PO-CH/NL/0190 PTD

Part D.

CONFIDENTIAL
(Circulate under cover and notify REGISTRY of movement)

COMMERCIAL-IN-CONFIDENCE.

Begins: 15/2/89.
Ends: 14/3/89.

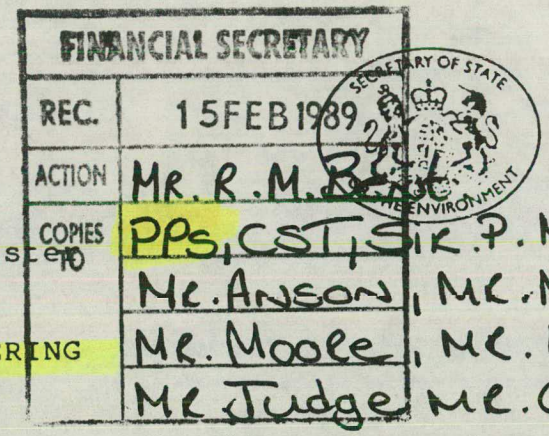
Chancellor's (Lawson) Papers:

WATER INDUSTRY
PRIVATISATION

Disposal Directions: 25 Years

26/9/95.

PO -CH /NL/0190
PART D



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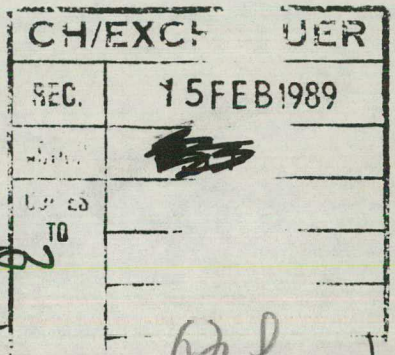


Prime Minister

WATER METERING

I wrote to you and colleagues on 3 November seeking agreement to include provision in the water undertakers' regulatory licenses that reasonable expenses of introducing water metering, or other alternative methods of charging, may be recovered through higher charges to customers.

You agreed with my proposals, and in particular that if a water undertaker decided in advance of privatisation to adopt metering, then a reasonable allowance to pay for the cost of installation should be provided in the initial price limits (Ks). Norman Lamont did not however favour making an allowance in initial Ks. He preferred that the companies should wait for the evidence of the metering trials on the effects of metering, and that the Director General of Water Services should be able to vet metering proposals through the price-control mechanism. David Young did not oppose allowance for metering costs in initial Ks but felt it necessary to protect customers from unreasonable proposals, both then and in price adjustments after privatisation. Other colleagues supported my proposal.

Since then, I have received a proposal from Severn Trent Water to introduce widespread metering in their area. The ambitious nature and cost of Severn Trent's proposals shows the difficulty we would be faced with if we attempted to reflect metering costs in initial Ks, before we have any feedback at all from the metering trials on what costs are reasonable. The scale of their proposed expenditure, which involves expensive solutions to properties where metering is not straightforward because of joint supply pipes, would necessitate an annual real terms increase (ie K) of about 1.5% on top of what will otherwise be needed. I could not sanction that on the current state of knowledge.

Metering is never likely to be economic, except possibly in the very long run in areas suffering from resource shortages. Companies will therefore only proceed with metering if they can recover the cost through higher charges, including the need to earn a return on their investment. However, I remain firmly of the view that metering is potentially the fairest method of charging for water and that we should not put obstacles in the way of those companies who want to adopt programmes on their appointment. The solution therefore must lie in the Director General allowing reasonable metering costs to be passed on to the consumer through revisions to the charging limit after appointment. Unlike me, he will progressively be able to take into account the results of the trials we are currently co-sponsoring with the industry, thereby promoting cost-effective solutions.

Subject to your views, I would like to announce our intention to amend the model instrument of appointment (the Licence) to provide for limited pass-through of metering costs, subject to annual cash ceilings per installation set by the Director General. The ceiling would take into account local circumstances but would be set low enough so as to discourage the more expensive metering options, for example, involving the wholesale separation of joint supply pipes. Any overspend would come out of profits. Disputes between the Director General and companies concerning the level of each ceiling would be referred to the MMC under the existing provisions in the draft Licences for pass through. Companies would be entitled to maintain their profits in the same way as the Licence allows for environmental obligations. There would be an agreed programme for each year and, if the undertaking did not complete the programme, the surplus revenue allowed in the charges limit would be carried forward and not put to profits.

If you and colleagues are content with the above proposal, I plan to make an announcement before the metering provisions of the Water Bill are discussed in Committee on 21 February. I attach the terms of my proposed announcement, in the form of a written answer. I would be most grateful for replies in time to allow that.

I am copying this letter to other members of E(A), to John Wakeham, David Waddington, John Belstead and Sir Robin Butler.

pp N R
15 February 1989

(approved by the Secretary of State and signed in his absence).

DRAFT ARRANGED PQ AND ANSWER

To ask the Secretary of State whether the charging price limits to be set for each water undertaker will include an allowance for the cost of introducing universal metering and if he will make a statement?

DRAFT REPLY

The abolition of the domestic rating system will mean that water undertakers will have to introduce alternative means of charging. That need applies quite independently of the privatisation of the industry. Although the Government regard metering as potentially the fairest method of charging, it will be up to each undertaker to decide how it wishes to charge. In deciding whether to introduce widespread metering each undertaker will need to take into account its own local circumstances and the information on the practicality, cost and effects of metering. This information will become progressively available to the industry over the next three years from the metering trials which they are carrying out with Government financial assistance. These decisions will be crucially important to customers and should be made on the best available information. Sufficient information is not available to me at this stage to allow for the cost of introducing widespread water metering in the initial charges limit to be assigned to each water undertaker from their date of appointment later this year. The model instrument of appointments will however be amended to provide for initial charges limits to be subsequently adjusted by the Director General of

Water Services to cover the reasonable cost of introducing widespread metering. We propose that each adjustment will be subject to an average cash ceiling per installation to promote economy in the development of metering solutions. There will be provisions to ensure that the additional revenue will be put towards metering and no other purpose. In setting the cash ceiling the Director General will be able to take into account information on the cost of installing meters in the trial areas, and later from each undertaker's metering programme. The detailed Licence provisions will be discussed with the industry.

Robert 5.14.02.89

FINANCIAL SECRETARY TO THE TREASURY

FROM: FINANCIAL SECRETARY
DATE: 15 February 1989

CHANCELLOR

cc Chief Secretary
Mr Anson
Mr Monck
Mr Moore
Mr Bent
Mr M I. Williams
Mr G E N S Wilson
Mr Holgate
Mr Judge
Mr Kelly
Mr P Morgan
Mr Portes
Mr Call

WATER AND ELECTRICITY PRIVATISATION: ADVERTISING AND SHARE INCENTIVES

I have discussed Mr Holgate's minute of 26 January and Mr Portes' of 8 February with officials.

I am very concerned about the costs of these advertising campaigns, even though the figures are still tentative. I strongly suspect that the advertising agencies have "taken us for something of a ride" on privatisations. I have therefore asked officials to explore ways of getting the figures down. I know Nick Ridley is also concerned; perhaps I could discuss it with him.

Secondly I would welcome your views on vouchers. I don't have strong views myself. I don't much like bribing people to buy shares with benefits in kind, but they do add a bit of razzamatazz to the employee share package. I am sure we will be strongly pressed by the sponsoring Departments.

R.C.M.J.

pp NORMAN LAMONT

Robert 3.16.02.89

FROM: R C M SATCHWELL
DATE; 16 February 1989

MR BENT

cc PS/Chancellor
Sir P Middleton
Mr Anson
Mr Monck
Mr Moore
Mr A M White
Mr M L Williams
Mr G E N S Wilson
Mr S Wood
Mr Judge
Mr Kelly
Mr Morgan
Mr Call
Mr Tyrie
Miss Wheldon - T.Sol

WATER PRIVATISATION: WELSH ISSUES

The Financial Secretary was grateful for your minute of 13 February. He is content with your proposed line in para 15 of your minute; though he has commented that we may in the end have to concede the case for a bilingual mini-prospectus, given the strong likelihood of bilingual advertisements and mailshots.

R. C. M. S.

R C M SATCHWELL
Private Secretary

98a/1 pe2.1a.5.16.2.docs

CONFIDENTIAL

FROM: PHILLIP MORGAN
DATE: 16 February 1989

1. **MR BENT**
2. **CHANCELLOR**

cc PS/Financial Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Mr Monck
Mr Byatt
Mr Moore
Mr Riley
Mr Gieve
Mr Houston
Mr M Williams
Mr Judge
Mr Price
Mr Call
Mr Tyrie
Mrs Chaplin

I would be inclined to let Deloittes set their own assumptions, including inflation - much harder to disavow if we have pressed them to amend a figure. But would you prefer to request a modification as suggested ? dr 16/2

WATER PRIVATISATION: ECONOMIC ASSUMPTIONS FOR MODELLING

The Government's consultants wish to issue to the industry assumptions for various macroeconomic variables. This note considers the presentational difficulties, and seeks views on a possible modification to the current proposals.

Background

2. DOE's consultants Deloitte, Haskins and Sells (DHS) are currently engaged in a large scale exercise to model the future financial performance of the 10 water authorities and 29 statutory water companies (SWC's), covering their operating costs and revenues, capital expenditure requirements, etc. This is an integral part of the process for setting K, in the RPI + K price cap which will apply to authorities and SWC's after flotation. We will be submitting full advice on this shortly in response to Mr Ridley's letter of 14 February to the Financial Secretary.

3. In carrying out this exercise, common central assumptions for various macroeconomic variables up to the year 2000 need to be made. Such assumptions need to be proof against judicial review of the k-values set by the Secretary of State. DHS have produced

a preliminary set of assumptions (see below) based on the Autumn Statement and an average of outside forecasts so far as the short and medium term are concerned. For the longer term, DHS have used their own judgement to form assumptions since very few forecasts are available on such a time frame. DHS's assumptions are:-

	1989	1990	1991	1992	Annual Average 1993-2000
RPI	6.0	4.8	4.6	4.5	4.5
Real GDP Growth	3.0	2.2	2.3	2.5	2.25
Short Term Interest Rates	12.0	9.5	9.0	9.0	9.0
Real Wage Growth	2.0	2.0	2.0	2.0	2.0
Real Price Changes in Other Elements of Operating Expenditure	0	0	0	0	0
Real Capital Cost Growth	0	0	0	0	0
Corporate and Income Tax Rates	No Change				

4. The intention is to present these assumptions to the industry for their comment next week. They will also appear shortly thereafter alongside all other modelling data on floppy discs to enable water undertakers and their merchant bank advisers to carry out modelling runs of their own.

Assessment

The figures will not be released to the press, but could well leak.

5. When these assumptions are released to the industry and its advisers, they effectively come within the public domain and may be presented in the media as Government-endorsed figures.

6. Almost all of DHS's assumptions for the longer term are close to those set out as the central case in the recent Treasury paper "Macroeconomic Assumptions for the Longer Term" (Mr Odling-Smee's minute to the Chancellor of 29th July 1988 refers). The one

exception concerns inflation where the Treasury paper shows a declining path over time in the central case.

Conclusions

7. We will seek to ensure that these assumptions are presented as a DHS assessment based on averages of outside forecasts. However, given the difficulty of avoiding the claim that these are government endorsed figures, you may wish to consider whether officials should request a modification to the inflation assumption for the longer term. One possibility might be:-

	1993-1997	1998-2000
RPI	4.0	3.5

A corresponding adjustment to the nominal short term interest rate assumption would then be necessary.

8. I would be grateful for your views by lunchtime Friday 17th. We will then ensure that DOE and Treasury press offices are appropriately briefed.

Phillip Morgan

PHILLIP MORGAN
PEAU

vh 0778t

DEPARTMENT OF HEALTH AND SOCIAL SECURITY

Richmond House, 79 Whitehall, London SW1A 2NS

Telephone 01-210 3000

From the Secretary of State for ~~Social Services~~ Health

The Rt Hon John Major MP
Chief Secretary to the Treasury
HM Treasury
Parliament Street
LONDON SW1

CHIEF SECRETARY
REC. 16 FEB 1989
ACTION Mr Sanders,
COPIES TO Ex-CC Sir P Middleton
Mr Anson, Mr Phillips, Miss Jenson.
Mr A Edwards, Mr Bent
Mr Judge, Mr Call

16 FEB 1989

Dear John,

Thank you for your letter of 31 January regarding the indemnity we offer to water undertakers to add fluoride to the water supply. I have also seen Michael Howard's letter to you of 9 February commenting on your proposals.

Like him I find them very attractive as a way of taking matters forward. Whilst I understand his reservations about amending the Water Bill to provide for a power to direct water industries to introduce fluoride, whichever course we pursue it will be necessary to table an amendment to the Bill relating to fluoridation to put the indemnity on a statutory basis. Moreover we face a prolonged controversy during the remaining passage of the Bill with the pro-fluoridationists if we fail to bring the water undertakers into line and Mr Bellak carries out his threat to give notice of termination of the country's biggest existing scheme in the West Midlands.

I very much doubt however whether we will in fact have to take powers of direction. Once the water undertakers realise that we are in earnest I feel confident that they will accept an indemnity on the lines you suggest. I would propose therefore to write to the Water Authorities Association in the next few days outlining our suggested changes to the indemnity and the likely consequences if they reject these concessions. We will then have an opportunity to finalise our plans in the light of their reply.

I am copying this letter to Nicholas Ridley, Malcolm Rifkind, Peter Walker, Tom King, Michael Howard and Sir Robin Butler.

Yours ever,

KENNETH CLARKE

CONFIDENTIAL

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

17 February 1989

Dear Shirley,

NITRATES IN DRINKING WATER

At E(A)(88)14th meeting your Minister was invited, in consultation with other Ministers concerned, to develop detailed proposals for a compensation scheme and to explore further the possibility of a levy on fertilisers to recoup the costs of such compensation.

I understand that officials have been carrying this remit forward. In view of the pressure of other business in E(A), I think the Prime Minister would find it helpful if your Minister, in consultation with the Secretary of State for the Environment and the Chief Secretary, were able to resolve the outstanding issues, without the need to bring this to a meeting of E(A). It would be helpful if your Minister was able to report on the outcome of those discussions within the next few weeks.

I am copying this letter to Roger Bright (Department of the Environment), Carys Evans (Chief Secretary's Office) and Trevor Woolley (Cabinet Office).

