by building societies.

9. Such sales are not then likely to present major obstacles to privatisation sales. The main danger remains the overall state of the equity market. A weak market - defined as one in which there is a widespread fear that prices could fall - could dampen the response to privatisations and raise underwriting costs, and could also increase any detrimental effects from building society flotations should these still go ahead. The evidence from the options market is that the cost of insuring against unit volatility has returned to only slightly above pre crash levels. But despite this there must be considerably less optimism of large rises in equity prices, probably coupled with greater worries about large falls.

#### The prospect for the institutions

10. The forecast for institutions' financial transactions is dominated by two opposing influences. On the one hand, new inflows are likely to be depressed. Unit trusts have already lost considerable business following the crash. Life assurance and pension fund inflows are forecast to fall away as continuing pension fund surpluses demand contributions holidays, as such funds approach maturity, and as single premium 'linked' business to life assurance companies continues to suffer from the crash.

11. On the other hand the gross supply of new gilts falls away to near zero, and net gilt repurchases by central government total as much as £10 billion per annum. Life assurance and pension funds traditionally invest much of their inflows in gilts; thus they are forecast to sell gilts and this leaves a large gap in their portfolios, filled in part by purchases of domestic equities and in part by investment in domestic and overseas bonds, which may be closer substitutes than domestic equities.

12. On balance there are unlikely to be direct constraints on new privatisations from institutional demand. The central



Forecast certainly has no fall in the share of UK equities in their - albeit slower growing - portfolios, and if anything the forecast balance between domestic and overseas securities may tilt excessively towards the latter.

TABLE 1 : INSTITUTIONS' PORTFOLIO SHARES (per cent)

	Gilts	UK equities	Overseas securities & bonds	Liquid assets	Other (eg property)
1982	25.0	37.2	9.8	3.2	24.8
1983	23.4	39.2	12.1	2.7	22.6
1984	21.0	42.5	12.4	3.1	21.0
1985	20.0	45.3	12.9	2.8	18.9
1986	17.4	47.8	14.5	2.9	17.3
1987	15.2	44.5	11.3	3.9	25.1
-----					
Forecast					
1988	12.6	45.3	11.9	3.3	26.9
1989	11.0	46.8	13.5	3.4	25.3
1990	9.6	47.5	14.6	3.6	24.7

### The personal sector

13. The forecast has continuing low saving ratios, which coupled with slower growth of credit, as house price inflation falls and interest rates rise, reduce the funds available for investment. The forecast has a limited return by the personal sector to equity and unit trust investment by end 1988 at the expense of liquid assets (which would be further hit should building societies choose to incorporate). It is harder to judge the downside risks in this area - individual enthusiasm for share ownership cannot be gauged accurately - , but wider share ownership has probably achieved a sufficiently strong base for persons still to be interested in privatisation issues. It is probable, however, that individuals will be looking to a reasonably assured capital gain in the aftermarket, as with previous privatisation issues sold widely prior to BP. (Details of these issues are contained in annex table 1.)

### The tightness of monetary policy

14. A sharper rise in short term rates than envisaged in the main forecast (or the variant with a quicker rise in interest



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(rates) could in the short term produce a weaker equity market than foreseen in the forecast and could enhance the attractions of bank and building society deposits relative to equity investment. It is, of course, impossible to say how short term interest rates will be behaving at the time of the main Water and Electricity sales.

**EA2**

**July 14 1988**



## ANNEX

Table 1

## EXPERIENCE WITH PRIVATISATIONS

Issue	Date	Public offer			Equity Prices (FTSE100) % change over	
		Number of times subscribed	Number of Applicants	Premium on first Day <i>(partly paid share)</i>	One month before day of subscrip- tion	One year before day of subscrip- tion
BT	28/11/84	4	2.1 m	86%	4.5	21.6
TSB	24/09/86	8	3.7 m (+1.3m customers)	62%	- 0.3	25.3
British Gas	03/12/86	4	4.5 m	25%	- 1.5	14.1
BA	06/02/87	23	1.2 m	68%	12.3	33.0
Rolls Royce	20/05/87	9	2 m	73%	11.5	37.1
BAA	08/07/87	10	2.5 m	46%*	5.8	38.2
BP	15/10/87	0.034	270,000	- 29%+	1.6	43.2

\* fixed price offer

+ supported by Bank of England buy back option





SECRETARY OF STATE FOR ENERGY

THAMES HOUSE SOUTH  
MILLBANK LONDON SW1P 4QJ

01 211 6402

CH/EXCHEQUER	
REC.	15 JUL 1988 ✓ 15/7
ACTION	MR O MOORE *
COPIES TO	FST, CST, SIR P MIDDLETON MR ANSON, MR MONCK MR HOUSTON MR TYRRE MR GALL

The Rt Hon Nigel Lawson MP  
Chancellor of the Exchequer  
HM Treasury  
Parliament Street  
LONDON  
SW1P 3AG

\* Attachment  
with top copy  
only.

Dear Nigel,

15<sup>th</sup> July 1988

**ESI PRIVATISATION PROGRAMME**

As you know, Kleinwort Benson and our other advisers have been working up detailed advice on the proposal to sell the twelve distribution companies all at once. They have now produced the attached document and I have had a presentation from them.

The main features of the proposal are:

- (a) there will be a security, presently called the Distribution Share, which will represent an entitlement to one share in each distribution company;
- (b) the marketing campaign, both to institutions and to individuals, would concentrate on the Distribution Share. It would be the Distribution Share alone for which all applicants could apply;
- (c) after the share issue, those who hold the Distribution Share will be able to act as follows:
  - (i) if pre-registered, customers and employees will be able to convert their Distribution Shares into shares of their particular distribution company by means of an Option Scheme. Sub-paragraph (g) below summarises the operation of the Option Scheme.
  - (ii) all Distribution Shareholders will be able to explode their Distribution Shares into the shares of the twelve underlying companies.
  - (iii) any holder of Distribution Shares will be able to continue to hold Distribution Shares for the life of the Distribution Share.
  - (iv) any holder of the Distribution Share could sell it intact.





- A price mechanism would be in force*
- (d) the Distribution Share should have a life of not less than five and not more than 10 years;
- (e) the Distribution Share itself would be priced at the time of the issue but the individual distribution company shares would not then be priced. Immediately trading starts, there will be 13 quoted securities: one for the Distribution Share and one each for the twelve company shares;
- (f) to allow the market to establish trading prices for the individual shares in the distribution companies, it will be necessary to allocate and publish at the time of flotation the later instalments for each of the individual companies as well as the Distribution Share.
- Offer to see for all customers (eg if all customers want to share)*
- (g) the Option Scheme would allow individuals to convert their Distribution Shares into shares in their local distribution company for a limited period commencing two weeks after the flotation (in order to eliminate any immediate trading volatility). Conversion would be on the basis of a market price for the relevant shares, such as the market price at the close of trading on the day on which the Option documents are received for processing. To overcome problems of imbalance between the demand for individual company shares resulting from the Option Scheme, the residual Government shareholding should be used to a limited and predetermined extent;
- (h) employees should be able to receive substantially similar benefits upon flotation as employees in other privatisations. Gifts of shares and matching offers by HM Government to employees could be effected directly in the shares of the relevant distribution company. Priority applications for employees would be through the Distribution Share with an option to convert in full;
- (i) the Distribution Share would be priced in the region of £10-15;
- (j) to encourage customers and employees to convert into their local distribution companies, HM Government could offer incentives such as loyalty bonuses and electricity vouchers only to those who convert under the Option Scheme.

In examining the KB proposal I focussed on five key criteria for a successful flotation:

- (a) Will it allow us to project a clear marketing message? I recognise that the flotation of the distribution companies will be the most complex privatisation flotation yet. I don't think that there is any easy way to market it but I do think that the Distribution Share route is as clear and straightforward as we can get. In particular TV and national media, which will be essential for the marketing





of the companies, have very different boundaries to the distribution companies and it will be most important there is a clear unified message to all members which will cross all boundaries. The Distribution Share is well suited to this. Lowe Bell and James Capel agree.

- (b) Will it allow us to maintain control of the privatisation process? Floating 12 companies at once is unprecedented and I am sure that if we are to succeed we must have very tight control. Some time ago, I agreed with the Area Board Chairmen that we would be selling all the Boards in one go. Since then they have pulled together and we have achieved the control we need. I am convinced that the Distribution Share proposal offers us the best way of keeping control of the process.
- (c) Will it achieve the privatisation? The KB proposal will privatise the distribution companies at once. I would be wary of a two-stage operation since the success of the second stage (and therefore of actually achieving privatisation) must in one way or another depend on the perceived success of the first stage and events in the mean time.
- (d) Will it achieve the widest possible share ownership? As I see it the KB proposal will, as well as drawing-in all the customers and employees who can be persuaded to invest in their local companies, also draw-in any small or large investors who may wish to invest in the distribution industry as a whole. Therefore the widest possible share ownership will be achieved - though I accept that customers will not be able to buy into their local company directly on day one.
- (e) Will it maximise overall Government proceeds? The KB proposal is for all the proceeds to result from the sale of Distribution Shares on day one. I believe that the use of this single instrument will enable us to price the issue at the very best level - leaving only a limited premium. This is clearly much more reliable than attempting to publicly price all 12 companies individually or spreading the offer over a month or more. KB's proposal will also enable us to take advantage of the dynamic pressures between the UK retail, UK institutional, and overseas markets to raise demand to the highest possible level. I feel that interplay between these three markets will be essential to the maximisation of proceeds.

*- 2 of the DS is v. heavy*

I have seen the proposals that Schroder Wagg have put to Nicholas Ridley on selling the water authorities simultaneously, as well as their criticisms of Kleinwort's paper. There are some detailed features of Kleinwort Benson's proposals that need refinement but I am confident that it provides a workable basis for a simultaneous flotation and I propose that further work on the flotation should proceed on the basis of Kleinwort Benson's proposals.





I recognise that there are differences between their approach and the one developed by Schrodgers. No doubt Nicholas Ridley will decide on the flotation process which will best meet his objectives. We will, of course, continue to work with DoE and Schrodgers to ensure that all technical differences are justifiable. However, there is one factor in the Schrodgers proposal that I would like to raise now; that of timing of flotations. The latest Schrodgers paper suggests that one option is for water to go in two stages in November 1989 and January 1990. They also suggest a possible need for a slot in April 1990. Clearly it is important for electricity that if water goes first it should be successful, but I would be seriously concerned about its impact on our marketing build up if water flotation was to be extended beyond Christmas 1989. My advisors advice is that this would make it virtually impossible to float electricity in the late Spring of 1990. The consequent delay to the remainder of the industry would jeopardise our plans to complete electricity privatisation this Parliament.

I am copying this to Nicholas Ridley, Malcolm Rifkind and Peter Walker.

Yours Ever,  
Cecil

CECIL PARKINSON



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*Thanks. I shd like FST's comments by close of play Mon. x an internal (HMT) mtg to discuss @ 9 am on Tues. M.*

CHANCELLOR

FROM: D J L MOORE  
DATE: 15 JULY 1988  
cc: Financial Secretary  
Sir P Middleton  
Mr Anson  
Mr Monck  
Mrs Lomax  
Mrs Brown  
Mr M Williams  
Mr Bent  
Mr Holgate  
Mr Tarkowski or  
Mr Lyne  
Mr Tyrie  
Mr Call

*These pps. are for your meeting on Tuesday - but you will want to see now.*

*JL 15/7*

**WATER AND ELECTRICITY PRIVATISATION**

1. At your meeting on 25 May it was provisionally agreed that all the Water Authorities should be sold in November 1989 and all the Electricity Area Boards in Summer 1990. Mr Ridley agreed to ask Schrodgers to try to develop a scheme for a simultaneous Water sale, and Mr Parkinson agreed to ask Kleinworts for further work on their Distribution Share proposal. The Welsh Office Minister is again invited because of the Welsh Water Authority. The Scottish Office have no direct interest but they have been given the opportunity to come so that they can be brought in to the privatisation debate in preparation for their own sale.

2. In his letter of 15 July, Mr Parkinson summarises Kleinworts' current conclusions and confirms that subject to further refinements the scheme for Electricity looks practicable. We agree with that, although, as explained below, there are a good many problems to be sorted out and in particular Kleinworts need to check urgently that certain key assumptions are acceptable to the Stock Exchange.



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3. Mr Ridley, in his letter of 14 July, reports that following Schroders' work he is convinced that it should be practicable to sell the Water Authorities in one go, though further work on the methods is necessary before this can be confirmed. He warns, however, that it is a high risk strategy, with uncertainties over the impact on proceeds and the promotion of wider shareownership. Schroders reject the Distribution Share approach (ie, the sale of Electricity industry shares with entitlements to shares in each of the 12 individual Area Boards). They recommend that the institutions should be required to buy a package, which bundles up some shares in each of the 10 Water companies, but that retail investors should be able to apply directly for an individual company. They see this as a much simpler proposition for the small investor than is the Distribution Share. The question is whether it could be operated successfully.

4. Both Kleinworts and Schroders advise strongly against the sale of individual companies to the small investor at the outset. They are worried about cherry picking and the difficulty of pricing 10 or 12 companies in a primary sale with the likelihood that prices would diverge sharply when dealing started. This could make it very difficult to underwrite the companies individually. And small investors in some regions could do badly. This drives Kleinwort to their Distribution Share solution and Schroders to a provisional proposal for a two part sale. The Water package would be offered to institutions in late November 1989 and there would then be separate sales to retail investors in mid January 1990 (4 weeks after dealings had started) by which time prices of the individual Water companies would have been established in the market.

5. We see very serious objections to splitting the Water sale. If we are right, Schroders either have to find an acceptable way for a simultaneous sale in November - under their own approach or by conversion to Kleinworts - or DOE have to back off and go back to consideration of selling Water in, perhaps, three slots, with consequent problems of fitting them in. But we do not recommend the imposition of Kleinworts' approach on Water. A sulky Schroders would be a recipe for disaster. And an unsuccessful

!!!  
What is  
the  
point?



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Water sale will damage Electricity. We have told DOE and Schrodgers that they may not have April 1990 as a reserve slot for any Water companies which miss the boat.

6. Mr Ridley wants to tell the Water Authority Chairmen now that it should be possible to sell the ten together even though it is too soon to go nap on the method. It is essential that he gets their commitment to working together on coordinated arrangements. But he still has a long way to go in finding a workable scheme and he will need to guard against the embarrassment of a retreat, should that prove necessary.

7. I have sent you a separate brief today on privatisation proceeds over the period. Energy accept the case for a partial sale of the Electricity industries. DOE continue to want 100% for Water. We think this is unacceptable; it would bring in too much proceeds and we see no case for treating Water differently from Electricity.

8. In the rest of this brief I summarise each of the proposed schemes and give our assessment of them. It is a long brief because the proposals are complex. Even so it is confined to the main points and there is a mass of important detail in the two reports that needs to be followed up. It is helpful that Schrodgers and Kleinworts have given each other a copy of their reports and it is important that they continue to compare notes. In judging the proposals we must acknowledge that both face a vastly more complex task, in bringing about the simultaneous sale of 10 or 12 companies, than in other privatisations. The sheer logistics make compromises necessary. Further market research is necessary and ideas will change. But there will be no escaping the size of the challenge and the risks.

ELECTRICITY

9. All applicants, institutions and retail alike, can apply only for Distribution Shares (DS). One DS, which would be valued at around £10-15, would represent an entitlement to one share in each of the 12 companies. Kleinworts suggest a minimum application of



£500, though this could be less. The DS will trade separately from the shares in the 12 companies which will be priced by the market when trading opens. The DS will have a limited life of about 5-10 years. This is partly because Kleinworts think the Stock Exchange would not agree to anything longer and partly because over time, as investors switch out of the DS and as the characteristics of the underlying companies change (eg, rights issues), it will become less and less useful.

10. After the sale, applicants can choose:-

- i. they can keep the DS;
- ii. or, they can sell it intact;
- iii. or, they can explode it into the shares of the 12 underlying companies and choose to sell some and to retain others.
- iv. or, small investors can opt for their own local company.

11. Kleinworts would prefer all small investors to switch out of the DS as soon as possible. To encourage this the Option Scheme provides for retail applicants, who have pre-registered, to opt to convert their DSs into the shares of their local company, but not into those of any other company. This scheme would be open for a limited period and Kleinworts propose that there should be bonus shares and vouchers to encourage takeup.

#### Advantages

12. Kleinworts argue that their approach has the following main advantages:

- i. HMG will be faced with one pricing decision, for the DS, rather than 12. If that decision is sound all retail investors should see some aftermarket premium on their DS. Whereas if there were applications for 12 separately priced



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companies, some retail investors could get premia and others either lower premia or losses, thus leading to complaints. (NB: in deciding on the underwritten price for the DS, a view may have to be taken on the likely price of each of the 12 companies; and it has yet to be established whether these assumptions would be disclosable and, if so, with what implications.)

ii. the marketing of the DS will be a national campaign directed to the virtues of the Electricity industry. This would avoid the chaos of 12 separate, concurrent and competing marketing campaigns - their idea is that local campaigns to encourage exercise of the options should follow in summer 1990 after the main sale in April/May. They also believe this approach would have much more appeal to overseas investors who are likely to be interested in the industry as a whole, rather than in particular Boards of which they have not heard. The logistics will also be easier, though still inevitably onerous. For example, they believe that on their approach the main prospectus could be 400 pages rather than a total of 1,000 pages if there were separate listings; the mini could be kept to 32 pages.

iii. The structure secures the tension between retail, UK institutions and overseas demand which is essential. It could accommodate clawback into the retail sector. It does not rule out the option of a partial tender.

iv. Because there would be one major campaign, and not a number of competing campaigns, they believe that HMG will get higher proceeds than otherwise.