Yours,

Paul

(PAUL GRAY)

CHIEF SECRETARY
REC. [illegible]
ACTION Mr Gerrard
COPIES TO CX, Mr Allard
Mr Burgner, Mr Slocock
Mr Brent, Mr Dodds

Mrs. Shirley Stagg,
Ministry of Agriculture, Fisheries and Food.

CONFIDENTIAL

CONFIDENTIAL

fluoride2

FROM: HUGH C BURNS
DATE: 17 February 1989

I agree

1. MR GRIFFITHS
2. CHIEF SECRETARY

HCB 17/2

Ch/ Full marks to Mr Clarke.

JR J. 17/2

cc. Chancellor
FST
Sir P Middleton
Mr Anson
Mr Phillips
Miss Peirson
Mr Moore
Mr Edwards
Mr Beastall
Mr Saunders o/r
Mr Meadows
Mr Bent
Mr Portes
Mr Call

FLUORIDATION OF WATER SUPPLIES AND THE PRIVATISATION OF THE WATER INDUSTRY

You will recall that the Water Authorities (WAs) are threatening to discontinue fluoridation of water supplies unless the Government extend an existing non-statutory indemnity to cover damages etc against WAs resulting from employee negligence. You wrote to Kenneth Clarke on 31 January (attached at A), proposing that they be offered a more limited extension to the existing indemnity (only indemnifying them for negligence where management had taken all reasonable steps to minimise the risk); and that the WAs be told that if this is not acceptable to them, the Government would seek to impose a statutory duty to fluoridate (where requested to by health authorities following local consultation) in the Water Bill, with no extension to the indemnity and an end to health authorities' meeting WAs' costs.

2. In his letter to you of 9 February (attached at B), Michael Howard suggested that the latter course of action would not be practical given the extra controversy it would bring to the Bill, which is already subject to a guillotine, and that your proposed solution could therefore backfire.

3. Mr Clarke has now sent you a very useful letter in support of your proposals (16 February, attached at C). He points out that the issue of fluoridation should be raised in the context of the Bill anyway because the existing indemnity needs to be placed on a statutory basis, and that the Government would face a prolonged controversy if the WAs carried out their threat. He also expresses doubts that the WAs would decline the extension to the indemnity you have suggested. This submission suggests that you write to Mr Clarke to agree that he should write to the Water Authorities Association in the terms originally proposed.

3. The issues and options were more fully set out in my submission of 26 January (attached at D on top copy only).

Discussion

4. We regard the principle that the Government does not indemnify private firms for sloppy management as an important one. And the powers to direct proposed as a fall-back would do no more than remove the WAs' right of veto under the existing arrangements. New fluoridation schemes would still be subject to the requirements for local consultation under the Water (Fluoridation) Act 1985.

5. However, this is essentially a political decision. Against the principle of not indemnifying for negligence, must be weighed concerns that an attempt to impose a statutory duty to fluoridate could introduce unwelcome extra controversy to the Water Bill and endanger the flotation. If you judge that the risks to the Water Bill can be contained, we prefer the negotiating strategy outlined in your letter of 31 January. Anything less than this is likely to leave a gun at the Government's head for use now or later.

6. If WAs are to discontinue fluoridation prior to flotation in September as they are threatening, they will need to give notice to their local health authorities by the beginning of March. I recommend that, if you are not persuaded by Mr Howard's arguments, you write to Mr Clarke agreeing that he should write to the Association in the terms you originally proposed. A draft letter is attached.

7. PE agree.

Hugh Burns

HUGH C BURNS

CONFIDENTIAL

DRAFT LETTER FOR THE CHIEF SECRETARY TO SEND TO:

The Rt Hon Kenneth Clarke MP
Secretary of State for Health
Department of Health
Richmond House
79 Whitehall
LONDON SW1A 2NS

FLUORIDATION OF WATER SUPPLIES AND THE PRIVATISATION OF THE WATER INDUSTRY

Thank you for your letter of 16 February.

2. I too appreciate the concerns Michael Howard has raised in his letter of 9 February, but like you, I do not think the risks are as serious as he suggests. We all agree that we should not accede to the Industry's demand for an indemnity covering negligence on the part of their employees and/or their management. An indemnity of this nature might itself be subject to criticism in the context of the privatisation and may have unwelcome repercussions elsewhere, including in future privatisations. On the other hand, the powers of direction I have proposed as a fall-back would do no more than remove the authorities' rights of veto under the existing arrangements - I am not suggesting that we remove the requirements for local consultation on proposals for new schemes under the Water (Fluoridation) Act 1985.

3. For the price of the slight risk of increased controversy which could result from my proposals, we can remove the Water Authorities Association's gun from the Government's head. I believe this would be worthwhile. However, as you say, the Water Authorities Association are likely to accept the indemnity I have suggested we offer, once it is clear that we would be prepared to take powers of direction. I am therefore content for you to write to the Association as you suggest.

4. Copies of this letter go to Nicholas Ridley, Malcolm Rifkind, Peter Walker, Tom King, Michael Howard and Sir Robin Butler.

[J.M.]

cst.ps/3jm31.1/lets

CONFIDENTIAL

file.

cc:
Chancellor
FST
Sir Peter Middleton
Mr Anson
Mr H Phillips
Mr Beastall
Mr A J C Edwards
Miss Peirson
Mr Saunders
Mr Bent
Mr Meadows
Mr Griffiths
Mr Burns
Mr Portes
Mr Call
Mr Hyett - T/Sols

Treasury Chambers, Parliament Street.

The Rt Hon Kenneth Clarke QC MP
Secretary of State for Health
Department of Health
Richmond House
79 Whitehall
London
SW1A 2NS

31 January 1989

Dear Secretary of State,

FLUORIDATION OF WATER SUPPLIES AND THE PRIVATISATION OF THE WATER INDUSTRY

Thank you for your letter of 16 January.

I think the Water Authorities' Association attempt to pressure the Government into giving the indemnity it seeks is quite unsatisfactory. I would be most reluctant to grant an indemnity to the Water Authorities and Companies (who have not up until now seen any need for this despite being in the private sector) for any negligence on the part of their employees, and hence, by implication, on the part of their managements. This would be a very significant departure from previous practice, with potential repercussions elsewhere. After careful consideration, however, I would be prepared to propose that we reduce the negligence exclusion in our indemnity so as to exclude only those costs and damages arising from employee action where the Authority/Company has not taken all reasonable steps to avoid it happening or damage resulting from it, or where the action is outside the scope of the employee's normal duties. This would avoid a situation where the Government is taking responsibility for the way in which private sector organisations oversee and manage their operations.

This is, however, subject to two conditions.

First, the indemnity, whether or nor we agree to extend it, should be put on a statutory basis in accordance with normal government accounting principles. We should do this in the Water Bill.

CONFIDENTIAL

Second, we should say we would be prepared to seek a power in the Water Bill to direct them to fluoridate. If the Water Authorities do not accept our offer of a limited extension to the indemnity, we would go down this road. If so, we would not necessarily need to continue to reimburse them for the costs. Nor would we extend the indemnity beyond its present terms. This would emphasise to the Water Authorities' Association that the exclusion I have proposed is the best they can expect.

One final point, Section 310 of the Companies Act places limitations on the indemnification of directors, so it may, in fact be unlawful for us to intervene in a way that resulted in the reduction of Water Authority/Company directors' responsibilities. This point needs to be addressed before we agree to any extension of the indemnity.

I am copying this letter to Nicholas Ridley, Michael Howard, Malcolm Rifkind, Peter Walker, Tom King and Sir Robin Butler.

Yours sincerely,

P. Walker

pp JOHN MAJOR

[Approved by the Chief Secretary and signed in his absence]

Department of the Environment
2 Marsham Street
London SW1P 3EB

Minister for Water and Planning

Telephone 01 276 3310

Mr Sykes

CHIEF SECRETARY

REC. [illegible]

ACTION Mr Saunders

COPIES TO Exfst, Sir P Middleton, Mr Anson, Mr Phillips, Miss Peirson, Mr A J C Edwards, Mr Bent, Mr Judge, Mr Clark.

R/PSO/3330/89

9th February 1989

Dear John

Thank you for sending me a copy of your letter of 31 January to Kenneth Clarke on fluoridation.

The proposals in your letter appear to be a reasonable way of resolving this issue - with one exception. I am sure that the threat of seeking a power to direct water undertakers to introduce fluoride is not one which we would be able to sustain in practice. The political controversy aroused by even suggesting such a possibility would introduce a most unwelcome dimension into the debate about water privatisation. You will be aware that we have had to impose a guillotine on the Committee stage. Any amendment to the Bill on such lines would immediately alienate a substantial body of our supporters, and seriously endanger the very tight Parliamentary timetable which is necessary to obtain Royal Assent this summer. This would put the privatisation of the industry at serious risk. I fear that any such threat would be likely to back-fire, and destroy any chance of reaching a compromise with the industry.

I am copying this letter to Kenneth Clarke, Malcolm Rifkind, Peter Walker, Tom King and Sir Robin Butler.

Yours ever

Michael

MICHAEL HOWARD

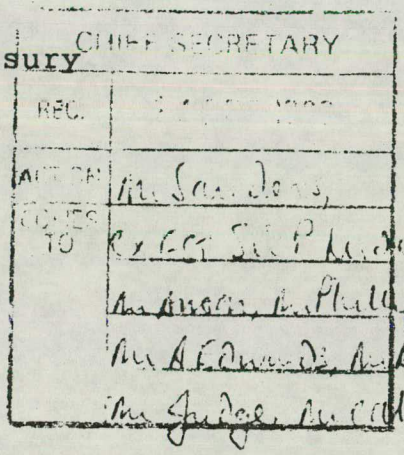
Rt Hon John Major MP

vh 0778t

DEPARTMENT OF HEALTH AND SOCIAL SECURITY
Richmond House, 79 Whitehall, London SW1A 2NS
Telephone 01-210 3000

From the Secretary of State for ~~Social Services~~ Health

The Rt Hon John Major MP
Chief Secretary to the Treasury
HM Treasury
Parliament Street
LONDON SW1



Dear John.

Thank you for your letter of 31 January regarding the indemnity we offer to water undertakers to add fluoride to the water supply. I have also seen Michael Howard's letter to you of 9 February commenting on your proposals.

Like him I find them very attractive as a way of taking matters forward. Whilst I understand his reservations about amending the Water Bill to provide for a power to direct water industries to introduce fluoride, whichever course we pursue it will be necessary to table an amendment to the Bill relating to fluoridation to put the indemnity on a statutory basis. Moreover we face a prolonged controversy during the remaining passage of the Bill with the pro-fluoridationists if we fail to bring the water undertakers into line and Mr Bellak carries out his threat to give notice of termination of the country's biggest existing scheme in the West Midlands.

I very much doubt however whether we will in fact have to take powers of direction. Once the water undertakers realise that we are in earnest I feel confident that they will accept an indemnity on the lines you suggest. I would propose therefore to write to the Water Authorities Association in the next few days outlining our suggested changes to the indemnity and the likely consequences if they reject these concessions. We will then have an opportunity to finalise our plans in the light of their reply.

I am copying this letter to Nicholas Ridley, Malcolm Rifkind, Peter Walker, Tom King, Michael Howard and Sir Robin Butler.

Yours ever,

KENNETH CLARKE

chex.ul/jt/17.2.2

CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 17 February 1989

MR MORGAN

cc PS/ Financial Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Anson
Mr Monck
Mr Byatt
Mr Moore
Mr Riley
Mr Bent
Mr Gieve
Mr Houston
Mr M Williams
Mr Judge
Mr Price
Mrs Chaplin
Mr Tyrie
Mr Call

WATER PRIVATISATION: ECONOMIC ASSUMPTIONS FOR MODELLING

The Chancellor has seen your note of 16 February.

2. He is not attracted to the alternative inflation assumption for the longer term which you suggest. He thinks it best to leave Deloittes to do their own thing, and for us to distance ourselves from it if asked.

J M G TAYLOR

chex.ps/jmt/47 **RESTRICTED**

FROM: J M G TAYLOR
DATE: 20 February 1989

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
Mr Anson
Mr Monck
Mr D J L Moore
Mr Bent
Mr M L Williams
Mr G E N S Wilson
Mr Holgate
Mr Judge
Mr Kelly
Mr P Morgan
Mr Portes
Mr Call

WATER AND ELECTRICITY PRIVSATISATION: ADVERTISING AND SHARE INCENTIVES

The Chancellor was grateful for the Financial Secretary's note of 15 February.

2. He shares the Financial Secretary's concern about the costs of these advertising campaigns, in terms of both corporate and flotation advertising.

3. As far as vouchers are concerned, he sees no reason to go beyond the British Telecom model, where there was a choice between bill discounts and extra shares - a choice which should be tilted to the latter.

J M G TAYLOR

Robert 2.20.02.89

FROM: R C M SATCHWELL
DATE: 20 February 1989

MR MORGAN

cc PS/Chancellor
PS/Chief Secretary
Sir P Middleton
Mr Anson
Mr Monck
Mr Byatt
Mr Moore
Mr Bent
Mr Houston
Mr Wilson
Mr Judge
Mr Call

WATER METERING

The Financial Secretary was grateful for your minute of 17 February. He agrees with your advice; but in view of the Prime Minister's comments (expressed in Mr Gray's letter of 19 February) feels there is no longer any need to write. I have let Mr Ridley's office know we are content with the draft Written Answer.

R.C.M.S.

R C M SATCHWELL
Private Secretary

dti

the department for Enterprise

The Hon. Francis Maude MP
Parliamentary Under Secretary of State for
Corporate Affairs

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

Rt Hon Nicholas Ridley MP
Secretary of State for the
Environment
2 Marsham Street
LONDON
SW1 3EB

Direct line 215 4417
Our ref
Your ref
Date 20 February 1989

(by fax)

Dear Mr Ridley,

In your minute of 15 February to the Prime Minister, you propose the introduction of limited pass-through of costs for installing water meters.

I am conscious that the option of water metering is a very expensive method of charging for the provision of a water supply, and while it may be fair, I agree that it should be subject to the fullest scrutiny by the Director General.

The setting of annual cash ceilings per installation by the Director General is a welcome concept. But the powers conferred on the Director General to discharge this duty should be carefully set out in the Bill.

I should be grateful if your officials would be in touch with mine on the drafting of the necessary amendments before these are shown to the industry.