These are powerful practical arguments in what is going to be an enormously complex sale. But it is not quite as simple as Mr Parkinson's confident letter might imply. We see the following main problems which need further thought.



Problems

13. First, the retail investor is severely constrained in his choices. If I live in the South West, and I want to invest in LEB only, I can wait and buy in the market or I have a choice of more indirect routes, eg, I could buy the DS, explode it, retain or increase my LEB holding and sell shares in the 11 other companies; while the arrangements will be designed to make this as simple and as cheap as possible, it cannot be a straightforward proposition. An alternative would be to modify the Option Scheme so that I could choose to opt for any one Board but not necessarily the Board in which I lived. (Preferably I could opt for more than one, but that might make things too complicated.) Kleinworts argue that this would detract from the objective of promoting ownership in local Boards and, by making it easier to move smoothly into a chosen Board, could add to the problems of some Boards being much more popular than others. According to taste this could be seen as a necessary constraint or as nannying. Market research may suggest that there is little retail demand for "other" Boards. But you might ask Mr Parkinson to consider, as part of the further work, whether a retail investor could opt for any one Board but would only get shares and vouchers if it were his own Board.

14. Second, the choice for the retail investor is not only constrained, but complex. When the option is exercised the instalments due on a particular company may well be different from those with a Distribution Share. While this is not an insuperable objection it illustrates one of the uncertainties Sid will face. Moreover, in the early days while the Option Scheme is in force, the price of individual companies is likely to be relatively volatile. So if I opt a week before my neighbour I could get a very different price from him. That may be a fact of life for an investor, but again it could lead to some unhappy Sids. It will be important to have market research into the likely response to these complexities, the impact on proceeds, and the possibilities for improvements. This research will influence, for example, the length of the period over which the option can be exercised and the instalment arrangements.



15. Third, it will be necessary to develop ideas for ensuring that retail shareholders shift out of the DS before it finally crumbles, and for accommodating those who would be happier holding on to shares in the industry in general rather than in particular Boards. It may therefore be necessary to have repeat offers of the Option Scheme - not necessarily with incentives - encouraging movements into individual Boards, and possibly to encourage one or two brokers to offer a facility for dealing in a packet of 12 separate shares or for converting some of them into a group stock. Again this is not unmanageable but it does of course imply a continuing cost, possibly falling on HMG. One possibility would be to encourage the development of some form of Electricity (or utilities) unit trust for those who want to continue with the industry as a whole. A continuing facility for a diversified holding could prove attractive to some investors if identification with local companies proved to be weak and if the companies' performance varied widely. But there may well be legal difficulties in this and you might not be attracted because it would not be genuine wider shareownership. Do you wish us to take this further?

16. Fourth, we must be satisfied that the dealing costs are not too onerous when retail investors explode their DSs and sell and buy to establish desired portfolios. Stamp duty exemptions are likely to be required (and Revenue will be putting advice to you on all the tax questions in the Autumn).

17. Fifth, we need to know much more about the consequences for proceeds, for Government holdings in individual companies, and for retail holdings of Kleinworts' proposals to deal with aftermarket imbalances in supply and demand for shares in the various companies. If substantial numbers of investors choose early on either to opt or to explode their holding, there will be a lively and possibly turbulent aftermarket in the individual shares. There could be shortages in the shares of companies in high demand and surpluses in others, and this could vary from day to day. To help deal with this Kleinworts propose that, assuming a partial sale, the Government should be ready to make some of its



retained holdings in popular companies available (at the going market price) and to take in holdings of shares in the more unpopular companies. To ensure that this does not lead to re-nationalisation of individual companies their provisional idea is that the Government might sell, say, 60% in each company and then be prepared to see its 40% residual holding in each rise in some cases to 49%, and in others fall to 30%. Kleinworts argue that such an operation would be preferable to leaving it to the market to settle the prices: if that happened, price movements could be too sharp. This is an area which we will need to probe much further. Quite apart from the uncertain impact on proceeds, we need to be satisfied that the Government would not lose on the swings and roundabouts of selling and buying back.

18. Sixth, secondary sales in, say, the early 1990s could be complicated. Some people may still be holding DSs then. But most, if not all, will be holding shares in the individual companies and HMG's holdings in those will need to be marketed separately. In other words it would seem difficult to recreate the DS approach.

WATER

19. Schrodgers reject the DS approach. They see it as a defective security because it would not have an indefinite life and in the long term could be uneconomical both for holders and for the companies whose shares underlie it; and they see it as too complicated for small investors, and therefore unhelpful to wider shareownership objectives. They and DOE are also influenced by the fact that the Water Authorities are insisting that they want to be sold as individual companies and not via a DS. (Our view is that if handled rightly they will do as they are told in order to get away.)

has limit to 49%

of water supply will be sold in the early 90s (our time to be signed)

no new or done k

also, chem path water



20. Schrodgers propose a two tier approach:

i. A package, at a composite price, of blocks of shares in each of the 10 Water companies. This package would be offered with a minimum application level of £5,000 ie, in practice to institutions and the very well off.

ii. Separate offers of shares in each Water company, aimed at small investors and employees. As with Electricity, these investors would have incentives to go for their local area and might well be confined to applications for it.

In principle these offers could be made simultaneously at the end of November 1989. But in practice Schrodgers currently think it necessary that the package offer to institutions should be at end November and that the separate offers to small investors should follow in mid January. This is because of the problem of pricing 10 separate Water companies in November before trading starts. They judge that inevitably there would be surges of buying in some and not others so that premia would vary and some small investors could make losses. (For institutions buying the package any discounts and premia stand a chance of balancing out.) Kleinworts are driven by this argument to the DS solution. Schrodgers conclude that they should wait until January for market prices to be established and then sell at some discount to those market prices. The market should be more stable and all applicants would have the prospect of a premium.

Comparison with Electricity

21. In both schemes the institutions would be in a broadly similar position. For Electricity they would have to take a DS with an underlying share in each of the 12 companies, and they could then keep it or explode and sell and retain selectively. For Water they will have a bundle of separate shares in each company and they can keep, or sell and retain selectively. The main difference is that the Water package will be relatively heavily weighted with those companies which it is judged will be more difficult to get away in the retail offer.



22. Electric Sid is offered a stake in the whole industry, though not indefinitely. Water Sid does not have this opportunity to invest in the whole industry. Both Sids are encouraged to buy shares in their local company and could be restricted to it. Electric Sid gets there by the more complicated route of the Option Scheme. Water Sid buys directly and so faces a simpler offer. Electric Sid should see a premium from his DS. So should Water Sid if his sale is in January. But he runs much more risk of a disappointing buy in November before prices have been established in the market and settled down.

The disadvantages of a sale split between November and January .

23. First, the received wisdom is that demand is generated, and keener pricing achieved, through encouraging tensions between potential institutional and retail applicants. If the Water sales were split, institutional investors in November would have much less feel for the likely demand and competition from retail investors in the following January.

24. Second, there is an obvious problem of managing the marketing and sale logistics over the Christmas period. In the six weeks from the end of November there would have to be regional marketing and mail shots. This campaign would be competing for TV time and for investors' attention over the Christmas and New Year period. Quite apart from these counter-attractions, the public will already have had the joys of water and sewage poured on them through the Autumn publicity campaign. Even if potential Water Sid is not bored stiff, mid January may not be a good time for him to find the cash. Moreover, by January the Electricity Distribution campaign will be getting underway and Sid may prefer to wait for the possibly more attractive Electricity sale. Energy are seriously worried over the thought of the Water campaign running on for so long.

25. Third, there are difficulties over the differences in prices and premia for the institutions buying in November and the small investors in January. Suppose the institutions get the package at 100p and suppose the equivalent market price in January is 120p.



It would be reasonable to offer the retail investor a price of around 110p - ie, the prospect of a premium of up to 10% if the market holds. But then he has done badly by comparison with the institutional investor who has a 20% premium. On the other hand, if DOE chose to let Sid have the shares at 100p they would knowingly have given away proceeds. With a split sale they cannot win on this count.

26. Fourth, it would very difficult to operate the now standard techniques of clawback in response to strong retail demand. If the institutions buy in November they will want to be free to trade their shares. If they have to sterilise some of them against the possibility of clawback in January we will face a cost, either through the price or through the underwriting arrangements.

27. Fifth, there would be serious underwriting complications in a split sale particularly if, as we propose, we are selling only 50-60% of the shares. Schroders propose that in November at least 51% of each company should be sold, and underwritten, to ensure that each is privatised. They would then put the remaining 49% on sale in January - not necessarily underwritten - for retail investors. We could therefore end up with 100% of each company sold, if the retail demand is sufficient. If we wanted to sell no more than 60% we would have to, say, sell and underwrite 30% in the institutional sale in November and a further 30% in the January retail sale (underwritten at a discount to the then market price). Underwriting costs in a split sale would probably be higher, And institutions could play the market in January to bring down the market price and therefore their underwriting liabilities.

A simultaneous November sale and other options

28. The objections to a split November/January sale forces us to ask why both Water tiers could not sold in November. But we are then back to the objection, strongly voiced by both Schroders and Kleinworts, that to price 10 or 12 companies at the outset is to ask for trouble. Small investors could suffer. And, under

*Handwritten note:*  
The same goes for assets



Schroders' proposals it could be difficult to have a partial sale because, while the package offer could be underwritten, the underwriters might shy away from individual companies in the separate offers; and we must sell and underwrite at least 51% of each company in order to privatise.

29. We conclude that either Schroders must do more work to convince us that November/January would work - and currently the objections seem overriding - or to convince themselves and us that a simultaneous sale in November would work.

30. Failing that, either they have to persuade themselves that Kleinworts' solution should be adopted for Water or we have to look again at the possibility of batch sales of Water taking up, say, three slots. Although on our current analysis we are forced to the conclusion that the Distribution Share approach is the answer to these problems it would be a mistake to twist the Schroder/DOE arm to adopt it. If they are compelled, but not convinced, they will not be motivated and this is a recipe for failure. To be cynical, if they are going to mess up Water it will be less damaging in its repercussions on Electricity if they are not using the same approach.

*Yes; but  
H. Morgan  
to water  
up; about*

*but some  
as share list  
Bas. to do*

31. Two slots for Water with five sales in each would not work because for those numbers it would be necessary to adopt the same techniques as discussed above. The most likely option would be three slots, each with three or four separate and roughly simultaneous sales on an orthodox basis. But then we are back to square one, and the problem that we have not got three slots available this Parliament, unless the Electricity sales cave in.

100% Or partial Water sales

32. We think Mr Ridley still wants a 100% sale, though his letter admits the possibility of a partial sale. This is partly because he believes that if HMG retains a holding it will be forced into a more active role in the event of an attempted takeover bid. But if he fears this he should be less shy of a Special Share. Schroders favour 100% because under their scheme



it is much more complicated to cater for a partial sale. DOE think that any Treasury problems of smoothing proceeds would be helped if we assumed that only, say, half the Water proceeds were equity and that the debt repayments could be deferred.

*possible*

33. Mr Ridley asks what proceeds you want from Water and when. We are assuming 3 equity instalments spread over 3 financial years, and it might help if debt repayments were deferred. But we cannot be precise on amounts. Our aim depends partly on what we are likely to get from the Electricity sales. We are also waiting for Schrodgers' revised estimate of total possible Water proceeds and for their assessment of plausible debt/equity ratios. They cannot mechanistically assume that 50/50 is acceptable. And if it were, a 100% Water sale, with no debt repayments in the period, would take us over your £5 billion target even if Distribution were at 60% and the other Electricity sales at 51% - see separate brief on privatisation proceeds.

34. Even if you were to conclude that some increase over £5 billion a year were acceptable there are serious objections to a 100% Water sale:

i. a major reason for partial sales is the difficulty of pricing a primary, and this will be eminently true for Water.

ii. If Water were 100% there is no obvious rationale for partial sales of the Electricity industries. The implication would be taken that the Government thought that they were a comparatively more risky investment. Energy appear to have accepted partial sales, but I cannot see that lasting if Water were 100%.

*depends on relative eqn & debt ratios*

iii. Unless our figures are ludicrously optimistic, 100% sales for all these industries would obviously take us far above £5 billion a year. We must take account of market capacity and appetite, and of the likely competing claims in this period from some of the Building Societies.



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35. We therefore recommend you to continue to insist on a partial sale of Water. You could say that you are very willing to look at 60% rather than 51%, but not 100%. We recognise that a 50-60% sale in November under the Schroders' scheme could raise serious problems on underwriting - and of course 51% has to be underwritten for each company to ensure privatisation. Schroders must now do a lot more work on this question.

CONCLUSIONS

36. Provisionally, we think the Electricity Distribution sale should be practicable on the lines proposed by Kleinworts. We recommend that you agree to further work, and in particular to urgent consultations with the Stock Exchange. (If they were not persuaded by Kleinworts' key assumptions the whole pack of cards could collapse). Mr Parkinson might report further in September. You could point out that there are a number of major points that we will want to follow up at official level - in particular constraints on retail choice, complexity, the handling of imbalances in demand for individual companies, dealing costs.

37. On Water we are much more worried. We recommend you to tell Mr Ridley

i. A split sale, November/January runs into serious objections.

ii. Therefore, Schroders should reconsider whether it is practicable to do a simultaneous sale in November. In particular they should do more work on the underwriting arrangements under the different options. And Mr Ridley should ensure this further work gets top level attention in Schroders - the present report, and recent work, seems to have been left to a good but junior director.

iii. If their scheme is impossible for November 1989, they will have to think of other options. They cannot have April 1990 as a reserve slot.



iv. In view of these uncertainties over the outcome, Mr Ridley should be cautious in what he says to the Water Authority Chairmen - no more than, we want a simultaneous sale in November 1989 provided a satisfactory method can be established.

v. We are not persuaded by the case for 100% sale of Water; he should continue to assume a partial sale though not necessarily of as low as 51%. We cannot give a simple estimate of what proceeds we want from Water. He needs to get an up dated estimate of the likely total and authoritative advice on what is a plausible debt/equity ratio.

38. You might ask both Mr Parkinson and Mr Ridley

i. to ensure that their two departments, and their advisers, continue to work together in comparing notes on technical points;

ii. that, in particular, there should be care in their approaches to the Stock Exchange. While it is alright for them to suggest different schemes it will not help either if the Stock Exchange are confused by apparently conflicting and contradictory approaches.

39. On the assumption that it is decided to go ahead with different approaches, the two departments and their advisers should work out an agreed line on how this would be explained and defended. For example, if the Schrodgers scheme were to go ahead, Energy and Kleinworts could be asked why they were going by the apparently more complicated Distribution Share route - and vice versa. Neither can answer by slagging off the other's scheme. So they had better construct an agreed line which points to some differences between the two industries which lead to different solutions.



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40. Finally, we would like to know whether you have any interest in encouraging some form of Electricity, or Water, or utilities, unit trust which would enable an investor to have a stake in the industry as a whole rather than in individual companies. This option need not be available at the time of the sale but it could be brought into play later on, and might be particularly helpful as the DS comes near to retirement. The obvious objection to this is that it is not wider shareownership. But it might have some appeal to some investors. Do you wish to encourage it, if the advisers thought that solutions could be found?

*up to the  
unit trust*

*D J L*

D J L MOORE





**CHANCELLOR**

**FROM: FINANCIAL SECRETARY**  
**DATE: 18 July 1988**

*Ch. See also Mr Call's  
note, behind.  
JK  
17/7*

cc Sir P Middleton  
Mr Monck  
Mr Moore  
Mrs Brown  
Mr Williams

**PRIVATISATION: WATER AND ELECTRICITY**

I have had a brief discussion with officials in advance of your meeting tomorrow. I have not had a chance to look in great detail at the Schroders/Kleinworts options, nor of course have I talked to the financial advisers directly. But I would make a number of preliminary observations:

(a) **Kleinworts Option for Electricity:** I think the distribution share approach is probably workable, although a great deal of further work needs to be done. Obviously, a major concern will be its complexity, and I think we need to bring in our PR consultants at an early stage. I am also concerned about the exact nature of the role the Government will be expected to play in the early days of the Option Scheme when the prices of the individual companies might be very volatile. I understand that the institutions will be expected to take up much of the strain or slack; but Kleinworts do envisage a situation where the Government might stand behind the market in some way. I don't think this would be acceptable at all.

(b) **Schroders Option for Water:** On Water, I am inclined to agree with officials that Schroders' proposed solution carries serious objections. I was initially attracted by its greater simplicity; but the problems



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outlined in Mr Moore's brief seem to me to be decisive. In particular, the disruptive effects of the Christmas holiday, the absence of any tension between institutional and retail investors, and the tightness of the overall privatisation programme for this Parliament which allows little room for flexibility in response to market conditions. There is the further point about the complications caused by the need to underwrite twice; but I am not convinced that the difficulties here are insurmountable.