I am copying this letter to members of E(A), to John Wakeham, David Waddington, John Belstead, and Sir Robin Butler.

Yours sincerely

Chris Noble

pp FRANCIS MAUDE
(Approved by the Minister and signed in his absence)

JCHAOZ

cst.ps/3jm20.2/lets

CONFIDENTIAL

cc:
Chancellor
FST
Sir Peter Middleton
Mr Anson
Mr Phillips
Miss Peirson
Mr Moore
Mr Edwards
Mr Beastall
Mr Griffiths
Mr Burns
Mr Saunders
Mr Meadwos
Mr Bent
Mr Portes
Mr Call

Treasury Chambers, Parliament Street, SW1P

The Rt Hon Kenneth Clarke QC MP
Secretary of State for Health
Department of Health
Richmond House
79 Whitehall
London
SW1A 2NS

Dear Ken,

20th February 1989

FLUORIDATION OF WATER SUPPLIES AND THE PRIVATISATION OF THE WATER INDUSTRY

Thank you for your letter of 16 February.

I too appreciate the concerns Michael Howard has raised in his letter of 9 February, but like you, I am not convinced that the risks are as serious as he suggests. We all agree that we should not accede to the Industry's demand for an indemnity covering negligence on the part of their employees and/or their management. An indemnity of this nature might itself be subject to criticism in the context of the privatisation and may have unwelcome repercussions elsewhere, including in future privatisations. On the other hand, the powers of direction I have proposed as a fallback would do no more than remove the authorities' rights of veto under the existing arrangements - I am not suggesting that we remove the requirements for local consultation on proposals for new schemes under the Water (Fluoridation) Act 1985.

For the price of the slight risk of increased controversy which could result from my proposals, we can remove the Water Authorities Association's gun from the Government's head. I believe this would be worthwhile. However, as you say, the Water Authorities Association are likely to accept the indemnity I have suggested we offer, once it is clear that we would be prepared to take powers of direction. I am therefore content for you to write to the Association as you suggest.

I am copying this letter to Nicholas Ridley, Malcolm Rifkind, Peter Walker, Tom King, Michael Howard and Sir Robin Butler.

Yours Ever, John

JOHN MAJOR

CONFIDENTIAL

FROM: G E N S WILSON
DATE: 22 February 1989

FINANCIAL SECRETARY

cc. Chancellor
Sir Peter Middleton
Mr Monck
Mr Scholar
Mr Culpin
Mr Moore
Mr Bent
Mr M Williams
Mr Judge
Mr Call
Mr Tyrie
Mr Hyett - TSol
PS/IR
Mr Reed - IR

WATER PRIVATISATION: CAPITAL ALLOWANCES

DoE has written to the Inland Revenue at official level proposing that the Water Privatisation Bill should include a provision giving their Secretary of State power to determine capital allowances with Treasury consent. This submission reviews the issues, has been agreed with the Inland Revenue and recommends that DoE's request be agreed.

Background

2. The Water Authorities have not been subject to taxation, and will only become taxable when vesting takes place. Accordingly, there is no tax position at present. The successor companies will, however, take over certain of the assets of the Water Authorities on vesting to which will be attached capital allowances which will be available to reduce future taxable profits.

3. The precise value of the 'inherited' capital allowances is uncertain at present, since not only are detailed asset figures not likely to be available in the near future, and even then, these will be subject to historical uncertainties which can never be resolved, but also discussions are continuing between the WAA and the Inland Revenue over the interpretation of the capital allowances legislation, as it pertains to different classes of assets, with consequential differences in the calculation of tax values. These matters are unlikely to be resolved within the timescale required to introduce amendments to the Water Bill.

Significance of capital allowances

4. We consider that these capital allowances could be of significance if we were to get value for them in proceeds. Figures produced prior to the current exercise indicated a tax holiday for the successor companies of some five years, which is likely to be an inefficient period for the Exchequer. We are likely to get better value the longer or shorter the period. A ten year holiday would suggest higher maintainable profits, higher dividends and hence proceeds. Alternatively, a two year holiday would produce higher corporation tax receipts sooner.

5. In theory, we could reduce the computed capital allowances by the extent of any write-off of NLF debt. However, since the Water Bill disapplies S.400 ICTA 1988 any write-off of NLF debt will leave the capital allowances unchanged. This was done for similar reasons as for British Steel and Scottish Electricity (Mr Holgate's submission of 15 February 1989) to prevent a tax 'overhang' whereby the excess of debt written off over existing tax allowances would be carried forward prejudicing the future tax positions of each. In both those cases, however, the application to disapply S.400 ICTA 1988 was accompanied by conditions to restrict appropriately the level of tax allowances to be carried forward to the successor companies.

6. By the time privatisation takes place, we will have arrived at an assessment of the numbers and a best interpretation of the legislation, both of which could simply be reflected in the prospectus. If we did nothing more than this, it would be open to the successor companies, once in the private sector, to challenge either the figures or the interpretation or both, in the hope of increasing capital allowances and reducing future tax bills. By then, of course, it would be too late for the Government to take account of the revised tax position in privatisation proceeds, and we might come in for criticism for selling the water companies on the cheap. We are, therefore, attracted to the proposition whereby powers are taken in the Water Bill to make a determination of the appropriate level of capital allowances prior to privatisation. The figure would be arrived at in accordance with out interpretation of the legal position. If the power was drafted in a way that provided that the Secretary of State's interpretation of the capital allowances legislation was final, the only ground on which the determination could be challenged would be that the Secretary of State had acted unreasonably in making the open market valuation.

Alternatives

7. The only alternative to legislation is free standing contracts with each successor company agreeing the value of capital allowances. In practice, these could not be enacted until after vesting, and there is now no guarantee that then all ten successor companies would agree. Moreover, this could be construed as a clear restraint on the Directors' duty to act in the interest of shareholders, and thus would be open to challenge unless there could be shown to be some corporate benefit to them all which seems unlikely. We have concluded, therefore, that this, the only alternative, is inappropriate.

Treasury position

8. While we cannot now determine what the position might indicate once the current work is complete, we consider that there is a need to remove the possibility of any challenge to our assessment of the tax position of the 10 privatised Water companies subsequent to privatisation that would retrospectively appear to damage proceeds.

Conclusion

9. Although we are currently uncertain about both the interpretation of tax law in this field and also about precise numbers, we believe that these uncertainties will be clarified by the time of privatisation. Meanwhile we recommend that a clause be added to the Water Bill to allow the Secretary of State to determine, with the consent of Treasury, the amount of capital allowances in respect of plant and machinery and buildings for each authority prior to privatisation. We therefore recommend that DoE's request be agreed and Inland Revenue concur.

10. The amounts to be determined would, of course, need to be derived from detailed information provided by the Water Authorities. In order to reduce the risk of successful challenge to the determination by way of judicial review, the legislation would have to be drafted in a way that would prevent the Water Authorities and the successor companies from challenging the Secretary of State's interpretation of the capital allowances legislation.

11. I would be grateful to know if you agree with this approach.

Guy Wilson

GUY WILSON

1Robert 6.21.02.89

CONFIDENTIAL: MARKET SENSITIVE

CC: Chancellor, 2
Sir P. Middleton
Mr Monck,
Mr Odling-Smee,
Mr D. Moore,
Mr Pirie, Mr Judge,
Mr Bent, Mr Portes,
Mr Devereux.

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Nicholas Ridley MP
Secretary of State for the Environment
Department of the Environment
2 Marsham Street
London SW1P 3EB

22 February 1989

Dear Nick

THAMES WATER ACQUISITION

Thank you for your letter of 14 February to Nigel Lawson.

I am content for you to allow Thames to proceed with an agreement to buy Portals' water treatment business after privatisation, subject to the conditions you set out.

I trust your officials will keep in touch with mine on the details of the agreement. We will clearly need advice from Schroders on the eventual detailed terms before giving final authorisation. One small point - it will of course be necessary that the agreement should state that the purchase should take place after the Secretary of State's holding in Thames falls below 50%, rather than at any specified date.

Yours ever

Norman

NORMAN LAMONT

pe2.pt/rb/22.2.3

CONFIDENTIAL

Setting price regulation for 39 companies is inevitably complex, and is not helped when 10 are public and 29 private sector bodies. This submission explains the issues fully first as background to the reply to Mr Ridley, and second to inform about the process of setting K, on which decisions will be needed for July. RBent 24/2

FROM: S P JUDGE

DATE: 24 FEBRUARY 1989

1. **MR BENT**
2. **FINANCIAL SECRETARY**

cc: **Chancellor**
Chief Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Mr Monck
Mr Byatt
Mr Moore
Mr Houston
Mr M L Williams
Mr G E N S Wilson
Mr P Morgan
Mr S Kelly
Mr Holgate
Mr Esau
Mr Portes
Mr Tyrie
Mr Call
Miss Wheldon TSOL

WATER PRIVATISATION: PRICE REGULATION

Mr Ridley's letter of 14 February sets out his view of how the privatised water industry should be regulated, and seeks your agreement to opening discussions with the industry, in response to their approaches. Our main worry is that DOE will give insufficient weight to the importance of getting defensible proceeds.

2. The key variable is K, which limits the amount by which price rises can exceed the increase in the RPI. This "RPI + K" regulation is to some extent analogous to the "RPI - X + Y" used in previous privatisations, and to be used for electricity. For both water and electricity, X reflects the industry's scope to eliminate inefficiencies and/or achieve further productivity gains. But Y differs between the industries. For water, it represents an allowance for the higher capital expenditure needed if vertically integrated companies are to meet new quality standards. For electricity distribution, it represents input costs transmitted from the generators.

3. Because current rates of return are very much lower than the market rate (unlike BT), K is almost certain to be positive. But how big? And how much will it vary between undertakers?

4. After long and vigorous discussions with DOE and their advisers, we seem to be moving towards convergence on ideas for K setting. But earlier misconceptions about flotation proceeds driving the K setting process have not entirely disappeared, and could still result in DOE policy lurching unpredictably, most probably towards protecting the consumer at undue cost to the taxpayer. With this in mind, the draft reply at **Annex A** accepts Mr Ridley's propositions in broad terms, but seeks to underpin his commitment to a satisfactory outcome.

Background

5. **Annex B** sets out the proposed regulatory structure which takes effect on vesting day - planned for 1 September:

(i) for the 10 water authorities, the announcement of K in July, and its use in the subsequent brokers' research papers, will be a key event in the institutional marketing campaign. Analysts will then start to produce forecasts of future profits etc.

(ii) for the 29 statutory water companies (SWCs), the plan is to move them to the new regulatory regime on vesting day. But this could be deferred if necessary: we need to keep this option open.

6. **Annex C** sets out the vast amount of detailed work that is needed to underpin the setting of K for 39 undertakers. This includes the discussions on "cost pass through" - eg, for metering.

7. **Annex D** sets out the planned timetable, indicating how and when Ministers get involved.

8. Annex E summarises legal points concerning the risk of judicial review. DOE make much of this risk, no doubt because of their experiences on local government finance. It should be set in context. Here, and on electricity, careful consideration of the data on merit will help to ensure that the right balances are struck, and that no-one will have cause to litigate.

Deloitte approach

9. Deloitte's approach - set out in paragraphs 11-16 and 23-29 of their paper - is really quite simple:

(i) one forms a view of the appropriate pre-tax cost of capital for the water industry (expected to be about 8 per cent real - see Annex C, paragraph 7);

and then, for each company:

(ii) one constructs forecasts of future capital expenditure and operating costs, taking account of efficiency gains (see Annex C again for details);

(iii) for a given value of K, one forecasts future revenue from charges, meters etc; and

(iv) for each K, (i) - (iii) are combined via a standard discounted cash flow calculation to form a **net present value** (NPV).

10. This NPV represents the amount the private sector should be prepared to pay now in return for these future cash flows. (Note that the NPV refers to operating cash flows but implicitly provides for tax, dividends, interest, net bank borrowings and equity issues, all of which are financing transactions.)

11. Of course, the total proceeds from the sale of the company - debt plus equity - will not equate to this NPV, in particular because:

- the market will not always give full value for future cash flows, eg, if heavy capital expenditure in the early years prevents positive cash flows emerging until, say, 1995;

- a discount may be needed to get such a large sale away; and

- the NPV applies only to water-related activities, whereas the holding company's value should reflect possible earnings from enterprise activities such as land redevelopment (mentioned in your letter of 6 February to Mr Howard, and in Tuesday's Independent).

The first two factors will reduce proceeds, while the third should boost them.

12. What the Deloitte approach does not do is to offer any criterion for selecting a K. By definition, the investor earns his market rate of return on his investment, and so the approach is indifferent whether the value of the business is a realistic figure, or as low as £1. Clearly, this is unsatisfactory, and we need to try to narrow the range of possible Ks in such a way as to place a realistic value on the business.

Schroders approach

13. The Schroders refinement (paragraphs 18-21 of Deloitte's note) is to point out that, for a company to trade successfully on the stock market, K should be set high enough (and the initial gearing low enough) to produce "reasonable profiles" over time of the key financial variables:

- operating profit growth

- initial dividend

- dividend growth

- dividend cover

- interest cover

- gearing

14. The critical parameter in this approach is the base level for the financial projections:

(i) for the 10 water authorities, where water charges will rise on average by an acceptable 9.8 per cent in 1989-90, this approach takes as given assumptions about the 1989-90 profit forecasts, and the first year dividend. It then aims to set K large enough to produce "reasonable" covers etc for the next 10 years. The shares are then priced from the first year dividend, probably as a fairly high yield stock. As in all privatisations, the first year profits and dividends are crucial to proceeds. But a particular complication which afflicts water at the moment is the proposed change to accounting policies (**Annex C**, paragraph 8) whose merits are still being examined by officials;

(ii) for the 29 SWCs, it may be necessary to base the equivalent financial profiles on an earlier financial year than 1989-90. To do otherwise could encourage them to put up their charges before vesting day as much as possible and could underwrite share prices inflated by bid speculation.

15. It should be noted that even the Schroders approach does not necessarily produce a single value for K. The range of possible Ks (likely to be +/- 1 per cent about a central value) is, however, much more suitable than under the Deloitte approach, because it uses the 1989-90 profits to set a floor to the valuation of the business. In the absence of a firm line from Treasury, DOE might simply fix K at the lowest level consistent with the Schroders approach, and pass the maximum benefit to the consumers. We will not know whether this is the right answer until the water industry supply the data on which K must be set; and if K is so low as to impose a high risk on investors, proceeds

could suffer unduly. To guard against the possibility that we may then wish to argue for a higher K than the department we need to table our own concept of what constitutes an acceptable basis for K setting.