2. I think that the main consideration for decision at this stage is a tactical one. It would certainly be a recipe for disaster if Schrodgers felt that we were forcing them to adopt the Kleinworts option. But I understand that they do accept that if Water were sold on a 51% basis, a Kleinwort-style simultaneous sale might be more attractive. So the objective would appear to be to get Schrodgers to come round willingly to the idea of a simultaneous sale in November next year; while at the same time making it quite clear that further work needs to be done by Kleinworts too.

Robert Sutherland (Private Secretary)

pp. NORMAN LAMONT



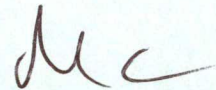
FROM: MARK CALL  
DATE: 18 JULY 1988

CHANCELLOR

cc Financial Secretary

WATER/ELECTRICITY PRIVATISATION

I can see considerable advantage in adopting a similar method of sale in the case of water and electricity. The idea of an exploding share, convertible into shares in one's local electricity distribution company is complex enough to market effectively. To attempt to sell simultaneously composite shares and separate offers of shares in individual WSPLCs could confuse Sid. Wouldn't it be sensible to adopt a similar exploding share mechanism in both cases?



MARK CALL





*by 30/9*

*by 29/9*

*by 26/9*

*pmf*

*by 22/7*

FROM: J M G TAYLOR

DATE: 18 July 1988

*by 20/9*

MR D J L MOORE

cc PS/Financial Secretary

Sir P Middleton

Mr Anson

Mr Monck

Mrs Lomax

Mr Sedgwick

Mr Brown

Mr Williams

Mr Hibberd

Mr Mowl

Mr Bent

Mr Lyne

Mr Call

Mr Tyrrie

*by [scribble]*

*by 12/9*  
*[scribble]*

**PRIVATISATION PROCEEDS**

*18/10*

The Chancellor was most grateful for your minute of 15 July.

2. He has commented that we will need to discuss this when we know more about where we stand on electricity and water.

*22/7 advised this will not - will do a further note.*

*[Signature]*

J M G TAYLOR





Thank  
Notes

Ch.

Water (+ electricity) privatisation

Jeremy Warner (the 'Independent') telephoned our Press Office this afternoon. He said that he understood that Mr Ridley had seen you this morning, and that the broad outlines of the water privatisation programme had now been settled.

In particular, he understood that it had been agreed that the Water authorities would be sold in one batch.

2. The Press Office said that we did not comment on the substance of confidential internal meetings.

3. Warner will no doubt run some story

~~that~~

/over



tomorrow. It was agreed, in any case,  
that Mr Ridley should indicate that  
in principle Ministers were disposed  
to sell the water authorities, and he  
will no doubt tell the water authorities  
this tonight. So no real harm  
done. But you will want to be  
aware.

AF  
19  
17



RESTRICTED



file AH/1  
 AH/1  
 AH/1

Mr Jessop

Ogs!

AH/1

FROM: A P HUDSON

DATE: 18 July 1988

MR JESSOP

cc. Mr. Houston (only)

Mr. Hudson,

Thanks, I agree. 'Getting on for two thirds' is correct and easier to say than 'around 65%', but for speeches I still prefer 'privatised' to 'privatisated'.

J.J.

cc PS/Financial Secretary  
 (with copy of Mr Jessop's minute)  
 Mr Monck  
 Mr D Moore  
 Mrs M Brown  
 Mr M Williams  
 Mr Gieve  
 Ms Simpson  
 Mr Houston  
 Mr Bent  
 Mr Tyrie  
 Mr Call  
 Mr Manoranjan CSO  
 Mr Dickman CSO

#### STATE SECTOR AND PRIVATISATION

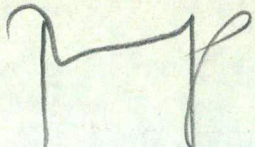
The Chancellor was grateful for your 4 July minute.

2. He would be inclined to say that "getting on for two thirds" of the 1979 State Sector will have been privatisated on completion of the current programme.

AH/1

A P HUDSON





FROM: P N HAYDEN  
DATE: 19 July 1988

- I agree*  
*J.D. 19/7*
1. MR DIXON
  2. CHIEF SECRETARY

cc ~~PS~~/Chancellor  
PS/Paymaster General  
Mr Anson  
Dame Anne Mueller  
Mr Luce  
Mr C W Kelly  
Mr Call  
Mr Sheridan

### PRIVATISATION OF PUBLIC SECTOR PENSIONS

You have received the attached letter (Flag A) from the Managing Director of the Public Sector Service Pensions Services Limited, suggesting that the provision of public service pensions might be privatised. They would like to discuss their proposals with you or officials. You asked for our views.

We have made various enquiries about this Company. No-one in Superannuation Division has heard of them. They are not listed in the National Association of Pension Funds directory, and we do not know what level of expertise they could offer in the public, as opposed to private, pension field. The substance of the letter is pretty thin. It merely asserts that large savings could be made, without even sketching out how they might be achieved. It is not, in our view, the basis for a discussion either with you or with officials.

We recommend that a short reply is sent, by this Division, asking for further details, so that you might be in a better position to know how they might be handled. A meeting at this stage would not be appropriate.

I attach a draft letter.

*Peter Hayden*

P N HAYDEN  
Superannuation Division



# PUBLIC SECTOR PENSION SERVICES LTD.

Pensions, Mortgages, Protection and Investment

Directors

JOHN MORAHAN

B.Sc.(Hons),M.Sc.,A.B.Ps.S.,M.I.T.D.,M.B.I.M.

CAROLYN CHARLESWORTH

B.A.(Hons),M.A.

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PRIVATE AND CONFIDENTIAL  
FOR THE ATTENTION OF THE CHIEF SECRETARY

The RT. HON. John Major  
Chief Secretary to The Treasury  
Parliament St  
LONDON  
SW1 3AG

28th June 1988

Dear Minister

Re: Privatisation of Public Sector Pension Arrangements.

We have recently been examining in depth the existing arrangements for Pension Provision throughout the Public Sector.

Our observations lead us to suggest that it would be advantageous to the Government and to its employees to examine our proposals for privatisation in this area.

Furthermore, we believe that we can stimulate genuine economic impact in several hard pressed regions of the country as a result of our policies being implemented.

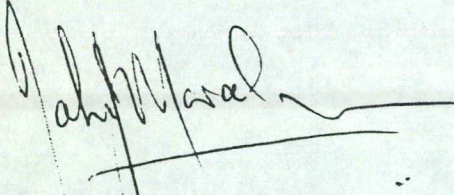
Considerable savings are possible as a result of a major privatisation exercise in this sector and I consider that the proposals we have are worthy of discussion at the highest level. I believe that the Cabinet would endorse the philosophy inherent in our proposals, and I would welcome an opportunity to discuss and explore the matter with you.



Could I be presumptuous and request a meeting with you and/or your senior advisors in order to conduct such an exploration.

I look forward to your reply on this.

Yours Faithfully

A handwritten signature in dark ink, appearing to read "John Morahan", written over a horizontal line. The signature is stylized and cursive.

JOHN MORAHAN  
MANAGING DIRECTOR



DRAFT

The Chief Secretary was interested in the ideas advanced in your letter of 28 June. He considers that the best way forward would be for you to write more fully expanding on your suggestions before he can take a decision on how your proposals might be handled.



pe2.bk/meb/mins 20

1. MR MOORE *D Wilson*
2. FINANCIAL SECRETARY

FROM: MRS M E BROWN  
DATE: 19 JULY 1988

cc      Chancellor  
         Sir P Middleton  
         Mr Anson  
         Mr Monck  
         Mrs Lomax  
         Mr Moore  
         Mr Ilett  
         Mr Williams  
         Mr Bent  
         Mr Guy  
         Mr Neilson  
         Mr Tyrie  
         Mr Call  
         Miss Wheldon (T.Sol)  
         Mr Hyett (T.Sol)

**RESIDUAL GOVERNMENT SHAREHOLDINGS: BAA AND OTHERS**

1. Lord Brabazon's letter of 20 June recommends an early placing of the residual BAA shares, worth around £30 million. At your request, Department of Transport have examined the possibility of a retail sale, but have concluded that it would not be cost-effective. Following receipt of Lord Brabazon's letter we asked Department of Transport to obtain legal advice on the options for a retail sale. This has only just been received: I am sorry that our advice has been delayed as a result.

2. In deciding your reply you will also wish to consider the options for disposing of other surplus holdings: Gas, BP and BA. The Chancellor of the Exchequer has commented that the BAA shares should be transferred to the Treasury for the Treasury to decide how to dispose of them. The present position is that Treasury controls major shareholdings (notably BT), where sales have been less than 100 per cent; but departments have retained the smaller holdings of shares which have proved surplus to bonus scheme requirements.



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Background

3. Lord Brabazon wrote to you in March recommending a quick placing with institutions of the 12 million surplus BAA shares (worth about £30 million: 2.4 per cent of BAA's total equity). You replied asking him to consider the possibility of a wider share ownership sale. DTP's advisers, County Bank, have prepared a report (copy attached) which concludes that an offering of around £30 million is too small to justify the costs involved. County, together with Cazenove, recommend an early placing. Sir Norman Payne is pressing hard for this too because he believes the Government's holding is overhanging the market, and because he is not keen on any further enlargement of his one million-strong shareholder list. Lord Brabazon and Sir Alan Bailey, the DTP Accounting Officer, are firmly persuaded that the share should now be disposed of as quickly as possible and in a way which DTP should defend to the PAC as being the most cost-effective.

4. There are two main routes for a retail sale:

- i. selling the BAA shares alone;
- ii. combining them in a package with other surplus privatisation shares.

Selling the BAA shares alone

5. The main options examined by County are:

(a) Offer for sale

This would involve a prospectus, and arrangements for the public to apply to a receiving bank for shares. County do not put precise figures on this but conclude that it would be costly (it would require advertising) and the shares would have to be priced at a discount to the market. There are value for money concerns about the use of this technique for a sale of the size envisaged.



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(b) Offer to existing BAA shareholders

This too would require some kind of prospectus and publicity. Costs should be somewhat less than for an open offer, since there would be a pre-defined audience, but would still be proportionally very high, given that an average number of 12 shares would be on offer to each shareholder. This approach would not widen share-ownership, but would deepen the holdings of existing BAA shareholders.

The remaining options involve financial intermediaries, who would either buy the shares as a block and sell them on, or act as distribution agents for the Government:

(c) Clearing banks

County base their advice on discussions with Natwest only. They envisage the Bank making available BAA shares to its existing customers (eg. by enclosing information with bank statements, or through regular contacts between branch managers and those customers who buy and sell shares through the bank). County are not enthusiastic about this approach. A bank would have to consider the legal propriety of 'peddling' particular shares in this way; there could be considerable administrative costs for which the bank would charge the Government; and the shares would have to be offered at a discount. The Government would also have to consider whether one or all the retail banks should take part. (This latter point should not in itself be an obstacle: a competition, based on maximising distribution and minimising fees, could probably be organised).



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(d) Building Societies

Legal advice from Allen & Overy is that, because of restrictions on investment activities by building societies, they would not (in the near future at least, and even after the proposed extension of their powers) be able to organise an offer of BAA shares.

(e) Stockbrokers

Private client departments would provide a smooth channel of distribution, but the shares would go only to sophisticated investors.

(f) Unit trust managers

They might be prepared to buy the shares (especially at a discount) for their portfolios. But this would not be a means of widening share ownership.

(g) PEP managers

County advise that most holders of non-discretionary PEPs have bought up to their limit for the year. So it would be necessary either to attract new PEP investors, and persuade them to opt for BAA shares; or to persuade existing investors to switch. Attracting new investors would be costly (it would require advertising) and more complicated than an open offer. Switching would be too costly for the investor and would not widen share ownership.

Selling BAA shares to PEP managers who have discretion over their funds is more promising. But County believe that in this case the number of shares available considerably exceeds likely demand. FIM comment that we would not want to force-feed PEP managers.

6. We agree with County's conclusion that all these routes appear too costly and/or raise other problems which rule out a retail sale of the BAA shares alone.



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A privatisation package

7. The other possibility is to sell a package of surplus privatisation shares.

8. The holdings are:

<u>Company</u>	<u>No of shares(m)</u>	<u>Price(p)</u>	<u>Total value (£m)</u>
Gas	50	185	93
BA	2.75	391	11
BAA	12	274	33
BP: bonus surplus (fully-paid)*	100	262	262
			—
			399
			—

\*assumes buyback of Bank of England partly paid shares.

9. The Treasury will add the Bank of England's 39 million partly paid BP shares to its holding of 61 million surplus fully paid BP shares this summer. After April 1989 all these shares could be sold fully paid. In addition, the Treasury Solicitor's advice is that there would be no problem in transferring the Gas and BAA shares to the Treasury. A transfer of functions order, subject to negative resolution, would be necessary for the BA shares.

10. Unless there were hopes for a package sale, the case for transferring back to the Treasury the residual BAA shares seems at best marginal. We think the same applies to the BA shares, given the size of the holding and the need for a transfer of



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functions order. These BA and BAA shares might lend a package offer of surplus privatisation shares more apparent variety, but in practice they would be more trouble than they were worth (any prospectus would have to give information about each company, yet the number of shares available would be comparatively few). We therefore recommend that DTp should retain the BA shares, and sell them as and when they wish to do so.

11. That leaves the BP and Gas shareholdings, amounting to about £355 million of the total £399 million. The BP shares are already held by the Treasury. There are no immediate plans to sell them, partly because of the residual impact of last Autumn, and partly because of the overhang of the KIO's shares. DEN currently have the Gas holding. They do not consider it opportune to sell at present while the MMC report on Gas is awaited. If these shares were transferred to Treasury, we would want to ensure that the responsibility for organising the outstanding Gas bonus and voucher scheme remained with Energy.

12. In considering whether and how the BP and Gas shares should be sold, the following points are relevant:

Method of sale

- Separate sales

We would have to choose between full-scale public offers: a rights offering to existing shareholders, which might deepen but not widen share ownership: or (if feasible) using clearing banks as intermediaries. We would rule out using building societies, brokers' private departments, and PEPs for the reasons given in paragraph 5 above;

- Simultaneous package sale incorporating Gas and BP, and possibly BAA and/or BA too if you did not agree that these should be disposed of separately.. The technicalities of packaging shares have been addressed by the Electricity and Water advisers. A permanent package is not likely to be viable, so the package would have to explode into the underlying shares. The package would have to be



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considerably larger than £250 to ensure that investors were not left with unrealistically small holdings of individual shares. In consequence, the wider share ownership appeal must be diminished. A third possibility is the formation of a privatisation unit trust. The Chancellor has indicated that he does not favour this approach in relation to water and electricity shares. Moreover, a substantial number of shareholdings (20+) are required to form a unit trust, so a small collection does not look to be feasible. A unit trust also has the disadvantage that people would purchase only the unit, and would thus have no direct interest in the underlying shares.

### - Timing

Any of these options would require publicity, and open offers - whether of individual or package shares - would require prospectuses and formal offer periods. A slot or slots would therefore have to be found in the privatisation programme. Water and Electricity will take up all available space from November 1989. Before that, there is Steel in November 1988.

A possible slot for a BP/Gas sale might be summer 1989, unless a BT sale were held then. We would also have to consider whether it was opportune to sell BP shares if KIO disposals were in train; and whether any building society flotations were planned at that time. But these considerations apart, we believe that there would be considerable risks to launching any kind of packaged sale before Water and Electricity. We want Kleinworts and Schrodgers to concentrate on developing a workable technique: bringing in a third cook on a BP/Gas package could spoil the broth. If the sale were not a success it could prejudice the much larger Water and Electricity sales. Distributing the surplus shares to retail buyers through clearing bank intermediaries might therefore be a more promising option. But this too would attract public attention, so the risk factor in advance of Electricity and Water would again have to be considered.



Conclusions

13. Four questions need to be decided:

i. whether to agree Lord Brabazon's recommendation that the BAA shares should be placed now with institutions, or to ask him to delay disposal until Treasury has decided what to do with all the privatisation surpluses. In view of the relatively small size of this holding and the likely costs of the alternative methods of sale we recommend you to agree a placing now. The BAA shares would not be transferred to the Treasury. We also recommend that, for the same reasons, the BA shares should be left with DTp to dispose of when they consider it appropriate;

ii. whether the Gas and BP shares should at an appropriate time, be sold to retail rather than institutional investors; and if so, whether by separate or simultaneous sales, or possibly by an offering to existing shareholders. Further work would be needed on any of these options, and you would probably want to keep the decision open for the time being. However, we consider that any public offering of the BP and Gas shares could be risky before Electricity and Water and it is not necessary for proceeds reasons.

iii. whether to transfer the Gas, BA and BAA holdings to the Treasury. Decisions on this rest largely on your decisions about disposal methods. As noted above, we recommend leaving the BA and BAA shares with DTp. If you want to leave open option of selling Gas shares to the retail market you may wish to transfer the Gas shares to us, whilst leaving open decisions about disposal methods. In this case, we would need to ensure that the responsibility for administering the Gas bonus and voucher scheme remained with Energy.



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14. Subject to your views on these questions, we will then provide a draft reply to Lord Brabazon.