Misconceptions

16. Before deploying our concept we first need to kill off a few misconceptions. The Treasury is sometimes portrayed by DOE as wanting to set K at the level needed to hit the Chancellor's target for privatisation proceeds, set in the Autumn Statement. This is of course over-simplistic. Market conditions and the state of the business determine what shares are worth on the open market, and we adjust to that: in the number of sales we bring forward in any one year; in the percentage of equity sold; in the timing of instalments; and in the arrangements for debenture repayments. We are not in the business of artificially inflating proceeds by tampering with K. Equally, however, we (and DOE) have the taxpayer's interest to protect in securing a realistic price for the assets that we sell. DOE do not pay sufficient attention to this. If the threat of judicial review looks like becoming serious because of conflicts between setting K for the authorities and for the SWCs, we may need to defer setting K for the SWCs (see **Annex E**). We should anyway amend the Bill to allow water undertakers to be appointed and the flotation timetable to proceed, even if K is left unresolved for one company in dispute (also **Annex E**).

Treasury concept

17. In the absence of data from the industry, we cannot say now what will, or will not, prove to be an acceptable outcome. Instead, any Treasury concept must revert to first principles:

a. if we were able to consider the water industry simply as a steady state business, we would set a regulatory regime for each undertaker of the traditional RPI - X type. X would depend on:

i) the degree of inefficiency/efficiency of the company and/or the scope for further productivity gains. This serves to reduce allowable price increases; and

ii) the need to remunerate the capital investment required to maintain assets in a steady state, not at the rate of return (about 2½ per cent) currently earned by the industry, but at the market rate of return (expected to be about 8 per cent). This serves to increase allowable price increases;

The second factor has not been very important in previous privatisations, but it may well outweigh the first for most water undertakers.

b) but the water industry is not a steady state business. It needs a major programme of new capital expenditure if it is to meet the new quality standards set for the industry by EC directives and UK statute. Charges must therefore go up by RPI - X + Y, where Y remunerates, at the market rate of return, the capital investment required to improve existing assets and/or add new assets in order to meet water quality standards.

Conclusion

18. The only estimates we have of the value of the water authorities are based on data submitted to DOE in October. A crude calculation by Schroders indicated that, if we sold 100 per cent of the equity, a K of 2 might produce proceeds of £8.2 billion (£2.9 billion debt, £5.3 billion equity), and K of 1 proceeds of £6.2 billion (£1.5 billion debt, £4.8 billion equity). This data is now very out of date: K-values are edging up all the time, even before the long list of "cost pass through" items is added on.

19. Coincidentally, these values for proceeds are not too far off the industry's historic cost net asset value of £8½ billion. But they are considerably below the current cost net asset value of £30 billion, and the industry's replacement cost (perhaps as much as £80 billion). Of course the value of the industry is not determined by the value of its assets but by the income they produce - which in turn is constrained by K.

20. We recommend that, in agreeing to Mr Ridley's broad thrust on price regulation, you should:

- express nervousness about dropping all reference to proceeds;

- put on the table the Treasury concept outlined above;

- indicate the importance of: basing financial projections for the SWCs on an earlier financial year than 1989-90; keeping open the option of deferring K-setting for the SWCs until after the flotation of the water authorities; amending the Bill to allow water undertakers to be appointed as planned in the event of a legal challenge to an individual undertaker's K;

- seek confirmation from Energy and Scotland that they are content; and

- stress that if the discussions with the industry need to start now, (in response to <u>their</u> requests for consultations on K), they should be as general and non-committal as possible: ideally they should focus on determining the appropriate figure for the cost of capital, pending Government decisions on provisional K-values.

S P JUDGE

CONFIDENTIAL

ANNEX A

DRAFT LETTER TO MR RIDLEY

PRICE REGULATION IN THE WATER INDUSTRY

Nigel Lawson has asked me to reply to your letter of 14 February.

2. As you say, the Regulator - in the first instance the Secretary of State, and subsequently a Director General appointed for the purpose - has a duty to balance the interests of the shareholders on the one hand, and of consumers on the other. This will be a complex task for the water industry given the need to act consistently and without bias towards 39 bodies, of which 10 are in the public sector but due for privatisation, and 29 are already in the private sector.

3. The Deloitte paper helps us get part of the way. By adopting a cash flow approach, it is possible to exemplify the effects of different levels of K. What we need, however, is to ensure that when picking one particular K for each company the right balance is struck between shareholders and consumers, both for policy reasons and to minimise the risks of judicial review.

4. Contrary to what your letter might imply, the Treasury does not have a preconceived, arbitrary idea about the level of Water flotation proceeds, and a wish to work back from this to fix an appropriate level of K for the 10 water authorities (which would then be imposed on the 29 statutory water companies). Nor are we in the business of arbitrarily inflating proceeds by adjusting K.

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On the other hand, I am nervous about pushing our proper concerns about proceeds too far into the background. When we come to sell the water authorities' assets, you must be able to convince the House that we have secured a good price. It should be possible to reconcile these objectives if, as you suggest, the K setting decision has regard to the kind of financial profile that investors would expect of similar well regarded plcs, and provided the authorities' forecast profits for 1989-90 are taken as the starting point, as Schroders propose. This effectively sets a floor on the valuation of the authorities, which will of course be much less than the current cost value of their net assets.

5. Adding the financial profile test

helps to narrow the range of Ks, but still does not point to a particular level. We need to consider, within the range, whether there are arguments of risk or investor confidence that point in one direction. Plainly, we would be unwise to take our thinking too far while we still await the data we need from the water industry in order to take specific decisions, and consider the implications of the industry's proposals for infrastructure accounting. But it may be worth approaching the next stage with a particular concept in mind.

6. Because the water companies are vertically integrated businesses, there are no costs transmitted from upstream suppliers. So, considered as steady state businesses, we would expect to set a regulatory regime of the traditional RPI - X type. In deciding X, two factors should be taken into account:

(i) while the companies may vary from inefficient to efficient, even the most efficient should have some scope for further productivity gains over time;

(ii) and operating in the opposite direction, the flow of capital expenditure needed to **maintain** the system in a steady state should be remunerated at the market rate of return on investment, not at the company's current rate of return. This factor has not been as important in previous privatisations as it will be for water, given the significant difference between market rates of return and the industry's current rate of return of 2½ per cent.

But the water industry is not a steady state business. It will have to invest heavily to achieve the new quality standards set by EC directives and UK statute. It is therefore appropriate to set a regulatory regime of the RPI - X + Y type, where Y is the charges increase necessary to allow capital expenditure to **improve** and **extend** the system to be remunerated at the market rate. Under this approach, K combines X and Y.

7. When the necessary data becomes available from the water industry, I would expect these principles to provide further guidance to us in pinpointing, within the discretion allowed by the Bill, the precise K that best balances the perceived interests of shareholders and of consumers. I look forward to seeing your proposals on provisional K-values at the end of April.

8. There are three further points I should make:

(i) in examining financial profiles for the water authorities, it is essential to base future projections on 1989-90 performance, given that we have secured increases to water charges averaging 9.8 per cent. But, for the statutory water companies, we should look to base the projections on an earlier financial year, to avoid endorsing recent bid speculation and encouraging the large increases in water charges proposed by the SWCs;

(ii) we should keep in reserve the option of deferring K-setting for the SWCs until after the flotation of the water authorities. The Bill will need to allow for this. Quite apart from the administrative simplifications, this option could give added flexibility under some circumstances, and should not be closed down prematurely; and

(iii) we should also try to ensure that, if anyone seeks judicial review of a K-value between the end of July and the projected transfer date (whether or not ultimately shown to have good cause), we can proceed as planned to set the transfer date - even if this means leaving K unresolved for the undertaker in question. The Bill may need to be amended to do this.

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9. Since it is important that price regulation for the water industry should not set unfortunate precedents elsewhere, I should be grateful for confirmation from Cecil Parkinson and Malcolm Rifkind that they do not foresee any difficulties for electricity in what is proposed for water.

10. If we are all agreed on substance, let me close by saying that I accept the need to open general discussions with the industry, in response to their requests for consultations on K setting, and in order to allay their suspicions about the Government's intentions. However, it would clearly be preferable if they could focus for the present on their views on the correct market rate of return on capital. We shall not have much to say to them on the precise methodology, or actual K values until we receive the further data we shall need to reach decisions. Pending final settlement of K, it would also be helpful if both sides, Chairmen and Ministers alike, could refrain from debating in public what the K-values will, or should, be.

11. I am copying this letter to Peter Walker, David Young, Cecil Parkinson, Malcolm Rifkind and Sir Robin Butler.

NORMAN LAMONT

ANNEX B

REGULATORY STRUCTURE

1. On vesting day (planned for 1 September) the assets and liabilities of the water authorities (WAs) will be split between the National Rivers Authority (NRA) and successor "undertaker companies". Each undertaker company will be a wholly owned subsidiary of a new water supply plc (WSplc), whose shares the Secretary of State will then offer for sale.

2. The Bill enables the Secretary of State to grant water and sewerage licences to each regional undertaker, and water licences to each of the 29 existing statutory water companies (SWCs). He has to grant licences on vesting day to cover every area of England and Wales (apart from the Isles of Scilly). A draft licence (65 pages) was published in December. The key condition sets a limit on the amount by which a specified tariff basket can increase over and above the RPI - the so-called "K" factor. It is intended that K will be set for ten years: ideally it will be same number in each year.

3. After vesting licence changes are the responsibility of the Director General. The licence will be reviewed after 10 years, and may be reviewed after 5 at the request of either party. Changes may be referred to the MMC for adjudication, with the undertaker paying the MMC's administrative costs.

4. The 29 SWCs are subject to a very odd regulatory regime at present. They are restricted - via a mass of specific legislation - as to the reserves they can accumulate and the dividends they can distribute. The **plan** is to move them to the new regulatory regime from vesting day (and thereafter to permit them to convert to plcs, if they wish). Indeed if the SWCs do go ahead with their threatened price rises (two have now done so) they are gambling on this move actually happening: if it does not they are likely to have to indulge in some creative accountancy. As Mr Ridley says in his letter, SWC share prices are likely to

fall once K values are set: indeed he sees this is as positively desirable. For marketing reasons, we will need to ensure that any fall in SWC share prices is sufficiently far in advance of the flotation.

5. For the 10 regional companies, the announcement of Ks will be a key event in the institutional marketing campaign. It will enable analysts to produce their own forecasts of future cash flows and financial profiles. K values will have to be accompanied by at least a provisional statement about the capital structure and dividend policy of each company. Marketing considerations point to fixing K as early as possible. Nevertheless we have retained the option of changing K (for crown owned companies) between vesting and flotation, if absolutely necessary. (Electricity do not have this option.)

ANNEX C

PRELIMINARY WORK

The following pieces of work are now in hand.

1. First, Underground Asset Management Plans (AMPs). Each undertaker must submit a formal letter setting out plans for the management of its underground assets - covering both replacement investment and new capital expenditure necessary to meet its obligations set out in the licence. The plan is important both for the K-setting process and the prospectus.

2. First drafts were due at the end of January, and have now been received from all undertakers except Cholderton and District Water Company (a SWC in Hampshire that serves 700 customers). The quality of these drafts is "generally deficient" and DOE's advisers will be working to rectify this.

3. Final AMPs (due in at the end of March) must be certified by undertakers' engineering consultants, following a scrutiny of initial AMPs by Binnies (the Department's engineering consultants) for consistency between undertakers, and value for money. Estimates of the capital costs of carrying out various programmes will provide baseline data for the work of the DG (whom DOE hope to appoint very soon).

4. Initial surface investment plans (SIPs) will be received slightly later (end-February). These plans (which relate to water and sewage treatment works, etc) will be subjected to a similar, if less formal, process of scrutiny and certification (the scale of expenditure involved is a great deal smaller).

5. Second, Efficiency studies. These aim to explain the comparative unit cost performance of each of the 39 undertakers, with a view to setting efficiency factors for incorporation into the K-setting process. Full consultation with the industry is underway, and final results are planned for end-March.

6. Third, the so-called "Book of Numbers". Financial projections of operating costs and revenues of each undertaker will be contained in the BoN, prepared by Deloittes, and will form a key input to the modelling process for determining K-values. Initial projections were sought from undertakers by end-January, and will be updated continuously over the coming months. 14 undertakers (including 5 authorities) have not yet submitted initial projections.

7. Fourth, an empirical study of the cost of capital. DoE's consultants have reviewed available evidence on the appropriate cost of capital for a private sector water undertaker. Taking account of the riskiness of the underlying assets, this points towards a figure of about 8 per cent real (which Treasury Ministers are about to announce as the new RRR for nationalised industries). The value chosen will be an important input to the K-setting process, and the industry's views will be sought on it.

8. Fifth, the industry is proposing a new accounting policy for infrastructure assets (underground systems, impounding and pumped storage reservoirs, dams and sea outfalls). We will be minuting you separately on this, but very briefly expenditure needed to **maintain** the operating capacity of these assets would in future be charged to the P+L account rather than capitalised. Expenditure to **enhance** or **extend** the system would continue to be capitalised. If agreed, this new policy (which would not apply to treatment works, office blocks, plant etc) would be applied in the 1988-89 accounts, and appropriate adjustments made to the four prior years in order to provide a run of consistent figures for the prospectus. Since the infrastructure assets would in future be required to be maintained in perpetuity, depreciation is not considered appropriate. This new presentation of accounting information might affect the modelling needed to produce K values, and the crucial 1989-90 profit forecast in the prospectus (see the attached article in today's Telegraph).

9. Sixth, work is continuing on the cost pass through provisions in the licence, which permit the DG to increase K in response to certain factors:

Daily Telegraph, 24/2/88.

Accounting changes could hit water sale

By Roland Gribben

THE Government may have to cut estimates of proceeds from water privatisation by £500m because of likely changes in accounting policies of the 10 water authorities involved, according to a stockbrokers' report yesterday.

Current water industry valuations are between £5 billion and £7 billion but the hiatus now surrounding the autumn privatisation has raised questions over the projections.

Stephen Clapham, of stockbrokers' Hoare Govett, says the 10 may introduce accounting policy changes that will further reduce the value of the businesses by altering the present practice of capitalising maintenance spending as asset expenditure and switching to the private sector approach of making a charge against profits.

"The water authorities could have spent as much as £300m on the preservation of their assets in the last financial year. None of this was charged against their profits," said Mr Clapham.

He estimates that profits could have been reduced by about £250m in the financial year ending March 1988 if the preservation spending had been treated as maintenance.

The profit cut would reduce interest and dividend cover and critically affect valuation, he argues.

But industry sources said that a restructuring of authority balance sheets, involving a debt write-off for some and an increase for others, would produce a totally different financial framework and have a more significant effect on valuation than a change in maintenance spending treatment.

(a) new statutory obligations imposed on the UK by the EC;

(b) new legal interpretations of existing obligations;

(c) metering (see Mr Ridley's minute to the Prime Minister of 15 February, and Paul Gray's reply of 19 February);

(d) more accurate costings of commitments that are known about now, but are not yet costable (eg relining needed to respond to the PAH problem, which relates to the bituminous material lining pipes); and

(e) the effects of the 1990 revaluation of non-domestic rates, and the new arrangements for formula rating. This could increase K by ½ in each of the first five years.

10. Seventh, work is proceeding separately on the tax treatment of the regional companies. Mr Wilson minuted you separately about this on 22 February.

11. This work should provide reasonably firm data for the consultation between Ministers on provisional K values, planned for May. However, Touche Ross, who manage the timetabling and work planning system, are already concerned that a substantial amount of it may not be completed in time for K-setting - in particular the assessment of the cost of cleaning up sewage treatment works (which is supposed to be completed by 1992).

ANNEX D

TIMETABLE FOR K-SETTING

DOE currently envisage the following timetable:

- initial AMPs were supposed to be submitted to DOE by 31 January;

- the Government must finalise any outstanding policy matters (eg on water quality, financial relationships between undertakers and the NRA) by mid-March;

- undertakers (all 39) should have submitted financial projections (of operating costs, capital expenditure, revenue bases) by 31 January, with updates at end-February and end-March;

- all this data is then verified by DOE's consultants by end-April;

- consultations with the industry on the K-setting methodology take place during March;

- the rules on cost pass through are finalised by early March;

- a variety of black boxes (yet to be built) produce a provisional K for each undertaker;

- Mr Ridley consults you about these early in May;

- Deloitte Haskins and Sells then discuss these provisional K values with undertakers during the six weeks ending 30 June;

- AMPs are finally signed off in July;

- after further Ministerial discussions - if necessary - the K to apply to vesting is fixed, before 25 July;

- August is taken up with a wide range of logistical tasks needed to produce the actual licences;

- DOE have, at our insistence, built in the option of changing K's for the 10 Government-owned plcs between vesting and flotation. We are not optimistic of being able in practice to make use of this option: precedent is against us;

- finally, it is worth noting here that final decisions on dividend policy, capital structure, offer structure, and underwriting will not be taken until the autumn. But "working assumptions" will be needed for the consultations in May and June (the industry would prefer "firm presumptions"), together with a "ready reckoner" indicating how the Secretary of State was minded to alter K for a given change in capital structure and initial dividend, or in response to new information abut capital expenditure plans. These working assumptions will need careful handling, if we are to protect the Government's position in the last-minute negotiations on dividend policy.

ANNEX E

JUDICIAL REVIEW

1. DOE point out that K must be set consistently with the Secretary of State's duties under Clause 6 of the Water Bill. (attached).

Legal advice

2. Their legal advice can be summarised as follows:

- the reference to "reasonable returns on capital" in Clause 6(2)(b) is obscure, but whatever it means the secondary duty to consumers under 6(3)(a) prohibits setting K above the level needed to satisfy 6(2)(b);

- as a matter of reality, the Courts would probably interpret Clause 6(2) to mean that businesses should be sufficiently profitable to pay dividends and attract investors;

- trying to make money for the taxpayer is an irrelevant consideration in fixing K.

Threats

3. The 29 SWCs are a major complication. DOE will need to demonstrate that Ks have been set for all 39 undertakers in a fair and consistent way, notwithstanding the different accounting policies used by the SWCs and their odd capital structure (they have very high gearing). If the existing shareholders do not like the Ks set for the SWCs, perhaps because they suspect that Mr Ridley has set K so as to clobber SWC share values (paragraph 5 of his letter), they may seek judicial review proceedings to press for higher K-values.

4. Similarly, the 10 water authorities could conceivably seek higher K-values after privatisation (we should be able to restrain them while they are wholly owned by the Crown). If they are

successful then the Government would have lost out on proceeds, and shareholders would have gained an unexpected bonus. I doubt the PAC would think much of this.

5. A second threat of judicial review, affecting both the SWCs and the water companies, might come from large industrial consumers, who - conversely - would be pressing for lower K-values.

Timetable

6. A legal challenge between the announcement of K and the transfer date (vesting day), whether or not ultimately shown to be valid, may threaten the regulatory timetable. As the Bill stands, if an application for judicial review of a particular K is not instantly dismissed, there is some doubt whether the Secretary of State can proceed with appointing the 39 water undertakers or, if the appointments have already been made, with setting the transfer date. Clearly this owuld delay the flotation process. An amendment to the Bill may be necessary to allow the appointments to proceed, even if one particular K remains unresolved for the period of the legal challenge.

Conclusion

7. The best answer to the dangers of judicial review is to fulfil statutory duties by setting Ks which balance the interests of shareholders and consumers in a manner consistent with the legislation.

8. However, Ministers will need to decide (perhaps as early as April) whether to:

a. move the 29 SWCs on to the new price regulation regime on vesting day; or

b. leave them on their current system of dividend control, let the DG sort out the subsequent mess, and give them K-values in a year or two.

DOE's legal advisers are apparently unsure that the Bill gives them sufficient cover for option b).

CLAUSE 6 OF THE WATER BILL

General duties

General duties with respect to water supply and sewerage services.

6.—(1) Subsections (2) and (3) below shall have effect, subject to subsection (4) below, for imposing duties on the Secretary of State and on the Director as to when and how they should exercise the powers conferred on the Secretary of State or on the Director—

(a) by or under the provisions of Chapter I of Part II of this Act; or

(b) by virtue of section 35, 65 or 152 below.

(2) The Secretary of State or, as the case may be, the Director shall exercise the powers mentioned in subsection (1) above in the manner that he considers is best calculated—

(a) to secure that the functions of a water undertaker and of a sewerage undertaker are properly carried out as respects every area of England and Wales; and

(b) without prejudice to the generality of paragraph (a) above, to secure that companies holding appointments under Chapter I of Part II of this Act as water undertakers or sewerage undertakers are able (in particular, by securing reasonable returns on their capital) to finance the proper carrying out of the functions of such undertakers.

(3) Subject to subsection (2) above, the Secretary of State or, as the case may be, the Director shall exercise the powers mentioned in subsection (1) above in the manner that he considers is best calculated—

(a) to ensure that the interests of every person who is a customer or potential customer of a company which has been or may be appointed under Chapter I of Part II of this Act to be a water undertaker or sewerage undertaker are protected as respects the fixing and recovery by that company of—

(i) charges in respect of any services provided in the course of the carrying out of the functions of a water undertaker or sewerage undertaker; and

(ii) amounts of any other description which such an undertaker is authorised by or under any enactment to require such a person to pay;

and, in particular, that no undue preference is shown, and that there is no undue discrimination, in the fixing of those charges and amounts;

(b) to ensure that the interests of every such person are also protected as respects the other terms on which any services are provided by that company in the course of the carrying out of the functions of a water undertaker or sewerage undertaker and as respects the quality of those services;

(c) to promote economy and efficiency on the part of any such company in the carrying out of the functions of a water undertaker or sewerage undertaker; and

(d) to facilitate effective competition, with respect to such matters as he considers appropriate, between persons holding or seeking appointments under that Chapter.

(4) The Secretary of State may give the Director directions of a general or specific character with respect to the exercise in relation to any company which is wholly owned by the Crown of any power conferred on the Director by or under the provisions of Part II of this Act; and it shall be the duty of the Director to comply with any such direction.

(5) It shall be the duty of the Authority, in exercising any of its powers under any enactment, to have particular regard to the duties imposed, by virtue of the provisions of Part II of this Act, on any water undertaker or sewerage undertaker which appears to the Authority to be or to be likely to be affected by the exercise of the power in question.

(6) It shall be the duty of the Secretary of State and of the Minister, in exercising—

(a) any power conferred by virtue of this Act in relation to, or to decisions of, the Authority; or

(b) any power which, but for any direction given by the Secretary of State or the Minister, would fall to be exercised by the Authority,

to take into account the duty imposed on the Authority by subsection (5) above.

VAT ADMINISTRATION DIVISION H
H.M. CUSTOMS AND EXCISE
NEW KING'S BEAM HOUSE, 22 UPPER GROUND
LONDON SE1 9PJ
01-620 1313 **Extn 5406**

Economic Secretary

FROM: D C HEWETT
DATE: 27 FEBRUARY 1989

NATIONAL RIVERS AUTHORITY (NRA): SECTION 20 VATA 1983

1. The problems relating to the financial impact on the NRA, if VAT on supplies in respect of their non-business activities remains non-recoverable, were discussed at a meeting with the Chief Secretary on 3 February. No decision was reached on whether the NRA should be allowed to benefit from section 20 or whether, alternatively, compensating PES provisions should be made. It was decided to reconsider the matter when the VAT position in respect of the various supplies was more clear. In this paper the VAT position of the various NRA activities is updated and the options with regard to section 20 considered.

Section 20

2. What is now Section 20 of the VAT Act 1983 was enacted originally to fulfil an undertaking, given before the start of the tax, that VAT would not be allowed to fall as a direct burden on the rates. To quote the original notes on the clause, section 20 "provides for refund of tax on purchases .... by certain bodies (namely local authorities and bodies with similar functions ....) .... in respect of their non-business activities." It was also stated that "there would have to be strong grounds for adding other bodies to the list". A policy of restricted entry was considered necessary because of the valuable fiscal benefits that section 20 provides.

---

cc Chancellor
FST

Mr Anson
Mr Monck
Mrs Lomax
Mr Burgner
Mr Moore
Mr Bonney

Mr Gilhooly
Mr R G Michie
Mr S Wood
Mr R Bent
Mr Potter
Mr N Richardson
Mr Devereux
Mr Graydon

Mr Call

Mr Wilmott
Mr Ruston

3. The criteria that have been applied in practice by Customs, when considering claims by additional bodies for section 20 treatment are:

a. that the activities in which the body is engaged must be local authority type activities, and

b. that those activities are funded directly from the rates or rate support grant, (ie as a direct precept on the rates).

Section 20 status has consistently been denied to bodies that receive support from the rates for only some of their activities and to those bodies that are grant or levy funded. In making the distinctions the criteria have been applied to the whole of the bodies activities, not just their non-business activities.

4. You will recall that last year, together with the Chief Secretary, you reviewed the rationale behind section 20, and considered how it ought to be applied. Key points which emerged from the review were:

- section 20 should continue to be allowed only to those bodies which perform local-government type functions and which are funded directly from the rates or rates support grant;

- as more and more local-government type functions are undertaken by bodies funded from the centre, pressure will increase to extend section 20. It was concluded that such pressures should be resisted and the same expenditure disciplines which apply to the central departments should thus be imposed upon those bodies.

5. The current cost of the section 20 policy, in terms of net sums repaid to local authorities, including a small percentage attributable to business activities, is some £1200M a year.

NRA

6. The NRA will be a DoE quango, but its activities seem to fall into two distinct sections, one of which will perform functions which come under the scrutiny of the DoE, the other will fall to MAFF. Total expenditure is anticipated to be around £315m in a full year. It is only the cost of (the majority of) the MAFF related activities (£165m) which will be contributed by local authorities. Thus, at best, only some 52% of NRA activities could be considered as funded from the rates. It is mainly because of this that approaches to include NRA in section 20 have so far

been rejected; although the fact that NRA funding is not via a direct precept on the rates also counts against their case.

DoE interests

7. There are a number of major DoE related activities which it is envisaged that the NRA will undertake. These include:

- water quality regulation and pollution alleviation;
- conservation and recreation;
- Navigation;
- Fisheries;
- Abstraction and discharge consents licences.

It is difficult to be absolutely conclusive as to the proper VAT liability of these aspects until the structure and content of the particular activity has been made clear in legislation and possibly practice. However, in all but one case, there are strong indications of a direct connection between the supply of the service and the payment made for it. Thus there seems little doubt that these services have the attributes of "business" activities, and therefore input tax in respect of them can be reclaimed. The position of navigation (including tolls) is not so clear and the whole matter, both in relation to NRA activities and other toll related activities, is under review by Customs.

8. Little, if any, of the funding for the "DoE" activities will be directly rates-sourced. Total expenditure is anticipated to be around £130m in a full year, which will be funded by around £60m of charges for services provided and £70m by grant in aid.

MAFF interests

9. MAFF is involved chiefly with the question of land drainage and flood protection work, and these were specifically referred to by Mr MacGregor in his letters. There does not appear to be a direct link between the supply and the payment made for these activities, which must therefore be regarded as non-business and thus outwith the normal tax mechanism. The activities will be undertaken by regional committees financed in part by the local authorities; each Authority's

contribution being determined by its share of the rateable value in the committee's area (from 1990 the allocation will be on a per capita basis). Total expenditure is anticipated to be around £185 in 1990-91, (and is likely to rise in later years), of which £165m will be contributed by local authorities (from their precept revenues), and £20m grant in aid from MAFF and the Welsh Office.

Revision of Section 20 Criteria

10. It has been suggested that the criteria outlined in paragraph 3 above should relate not to the total activities of any body, but to the non-business activities only. Such a relaxation in the working criteria would certainly be within both the spirit of the provision and the wording of the original note on the clause. The present criteria could result in a body being excluded from section 20, and thus not be able to reclaim VAT incurred on supplies connected with their local authority type activities, which are funded from the rates. The case for change is therefore a good one.