15. This minute is agreed with FIM.

Mary Brown

MRS M E BROWN





The Rt Hon Norman Lamont MP  
 The Financial Secretary  
 Treasury Chambers  
 Parliament Street  
 London  
 SW1P 3AG

20 JUN 1988

*Norman Lamont*

MEMORANDUM  
 TO THE SECRETARY OF STATE  
 FROM THE SECRETARY OF STATE  
 DATE 19 JUN 1988  
 SUBJECT: BAA SHARES

EXCESS BAA BONUS SHARES

When we corresponded in March, you were unable to agree to early disposal of the BAA shares held by the Government which are not required for the loyalty bonus. Instead you felt that we should explore other methods of selling the shares with a view to furthering the Government's policy of widening and deepening share ownership. Now that the company has announced their preliminary results for 1987-88, and there is therefore no longer any legal objection to early disposal, we need to consider again the timing and method of disposal of our shareholding (which has now risen to 12.2 million shares worth about £33m).

Following our decision in March to postpone sale County NatWest were asked to advise on possible ways of introducing a retail element into the disposal of these shares. County NatWest's report considers a number of possibilities, including a direct offer for sale, and various ways of indirect disposal through intermediaries such as banks, building societies or PEPs funds. It has been seen by your officials, who have also attended a discussion of it with my officials and our advisers.

County NatWest's overall conclusion is that, while the options considered by them might do more to widen or deepen share ownership than a placement with institutional investors, all of them would involve selling at 5-10% below the market price, and significant additional costs for advertisers, advisers etc. (For example I gather that the cost of merchant bank advice on flotation of a company with a market capitalisation of £33m would be about £½m, whereas the cost of a placement is unlikely to exceed £150,000.) Because any of the methods (other than a full scale open offer) would be innovatory, considerable further work would be required



into the legal and logistical aspects before we could be sure any of them was workable. County NatWest consider that the disposal is likely to be too small to justify the costs which would be involved with any of these alternatives, and that the Government should therefore employ the placing route, which is also likely to be the most cost-efficient method. Cazenoves remain of the view that the Government should dispose of its shares as soon as would be consistent with securing adequate proceeds.

BAA understandably favour disposal by placement. On this point it is worth bearing in mind that, even after the second call, the company still has over 1 million shareholders, many with very small holdings. Any method of disposal of our surplus shares which lead to an increase in the size of their share register would therefore add to their costs, even though the original sale of BAA had already done much to further our policy on wider share ownership.

In the light of these considerations I remain firmly of the view that we should dispose of our surplus share holding by placement, as I had originally proposed. The costs and risks involved in any of the various alternative options considered by our advisers seem to me, and to my Accounting Officer, to be too great in relation to any possible benefits. If you are able to agree to disposal by placement, we shall consult BAA to make sure that there are no difficulties for them on timing. Subject to their views, however, I would propose to instruct our brokers to dispose of the surplus shares as quickly as possible by placing them with institutional investors. I also envisage that any further shares that may become surplus between now and the time when bonus shares become payable should be disposed of in this way as and when necessary.

*Wm W*

*Wm*

THE LORD BRABAZON OF TARA



# COUNTY NATWEST

*Johns.*

County NatWest Limited  
Drapers Gardens, 12 Throgmorton Avenue, London EC2P 2ES  
Switchboard: 01 382 1000 Telex: 882121 Fax: 01 638 4679

Direct Line 826 8618  
Switchboard Extension: 8618

JDD/2886H/js/78

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C Grimsey Esq  
Department of Transport  
2 Marsham Street  
London  
SW1P 3EB

26th May 1988

Dear Colin,

## Excess BAA Bonus Shares

You asked for our views on how a retail element might be introduced into the disposal of H M Government's holding of approximately 10.5 million BAA shares which are no longer required to meet bonus share entitlements.

Shares could be made available to the public either directly, by way of a secondary offer for sale, or indirectly, using an intermediary. We have not considered offering shares to present BAA shareholders as this will not lead to a widening of share ownership.

### DIRECT SALE

A secondary offer for sale would involve the production of a new prospectus, albeit in considerably shorter form than was required for the initial offering last July. The public would be able to apply for shares on an application form contained in the prospectus and share allocations would be determined on much the same basis as for the initial offering. In view of the anticipated size of the offering, it would probably be more cost effective to offer the surplus shares at a fixed price rather than incorporating a tender arrangement into the proposals.



In addition to professional fees this route is likely to involve considerable costs for advertising the offer and printing the prospectus, as well as receiving bank fees for the administration of applications. It would also require the full cooperation of BAA. The shares would presumably have to be offered at a discount to the market price to encourage the public to apply. For comparison, in the Cable and Wireless secondary sale in December 1985 shares were offered at a 5 per cent. discount to the (fully paid) market price.

#### INDIRECT SALE

There are certain organisations with access to a large number of retail customers which may be able to act as intermediaries for a sale. These include:

- (a) clearing banks
- (b) building societies
- (c) stockbrokers
- (d) unit trust managers
- (e) PEP managers

Arrangements could be put in place for the intermediaries to market the available shares to their customers. It would be necessary for H M Government to agree with the intermediary the basis on which this would be done with a view to achieving as wide a spread of share ownership as practicable. The intermediary could act either as principal or as agent.

We are concerned that the Financial Services Act 1986 may restrict the ability of certain of the intermediaries to market securities or to provide investment advice. This issue would need to be resolved with Allen & Overy at an early stage.

On the assumption that it is lawful for the intermediaries listed above to act as such we would comment further:

#### (a) Clearing Banks

The UK clearing banks are, by nature, conservative organisations and would need to be persuaded of the benefits which would accrue to them from distributing the shares. It would be a one-off distribution of a product unconnected with the bank which would probably mean that they would perceive there to be no long term strategic benefit to them from being involved. Consequently their attitude may well be that they would wish to recover all their costs from such an exercise. In addition to those costs which will occur whichever method of disposal is considered there will be the additional administrative costs in this situation of briefing employees at all the branches of the bank(s) being used and in coordinating the response of the public between the different retail outlets.



The computer based share dealing system operated in 245 National Westminster Bank branches (previously known as "Project Suffolk" but now renamed "Shade") could be made available to aid the administration of a sale. The system is real time and involves the immediate issue of a contract note or dealing confirmation, but requires that the investor has an account with National Westminster Bank. It may, however, be necessary for a certain amount of software reprogramming to take place and this could prove to be expensive.

We have not approached any of the other clearing banks for their views.

(b) Building Societies

A number of the comments made about the clearing banks also apply to the building societies. Although the building societies are trying to establish a presence in the retail banking market they traditionally do not have as close a relationship with their customers as the clearing banks. Nevertheless, because they are trying to break into new financial services markets they may be prepared to adopt a more aggressive approach than that which it appears the clearing banks are adopting.

(c) Stockbrokers

The use of private client departments of stockbroking firms by definition is unlikely to give HM Government an opportunity to widen share ownership. It may, however, give rise to a deepening of it. An attraction of using this route is that, because the potential investors are likely to be somewhat more sophisticated than those who would be approached by a clearing bank or building society, it may be possible to offer the shares at a smaller discount than may otherwise be the case. On the other hand it may be necessary to use a number of firms of stockbrokers in order to reach a sufficient number of investors. For example, NatWest Stockbrokers has approximately 7,500 private clients.

(d) Unit Trust Managers

Unit trust managers may be prepared to incorporate BAA shares into their portfolios. However, investors who own units in a unit trust are not regarded as being shareholders in the individual investments held in the trust portfolio. Consequently the objective of widening share ownership would not be achieved by this route.



HM Government may consider that the establishment of a privatisation unit trust, which would invest solely in privatised companies, would meet their objectives. It would be possible to argue that unitholders in such a unit trust were interested in an instrument representing only privatised companies and hence should be included in any statistics produced by HM Government on the number of shareholders in such companies.

(e) PEP Managers

The disposal of HM Government's holding of surplus bonus shares from the BAA sale and other privatisation issues may offer an opportunity to develop further the level of investment in Personal Equity Plans.

There are two broad categories of Personal Equity Plan:

- (i) non discretionary schemes, where the plan manager invests in whichever way the investor chooses; and
- (ii) discretionary schemes where the investor allows the plan manager to take decisions on his behalf.

From discussions with the NatWest PEP Office it would appear that the large majority of non discretionary PEPs under their management are subscribed fully up to the present limit of £3,000. As individuals are only allowed to take out one PEP in any calendar year it would probably be necessary for investors to sell current holdings in order to accommodate the BAA shares. This would, under the NatWest scheme, give rise to a charge of £5 plus commission at 1 1/2 per cent. of the value of the switch and stamp duty, presently at 1/2 per cent. of the value of the purchase. Consequently the investor would need a financial incentive to make such a switch worthwhile. It would also be necessary to take advice on the taxation consequences for a PEP holder making such a switch.

More fundamentally such a switch would neither widen nor deepen share ownership. In order to meet HM Government's objectives it would be necessary to encourage individuals who do not hold PEPs to take them out.

In the case of the discretionary PEP, the manager has additional responsibilities as it is he who decides whether an investment should be made in a particular stock or not. The manager would wish to put off his investment decision until the very last moment (thereby reducing what is still a considerable market risk) and this decision will be based, inter alia, on market conditions at the time the shares are available. This situation has caused problems in getting PEP managers involved in HM Government's privatisation programme to date. The agreement of a timetable with the reduction of exposure to market risk of PEP managers would increase the chances of the successful exploitation of this route.





Treasury Chambers, Parliament Street, SW1P 3AG  
01-270 3000

19 July 1988

Ms Deborah Lamb  
PS/Secretary of State for the Environment  
Department of the Environment  
2 Marsham Street  
LONDON  
SW1P 3EB

Financial Secretary  
Sir P Middleton  
Mr Anson  
Mr Monck  
Mrs Lomax  
Mrs Brown <sup>MR Moore</sup>  
Mr M Williams  
Mr Bent  
Mr Holgate  
Mr Tarkowski or  
Mr Lyne  
Mr Tyrie  
Mr Call

**WATER AND ELECTRICITY PRIVATISATION**

The Chancellor held a meeting this morning with your Secretary of State, the Secretary of State for Energy, the Financial Secretary, the Minister of State (Commons) of the Scottish Office and the Parliamentary Under-Secretary of State for Wales. Departmental officials were also present. The meeting had before it your Secretary of State's letter of 14 July, and the Secretary of State for Energy's letter of 15 July.

The Chancellor, opening the discussion, said that the proposed arrangements for privatising the Water and Electricity industries caused him some concern. These were the two biggest and most complicated privatisation exercises so far. The exercises were mutually inter-dependent for their success: failure in one would make it difficult satisfactorily to complete the other. The proposals were made more difficult by the intention to complete both privatisations within the span of a single Parliament. It was therefore essential that ways were found of minimising the risks involved.

Your Secretary of State said it would seem very curious to approach the privatisations with a different method of flotation for each. The advisers should be brought together, to devise one system which could be used for both privatisations. Flexibility for the Water privatisation should be retained. It was too early to decide now on the precise timing of the privatisations and on the method. It would be helpful, however, to announce this week that the intention would be to float the Water companies simultaneously. It would also be helpful to have a view of the volume of proceeds envisaged from the Water sales, and to know when these receipts would be





required. The answers to these questions would have a bearing on the method of flotation. The Chancellor shared your Secretary of State's view that it would be highly desirable to have the same method of flotation for both Water and Electricity distribution. The separate methods envisaged were each very complicated. Having the two together would make it even harder for potential small investors to understand.

The Secretary of State for Energy agreed that a single approach should be adopted. The proposals for Water caused two particular difficulties. First, there were obvious disadvantages with selling the industry in two tranches straddling the 1989 Christmas break. Second, if some of the Water privatisation were held over into January 1990, this would be too near to the marketing and the sale of Electricity distribution. Water should be sold in one go, before Christmas 1989. Your Secretary of State said that he currently envisaged a unitary debt/equity ratio. If total proceeds were £10 billion (and this was still a very uncertain estimate), selling 51 per cent of the equity would then raise a total of some £2½ billion equity; most of this might be raised from the institutions with, say, around £500 million from customers and employees. Even if the latter part of the sale were in January, this should not severely over-hang the Electricity privatisations. He would nevertheless prefer to complete the Water sales (whether in one or two stages) before Christmas. But the amount of preparatory work was such that this could not be guaranteed.

The Chancellor said that, as far as receipts were concerned, present plans envisaged proceeds of £5 billion a year in total. It would be desirable to stick to this programme. The debt/equity ratios were important for planning purposes, and the sooner they could be confirmed, the better. The sale of debt could be postponed until the next Parliament, but the ratio of equity to debt would be one of the major factors determining whether significantly more than 51 per cent of the equity would need to be sold in this. Your Secretary of State's present plans for Water would not be likely to encourage significantly the agreed policy objective of wider share ownership. It was important that the method of privatisation chosen would stand a good chance of enhancing this objective. A split sale did cause a number of significant difficulties, and it would be highly desirable to aim for a scheme in which there were a single date for flotation.

Your Secretary of State noted that, under the simultaneous flotation package envisaged by Schrodgers, there could be risks to the small investor if wider share ownership were pressed. Small shareholders in the less desirable companies would risk facing losses. The Chancellor noted that this could be counter-balanced by accurate pricing. If wider share ownership were not a major objective, the rationale of the privatisation could be cast into doubt. The regional nature of the industry would be part of the pitch. Under the Schrodgers scheme, only a





small discount could be defensibly offered to small shareholders in a January sale, with the result that institutions buying in November could do much better. This further encouraged the view that a single, common method of flotation for both privatisations should be established.

Your Secretary of State said he was easily persuaded that a common method of flotation should be devised. The package approach suggested by Schrodgers seemed, however, to involve less risks than the exploding share approach favoured by Kleinworts.

The Chancellor said that the advisers should be brought together, and asked to devise a single scheme with a single flotation date for each industry. The suggestion that individual small investors should be permitted only to buy shares in their local companies (as opposed to being encouraged to buy only those shares) should be reviewed. It would be important to arrive soon at accurate debt/equity ratio estimates for the proposed flotations of both industries. We would seek to provide guidance on the level of receipts required as soon as possible. Your Secretary of State could say, in the meantime, that the intention was to have a simultaneous sale of the Water companies.

It was agreed that the Chancellor would hold a further meeting, before the Summer break, with your Secretary of State and the Secretary of State for Energy, together with the merchant bank advisers, in order to steer them towards devising similar schemes for the two privatisations.

I am copying this letter to Stephen Haddrill (Energy), Ian Jardine (Scottish Office) and Jan Dominguez (Welsh Office).

*Yours truly*

A handwritten signature in dark ink, appearing to read 'J M G Taylor', written in a cursive style.

**J M G TAYLOR**  
Private Secretary





28/7

Treasury Chambers, Parliament Street, SW1P 3AG  
01-270 3000

20 July 1988

Michelle Cameron  
Diary Secretary  
Secretary of State for the Environment  
Department of the Environment  
2 Marsham Street  
London SW1B 3EB

cc: PS/Financial Secretary  
Mr Monck  
Mr D J L Moore  
Mrs M E Brown  
Mr M L Williams  
Mr Lyons

Dear Michelle

**ELECTRICITY AND WATER PRIVATISATION**

I am writing to confirm the arrangements we have made for a further meeting on Electricity and Water Privatisation, at 3.45pm, on Thursday 28 July in the Chancellor's room in the Treasury. Mr Parkinson and the Financial Secretary, will also be attending.

As I mentioned on the phone, we would like Mr Ridley and Mr Parkinson to be accompanied by their Merchant Bank Advisers and Officials. I would be grateful if you could let me know their names in due course.

I am copying this letter to Phillipa Jones in Cecil Parkinson's office and to Tony Lyons in the FST's office.

yours  
Julie

MRS JULIE THORPE  
Diary Secretary



pe2.bk/meb/min 8

- 1. MR MOORE — discussed in draft.
- 2. CHANCELLOR

FROM: MRS M E BROWN  
 DATE: 21 JULY 1988

- cc Financial Secretary  
 Sir P Middleton  
 Mr Anson  
 Mr Monck  
 Mrs Lomax  
 Mr M Williams  
 Mr Bent (or)  
 Mr Holgate  
 Mr Tarkowski (or)  
 Mr Lyne  
 Mr Tyrie  
 Mr Call

*Ch* / content for me to write as proposed?

*22/7*

*OK*

**WATER AND ELECTRICITY PRIVATISATION**

1. You are due to meet Mr Ridley and Mr Parkinson, with Schrodgers and Kleinworts, next Thursday 28 July. The purpose of the meeting is to ask the advisers to report back in September with joint recommendations on a common method of sale for water and electricity.

2. I attach:

(i) a brief, with points to make;

(ii) a draft Private Secretary letter, enclosing your speaking brief, together with tables showing the proceeds arithmetic for 100% and 51% sales. We think it important to give departments these figures, since Doe at least seem not to have put enough weight so far on our assumption that sales will be less than 100%.

*Mary Brown*

MRS M E BROWN



pe2.bk/meb/min 16

**WATER AND ELECTRICITY PRIVATISATION: BRIEF FOR MEETING ON THURSDAY 28 JULY****Introduction**

Mr Ridley will bring ..... from Schroders.

Mr Parkinson will bring ..... from Kleinworts.

) see list;

You might start by

- thanking the advisers for their reports on sale methods, which you have discussed with Mr Ridley and Mr Parkinson;
- explaining that the purpose of this meeting is to convey the decisions you and your colleagues have taken, and to ask for some further work;
- reminding them that there is an intensive privatisation programme to the end of this Parliament: 10 water authorities, 12 electricity distribution companies, followed by two generating companies in England and Wales and Scottish Electricity.