11. Revision of the section 20 criteria on the basis suggested above, so that they would apply only to non-business activities, would still mean the exclusion of bodies whose non-business activities are not wholly funded directly from the rates (although at working level some de minimis limit would, of course, have to apply, and this would be difficult to maintain over time). A revision relaxing the "funded from a direct precept on the rates" criterion, so as to encompass bodies receiving local authority financial support, would open section 20 to a very large number of organisations which receive funds from local authorities and which could reasonably argue that they are carrying out local authority type activities. For example tourist boards, industrial training boards, urban development corporations, housing and community associations, neighbourhood councils, parochial church councils and parish meetings, regional arts associations, conservators of commons, the Countryside Commission, fishery boards, regional development councils, voluntary management committees, rural development boards, trusts of a varied nature, advisory committees set up by local authorities, playing fields associations, museums and related organisations, some village halls, charity organisations and many housing associations. Many of these may have fairly extensive non-business activities.

12. A possible way of limiting the revenue effects of such a relaxation in the funding criterion would be to include only those like the NRA, who have a statutory right to local authority funding. However the overall cost of such a move is impossible to quantify, because the number of organisations that could benefit, and the extent

of their non-business activities, is unknown. The cost could be significant; in respect of the NRA, it is likely to be £15m-£20m a year. In macro terms, of course, where VAT costs are to be met in any case, via PES if necessary, the cost of relaxing the criterion would be more theoretical than real.

Conclusions

13. Any suggestion of solving the current problem, by admitting the NRA to section 20 without regard to the criteria must be resisted. While such a move is possible within the terms of the relevant legal provisions, it would be certain to bring with it serious repercussions in the form of claims by other bodies (perhaps other DoE or MAFF sponsored bodies) for similar treatment. In our view it would be impossible to successfully ring-fence the NRA so as to avoid these "same as" claims. The present policy, followed by successive governments since 1972, has worked because every application not satisfying the letter of the criteria, however strongly pressed, has been rejected. Only those with impeccable credentials, eg the Residuary Bodies, have been admitted.

14. The present section 20 provisions do cause administrative problems. The valuable fiscal benefits that it provides are sought by many organisations. When applications are rejected the criteria are represented as unfair, illogical and arbitrary, and specific claims often lead to protracted Ministerial correspondence. However, the rationale behind section 20 was reviewed last year. At that time you and your colleagues were far from convinced that the Government would choose to protect local ratepayers as opposed to the generality of tax payers in this or any other way if VAT was being introduced now. Holding a hard line was seen as all the more essential, to restrict the cost of the provision, now that more and more bodies are severing their connections with local authorities.

15. Having said that, the present criteria frustrate the original intention of the provision, "to provide for refund of tax on purchases .... in respect of .... non-business activities." As is discussed in paragraph 10 above, a relaxation to apply the "local authority type activities" criterion to non-business activities only (rather than total activities) would be more within the spirit of the provisions, and more in accord with its original intentions. The cost of such a relaxation is difficult to estimate, but is likely to be fairly small. Apart from the NRA, only the Broads Authority comes readily to mind, as a past applicant for section 20 treatment who may benefit from such a move, (although both bodies are also excluded from section 20 under the funding criterion). In the circumstances we

recommend that this mainly cosmetic relaxation is implemented.

16. A relaxation of the "funded from a direct precept on the rates" criterion would, no doubt, be a popular move, particularly with DoE. But even if restricted to encompass only organisations which have a statutory right to local authority funding (as discussed in paragraphs 11-12) would open a fairly wide flood-gate. The cost in terms of lost revenue is indeterminable in advance, but would undoubtedly be large. We therefore recommend against such a relaxation.

17. The NRA can legitimately be admitted to section 20 only if both the "funded from a direct precept ...." and the (non-business) "local authority type activities" criteria are relaxed. It follows that, if the recommendation in paragraph 16 to maintain the funding criterion is accepted, we must maintain our refusal to Mr Howard.

18. Refusal of Section 20 treatment for the NRA leaves the question of possible compensating PES provisions open. You may agree that the best way forward is for you to convene another meeting with interested parties from Customs and Treasury to discuss this whole matter further.

D C HEWETT

Susan 5.27.02.89

CONFIDENTIAL

FROM: **MISS S J FEEST**
DATE: **27 February 1989**

Mr G E N S WILSON

cc Chancellor
Sir Peter Middleton
Mr Monck
Mr Scholar
Mr Culpin
Mr Moore
Mr Bent
Mr M Williams
Mr Judge
Mr Call
Mr Tyrie
Mr Hyett- TSol
PS/IR
Mr Reed - IR

WATER PRIVATISATION: CAPITAL ALLOWANCES

The Financial Secretary was grateful for your minute of 22 February 1989 and agrees with the proposed approach.

Susan Feest

SUSAN FEEST

chex.ps/jmt/35 **CONFIDENTIAL**

FROM: J M G TAYLOR
DATE: 28 February 1989

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Mr Monck
Mr Byatt
Mr D J L Moore
Mr Houston
Mr M L Williams
Mr Bent
Mr G E N S Wilson
Mr P Morgan
Mr S Kelly
Mr Judge
Mr Holgate
Mr Esau
Mr Portes
Mr Tyrie
Mr Call

Miss Wheldon - T.Sol

WATER PRIVATISATION: PRICE REGULATION

The Chancellor has seen Mr Judge's note of 24 February.

2. He has one amendment to the draft letter. The fourth sentence of paragraph 4 should read: "When we come to sell the Water authorities' assets, you must be able to convince the Public Accounts Committee that we have secured a fair price." He is otherwise content.

J M G TAYLOR

CONFIDENTIAL

SCOTTISH OFFICE

WHITEHALL, LONDON SW1A 2AU

CHIEF SECRETARY	
REC.	28 FEB 1989
ACTION	McGriffiths
COPIES TO	Gyfft, Sir P Middleton, Mr Anson, Mr Phillips, Miss Peirson, Mr Moore, Mr Edwards, Mr Bent, Mr Saunders, Mr Judge, McCall

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

28 February 1989

Dear John,

FLUORIDATION OF WATER SUPPLIES

I have been following with interest the recent correspondence between yourself and Kenneth Clarke on the question of widening the indemnity to be given to water authorities, the present water companies, and the successor companies in England against legal action in respect of fluoridation. I note that it has been agreed to extend the scope of the indemnity to exclude only those costs and damages arising from employee action where the authority/company has not taken all reasonable steps to avoid it happening or damage resulting from it, or where the action is outside the scope of the employee's normal duties, as set out in your letter of 31 January.

As you are aware the situation in Scotland is rather different. We have, however, over recent months been consulting with the Convention of Scottish Local Authorities on behalf of the water authorities in Scotland (the Regional Councils) on the terms of a draft Model Agreement between the water authority and the Health Board for the fluoridation of water supplies and on a draft Indemnity against legal action in respect of fluoridation. As issued for consultation, the draft Indemnity does not cover negligence on the part of the authority and its employees and while COSLA has raised a number of points directed towards widening some aspects of the Indemnity, it has not questioned the fact that negligence is not covered. Nevertheless, I have no doubt that when the extension to the indemnity you have agreed for England becomes public knowledge, as I understand it shortly will, then COSLA will press hard for a similar extension in Scotland. I would find it difficult to resist COSLA on this point, and indeed given that I would welcome from a dental health point of view anything which facilitates the fluoridation of water supplies, I would not wish to do so.

CONFIDENTIAL

EML058L7

I would therefore be grateful if you would agree to my offering COSLA the same extension to the Indemnity in Scotland in respect of negligence as you have agreed with Kenneth Clarke. Given that in Scotland the water authorities will remain the local authorities, that they have not threatened to be uncooperative over fluoridation and that COSLA are likely to be satisfied with the revised Indemnity I see no need to put the Scottish Indemnity on a statutory basis.

Copies of this letter go to Nicholas Ridley, Kenneth Clarke, Peter Walker, Michael Howard, Tom King and to Sir Robin Butler.

Yours ever,

MALCOLM RIFKIND

EML058L7

10 DOWNING STREET

LONDON SW1A 2AA

From the Principal Private Secretary

1 March 1989

CHIEF SECRETARY

REC. - 1 MAR 1989

ACTION Mr Finnegan

COPIES TO Cx Mr Anson, Mr McKeon, Mr Phillips, Miss Benson, Mr Burgner, Mr Bent, Mr Saunders, Mr Call

CRYPTOSPORIDIA IN WATER SUPPLIES

The Prime Minister has seen your Secretary of State's minute of 28 February. She is content with the proposal to announce the establishment of a Committee of experts and is content that this should be announced in answer to a PQ this week.

I am copying this letter to Andy McKeon (Department of Health), Steve Catling (Lord President's Office), David Crawley (Scottish Office), Stephen Williams (Welsh Office), Stephen Leach (Northern Ireland Office), Shirley Stagg (Ministry of Agriculture, Fisheries and Food), Carys Evans (Chief Secretary's Office), Peter Smith (Office of the Chancellor of the Duchy of Lancaster) and to Trevor Woolley (Cabinet Office).

ANDREW TURNBULL

Roger Bright, Esq.,
Department of the Environment.

dg1.3.3 CONFIDENTIAL

FROM: D P GRIFFITHS
DATE: 1 March 1989

CHIEF SECRETARY

cc Chancellor
Financial Secretary
Sir P Middleton
Mr Anson
Mr Phillips
Miss Peirson
Mr Moore
Mr Edwards
Mr Saunders
Mr A M White
Mr Bent
Mr Meadows
Mr Portes
Mr Call

FLUORIDATION OF WATER SUPPLIES

1. In his letter of 28 February Mr Rifkind seeks your approval to offer the Scottish water authorities (the Regional Councils) the same extended indemnity agreed with Mr Clarke for England. An authority would be indemnified for costs and damages arising from employee negligence provided that it had taken all reasonable steps to prevent it happening or avoid resulting damage.

2. A draft indemnity has already been put to the Scottish authorities. This did not include any indemnity for negligence nor (so far at least) have the authorities pressed for this to be covered. But Mr Rifkind is probably right in saying that as soon as the proposed extension for England becomes public knowledge the Scots will demand similar treatment. And this would be difficult to resist. I recommend that you agree to Mr Rifkind's request.

3. However, Mr Rifkind has confused the need for a statutory indemnity with a statutory duty to fluoridate. He suggests that there is no need to put the indemnity on a statutory basis since the Scots authorities are not being difficult on fluoridation. This ignores the fact that granting an indemnity involves a contingent liability which should be reported to and approved by Parliament. In accordance with Government Accounting principles any such indemnities should be put on a statutory basis before they come into effect or at the earliest opportunity thereafter. DOE say this can be done in the Water Bill.

PE and TOA agree with this advice. I attach a draft reply.

D P GRIFFITHS

DRAFT LETTER FROM THE CHIEF SECRETARY TO:-

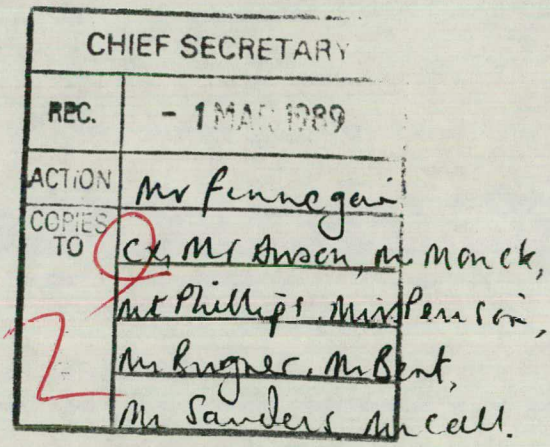
The Rt Hon Malcolm Rifkind QC MP
Secretary of State for Scotland
Scottish Office
Whitehall
London SW1A 2AU

FLUORIDATION OF WATER SUPPLIES

Thank you for your letter of 28 February.

I was interested to see that the Scottish water authorities have not questioned the exclusion of negligence from the draft Indemnity you have put to them but I am content for you to offer the limited extension we have agreed for England. This is, of course, subject to the same two conditions I set out in my letter of 31 January. From what you say it seems unlikely that we will need to invoke the threat of taking powers of direction. But the grant of an indemnity involves a contingent liability and it is essential that, in accordance with government accounting principles, the indemnity is put on a statutory basis as soon as possible. I understand that we can use the Water Bill for this purpose. I am not sure when your indemnity will be finalised but if you wish to issue it before the Bill is enacted, you will also need to follow the procedure agreed with the PAC for handling new non-statutory indemnities: it would have to be notified to Parliament by means of a Treasury Minute 14 days in advance of its being granted.

I am copying this letter to Nicholas Ridley, Kenneth Clarke, Peter Walker, Tom King, Michael Howard and to Sir Robin Butler.



Prime Minister

CRYPTOSPORIDIA IN WATER SUPPLIES

Kenneth Clarke and Michael Howard have been considering with the Chief Medical Officer the national implications of the current outbreak of cryptosporidiosis in the Oxford/Swindon area. We consider that an expert group should be established quickly to advise the Government and I should like to see this announced on Thursday.

The presence of cryptosporidia in Oxford/Swindon water supplies was taken by the local health authorities to be linked to the recent increase in cryptosporidiosis in these areas. The organism has since been detected at a number of other treatment works in the Thames area, including those serving London, at levels comparable to those at the Oxford works, where boiling has been recommended by the local medical officers for vulnerable groups. However there is as yet no evidence of an increased incidence of diarrhoeal illness in London associated with water. In the absence of such evidence the Chief Medical Officer sees no need for any special precautions such as boiling the water.

The Communicable Diseases Surveillance Centre (part of PHLS) have been reviewing health statistics in the Thames Region but have not yet found any links with water supplies. Further epidemiological work is proceeding urgently. Even if it were shown to be so related, boiling notices would not necessarily be recommended. This would leave us with the problem that boiling has been recommended in the Oxford/Swindon area but not in other areas, including London. We would ask the expert group to give advice on this as a priority.

There could be national implications for several reasons. The organism is widespread in the environment. We do not know whether the organism is present in other water supplies in the country,

as it is not sampled routinely: indeed only 2 or 3 water undertakers have the technical capability to do so. It is not killed by chlorination. Cryptosporidiosis is usually a minor illness which causes diarrhoea. In small infants it is occasionally a serious illness and it can be serious in immuno-compromised people, eg those with AIDS. The EC Drinking Water Directive specifies that water supplies should not contain pathogenic organisms or parasites.

There is very little information or experience on this matter in the country or elsewhere and the quickest way to reach sound conclusions is to bring together leading experts to consider the issue. Suggested terms of reference of a committee on the subject are in the Annex. As a first priority they should address the health question.

It would be very useful to announce the committee in answer to a PQ this week, before the subject develops in the media. MPs are already asking a number of PQs on cryptosporidia. Thames Water issued a press release on Saturday stating that this organism has been detected in other water supply areas, but so far the media have not recognised the significance of this.

I would be glad to have your agreement to the proposed action.

I am copying this minute to Kenneth Clarke, John Wakeham, Malcolm Rifkind, Peter Walker, Tom King, John MacGregor, John Major, Tony Newton and to Sir Robin Butler.

R Bright

pp N R

28 February 1989

(approved by the Secretary of State and signed in his absence).

ANNEX

TERMS OF REFERENCE OF ADVISORY COMMITTEE

1. To assess the significance for public health of cryptosporidia in water supplies.

2. To assess methods of monitoring for cryptosporidia and to formulate advice to water undertakers upon monitoring strategy.

3. To examine the occurrence and extent of cryptosporidia in water supplies.

4. To consider and formulate advice upon the protection of water supplies, treatment processes and the maintenance of distribution systems.

of their non-business activities, is unknown. The cost could be significant; in respect of the NRA, it is likely to be £15m-£20m a year. In macro terms, of course, where VAT costs are to be met in any case, via PES if necessary, the cost of relaxing the criterion would be more theoretical than real.

Conclusions

13. Any suggestion of solving the current problem, by admitting the NRA to section 20 without regard to the criteria must be resisted. While such a move is possible within the terms of the relevant legal provisions, it would be certain to bring with it serious repercussions in the form of claims by other bodies (perhaps other DoE or MAFF sponsored bodies) for similar treatment. In our view it would be impossible to successfully ring-fence the NRA so as to avoid these "same as" claims. The present policy, followed by successive governments since 1972, has worked because every application not satisfying the letter of the criteria, however strongly pressed, has been rejected. Only those with impeccable credentials, eg the Residuary Bodies, have been admitted.

14. The present section 20 provisions do cause administrative problems. The valuable fiscal benefits that it provides are sought by many organisations. When applications are rejected the criteria are represented as unfair, illogical and arbitrary, and specific claims often lead to protracted Ministerial correspondence. However, the rationale behind section 20 was reviewed last year. At that time you and your colleagues were far from convinced that the Government would choose to protect local ratepayers as opposed to the generality of tax payers in this or any other way if VAT was being introduced now. Holding a hard line was seen as all the more essential, to restrict the cost of the provision, now that more and more bodies are severing their connections with local authorities.

15. Having said that, the present criteria frustrate the original intention of the provision, "to provide for refund of tax on purchases .... in respect of .... non-business activities." As is discussed in paragraph 10 above, a relaxation to apply the "local authority type activities" criterion to non-business activities only (rather than total activities) would be more within the spirit of the provisions, and more in accord with its original intentions. The cost of such a relaxation is difficult to estimate, but is likely to be fairly small. Apart from the NRA, only the Broads Authority comes readily to mind, as a past applicant for section 20 treatment who may benefit from such a move, (although both bodies are also excluded from section 20 under the funding criterion). In the circumstances we

Robert 02.2.03.89 **CONFIDENTIAL** CC: PPS, CST,
Sir P. Middleton,
Sir T. Burns, Mr Anson,
Mr Monck, Mr Byatt,
Mr D.J.L. Moore, Mr Houston,
Mr M.L. Williams, Mr Bent,

FINANCIAL SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

Mr G. Wilson, Mr P. Morgan,
Mr S. Kelly, Mr Judge,
Mr Holgate, Mr Esam,
Mr Portes, Mr Tyrie, Mr Call.

The Rt Hon Nicholas Ridley AMICE MP
Secretary of State for the Environment
Department of Environment
2 Marsham Street
London
SW1P 3EB

Miss Wheldon - T.Sol -

2 March 1989

REGULATION OF PRICES IN THE WATER INDUSTRY

Thank you for your letter of 14 February to Nigel Lawson.

As you say, the Regulator - in the first instance the Secretary of State, and subsequently a Director General appointed for the purpose - has a duty to balance the interests of shareholders on the one hand, and of consumers on the other. This will be a complex task for the water industry, given the need to act consistently and without bias towards 39 bodies, of which 10 are in the public sector but due for privatisation, and 29 are already in the private sector.

The Deloittes paper helps us get part of the way. By adopting a cash flow approach, it is possible to exemplify the effects of different levels of K. What we need, however, is to ensure that when picking one particular K for each company, the right balance is struck between shareholders and consumers, both for policy reasons and to minimise the risks of judicial review.

Contrary to what your letter might imply, the Treasury does not have a preconceived, arbitrary idea about the level of Water flotation proceeds, and a wish to work back from this to fix an appropriate level of K for the 10 water authorities (which would then be imposed on the 29 statutory water companies). Nor are we in the business of arbitrarily inflating proceeds by adjusting K. On the other hand, I do not think we have to push quite proper concerns about proceeds far into the background. When we come to sell the water authorities' assets, you must be able to convince the Public Accounts Committee that we have secured a good price. It should be possible to reconcile these objectives if, as you suggest, the K setting decision has regard to the kind of financial profile that investors would expect of similar well-regarded plcs, and provided the authorities' forecast profits for

1989-90 are taken as the starting point, as Schroders propose. This effectively sets a floor on the valuation of the authorities, which will of course be much less than the current cost value of their net assets.

Adding the financial profile test helps to narrow the range of Ks, but still does not point to a particular level. We need to consider, within the range, whether there are arguments of risk or investor confidence that point in one direction. Plainly, we would be unwise to take our thinking too far while we still await the data we need from the water industry in order to take specific decisions, and consider the implications of the industry's proposals for infrastructure accounting. But it may be worth approaching the next stage with a particular concept in mind.

Because the water companies are vertically integrated businesses, there are no costs transmitted from upstream suppliers. So, considered as steady state businesses, we would expect to set a regulatory regime of the traditional RPI - X type. In deciding X, two factors should be taken into account:

(i) while the companies may vary from inefficient to efficient, even the most efficient should have some scope for further productivity gains over time; and

(ii) (operating in the opposite direction), the flow of capital expenditure needed to **maintain** the system in a steady state should be remunerated at the market rate of return on investment, not at the company's current rate of return. This factor has not been as important in previous privatisations as it will be for water, given the significant difference between market rates of return and the industry's current rate of return of 2½ per cent.

However, the water industry is not a steady state business. It will have to invest heavily to achieve the new quality standards set by EC directives and UK statute. It is therefore appropriate to set a regulatory regime of the RPI - X + Y type, where Y is the charges increase necessary to allow capital expenditure to **improve** and **extend** the system to be remunerated at the market rate. Under this approach, K combines X and Y.

When the necessary data becomes available from the water industry, I would expect these principles to provide further guidance to us in pinpointing, within the discretion allowed by the Bill, the precise K that best balances the perceived interests of shareholders and of consumers. It will of course be essential, as I know you recognise, that the scrutiny of the industry's figures by your professional advisers enables us to ensure that we can base our decisions on K on realistic numbers. Only if that is done will we be able to avoid having to choose between unacceptably high levels of K and unacceptably low levels of proceeds. I look forward to seeing your proposals on provisional K-values at the end of April.

There are three further points I should make:

(i) in examining financial profiles for the water authorities, it is essential to base future projections on 1989-90 performance, given that we have secured increases for water charges averaging 9.8 per cent. But, for the statutory water companies, we should look to base the projections on an earlier financial year, to avoid endorsing recent bid speculation and encouraging the large increases in water charges proposed by the SWCs;

(ii) we should keep in reserve the option of deferring K-setting for the SWCs until after the flotation of the water authorities. The Bill will need to allow for this. Quite apart from the administrative simplifications, this option could give added flexibility under some circumstances, and should not be closed down prematurely; and

(iii) we should also try to ensure that, if anyone seeks judicial review of a K-value between the end of July and the projected transfer date (whether or not ultimately shown to have good cause), we can proceed as planned to set the transfer date - even if this means leaving K unresolved for the undertaker in question. The Bill may need to be amended to do this.

Since it is important that price regulation for the water industry should not set unfortunate precedents elsewhere, I should be grateful for confirmation from Cecil Parkinson and Malcolm Rifkind that they do not foresee any difficulties for electricity in what is proposed for water.

If we are all agreed on substance, let me close by saying that I accept the need to open general discussions with the industry, in response to their requests for consultations on K setting, and in order to allay their suspicions about the Government's intentions. However, it would clearly be preferable if they could focus for the present on their views on the correct market rate of return on capital. We shall not have much to say to them on the precise methodology, or actual K, until we receive the further data we shall need to reach decisions. Pending final settlement of K, it would also be helpful if both sides, Chairmen and Ministers alike, could refrain from debating in public what the K-values will, or should, be.

I am copying this letter to Peter Walker, David Young, Cecil Parkinson, Malcolm Rifkind and Sir Robin Butler.

Yours ever

Norman

NORMAN LAMONT

peau.pp/gensw/28.2.M(2)

CONFIDENTIAL

FROM: G E N S WILSON
DATE: 2 March 1989

FINANCIAL SECRETARY

cc. PPS
PS/Chief Secretary
PS/Paymaster General
Sir Peter Middleton
Mr Anson
Dame Anne Mueller
Mr Monck
Mr Moore
Mr Bent
Mr M Williams
Mr MacAuslan
Mr S Wood
Mr Potter
Mr Rayson
Mr Judge
Mr Sheridan
Mr M Newman
Ms Walker
Mrs Chaplin
Mr Call
Mr Hyett - TSol
Mr Ballantine - GAD

WATER PRIVATISATION: PENSIONS - UNFUNDED LIABILITIES

DoE has copied us in at official level on their submission to Mr Howard concerning the action required on certain pension issues in order to reflect properly the commitments given. The commitments were encapsulated in a letter from Mr Howard to the WAA on 23 November 1988, a copy of which is attached. This submission reviews the issues, has been agreed with PE, GEP, LG and Superannuation Divisions and recommends that DoE's proposed course of action be approved.

Background

2. Discussions about pensions commenced last summer and culminated in an agreement that legislation should provide for the successor plcs to set up 'mirror image' pension schemes to receive

funds computed by actuaries from the WASF to cover the then liabilities for those employees who wished to transfer. It was agreed that all other funding obligations in respect of the liability for basic superannuation benefits in respect of existing and deferred pension rights and for the associated pension increase liability should rest with the WASF. This was agreed because it was beneficial for proceeds for Government to assume responsibility for these liabilities.

3. This position is agreed by all parties and enshrined in legislation. The WAA has not pressed very hard about the absence of a statutory provision enforcing pensions increase in the Water Bill, relying instead on the Trust deeds to be finalised by the Secretary of State before privatisation. There is continuing discussion between actuaries (inevitably!) over the value to be transferred (the difference in views currently amounts to £300m) and, although this must be resolved properly, urgency is required if we are not going to encounter prospectus disclosure difficulties, but DoE are aware of this and are pursuing the matter through GAD.

4. The current issues arise from the fact that, upon examination, there now appear to be 32 further types of pension payments to former members of the Water industry, which are not charged to the WASF, although governed by the LGSS regulations and paid to the same classes of people or paid by analogy with the LGSS. These additional payments are set out in Tables 1 to 4 attached (although Item 1 is covered by existing legislative proposals).

5. In summary, these comprise pension payments made by:-

(a) the administrators of the WASF and recharged to water authorities by pensioner;

(b) local authorities and recharged to water authorities by pensioner;

(c) the administrators of the WASF and recharged to water authorities on a formula basis;

(d) the water authorities.

Pensioners can, therefore, receive cheques from more than one source in respect of the same period of service.

Assessment

6. Whereas our primary concern will be to discern how the allocation of these pensions between Government and the successor plcs might affect proceeds, Government is under an obligation to honour the commitments made. The amounts involved do not appear to be significant as far as annual cost is concerned, and thus any undue effort to avoid liabilities through interpretation of the stated intentions may lead to complaints that the spirit of the commitments had not been adhered to with a potential consequent adverse impact, although unquantifiable, upon the perception of the flotation which seems to be an unnecessary risk in view of the sums involved.

Proposals

7. The proposals try to reflect the spirit of the commitments and are as follows:-

(a) for Water industry employees generally and former Board members and former Chairmen of authorities and the former NWC, all those items of pension enhancement by gratuity award, injury allowances, added years and pension increases should be made liabilities of WASF which the Secretary of State is given a duty to finance and which the NRA will administer. This comprises Items 2 to 8 inclusive of Table 1, all items in Table 2 and Items 16 to 20 inclusive in Table 3.

DoE believe that this can be done by a simple regulation making power in the Bill and appropriate requlations. There is a potential problem here in that certain of the liabilities may not be allowed in WASF and, consequently, may require special purpose vehicles. DoE are aware of this and are pursuing the matter further. The unfunded liability for these items is some £125m with an annual ongoing cost of some £12.5m;

(b) all authority specific schemes, such as that for the Metropolitan Water Board, should rest with the relevant Water Authority's successor company. In practice, all such schemes relate to Thames Water Authority and encompass Item 9 of Table 1 and 21 to 23 inclusive of Table 3.

(c) pension payments made by local authorities and recharged to Water Authorities as a result of pension schemes under LGSS should rest with the successor companies. These encompass Items 24 to 33 inclusive of Table 4. DoE comment that they amount to some £7m per annum representing an unfunded liability of some £63m relating to Items 24 to 30 inclusive and Item 32. These liabilities, however, may not fall on the successor companies after 1 April 1990 if DoE legislation currently proposed to be announced in the near future is enacted whereby the local authorities would assume such liabilities.

(d) DoE's Ministers' intention that the 'admitted bodies', for example the Water Research Council, should be treated in the same way as other members of WASF will need an amendment to the Bill to give it effect;

(e) Executive Board members and former Board members are full members of the LGSS whose pensions are payable from WASF, and thus no specific provision is needed for them;

(f) Chairmen are outside LGSS and are a liability of the Water Authority, and as such will be transferred to the successor company. Chairmen who have a post in the successor company's group can negotiate with that group as to how their arrangements are to be constructed. It should be noted that this is obviously a sensitive issue with the Chairmen and has been raised specifically by them with DoE. We consider, however, that our position is reasonable and defensible.