**Points to make**

(i) Ministers have agreed to plan for two simultaneous sales of water and the electricity area boards;

(ii) water will be first. Important to complete it in good time before run-in to electricity. Therefore aiming for a single water sale in November 1989, and electricity distribution in early summer 1990;



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(iii) main question is method of sale. Don't want to impose a solution. But having two complicated and different methods within 6 months of each other likely to confuse small investors. Highly preferable to have same method for each sale.

(iv) therefore want advisers to get together and make joint recommendations for a common method of flotation for both privatisations. Aim for report in early September. Should involve respective brokers, lawyers and PR advisers in this work. Hoping for agreed approach. But if necessary should set out alternative options, with agreed assessment of advantages and disadvantages of each.

(v) both sales should make a major contribution to wider share ownership. Sale method should take this fully into account;

(vi) do not favour split sale, as proposed for water. Difficulties in 2 sales for marketing, underwriting, and clawback - especially if straddle Christmas and New Year. Also too much risk that small investors will have to pay more than institutions - or be heavily subsidised by Government;

(vii) understand advisers also need guidance on amount of equity to be sold. This depends on amount of debt to be retained in privatised companies. Would like clear advice from both Schroders and Kleinworts on appropriate debt equity ratios for the two industries. Also best estimates of total proceeds. Accept that there are a number of uncertainties and such estimates will have to be reworked as we near flotation;

(viii) present judgement is that, to meet Government's target for privatisation proceeds, sales should be less than 100%. Advisers should make clear in report whether recommend any difference in sale methods if all, or only some, of equity is sold.

PE2

20 July 1988



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pe2.bk/meb/min 14

DRAFT LETTER FROM PS/CHANCELLOR TO PS/ENVIRONMENT SECRETARY

*Roger Bight*

**WATER AND ELECTRICITY PRIVATISATION**

1. I am writing further to Julie Thorpe's letter of 20 July
2. At their meeting with the Chancellor on 19 July, your Secretary of State and the Secretary of State for Energy asked for guidance on the level of proceeds which Treasury Ministers will be seeking from these sales. I enclose tables showing some proceeds arithmetic for 51% and for 100% sales based on the figures which your departments have so far given the Treasury for Water and Electricity. They assume three equity instalments for each of the major sales split approximately on a conventional 40:30:30 basis. The figures are understandably subject to a wide range of uncertainty. The tables can be updated as soon as we have more authoritative figures and, in particular, advice on what are plausible assumptions for debt/equity ratios. There may be some scope for more smoothing of proceeds between years. But at the moment if total proceeds are to be kept in the order of £5 billion a year, it seems clear that we are looking for partial sales both Water and Electricity much nearer to 51% than to 100%. On our present figures, 100% sales would present very heavy demands from a market in which appetite might still be weak, and which could also be facing large and attractive calls from some of the Building Societies. The confidentiality of these tables should be stressed to the advisers.
3. I am also enclosing the speaking brief which the Chancellor will draw on at next Thursday's meeting.
4. I am copying this letter to Stephen Haddrill in Mr Parkinson's office.

J M G TAYLOR



## PROCEEDS: Water and Electricity sales of 100%

	89-90	90-91	91-92	92-93	
Total in the Pipeline (including Steel)	3900	500	500	450	
Water	2000	1500	1500	-	
Distribution	-	2000	1500	1500	
CEGCO	-	3000	2000	2000	
Scottish Electricity	-	800	1200	-	
GENCO	-	-	2000	1500	1500 in 93-94
TOTAL	5900	7800	8700	5450	



## PROCEEDS: WATER AND ELECTRICITY SALES OF 51%

	89-90	90-91	91-92	92-93	
* Total in the Pipeline (including Steel)	3900	500	500	450	
Water	1000	750	750	-	
Distribution	-	1000	750	750	
CEGCO	-	1500	1000	1000	
Scottish Electricity	-	400	600	-	
GENCO	-	-	1000	750	750 in 93-94
<b>TOTAL</b>	<b>4900</b>	<b>4150</b>	<b>4600</b>	<b>2950</b>	

Assumptions:

		Equity	Debt	Total £billion
November 89	Water	5	5	10
Summer 90	E/Dist	5	2	7
Autumn 90	CEGCO	7	0	7
January 91	Scot/Elec	2	1	3
Summer 91	GENCO	5	1½	6½
		<b>24</b>	<b>9½</b>	<b>33½</b>

Note the totals, and the split between debt and equity, are still very provisional and uncertain estimates. The assumptions for Water are the provisional figures quoted at the Ministerial meeting of 19 July. The Electricity figures (other than Scottish Electricity) are, with rounding, those given to Energy by Kleinworts on 9 May.

\* This line provides for redemption of Gas debt in each year and for other smaller, miscellaneous proceeds. In 1989-90 there is the 3rd BP instalment and allowance for a second Steel instalment.




NOTES OF A MEETING HELD IN THE FINANCIAL SECRETARY'S OFFICE  
ON FRIDAY, 22ND JULY 1988 AT 4.00PM

Those present: Financial Secretary  
Jeremy Hanley MP

Philip Hardman - ICA  
Edmund Vidler - ICA

Mr Cayley - IR  
Mrs Smyth - IR  
Mr Sadler - IR  
Mrs Majer - IR



Mr Hanley explained that he had placed his amendments on behalf of the Institute of Chartered Accountants at the report stage of the Finance Bill but had withdrawn them in view of the lack of time available for the debate.

SECTION 79 - UNAPPROVED EMPLOYEE SHARE SCHEMES

Mr Hardman explained that the ICA had met with Mr Isaac and Mr Painter (IR) to discuss this subject and he asked that a further meeting could be arranged for further discussions. The Financial Secretary agreed.

Mr Hardman explained that the ICA would appreciate a clear statement on the exact interpretation of "an independant subsidiary". He was also concerned by the 7 year quarantine period on employees who have left their companies and face charges to income tax if, when and to the extent that value shifts preferentially into the employee - acquired shares.

The Financial Secretary explained that the purpose of this legislation was to stop abuse. He pointed out that Mr Hanley's amendment could be used as a golden handshake ie it would be easy for an employee to acquire restricted shares shortly before his departure on the understanding that the restrictions would be lifted 12 months later with a resulting increase in share value.



Mr Hardman disputed this suggestion and felt that it would be far better for the Employer to give a bonus (on which he would receive tax relief). He also pointed out that the alignment of IT and CGT rates had made this type of abuse less attractive. He felt that the whole rationale on Employee Share Scheme abuse should be re-examined.

The Financial Secretary agreed that alignment had made a difference in number of areas. He asked what the ICA's reasons were for their amendment to clause 83 on Information Returns - non resident companies.

Mr Hardman felt there were practical difficulties for a director in a foreign company to give certificates to foreign revenue authorities. He saw the clause in the finance bill as very confusing particularly for someone who doesn't speak the language.

Mr Cayley said that foreign language difficulties were familiar problems. He asked that the ICA provide details of actual problems faced before their next meeting with the Revenue.

### LOSSES

Mr Hardman referred to Mr Hanley's new clause 26 which would allow capital losses to be offset against general income and trading profits and also trading losses against capital gains. He thought there would soon be a wide spread demand for this.

The Financial Secretary emphasised that although both CGT and IT rates had been aligned; the actual taxes were still separate. It would be very expensive for the Exchequer to offset losses in this way and was therefore unlikely to be considered. He pointed out that in the USA (where they also have aligned tax rates) they do not allow cross-use of losses.

Mr Hanley asked what the cost would be. Mr Cayley said it would run into the billions of pounds. He also pointed out that to make this change would allow taxpayers scope to arrange to have capital losses to set against income (ie bed and breakfasting).



Mr Hardman said that there were a number of expenses for which there was no relief available (ie cost of terminating a lease) but which were genuine business costs.

#### REBASING AND ROLLOVER

Mr Hardman explained that there was a problem in that the new legislation requires valuations for three years between 1982 and 1988 to be made before relief can be given on gifts made.

He felt this was an excessive demand and that it would vastly increase the work load for valuation departments.

Mr Cayley said that the Revenue were aware of the problems and were trying to streamline the work in order to get the smaller cases dealt with as soon as possible.

The Financial Secretary pointed out that a valuation is already required for indexation purposes.

#### INDEXATION (TIME APPORTIONMENT)

Mr Hardman said that there was a disagreement as to when time apportionment should be carried out on the sale of a pre-65 asset (ie before or after indexation). He felt it was more equitable to time apportion before indexation. He wanted to see a test case in High Court to clarify this.

Mr Cayley felt that with 1982 rebasing it would not be worth changing the law as Mr Hardman suggested. He also pointed out that Mr Hanley's New Clause was retrospective and would mean re-opening a number of settled cases. However a test case would not affect the settled cases.

#### EXIT CHARGE - COMPANY RESIDENCE/MIGRATION

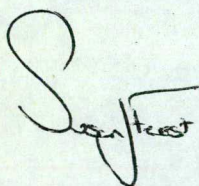
Mr Hardman explained that the ICA were seeking to abolish the provision which states that companies which cease to be resident in the UK will normally be deemed for CGT purposes to have disposed of their assets on migration (ie exit charge).



The Financial Secretary said he thought this point was a weak one and pointed out that no other representations had been made suggesting this.

Mr Hardman, in conclusion, said he was really looking at ways to simplify the tax system by examining the anti-avoidance provisions; accrued income schemes and close company apportionment.

The Financial Secretary said he would be interested to receive Mr Hardman's views on possible simplifications.



SUSAN FEEST  
22 July 1988

cc PS/Chancellor  
Mr Gilhooly  
Mr Cropper  
Mr Isaac  
Mr Painter  
Mr Houghton  
Mr Cayley  
Mrs Majar  
Mr Fawcett  
PS/IR



M Brown Mite Williams

(Mondy & more) 2 Bank

advisers  
+ advisers



FST  
Meredith  
Bank  
advisers  
support

C/ I understand you would like to hold a further meeting with Mr Ridley & Mr Parkinson & others, to discuss elect. & water privatisation, before the holiday. I have spoken to their offices & one possible time might be <sup>3.45pm</sup> ~~5.00pm~~ on Thursday 28 July. If this is too late another time might be 5.00pm on Tuesday 26 July but this time is not so convenient for Parkinson (especially), Ridley & us!

Content with 28 July at 3.45. 5.00pm?

OK  
Julie  
19/7.



CONFIDENTIAL

cc: Financial Secretary  
 Sir P Middleton  
 Mr Anson  
 Mr Monck  
 Mr Moore  
 Mrs Lomax  
 Mrs M E Brown  
 Mr M Williams  
 Mr Bent o/r  
 Mr Holgate  
 Mr Tarkowski o/r  
 Mr Lyne  
 Mr Tyrrie  
 Mr Call



Treasury Chambers, Parliament Street, SW1P 3A  
 01-270 3000

25 July 1988

Roger Bright Esq  
 PS/Secretary of State for the Environment  
 Department of the Environment  
 2 Marsham Street  
 London SW1

*Dear Roger*

#### WATER AND ELECTRICITY PRIVATISATION

I am writing further to Julie Thorpe's letter of 20 July.

At their meeting with the Chancellor on 19 July, your Secretary of State and the Secretary of State for Energy asked for guidance on the level of proceeds which Treasury Ministers will be seeking from these sales. I enclose tables showing some proceeds arithmetic for 51% and for 100% sales based on the figures which your departments have so far given the Treasury for Water and Electricity. They assume three equity instalments for each of the major sales split approximately on a conventional 40:30:30 basis. The figures are understandably subject to a wide range of uncertainty. The tables can be updated as soon as we have more authoritative figures and, in particular, advice on what are plausible assumptions for debt/equity ratios. There may be some scope for more smoothing of proceeds between years. But at the moment if total proceeds are to be kept in the order of £5 billion a year, it seems clear that we are looking for partial sales<sup>to</sup> both Water and Electricity much nearer to 51% than to 100%. On our present figures, 100% sales would present very heavy demands from a market in which appetite might still be weak, and which could also be facing large and attractive calls from some of the Building Societies. The confidentiality of these tables should be stressed to the advisers.

I am also enclosing the speaking brief which the Chancellor will draw on at next Thursday's meeting.

I am copying this letter to Stephen Haddrill in Mr Parkinson's office.

*J M G Taylor*  
*J M G Taylor*  
 J M G TAYLOR  
 Private Secretary



pe2.bk/meb/min 16

**WATER AND ELECTRICITY PRIVATISATION: BRIEF FOR MEETING ON THURSDAY  
28 JULY**

Introduction

Mr Ridley will bring ..... from Schroders.

Mr Parkinson will bring ..... from Kleinworts.

You might start by

- thanking the advisers for their reports on sale methods, which you have discussed with Mr Ridley and Mr Parkinson;
- explaining that the purpose of this meeting is to convey the decisions you and your colleagues have taken, and to ask for some further work;
- reminding them that there is an intensive privatisation programme to the end of this Parliament: 10 water authorities, 12 electricity distribution companies, followed by two generating companies in England and Wales and Scottish Electricity.

Points to make

(i) Ministers have agreed to plan for two simultaneous sales of water and the electricity area boards;

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(vi) do not favour split sale, as proposed for water. Difficulties in 2 sales for marketing, underwriting, and clawback - especially if straddle Christmas and New Year. Also too much risk that small investors will have to pay more than institutions - or be heavily subsidised by Government;

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PE2

20 July 1988



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<hr/>					
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					93-94
<hr/>					
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SCOTTISH OFFICE  
WHITEHALL, LONDON SW1A 2AU

28 JUL 1988

The Rt Hon Norman Lamont MP  
Financial Secretary to the Treasury  
Treasury Chambers  
Parliament Street  
LONDON  
SW1P 3AG

FINANCIAL SECRETARY	
REC.	28 JUL 1988
ACTION	Mr. Guy
COPIES TO	PPS, CST
	Mr. Ansell
	Mr. March
	Mr. Keenan

26 July 1988

Dear Norman,

SCOTTISH TRANSPORT GROUP: PRIVATISATION

Mr. Moore  
Mr. A.M. White  
Mrs. Brain  
Mr. Lutnam  
Mr. Tyne  
Mr. Cell

In order to take forward the privatisation of the Scottish Bus Group I would like to appoint financial advisers to see the sale of the Scottish Bus Group through to its conclusion.

Under the Treasury arrangements for the appointment of financial advisers, it is possible to reappoint the advisers responsible for the preliminary advice, without the need for any further competition, subject to Treasury agreement and subject to competitive fees being quoted. I would be grateful for your agreement to my taking this course and reappointing Quayle Munro as advisers for the sale of the Scottish Bus Group.

The reasons for my wanting to reappoint Quayle Munro are as follows. In my view Quayle Munro produced a very professional and satisfactory piece of work in the preliminary advice which they gave me on the form of privatisation of the Scottish Bus Group. Your officials were sent the main report but it was backed up by a full report on each individual subsidiary company and this formed the foundation for their overall recommendations. I think that this approach based on detailed investigation was a very sound one and the substantial work carried out as a result is a good foundation for them to provide advice on the full privatisation. Their work has given them a very good working knowledge of the Scottish Bus Group which would make them the obvious choice in any open competition.

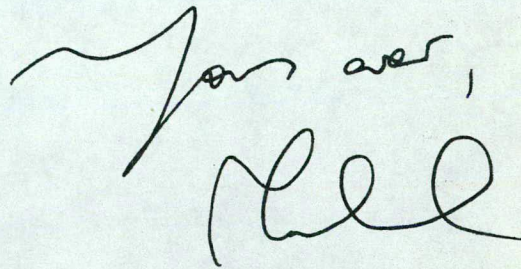
My officials have had discussions with Quayle Munro. The team which they will use for this will be the same as that for providing preliminary advice. They will add manpower to this and commit the team to the work of privatisation. They will also sub-contract to some extent to the accountants Ernst and Whinney. The sub-contracted amount will be possibly 25% of the total value of the work carried out. There will be separate appointments of property and pensions advisers just as there was in the case of the National Bus Company privatisation. This will not be part of the Quayle Munro contract.



I would intend to put a cap on the fees and to require that the rates quoted within this cap were competitive.

Given the scale of the Scottish Bus Group privatisation compared with the National Bus Company, I am confident that Quayle Munro can satisfactorily carry this out despite the fact that they are, by London standards, a small merchant bank. They have the knowledge and experience of the Scottish Bus Group built up on the first part of their remit, together with a wide experience of the Scottish situation. They also have experience of management buy-outs and trade sales of companies. They also have a clear view of the Government's objectives.

I would be very grateful to your agreement to my appointing Quayle Munro as financial advisers for the sale of the Scottish Bus Group on the basis I have outlined in this letter.

A handwritten signature in black ink, appearing to read 'Malcolm Rifkind', with a stylized flourish at the end.

MALCOLM RIFKIND





CH/EXCHEQUER	
REC.	27 JUL 1988 ✓ 27/7
ACTION	MR O MOORE
COPIES TO	FST SIR P MIDDLETON MR ANSON, MR MONCK MRS BROWN, MR M L WILLIAMS MR ILETT, MR BEAOT, MR TARKOWSKI MR LYNE, MR TYRRE MR CALL

PRIVY COUNCIL OFFICE

WHITEHALL, LONDON SW1A 2AT

26 July 1988

Dear Nigel

FLOTATION STRATEGY

I have seen a copy of Nicholas Ridley's letter to you of 14 July about the arrangements for the flotation of the water and electricity supply industries.

Both Nicholas Ridley and Cecil Parkinson have requested that their respective Bills be given Royal Assent before next year's Summer Recess (as indeed has John Moore for his Social Security Bill). While we shall naturally do everything possible to seek to meet these requirements, I think it would be quite unrealistic at this stage to guarantee that both the major privatisation Bills could be enacted by the summer. I shall certainly look to both Nicholas and Cecil to have their Bills ready for introduction at the very beginning of next Session and provided that this can be achieved and that the Bills are not subject to substantial policy alterations during their passage, I believe that we could be reasonably certain of getting at least one of them enacted before the end of July. But I am sure that for some time at least it will be prudent to have a back-up plan against the possibility of either, or both, Bills being delayed into next year's spillover.

In planning the handling of next Session's programme, it would be most helpful to have your advice on the relative priority, in terms of timing, to be attached to these two main privatisation Bills.

I am copying this letter to the Prime Minister, Nicholas Ridley, Cecil Parkinson, John Belstead, David Waddington and Sir Robin Butler.

*John Wakeham*

JOHN WAKEHAM

Rt Hon Nigel Lawson MP  
Chancellor of the Exchequer



Ch. Mr Parkinson's office did ring, but to suggest instead a pre-meeting between yourself, Mr P. +

FROM: M L WILLIAMS  
DATE: 26 JULY 1988

PS/CHANCELLOR Mr Ridley. This would be at 3.45, with the meeting with advisers put back to 4.00.

cc PS/Financial Secretary  
Sir P Middleton  
Mr Monck  
Mrs Brown  
Mr Lyne  
Mr Tyrie  
Mr Call

This seems sensible. Contact? OK.  
25 26/7

**WATER AND ELECTRICITY PRIVATISATION**

You may get a telephone call from Mr Parkinson's office about Thursday's meeting with the Chancellor, Mr Ridley and merchant bank advisers. Apparently Mr Parkinson feels that advisers should not be present at the meeting. Instead there should be a more political discussion between the 3 Ministers to form a view on the trade-offs between different objectives (notably wider share ownership and proceeds, but also on more technical issues such as the degree of importance attached to avoiding the risks of pricing individual companies in a simultaneous sale). Mr Parkinson envisages the respective Ministers subsequently telling the advisers the results of these deliberations, and asking them to produce their joint paper accordingly.

2. If Mr Parkinson's office does call to this effect, I would recommend that you argue that the meeting goes ahead as planned:

(i) It is important that the advisers hear Ministers' collective views at first hand. In particular there is a risk that, by talking only to their respective Ministers, they will fail to appreciate the problem - of particular concern to the Treasury - that there are two sales, bunched closely in time, which both need to be successful.

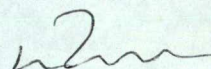
(ii) The political trade-offs were discussed by Ministers at last week's meeting (when the Chancellor emphasised the



importance of wider share ownership, the desirability of avoiding a split sale, and the need to avoid two complicated and different methods. They are implicitly further addressed in the briefing note circulated to Private Offices.

(iii) If the advisers need further guidance, Thursday's meeting will be a suitable opportunity, when at least they will both be getting the same message. We expect there to be some discussion of the issues.

3. If Mr Parkinson nevertheless feels need for some Ministerial discussion, you might like to offer him a telephone call with the Chancellor or a pre-meeting with the Chancellor and Mr Ridley before advisers are invited in on Thursday.



**M L WILLIAMS**





EXCHEQUER	
27 JUL 1988	
MR O MOORE	
FST, SIR P. M. ODETON	
MR ANSON, MR MONCK	
MRS BROWN, MR M. L. WILLIAMS	
MR ILETT, MR BENT,	
MR TARKOWSKI	
MR LYNE, MR TYRRE	
MR CALL	

PRIVY COUNCIL OFFICE

WHITEHALL, LONDON SW1A 2AT

26 July 1988

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I am copying this letter to the Prime Minister, Nicholas Ridley, Cecil Parkinson, John Belstead, David Waddington and Sir Robin Butler.

*John Wakeham*

JOHN WAKEHAM

Rt Hon Nigel Lawson MP  
Chancellor of the Exchequer



CONFIDENTIAL

FROM: M L WILLIAMS

DATE: 27 JULY 1988

CHANCELLOR

cc: Financial Secretary  
 Sir P Middleton  
 Mr Monck - o/r  
 Mr Moore - o/r  
 Mrs Brown  
 Mr Lyne  
 Mr Bent  
 Mr Holgate  
 Mr Call  
 Mr Tyrie

*Mr Parkinson's questions, as transmitted by his PS, were indeed the same as in the Kleinworts list, attached.*

*27/7*

**ELECTRICITY AND WATER PRIVATISATION: MEETING WITH ADVISERS**

1. I understand that Mr Parkinson's private secretary has indicated to yours the kind of questions that he may wish to raise with you and Mr Ridley at your premeeting tomorrow, before seeing the advisers. He is concerned that the advisers should be given as detailed political guidance as possible before they write their note, in order to avoid too many future iterations with Ministers.

2. Mr Parkinson's concern has been crystalised by Kleinworts who are distressed by the prospect that, not only may their previous work be aborted, but also they will not be able to firm up their proposals until after the arrangements for the water sale are agreed. If there is a presumption that similar sale methods are adopted, DEN are put at a disadvantage by being second. I suspect that Mr Parkinson's questions will be similar to the attached list, which Kleinworts have drawn up. It is of course a list of leading questions designed to elicit the response "It must be Kleinworts".

3. It will not be possible for Ministers to give the advisers unequivocal guidance about their political trade-offs; indeed it is part of the point of the present exercise that the advisers should put some numbers and judgements against the trade-offs so that Ministers can decide which method best meets the whole range



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of their objectives. That said, we do think that it would be helpful if the guidance to the advisers could be in the form of Ministerial "presumptions", since that would help to focus the next month's work and make it easier for Kleinworts and Schroders to work together. Most of the key points in this context are already in your speaking note, notably the importance of wider share ownership, and the desirability of avoiding a split sale, securing the benefits of institutional/retail/overseas tension and leaving a reasonable time gap between water and electricity.

4. Kleinworts at least will also want to press on the need to avoid separate pricing of all 10 or 12 companies in a simultaneous sale. They and James Capel have done some simulations demonstrating the difficulty of avoiding a wide range of premiums (and discounts), a reflection of the need to price the companies relative to each other in a narrow band of yields. This of course is the fundamental difference between their and Schroders' sale method. You may wish to acknowledge these difficulties, which are indeed of concern to us. But part of the point of the further work should be for the advisers to agree a statement of the risks, and how these might be avoided.



**M L WILLIAMS**



Draft: 26.7.88

*(prepared by Kleinwelts).*

QUESTIONS TO BE ADDRESSED AT THE MINISTERIAL MEETING

ON 28TH JULY 1988

- Do Ministers wish each sale to take place on a single day, or can the institutional and individual offers be separated?
  
- Do Ministers believe that Water should be completed by Christmas 1989?
  
- Would Ministers accept a scheme requiring the pricing of individual companies at the time of flotation?
  
- Do Ministers wish individuals to have the right to purchase an interest in the entire industry?
  
- Do Ministers wish to have overseas issues?



CONFIDENTIAL



DEPARTMENT OF TRANSPORT  
2 MARSHAM STREET LONDON SW1P 3EB

My ref:

Your ref:

The Rt Hon John Wakeham MP  
Lord President of the Council  
Privy Council Office  
68 Whitehall  
LONDON  
SW1A 2AT

H/EXCHEQUER	
REC.	28 JUL 1988
ACTION	FST
COPIES TO	

28 JUL 1988

29/7

**PRIVATISATION OF LOCAL AUTHORITY BUS COMPANIES**

In your letter of 26 May about the possibility of including our local authority bus company privatisation provisions in next Session's Legislative Programme, you explained that QL did not see any scope for this because of the pressures on the programme. However, you said that the Committee would be prepared to consider the matter again if I or other colleagues were able to offer compensating reductions. I think that we can.

As you know, one of my Department's Bills scheduled for next Session is the Ports Bill. Having checked the position with the Cabinet Office Secretariat in the light of your letter we have discovered that it has been allocated space on the basis of the original bid for a "substantial" Bill, i.e. 25-50 clauses. However, you will recall that when we considered the policy, colleagues decided that it would be preferable to go for a much narrower Bill. The effect of this decision is to reduce the Ports Bill to only 10 clauses, thereby achieving a significant saving which should more than offset the 10-odd clauses required for the local authority bus company privatisation provisions.

I have no strong views on which would be the most appropriate vehicle for the provisions. I would be happy to promote a free-standing Bill if you feel that the handling problems of including them in either the Transport (Scotland) Bill or the Housing and Local Government Bill really are too great. However, it seems a pity not to use the opportunity of one of these Bills when the bus company privatisation measures would fit so well with either. In particular, I wonder whether the difficulties of including the provisions in the Scottish Bill are really as considerable as has been suggested. I have had a chance of discussing this with Malcolm Rifkind, and I understand that, as the Bill is already a controversial measure, it would not be suitable anyway for the Scottish Grand Committee Procedure and no additional time would be required on the floor of the House.

CONFIDENTIAL



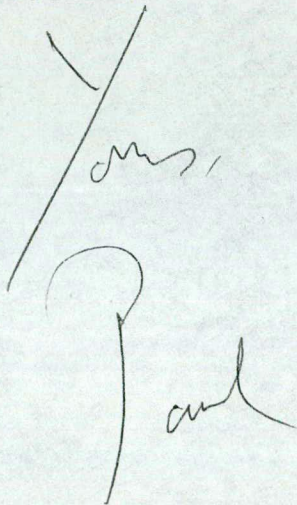
CONFIDENTIAL

Moreover, I take it that there could be political advantages in diluting the wholly Scottish nature of the Bill, thus relieving the pressure on our Scottish back-benchers - although it would clearly be appropriate for Malcolm to remain in the lead.

Malcolm Rifkind would like to defer taking a final decision on the privatisation of the Scottish PTCs until later in the Autumn, as there is a possibility that at least some of the PTCs in Scotland will be sold on a voluntary basis creating an atmosphere in which others might follow suit. What we would propose is that Parliamentary Counsel be instructed to draft provisions on a contingency basis. If you are content, these contingency provisions could be drafted so as to cover the English and Welsh PTCs as well as the Scottish ones (which should not cause any significant problems). We would expect there to be one set of identical provisions of about 10 clauses. If Malcolm then decides that he does not need provisions to privatise the Scottish PTCs, I would hope for agreement in principle now that room should be found for these provisions elsewhere, if necessary as a free-standing Bill.

I hope that QL will find this acceptable. The important thing is to ensure that the local authority bus companies in England and Wales, as well as in Scotland, are privatised as soon as possible, and we should not lose the opportunity of early action. Officials from my Department, the Scottish Development Department and the Welsh Office have discussed the form which the provisions should take, and I am content that provisions can be drafted along the general lines proposed in the paper circulated with my minute of 19 February to the Prime Minister and other members of EA, although there are some tricky issues which will need a little further thought, especially on enforcement.

Copies of this letter go to members of QL, Malcolm Rifkind, Peter Walker and Sir Robin Butler.

A handwritten signature in dark ink, appearing to read 'Paul', is written over a large, light-colored scribble or mark.

PAUL CHANNON

CONFIDENTIAL





FROM: FINANCIAL SECRETARY

DATE: 28 July 1988

CHANCELLOR

*Thanks. I agree with Rose conclusions, in partic. the formula used for a primary offer. 2. To conclude @ X was head for country & JBS & JBS, & via New & Schroder & Lehman.*

- cc Economic Secretary
- Sir P Middleton
- Sir G Littler
- Mr Monck
- Mr Scholar
- Mrs Lomax
- Mr Ilett
- Mr Moore
- Mrs Brown
- Mr Neilson
- Mr Williams
- Mr Bent
- Dr Kosmin
- Mr Barker
- Mr Cropper
- Mr Call

**PRIVATISATIONS: FORMULA PRICING AND UNDERWRITING**

I have discussed with officials the wider shareownership implications on formula pricing, and some of the other issues raised in Mr Moore's paper of 27 May.

**Formula pricing**

2. The wider shareownership implications of a move to formula pricing are set out in the attached note by FIM. The main conclusion is that it looks much more attractive for a secondary offer than for a primary offer. Even in a secondary offer I see some danger that formula pricing might take the excitement out of an offer, with fewer stags, a less positive press reaction, and thus fewer smaller investors. That said, I believe a formula priced secondary offer could be made to work, and be marketed effectively. Formula pricing has worked in Japan. But there was no floor price in the Japanese sales, and I have asked officials to look at whether we could dispense with the floor price, since it could be a significant barrier to marketing a formula price sale to small investors.

*John Smith - it, NK, this? can we see the...*



3. My conclusion is therefore that formula pricing should be retained as an option when next we do a secondary offer.

Offer structure

I also briefly discussed some of the other issues in Mr Moore's minute of 27 May:

i. Following BP, it is vital that we spread the international underwriting more widely, as PE propose.

ii. We must seek to avoid having to firm place any shares in future sales, though this may prove difficult on Water.

X | iii. We should use the BP-type tender with clawback (as opposed to the BAA tender) with clawback as the model for the Water and Electricity sales. I see no reason why this structure should not be compatible with what we have in mind for those sales.

  
NORMAN LAMONT



CONFIDENTIAL

p4

FROM: M J NEILSON

DATE: 20 July 1988

1. MRS ~~LOMAX~~ RL 22/7
2. FINANCIAL SECRETARY

cc Sir P Middleton  
Sir G Littler  
Mr Monck  
Mr Scholar  
Mr Ilett  
Mr Moore  
Mrs Brown  
Mr Williams  
Mr Bent  
Dr Kosmin  
Mr Barker  
Mr Gropper  
Mr Call

### PRIVATISATIONS: FORMULA PRICING

The Chancellor has asked you to consider the wider shareownership implications of any move to formula pricing (Mr Taylor's minute of 15 June). This note sets out FIM's thoughts.

2. The position looks very different for primary and secondary offers. Formula pricing will also tend to have a different impact on long-term investors and stags. From a wider share ownership view point, our main interest is in potential long term investors. But there is a continuing question about whether we need stags for an offer to be successful.

### Secondary Offers

3. In a secondary offer there is already a market price for the share, which can be used to set the initial discount, and to maintain that discount if prices move. This should make it relatively straightforward to organise and market a formula priced offer.

4. In theory, the long-term investor could be put off by either complexity or insufficient premium, but:

- it should be possible to explain a formula priced offer



quite simply to unsophisticated investors. The straightforward message would be that investors will receive shares at a [5%] discount to the market price when the offer closes. With the memory of BP still fresh, this could be presented very positively as offering something to investors as much as to vendors. The message would be slightly complicated by including a floor price, which would also create a risk that the "guaranteed" discount might be eroded.

- it is possible that genuine long-term investors are only attracted into an offer if media coverage suggest that there will be a reasonable premium. But this is more a question of how large a discount is set, rather than an argument against formula pricing per se. All formula pricing does is remove unintended premia as a result of market movements.

5. Formula pricing might well reduce staggings. In a secondary offer stags will look at movements in the market price to see whether the premium will be large enough to make staggings worthwhile. Thus for a secondary offer stags might be put off relative to a normal fixed price offer, but only if the market price rises significantly during the offer period. In general, the right approach would seem to be to decide whether stags constitute a necessary element of demand for an offer, to set the discount at the level necessary to attract them (if they are wanted), and then to use formula pricing to ensure no unintended windfall premiums.

### Primary Offers

6. In a primary offer there is no market price to use as a benchmark either for pricing the offer, or for establishing a discount. There are thus two elements of uncertainty - the original pricing decision, and movements in market prices after the price is set. Formula pricing can only deal with the second difficulty and then only by reference to a price index, such as FTSE 100 - a much more complex concept than an identifiable market price for a single stock. Arguably, however, the uncertainty about the pricing decision is far more important than the market movement uncertainty - so the benefit of formula pricing may be outweighed



by the cost in terms of greater complexity.

7. The offer could not be marketed as giving a guaranteed [5%] premium - if the pricing decision is wrong the offer could go to a large premium, or to a large discount, even if the price is linked to an appropriate market index. Most inexperienced investors would have to rely on press commentators, who should be able to grasp the interaction of the two factors. But it is not clear that potential investors would be willing to trust those commentators if they could not themselves understand the offer.

8. The potential stags would no doubt be able to understand the complexities. They would apply if the likely premium (allowing for any mis-pricing) was sufficiently attractive.

### Conclusion

9. On wider share ownership grounds formula pricing thus looks quite workable for secondary offers, but rather more problematic for primary offers. It would certainly make sense to try it for the first time for a secondary offer, such as BT next Summer. Once it has been tried on a secondary offer we should be in a better position to judge whether it would be workable for primary offers.

### Other implications

10. A move to formula pricing raises a number of other subsidiary issues:

i. If formula pricing is introduced for a secondary offer, producing a pre-determined discount at the end of the offer period, this would highlight the need to minimise the gap between the end of the offer period and the date when investors receive the RLAs (2 weeks for BP). This is because one major attraction of formula pricing for a secondary offer would be the certainty of a given discount to the market price - a long delay before trading can begin exposes the small investor to the risk that the market price might fall before they can trade, and might thus require a higher discount



to attract investors.

ii. Formula pricing without a floor price might reduce the tendency to apply at the very last moment. But with a floor price applications are likely to be left till the last minute.

iii. We do not see high transaction costs as a barrier to introducing formula pricing. In any secondary offer there is always a risk that, if allocations are small, the commission costs of selling would be larger than the discount. Once more, it is a question of how large the discount has to be to attract investors; formula pricing only removes unintended premia. This is not to say that high commission costs on small allocations do not constitute a serious problem generally, rather than in relation to formula pricing.

#### **Formula pricing in Japan**

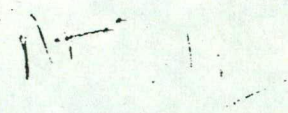
11. As you may know, the Japanese Government has used a variant of formula pricing in recent secondary offerings of shares in both NTT and JAL. They did not use formula pricing for the primary offer of NTT shares in October 1986, but, interestingly, they used an approach with some similarities to that proposed by Schroders for the water privatisation.

12. The primary offer for NTT was in two stages. There was an auction in October 1986, with participation by both institutions and large scale private investors. A weighted average of successful bids was then used as the price for a normal fixed price public offer (though with a price per share of over £5,000). The fixed price offer took place in mid-November. Shares were allocated in early January with share certificates arriving at the end of January.

13. The secondary offer for NTT took place between November 10 and 12 1987. It was announced in advance that the shares would be priced at a discount of 3.5% to the closing price for NTT on November 9. But applications could be made from October 9 onwards, in the knowledge of what the discount to the market price would



be. This way of structuring the offer did not involve setting a floor price.

  
M J NEILSON





Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon Paul Channon MP  
Secretary of State for Transport  
Department of Transport  
2 Marsham Street  
LONDON SW1P 3EB

29 July 1988

*Don Paul*

**PRIVATISATION OF LOCAL AUTHORITY BUS COMPANIES**

1. You copied to me your letter of 28 July to the Lord President.
2. I strongly support your objectives of taking powers to privatise Local Authority bus companies as soon as possible. Although there are still questions to be settled on the appropriate legislative vehicle, I hope that John Wakeham will now feel able to give you the drafting authority which you are seeking.
4. Copies of this letter go to members of QL, Malcolm Rifkind, Peter Walker and to Sir Robin Butler.

**NORMAN LAMONT**





SECRETARY OF STATE FOR ENERGY  
THAMES HOUSE SOUTH  
MILLBANK LONDON SW1P 4QJ

01 211 6402

BF3/8. JMG

EXCHEQUER	
DATE	02 AUG 1988 ✓ 2/8
ACTION	MR D MOORE
COPIES TO	FST, SIR P MIDDLETON MR ANSON, MR MORCK MRS BROWN, MR M L WILLIAMS, MR ILETT, MR BENT, MR TARKOWSKI, MR LYNE, MR TYRRE, MR CALL

The Rt Hon Nigel Lawson MP  
Chancellor of the Exchequer  
HM Treasury  
Treasury Chambers  
Parliament Street  
LONDON  
SW1P 3AG

29 July 1988

Dear Nigel,

I have seen a copy of John Wakeham's letter to you of 26 July about the timetable for the Water and Electricity Privatisation Bills.

I appreciate the difficulties that the Business Managers have to face in coping with a heavy legislative programme for the next session. But I have to say that I, and I am sure you and other colleagues, am seriously concerned at the suggestion that it may not be possible to secure passage of these Bills by the end of July 1989. It is essential to the timetable of the whole privatisation programme that both these Bills be given the highest priority. Failure to secure the passage of either by next summer would imperil the flotation of the Area Boards in early 1990, and make it extremely difficult to complete the sale of the whole electricity industry this Parliament.

This is because there are a great number of steps which need to be completed before vesting but which cannot be taken before Royal Assent. These include approving the schemes for the allocation of the CEGB's and the Electricity Council's assets, negotiations on the capital structure of all 15 successor companies, decisions on the X factor for the distribution companies and setting up a complex regulatory body. It would be extremely difficult, if not impossible to fit all this in between the spillover and 1 January 1990. If vesting and the first flotation had to be delayed, it would affect subsequent privatisations and would probably mean that part of the industry would be kept in the public sector until the next Parliament. That is why our overall timetable for electricity has always been based on Royal Assent in July 1989, as I made clear in submitting my original bid for a place in the legislative programme.





We are well up to our timetable, and have met our commitments to Parliamentary Counsel. I hope that you will agree that it would be premature, at this stage, to delay our plans.

I am copying this letter to the Prime Minister, Nicholas Ridley, Malcolm Rifkind, John Belstead, David Waddington and Sir Robin Butler.

Yours Ever,  
Cecil

CECIL PARKINSON



C.C. FST  
Mrs BROWN  
MR Williams.*+Internals'*

Treasury Chambers, Parliament Street, SW1P 3AG  
01-270 3000

29 July 1988

*PPF*

Roger Bright Esq  
PPS/Secretary of State for the Environment  
2 Marsham Street  
London SW1

*Dear Roger***WATER AND ELECTRICITY PRIVATISATION**

The Chancellor, together with your Secretary of State, the Secretary of State for Energy and the Financial Secretary held a meeting yesterday with the advisers. Departmental officials were also present. A note of that meeting is enclosed.

Before the meeting, the Chancellor had a preliminary discussion with the other Ministers. The key points made in that discussion were:

- (i) it was agreed that each of the sales should take place on a single date;
- (ii) it was agreed that we should not, at this stage, give up the idea of individual pricing of companies. On the one hand, it was noted that individual pricing would permit individuals to invest with the hope of an early premium. It would also assist local marketing. This could help to promote wider shareownership. On the other hand, there were considerable difficulties in accurately pricing each company. Although each company was, in large measure, effectively "gilt edged" - which should make pricing easier - the absence of a significant private sector in utilities in the UK created difficulties. The taxpayer's interest in accurate pricing had also to be borne in mind;
- (iii) although individuals should be encouraged to invest in their local company, they should be permitted to apply for shares in any other companies if they wished. Encouragement to invest in local companies could be provided by direct incentives eg bill vouchers.

I am copying this letter and enclosure to Stephen Haddrill (Department of Energy).

*JMG Taylor*

J M G TAYLOR  
Private Secretary



**CONFIDENTIAL****NOTE OF A MEETING HELD IN THE CHANCELLOR'S ROOM, HM TREASURY  
AT 4.00PM ON THURSDAY 28 JULY 1988**

Present: Chancellor of the Exchequer  
Financial Secretary  
Mrs M E Brown  
Mr M L Williams

Secretary of State for the Environment  
Mr Brown (DOE)  
Mr Broadbent )  
Mr Challen ) Schrodgers  
Mr Drayton )

Secretary of State for Energy  
Mr Guinness (Depart. Energy)  
Mr Barker )  
Mr McCarthy ) Kleinworts

Mr Henderson (Slaughter & May)

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**WATER AND ELECTRICITY PRIVATISATIONS**

The Chancellor, opening the discussion, thanked those present for attending the meeting. Ministers had read with much interest the reports prepared by Schrodgers and Kleinworts, and had discussed the proposals amongst themselves. They had reached certain conclusions, one of which was that further work was required. He stressed the vital importance of the Water and Electricity privatisation programmes. It was essential that both should be successful. The timetables would be very tight, and the details of each privatisation must be got absolutely right. It was particularly important that the arrangements for the Water privatisation were ideal - since that privatisation would be going ahead first, its success or failure would overshadow the rest of the programme.

2. The Chancellor said the intention was that the Water sale should take place in November 1989, with the sale of the Electricity distribution companies in early Summer 1990. Both privatisations would be far more complex than previous flotations



of nationalised industries. It was therefore considered essential that the same method of sale was used for both. Wider shareownership was a principal objective of the Government in relation to both sales. A lot of effort would therefore need to go into explaining the method of sale.

3. The Chancellor said that the advisers should now get together and report back in six weeks with a method of sale which was appropriate for both privatisations. If it were impossible to agree on a single method, they should jointly set out the two approaches favoured, and the pros and cons of applying each method to each privatisation. Ministers would then need to decide on that basis which approach to follow. It would be far preferable, however, for the advisers to come up with a single recommendation. The Secretary of State for the Environment noted that any differences between the methods of sale for each industry could only be justified by the differences between the industries themselves.

4. The Chancellor said that each sale must take place on a single day. The split sale, suggested by Schrodgers for the Water privatisation, raised insuperable difficulties. The report should also advise on whether individual pricing of the companies at the time of the offer was practicable. In principle, individual pricing was desirable. But it would need to be examined whether the problems created by individual pricing could be overcome. The proportion of equity to be sold would depend, first, on its valuation and, second, on the capital structure of the companies. The reports should both provide a general valuation of the equity, and guidance on what the advisers thought what would be a reasonable capital structure. It was highly unlikely that 100 per cent of the equity would be sold, but the proportion might well be more than 51 per cent. The advisers would also wish to specify whether different assumptions about the debt/equity ratio affected their recommendations on the methods of sale.

5. The Secretary of State for Energy agreed that wider shareownership was a key consideration. Incentives should be built into the offer to encourage individuals to invest in their local



companies. A single day sale was vital. Substantial overseas sales would be required for Electricity, and the sales method must allow for this. Water privatisation must be capable of implementation by end 1989, to leave a clear path for the Electricity sales. The Chancellor noted that it was essential to appeal to both small shareholders and to institutional investors. Different aspects of the method adopted might need to be emphasised to appeal, respectively, to individuals and institutions. The Secretary of State for the Environment said that the main attraction for individual investors in past privatisation was the possibility of the shares going to a premium. This should be taken fully into account in the Advisers' considerations.

6. In discussion, the following points were made:

- (i) the advisers should come forward with the best approach, as seen from the Government's point of view;
- (ii) it was noted that the shares of the individual companies would almost certainly go to different premia or discounts. The advisers' report should make an assessment of the consequences of individual pricing in this respect. The possible ranges should be discussed, and advice given on how far these were tolerable;
- (iii) regardless of which approach was recommended, clawback from the institutional offer to the retail offer should be included as a firm option in the report;
- (iv) marketing would, to a large extent, need to be focused on each industry as a whole, rather than its individual companies. But local companies would also be promoted in their own areas;
- (v) although individuals should have incentives to invest in their local boards, they should certainly not be prohibited from investing in other companies if they wished. It was desirable that they should also be able to invest in the global shares, as well as the retail shares. But it was for consideration whether any investment in the global shares should be time limited and, if so, for how long.



The Chancellor, summing up, invited the advisers to submit a report on the lines discussed within six weeks.



J M G TAYLOR  
Private Secretary

29 July 1988

Circulation:

Those present  
Sir P Middleton  
Mr Anson  
Mr Monck  
Mr D J L Moore  
Mr Tyrie



CONFIDENTIAL



FROM: J M G TAYLOR

DATE: 1 August 1988

A large, stylized handwritten signature in the top right corner of the page.

PS/FINANCIAL SECRETARY

cc PS/Economic Secretary  
Sir P Middleton  
Sir G Littler  
Mr Monck  
Mr Scholar  
Mrs Lomax  
Mr Ilett  
Mr Moore  
Mrs Brown  
Mr Neilson  
Mr Williams  
Mr Bent  
Dr Kosmin  
Mr Barker  
Mr Cropper  
Mr Call

**PRIVATISATIONS: FORMULA PRICING AND UNDERWRITING**

The Chancellor was grateful for the Financial Secretary's note of 28 July.

2. He agrees with the Financial Secretary's conclusions, and in particular that formula pricing should not be used for a primary offer.

3. He has commented that the conclusion that we should use the BP-type tender with clawback as the model for the Water and Electricity sales will need to be conveyed to DOE and DEn, and thence to Schrodgers and Kleinworts forthwith (if this has not already been done).

A handwritten signature in the bottom right corner of the page, appearing to be 'J M G Taylor'.

J M G TAYLOR



COVERING CONFIDENTIAL

FROM: H R G GIBBON  
DATE: 1<sup>st</sup> AUGUST 1988

*PMF*

- R Burt*
1. MR BENT
  2. PS/FINANCIAL SECRETARY

cc PS/Chancellor  
PS/Chief Secretary  
PS/Paymaster General  
Sir P Middleton  
Mr Anson  
Mr Monck  
Mr Scholar  
Mr Moore  
Mr Culpin  
Mrs Brown  
Mr Williams  
Mr Lyne  
Professor Griffiths (No 10)  
Mr Call

PRIVATISATION BRIEFING BOOK

I attach a copy of the latest version of the Briefing Book. This replaces the edition dated 30 March 1988.

*H R G Gibbon*

H R G GIBBON





CH/EXCHEQUER	
REC.	02 AUG 1988 ✓ 2/8
ACTION	MR D MOORE
COPIES TO	FST, SIR P MIDDLETON
	MR ANSON, MR MORCK,
	MRS BROWN,
	MR M G WILLIAMS,
	MR ILETT, MR BENT,
	MR TARKOOSKI, MR LYNE, MR TYRIG MR CALL

2 MARSHAM STREET  
LONDON SW1P 3EB  
01-212 3434  
My ref:  
Your ref:

The Rt Hon John Wakeham MP  
Lord President of the Council  
Privy Council Office  
Whitehall  
LONDON  
SW1A 2AT

| August 1988

*Dear John*

#### FLOTATION STRATEGY

I have seen your letter of 26 July to Nigel Lawson.

On 20 July, I announced our intention that there should be simultaneous flotation of all ten successor companies to the water authorities. We are clear that we have to target November 1989 for this flotation. In order to hit this target, the Water Bill will have to receive Royal Assent no later than the end of July. If Royal Assent were delayed until October, it would be impossible to move through the vesting and appointment of the successor companies to the issue of prospectuses and the marketing of the offer for sale in time for a flotation the following month. *I think water must have priority to get through before next years Long Run.*

I am copying this letter to the Prime Minister, Nigel Lawson, Cecil Parkinson, John Belstead, David Waddington and Sir Robin Butler.

*James  
Nicholas*

NICHOLAS RIDLEY



# dti

the department for Enterprise

*Paul*

**CONFIDENTIAL**

The Rt. Hon. Lord Young of Graffham  
Secretary of State for Trade and Industry

The Rt Hon John Major Esq MP  
Chief Secretary to the Treasury  
HM Treasury  
Parliament Street  
LONDON  
SW1P 3AQ

**Department of  
Trade and Industry**

1-19 Victoria Street  
London SW1H 0ET

Switchboard  
01-215 7877

Telex 8811074/5 DTHQ G  
Fax 01-222 2629

Direct line 215 5422  
Our ref PSLBGQ  
Your ref  
Date 3 August 1988

CHIEF SECRETARY	
REC.	- 4 AUG 1988
ACTION	Mr Burgner
TO	Cx Sir Phillip Mr Anson, Sir Wilson, Mr Mansel, Mrs Case, Mr Turnbull, Mr Robson, Mr Walker, Mr Call, Mr Mason, Mr James Mr Bradley, Mr Elias

*John*

## NEL PRIVATISATION

As you know, when announcing on 7 June the outcome of my review of the DTI's research establishments, I invited organisations with experience of carrying out R&D to make proposals by 22 July to develop NEL within the private sector. We have now received nine bids for NEL, including one from the management of NEL itself. My Department is now evaluating these bids with the aim of deciding by mid August which one offers the best prospects for privatising NEL.

However, before the Department can negotiate with a potential new owner of NEL, we need to resolve a major difficulty due to the likely cost of redundancy payments. NEL has some 624 staff who are all established civil servants, covered by the Principal Civil Service Pension Scheme. Payments for redundancy are automatically triggered by the PCSPS upon termination of employment and transfer outside the civil service (eg, to the new owner of NEL) unless an employee resigns or leaves voluntarily. The trade unions and staff at NEL can be expected to be well aware of the position under the PCSPS.





the department for Enterprise

In some earlier privatisations, the provisions of the PCSPS relating to redundancy were overridden by legislation. However, there is no opportunity for legislation in the 1988/89 Parliamentary Session to deal with NEL. This leaves four main alternatives: (a) to make redundancy payments to all NEL staff not offered jobs in the civil service; (b) to seek legislation in the 1989/90 Parliamentary Session; (c) to consider NEL as a candidate for an executive agency, or (d) to close NEL.

I have considered what would be involved if all NEL staff transferring to the new owner received redundancy payments (ie, in addition to those actually made redundant and not re-employed). This would enable us to go ahead with maximum speed. The cost in the first year following privatisation would be about £8 million - offset by any cash proceeds from the sale - and subsequent compensation payments (paid annually) totalling £19 million over a number of years. I would need to bid for extra provision to meet these costs in the PES period although I might be able to offer some compensatory reduction in funding from NEL. If costs were to be incurred in the current year, I would be prepared to meet these from my Department's provisions. It would enable us to offer the NEL to bidders clear of inherited redundancy obligations to the staff, which should be more attractive to bidders. We could respond to any criticism of apparently over-generous treatment of civil servants by pointing to the particular circumstances of NEL and its very difficult market prospects.

Legislation does not offer a practicable way forward. A delay, for example, before legislation in the 1989/90 Parliamentary Session and hence privatisation in nearly two years time would lead to a collapse of morale and skilled staff leaving as well as loss of interest by the current bidders. In these circumstances, we might have to consider closure of NEL which in itself would of course lead to the payment of the full redundancy liability and would be highly unwelcome in Scotland. Nor would it be possible to force civil servants to accept secondment to a new owner before a Bill were to take effect. In any case with legislation, bidders would almost certainly argue that HMG should underwrite the obligation relating to the period of employment in the civil service.

If we do not continue with privatisation, we would have a serious problem. We could not keep NEL in a state of uncertainty on its future much longer. It might be possible to explore the extent to which NEL could become an executive







the department for Enterprise

agency with the public sector. However, this option is not straightforward given the need for a framework in which NEL would flourish, including pay flexibility if it is to attract professional staff with a high level of marketing and technical skills to succeed in competition in the private sector. Furthermore, an agency would pose difficulties for the policy of having done within Government only that work needed for Government (ie, for policy, regulation and procurement).

I will look at the position in mid August when all the bids have been properly studied. More details of the evaluation will be circulated by officials following discussions with the bidders. But my preliminary view on the evidence so far is that the management buy out bid may well prove attractive. NEL would continue to offer a wide range of technology transfer capabilities to industry with approximately 500 employees. Despite transitional funding and redundancy payments the costs to the Exchequer over five years would be less than the costs of NEL on its current programme and offers a good return on DCF calculations with no liability for government funds. If the MBO turned out to be the best bid, the special circumstances might help us to minimise the danger of setting a difficult precedent of paying redundancy for other privatisations.

I would be grateful if I could have an indication of your initial reaction and those of colleagues to this letter by 10 August. I would like to be able to announce then that we have selected the best bid and that we are continuing to negotiate with this bidder still with a view to establishing whether privatisation of NEL could be achieved on acceptable terms. If we can find a way forward on the redundancy payment issue, I would want to make a more definite announcement on privatisation of NEL in September.

I am copying this letter to the Prime Minister, Malcolm Rifkind, Nicholas Ridley, Paul Channon and Cecil Parkinson and to Sir Robin Butler.





10 DOWNING STREET  
LONDON SW1A 2AA

From the Private Secretary

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prof

Think pots are  
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2  
3/8

Dear Jonathan

I enclose a draft book review by Alan Walters, which he has sent to No.10 for clearance. Nigel Wicks and I have looked at this, and can see no problems with it. I should be grateful if you could cast a very quick eye over it as well and let me know fairly quickly if it causes you any difficulty.

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Amy

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P. A. Bearpark

Jonathan Taylor, Esq.,  
H.M. Treasury.



Review - Doc Name: Vickers  
6 to 8 double spaced pages  
25 July 88

*Nigel Wright*  
*A review for*  
*the journal Regulation*  
*AW*

Privatization: An Economic Analysis  
by John Vickers and George Yarrow

This book is one of a series on the regulation of economic activity. The first four chapters are devoted to a review of what the authors regard as the relevant theory for the study of incentives, ownership, competition and regulation. So far as I could see, although it is a competent survey of the literature, there are no new insights. The main contribution, however, in chapters 5 to 11, is the description and analysis of the Thatcher privatization program in the United Kingdom.

One of the remarkable characteristics of virtually all the major elements of Mrs Thatcher's economic reform program has been the mass opposition by academic economists. The notable outcome of the Thatcher reforms has been the considerable political and economic success of the program. Privatization is no exception; indeed the success of privatization in Britain is serving as a model for many other countries. But it is not beyond the abilities of academic economists to <sup>argue</sup> show that it has been a dismal failure and that their prognostications of disaster will be borne out sometime in the future. The book concludes with the forecast that "...the Government is undermining the long-run success of privatization in Britain."

On the whole however, the authors approve of the privatizations into the competitive sector. (Oddly enough the authors do not consider the biggest and most successful privatization of all, that of public housing being sold to sitting tenants.) They complain about the way it was done - particularly



that they were sold too cheaply, redistributed wealth in the "wrong" way etc. (Incidentally I will give a prize to anyone who can show me a privatization program where the opposite allegation is made!). They say that the exchequer gave up valuable revenue by selling shares at a discount (and adding shares as a loyalty bonus) to the small shareholder and particularly the workers. Anyone with a knowledge of marketing will see such a criticism as suspect. Moreover, ensuring that the shares were bought and held by the workers and small shareholders reduced the probability of renationalization and virtual expropriation by some future (socialist) government. Such an insurance against future socialist predators, of course, enhanced, perhaps greatly, the value of the shares. And if one took account of the "externalities" on parallel and future privatizations, the effects of such underpricing become even more apparent. Give-aways maximise !. The authors display similar naivete at many points in their exposition. For example they argue that one of the main reasons for privatization was to reduce the Public Sector Borrowing Requirement (PSBR) in order to meet target levels. All those involved, including the Prime Minister, has no such illusions about the difference between public spending and asset sales; we may have been illinformed, but I do not think any of us were as misguided as the authors so confidently assert. (2)

Quotable? X → Their real complaints, however, are levelled against the privatization of the great utilities (Telecom, Gas, Airports and the incipient privatizations of Electricity and Water). "Too cheap" of course, but also they believe that too much monopoly power was left in the hands of the new corporations, and that such monopoly power was not suitably curbed by the new regulatory systems. I think that they are right in complaining about the constraints on competition in telecommunications and gas, but their complaints need to be put into a realistic rather than idealist framework. For example, the authors clearly think that



13  
it would have been better to break up British Telecom on the lines of the Baby Bells. But they do not mention any cost in so doing. When I was Mrs Thatcher's advisor, I can testify that all the relevant ministers, including the Prime Minister, were very keen on such a break-up. But we were eventually convinced that, because of the need to allocate liabilities and assets and prepare separate accounts, such a move would take at least two, perhaps three, years to implement. And with the need to search for a new political and economic "window of opportunity", this would have delayed privatization even longer. In effect telecom would have remained nationalized. Similarly since I was involved peripherally in the deal that induced the BT competitor, Mercury, to commit itself, I find the discussion in this book quite innocent of the central issues that there arose. It is also clear that there is much more competition in telecommunications than was thought conceivable at the time of transfer of ownership.

2 |  
But their big bone of contention is the regulatory system. Their discussion of competition concludes with a wonderful non sequitur, namely that where potential competition cannot exist and "...where the threat of entry simply does not exist and cannot be made to exist. Direct regulation of the dominant firm is then required". (p.61) Then after a very long discussion of the theory of regulation, there is only a general outline of the government's administration of the nationalized industries. In a series on regulation this is rather odd. Even more surprising is the fact that, since they place such faith in regulation, they did not discuss the actual consequences of regulatory systems. As many scholars, such as Walker in Britain and Nelson in the United States, have shown, regulation in the transport industries over a history of almost 150 years has virtually always had the opposite effects to those intended. This nettle is neither exposed nor grasped. Nor do the authors tell us how the covert system of regulation worked in any of the other



nationalized industries.

(4)

The reader will also find no discussion of the enormous changes in management and administrative structure that precede and accompany privatization. For example British Telecom had been run like a government department with cash accounting only and rigid functional lines of responsibility. There is no mention of the enormous reorganization required to equip this behemoth with a modern management structure and suitable internal incentives for efficiency.

Perhaps the most surprising omission is any mention of the first great privatization in 1954-56 - authorized in the Transport Act of 1953 - of the nationalized trucking industry. One would have thought that this provided ideal conditions for the study of privatization. The regulatory system remained unchanged, and we have a long history (almost 30 years) when we can surely examine the long run effects of a change in ownership which the authors rightly regard as so important. Indeed since part of the industry (the National Freight Corporation, see page 161) remained in public ownership until 1982, when it became one of the financially most successful privatizations, one also has some sort of cross section comparator. Rather parochially the authors do not survey the evidence of the efficacy of privatization in other countries, except for the United States. Such a circumscription of their task is perhaps understandable, although they should have surely provided references and a summary of this evidence, which, I can testify, had a considerable impact in public sector decision making.

One of the features of the Thatcher privatizations was the development of a new system of regulation of the utilities. The ministers in the Thatcher government were well aware of the gulf between the ideals of regulation and the reality of practical



application. In particular the absurd wastes of having a maximum rate of profit (i.e. a 100 percent marginal tax rate above the maximum rate) were to be avoided. The minimum intrusion and the least that was politically acceptable was a maximum average revenue condition applied to a basket of services comprising roughly one half of BT's total value added, where there was some considerable monopoly power...known as the RPI-X rule. In the case of BT, where X was set at 3, this implied that the prices were to be such that the corporation increased (monopoly basket) prices, on the average, over the year by less than the increase in the retail price index minus 3 percent. This rule was set for five years, since when there has been a resetting for the next five years with X at 4.5 per cent, a rather more stringent target. The idea was that, by reducing the size of the basket, as competition, such as phones on a cable network, developed, price control would eventually be phased out.

The authors are highly critical of this new regulatory arrangement. They assert that it amounts to much the same thing as a maximum rate of return system - although I cannot follow the argument by which they reach such a conclusion. They also object to the possibility for discrimination within the basket - but the whole point has been to design an arrangement that allows flexibility instead of the detailed minutiae of normal forms of price control and all the rigidities that those controls entail. After all the criticism, however, the authors supply no alternative system of regulation. We are left wondering. This is a pity. A system of regulation similar to the RPI-X system is proposed by the FCC, and it would be useful to have a balanced analysis of the options. This study does not provide one.

Space does not permit a discussion of the errors in analysis and application which appear in various chapters in part II. In a final judgement, I would commend this book, however, as



the most comprehensive account of privatization in Britain yet published. It is most useful as a source book, but one should pursue many of their arguments further than the authors take them, and one should balance their diet with a pinch of the salt of reality of regulatory systems. (6)



CONFIDENTIAL

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CHANCELLOR

FROM: MRS M E BROWN  
DATE: 3 AUGUST 1988

cc PS/Financial Secretary  
Economic Secretary  
Sir P Middleton  
Mr Anson  
Mr Monck (or)  
Mr Moore (or)  
Mr Odling Smee  
Mr Williams  
Mr Lyne  
Mr Bent  
Mr Holgate  
Mr Tarkowski  
Mr Tyrie  
Mr Call

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3/8

**FLOTATION STRATEGY**

1. In his letter of 26 July Mr Wakeham says he cannot guarantee that both the Water and Electricity Bills will be enacted by the end of July 1989. He asks your advice on relative priorities in case at least one of them has to be delayed to the spill-over Session. Mr Parkinson and Mr Ridley (letters of 26 July and 1 August) have both replied that their Bills must be completed before the Summer Recess in order to complete all the necessary preparations for the sales, including vesting, setting up the new regulatory regimes and launching the marketing campaigns.

2. It is disingenuous of the Lord President to ask you to make this choice. Both departments have throughout made clear the importance of Royal Assent by July; and I suspect that the difficulties reflect late additions to the agreed programme as much as the problems of the two bills themselves. We therefore recommend that you affirm the need for both bills to be completed by end July 1989.

3. In one sense, Mr Parkinson's arguments are marginally weaker. For water, October Royal Assent would rule out a November 1989 flotation. But Electricity distribution sale is due to take place in April/May 1990, at least four months after Water, and if



**CONFIDENTIAL**

everything went smoothly it would in theory be possible to complete the necessary preparations in the period following October 1989. However, we think it would be foolish to plan on that basis: it would allow no margin for any Parliamentary hiccup in the spill-over period, or any other pre-sale problems. If there were any delay, not only would the electricity sale be prejudiced, but there would be the most damaging debate and publicity just at the time of the final run-up to the water sale in November 1989. The water timetable is as tight as it can possibly be, even assuming Royal Assent in July 1989. The risks of running electricity equally tightly are too great and any slippage in electricity distribution probably rules out privatising the whole electricity industry this Parliament.

4. This note, and the attached draft reply, has been agreed with PE1.

*Mary Brown*

**MRS M E BROWN**



CONFIDENTIAL

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*Pse type final*

**DRAFT LETTER FROM THE CHANCELLOR TO THE LORD PRESIDENT OF THE COUNCIL**

**FLOTATION STRATEGY**

1. Thank you for your letter of 26 July. Cecil Parkinson and Nicholas Ridley have responded in their letters of 29 July and 1 August respectively.

2. I agree with them that both the water and electricity privatisation Bills must be enacted no later than the end of July 1989. If both industries are to be privatised this Parliament it is essential that we ~~try to~~ keep to this timetable. There are too many steps to be taken following Royal Assent, including vesting the new PLCs, setting up the regulatory regimes for both industries, and launching the marketing run-up to each sale, to make any other timetable acceptable. Indeed the perception that either Bill might slip to October would generate uncertainty about our privatisation plans which would itself be damaging.

3. I am copying this letter to the Prime Minister, Nicholas Ridley, Cecil Parkinson, John Belstead, David Waddington and Sir Robin Butler.

**NIGEL LAWSON**



CONFIDENTIAL

BF 579

From: SIR PETER MIDDLETON

Date: 4 August 1988

CHANCELLOR

*Ch.*  
*This seems right,  
and sensible. Agree?*

cc Dame A Mueller  
Mr Anson  
Sir G Littler  
Mr Phillips  
Mr L Harris

*Thanks.*  
*Agreed - this I will*  
*delete*  
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*case of*  
*also, for example, we*  
*will be private*  
*with a 13 year*  
*period*  
*you should*  
*follow up*  
*me.*

PRIVATISATION AND NEXT STEPS

Following last week's various announcements on Next Steps, I wrote to Permanent Secretaries setting out the line that the Treasury proposed to take if asked about the relationship between the agency programme and the Government's privatisation policy. This was that privatisation had to be considered as an option before any activity was given agency status; that the establishment of an agency implied that privatisation had been considered but not chosen as an immediate option; and that in many cases the setting up of an agency "could prove a transitional step towards eventual privatisation." All this is consistent with the Guidance Note on agencies approved by the Cabinet and the evidence given by the Government to the TCSC Sub-Committee on Next Steps.

2. The Project Manager and one or two other Permanent Secretaries have argued that although privatisation must remain a theoretical option even after an agency has been established, it will create needless apprehension, especially among the staff interests concerned, to give the impression that in many cases agency status is a stage along the road to eventual privatisation. They take the view that privatisation will be the outcome in relatively few cases, and that to imply otherwise will create a degree of uncertainty which will be demotivating both for agency managers and for their staff.



CONFIDENTIAL

3. I do not think we can go along with this approach. The Project Manager has said in evidence to the TCSC Sub-Committee that he estimates that within ten years 75% of the Civil Service will be organised into agencies, with the remaining 25% in core policy departments (which will, by definition, be unlikely candidates for privatisation). We cannot be driven into a tacit admission that the agency programme means that further privatisation of central Government activity becomes no more than a remote and theoretical possibility. Indeed, as the more successful agencies become increasingly commercial in their outlook and detached from their parent departments, we should find that operations which in the past have always been assumed to be proper to Government - for example, because they have a regulatory element - begin to look eminently suitable for transfer to the private sector.

4. I do not want to make a great issue of principle out of what may be no more than a matter of drafting, but equally I think that we must stick to our position that the advent of agencies in no way waters down the Government's commitment to privatisation as the preferred option wherever it is appropriate. If you agree, I propose to reply to colleagues accepting that while it is right that agencies once established should have a period of stability before privatisation is further considered, this need not be very long and many of them will sooner or later be potential candidates - precisely how many only time will tell. Meanwhile, we should be careful to imply neither that privatisation is an imminent possibility, nor that it is ruled out indefinitely.

... 5. I attach a copy of the letter I propose to send Peter Kemp.



P E MIDDLETON



MANAGEMENT IN CONFIDENCE

DRAFT LETTER FROM: Sir Peter Middleton

TO: E P Kemp Esq CB  
Office of the Minister for the Civil Service  
Horse Guards Road  
LONDON  
SW1

NEXT STEPS AND PRIVATISATION

Thank you for your letter of 26 July commenting on my earlier letter about the relationship between agencies and the privatisation programme. You will have seen the letters from Brian Hayes and Alan Bailey on the same subject.

2. I have no difficulty with the proposition that once an agency has been set up it should be allowed a period of stability in which to deliver the benefits expected from the Next Steps approach before any further change in status is considered. I have never argued otherwise. I did not, pace the last paragraph of Alan Bailey's letter, say that agency status was "generally" only a transitional step to "early" privatisation. What I did say was that in many cases it could prove a step towards eventual privatisation. That seems to me to be self-evident, and in line with Government policy. As agencies become more efficient, independent, and commercially-oriented, the Government will need to keep the possibility of privatisation under continuous review, and I would guess that a fair number of them will end up in the private sector, in some cases after only a few years.

3. We cannot at this early stage give credence to the idea that agency status is a permanent substitute for privatisation, and I am glad to see from your letter that you have now clarified the position with the unions. That is important, because any capital they may try to make from a privatisation scare now will be far less damaging than giving them scope for a charge of bad



## MANAGEMENT IN CONFIDENCE

faith later on. Moreover, the best way to avoid charges of hidden agendas is to get the position clear in general - as I did in my evidence to the Select Committee. Then there is no need to state our precise intentions as regards privatisation for each agency. Individual privatisation announcements can be made as the agencies develop and if and when we are ready to make them.

4. Having said all that, and provided that there is no misunderstanding about the Treasury's view, I am not much fussed about the precise words used to protect the Chancellor's position. If it would help to allay colleagues' anxieties, I would be quite happy to replace the last clause of the second sentence of my letter with something like "but there is no implication that an agency, once established, will cease to be considered for privatisation in the future."

5. I am copying this letter as before.

[PEM]