Other matters - IVAN BOESKY

8. I hesitate to mention Mr Boesky in the context of public share offerings, but it appears that WASF invested in certain of Mr Boesky's companies. Depending on the outcome of current events, WASF may have to make further payments. This does not affect the funds transferred to Water Pension Schemes or Mirror Image Schemes, as these will be sufficient to ensure that the latter are appropriately funded, but means merely that there remains a contingent liability on WASF. DoE do not wish to transfer this potential liability to the successor companies, but leave any further calls to be met by topping up by the Secretary of State under Clause 160(2). We concur with this decision, since any mention of Mr Boesky in the prospectus would be extremely unlikely to enhance credibility.

9. Problems of this kind will not arise for the Electricity industry on privatisation, since the pension scheme has always been separate and will be fully funded in the near future, thus eliminating any contingent liability on Government.

Conclusion

10. We consider that the proposed allocation of pension liabilities is in line with Government's commitment and within the quantum of amounts previously agreed. The allocation also helps to clarify the pension disclosures required in the prospectus by way of minimising the uncertainties which is an advantage to the privatisation process. Although Government is retaining some liabilities, currently estimated by DoE at some £125m with an annual ongoing cost of some £12.5m, it has been argued that it is cheaper for Government to fund these as required as opposed to an immediate cash payment to the successor companies. The assumption of these liabilities will not damage proceeds, but any improvement is unquantifiable, since the annual effect on future profits is not significant. Thus the impact on proceeds relies principally on minimising the uncertainties in the prospectus disclosure to improve the perception.

11. We, therefore, recommend that DoE's proposal to amend appropriately the powers in the Bill in accordance with the proposals set out above be approved.

12. DoE are anxious to proceed due to the pressing timetable of the Bill, and I would be grateful to know if you agree with this approach.

Guy Wilson

GUY WILSON

2. Pensions letter

Department of the Environment
2 Marsham Street
London SW1P 3EB

Minister for Water and Planning

Telephone 01 276 3310

WS 3/5/2

23 November 1988

Dear Michael

WATER PRIVATISATION: PENSIONS

It is important that when the Water Bill is debated in Parliament the proposals for dealing with pensions should be clear. My proposals, which have been agreed by Treasury colleagues, are set out more fully in the attached paper but the principal points are these:

(i) the mirror image scheme should reproduce the benefits of the Local Government Superannuation Scheme at the same cost to the employee, as that scheme is at the transfer date. After flotation, it will be up to the water industry whether to follow any improvements in the Local Government Superannuation Scheme;

(ii) provisions in the Bill, together with changes in the Local Government Superannuation Regulations, will ensure that funds will be transferred from the Water Authorities Superannuation Fund to the new water pension schemes and the mirror image scheme to cover the liability for basic pensions and pension increases in respect of employees' past service;

(iii) the liability for basic pensions in respect of existing and deferred pension rights and for the associated pension increase liability will rest with the remnant Water Authorities Superannuation Fund. The Government will ensure that the fund can meet these liabilities;

(iv) the cost of pension increases in relation to future service will rest with the employer.

These arrangements apply both to the water authorities and the admitted bodies. I am therefore writing in similar terms to Gordon Jones and Bernard Henderson.

Yours ever
Michael

MICHAEL HOWARD

Sir Michael Straker CBE JP

525/11

Table 1: Current and deferred unfunded pension liabilities paid by WASF

Note: These payments are recharged to each authority according to the actual incidence of payment.

		£m
1.R	Pensions increase on unfunded LGSS benefits. Pensions Increase Act 1971	477.6+
2.R	Gratuity awards. S.18, Local Government Superannuation Act 1953 or Part K, LGSR 1986 SI No 24	
3.R	Injury allowance. Part L, LGSR 1986 SI No 24	
4.	Retirement compensation from added years of service Compensation for Loss of Office Regulations, 1974 SI No 463	
5.	Pension enhancements from added years awarded Retirement of Chief Officers Regulations 1973 SI No 1260	
6.	Pension enhancements from added years of service granted under the Water Industry Severance Scheme or other local arrangements. This includes pensioners of the new Water Pension Schemes as well as WASF. Enabling powers of Water Act 1973 ("anything conducive")	58.9*
7.	Pensions payable to former water authority Chairmen and Board members through determinations made by the Secretary of State. Water Act 1973, Schedule 3, Part I, as amended by Water Act 1983	
8.	Pensions increase on awards made under items 2 to 7.	56.9
9.	Thames Water Authority pension arrangements. Clause 21, Metropolitan Water Board Superannuation and Provident Fund Scheme	

Notes: + £477.6m includes provision for pension increase for deferred pensions.

* £58.9m includes items 2 to 7 but only item 6 is a material amount.

'R' indicates that regulations can be made under the Superannuation Act 1972 for transferring the liability to the WASF and the corresponding pension increase from item 8.

Table 2: Other unfunded pension liabilities paid by WASF

Note: These payments are recharges to authorities according to a statutory formula.

10.R Pensions increase awards on LGSS benefits currently in payment and deferred awards to former NWC employees.

11. Pensions increase awards on benefits provided in accordance with item 12 below.
10 and 11. Pensions Increase (Local Authorities etc Pensions) (Amendments) Regulation 1983 SI No 1315

12. Benefits payable under the Water Authorities (Retirement of Chief Officers) Regulations 1983.

13. Additional pensions from added years of service granted under the Water Industry Severance Scheme and the associated pensions increase added.
12 and 13. Water (Compensation) Regulations 1983 SI No 1267

14. Pensions payable to former NWC Chairmen and the associated pensions increase awards.

15. National pensions increase awards granted to pensioners of the former British Waterworks Association.
14 and 15. Water (Pensions and Pensions Liabilities) Regulations 1983 SI No 1319

Notes: Items 10 and 11 each relate to less than 70 people.
Items 12 to 15 relate to less than 10 people in total and about £60000/year in total.
No global estimate of the unfunded liability is available.
'R' indicates that regulations can be made under the Superannuation Act 1972 to transfer the liability to the WASF.

Table 3: Current and deferred unfunded liabilities paid by water authorities to pensioners

16. Long-term compensation and retirement compensation awards.
Compensation for Loss of Office Regulations 1974 SI No 463

17. Pensions payable to former Chairmen in preference to WASF acting as paying agent - determinations made by the Secretary of State under the Water Acts 1973 and 1983.

18.R Gratuity awards.
Section 18 of the Local Government Superannuation Act 1953, or
Part K of the LGSR 1986

19.R Injury allowances.
Part L of the LGSR 1986

20. Pensions increase on items 16 to 19.

Thames Water Authority pension arrangements -

21. (i) Responsibility for administering and financing the "closed" Lea Conservancy Catchment Board's Pension Scheme, and pensioners of the former Thames Conservancy.

22. (ii) Payments made or due under Clause 21 of the former Metropolitan Water Board Superannuation and Provident Fund Scheme (compensation for loss of office). In some cases the beneficiary has given an undertaking that a preserved lump sum retiring allowance awarded under the LGSR will be paid to Thames Water Authority when it becomes available in return for the Clause 21 payment.

23. (iii) Enhanced lump sum death benefit available to members of the former MWB Superannuation Scheme where no spouse's or dependent's pension liability exists for death in service and possibly death in retirements.

'R' indicates that regulations can be made under the Superannuation Act 1972 for transferring the liability to the WASF and the corresponding pension increase from item 20.

Table 4: Recharge by local authorities on water authorities

24.R Pensions increase on the funded LGSS pensions etc.
Pensions (Increase) Act 1971

Additional pensions resulting from employer's discretionary decisions under statutory Local Government Superannuation provisions.

25.R (i) Conversion of non-contributing (half rate) to contributing (full rate) service for calculation of benefits.
Section 2(2) of the Local Government Superannuation Act 1953 and
Regulation D9 of the Local Government Superannuation Regulations (LGSR) 1974 SI No 520

26.R (ii) Recognition of indirect employment (articled service) as non-contributing service.
Section 12 of the 1973 Act and
Regulation D4 of the 1974 Regulations

27.R Gratuity payments.
Section 18 of the 1953 Local Government Superannuation Act and
Regulation 7 of the Local Government Superannuation (Benefits) Regulations 1954 SI No 1048

28.R Injury allowances.
Local Government Superannuation Act 1953 and
Local Government Superannuation Regulations 1954 SI No 1048

29. Long-term compensation and retirement compensation from added years of service.
Section 259 of the Local Government Act 1972 and earlier legislation
Compensation for Loss of Office Regulations 1974 SI No 463

30. Pension enhancements from added years of service awarded to former Chief Officers.
Local Government (Retirement of Chief Officers) Regulations 1974 SI No 73 made under Section 260 of the Local Government Act 1972

31. The additional liability imposed on Local Government Superannuation Funds for early payment of LGSS benefits in consequence of the regulations at Item 30 above.
Regulations P11 of the 1986 LGSR (only Anglian Water have made payments so far)

32. Pensions increase added to awards under items 25 to 30 above.
Pensions (Increase) Act 1971

33. Recharges awaiting agreement between local and water authorities on the method of determining and the amount of the reimbursements to be made for additional liability imposed on LGS funds.
Regulation P11 of LGSR 1986 SI No 24

Note: Additionally there are deferred pension liabilities under items 24 to 26.

'R' indicates that regulations can be made under the Superannuation Act 1972 for transferring the liability to the WASF and the corresponding pension increase from item 32.

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The baseline recalled by this research is not good. There was extensive and critical press coverage during the survey period, but the concerns seem more fundamental.

FROM: J D PORTES
DATE: 3 March 1989

1. MR BENT
2. FINANCIAL SECRETARY

Once the Bill is behind them, DOE Ministers will need to stress: that this is a business like any other; that Chairman and Ministers will be fully behind the offer of shares when they come to the market later this year; and that a little uncertainly and misconception is only to be expected in these preliminary stages. This political backdrop will be essential if the corporate and flotation advertising is to make its mark.

cc Chancellor
Chief Secretary
Mr Monck
Mr Moore
Mr M Williams
Mr Holgate
Mr Judge
Mr Kelly
Mr P Morgan

WATER PRIVATISATION: MARKET RESEARCH

JB 3/3

As set out in my submission of 5 December 1988, the Government and the Water Authorities Association have commissioned MORI to track the attitudes of the general public to the water industry in the run-up to privatisation.

2. This survey was conducted just before the start of the industry's corporate advertising campaign. It will serve as the 'baseline' against which the success of the advertising campaign will be measured.

3. The figures have changed little since the last survey in November - in other words they're still pretty bad. Several more sensitive questions have been deleted from the survey for the time being, both because they are not particularly helpful in planning the advertising and for fear of leaks. The questions deleted include "Do you support/oppose privatisation" and "Are you interested in buying shares". Other indications are that the ratings on these points are still very negative. These questions will be reinstated nearer the flotation campaign.

Industry's image

4. Some improvements here:

	November 1988	February 1989	Change
Needs huge investment	38	29	-9
Safe to invest in	16	19	+3
Inefficient	15	11	-4

6. It would have been unrealistic to have expected a significant improvement in these figures given recent publicity. We would now hope that the corporate advertising campaign, and better planned and coordinated public relations from Government and industry, would start to improve the industry's image.

7. Dewe Rogerson (our market research advisers), have submitted detailed advice on how this might be achieved: they emphasise that both Government and industry must make clear in public that they believe privatisation will be achieved on schedule, and that it will be successful. As I said in my submission of 5 December, we believe that an overstressing by DOE of the environmental aspects of the privatisation and the necessity for substantial capital expenditure has not helped the prospects for a sucessful flotation; we agree with Dewe's recommendation that all parties must make it clear that we intend to float profitable and sucessful businesses. In practice this redirection of the public relations campaign is unlikely to take place befor the the Bill leaves the Commons at Easter, and maybe not until Royal Assent in July.

8. We will continue to keep you in touch with developments.

J D PORTES

Effects of privatisation

5. The perception here is still fairly negative:

Q Do you think that the charges that you pay for water related services will be higher when the industry is privatised, or higher if it was not privatised?

	November 1988 %	February 1989 %	Change +%
Higher if privatised	81	83	+2
Higher if not privatised	5	4	-1
No difference	8	7	-1
No opinion	6	6	0

Q And do you think that privatisation will result in a better or worse service to the consumer?

	November 1988 %	February 1989 %	Change +%
Better	30	29	-1
Worse	39	36	-3
Neither	19	23	+4
No opinion	11	12	+1

Q And do you think the industry will be run more efficiently if it is privatised, less efficiently or will there be no difference?

	November 1988 %	February 1989 %	Change +%
More efficient	34	34	0
Less efficient	27	26	-1
No difference	31	32	+1
No opinion	8	8	0

Q And do you think the industry will care more for the environment if it is privatised, do you think it will care less or will there be no difference?

	November 1988 %	February 1989 %	Change +%
Care more	20	18	-2
Care less	37	40	+3
No difference	36	35	-1
Don't know	7	7	0

cst.ps/15jm6.3/lets

CONFIDENTIAL

CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P

cc:
Chancellor
FST
Sir Peter Middleton
Mr Anson
Mr H Phillips
Miss Peirson
Mr Moore
Mr Edwards
Mr Saunders
Mr A M White
Mr Griffiths
Mr Bent
Mr Meadows
Mr Portes
Mr Call

The Rt Hon Malcolm Rifkind QC MP
Secretary of State for Scotland
Scottish Office
Dover House
Whitehall
London
SW1A 2AU

6th March 1989

Dear Malcolm,

FLUORIDATION OF WATER SUPPLIES

Thank you for your letter of 28 February.

I was interested to see that the Scottish water authorities have not questioned the exclusion of negligence from the draft Indemnity you have put to them but I am content for you to offer the limited extension we have agreed for England. This is, of course, subject to the same two conditions I set out in my letter of 31 January. From what you say it seems unlikely that we will need to invoke the threat of taking powers of direction. But the grant of an indemnity involves a contingent liability and it is essential that, in accordance with government accounting principles, the indemnity is put on a statutory basis as soon as possible. I understand that we can use the Water Bill for this purpose. I am not sure when your indemnity will be finalised but if you wish to issue it before the Bill is enacted, you will also need to follow the procedure agreed with the PAC for handling new non-statutory indemnities: it would have to be notified to Paliament by means of a Departmental Minute 14 days in advance of its being granted.

I am copying this letter to Nicholas Ridley, Kenneth Clarke, Peter Walker, Tom King, Michael Howard and to Sir Robin Butler.

Yours Ever, John

JOHN MAJOR

CONFIDENTIAL

fst.jf/Robert/6.3.2

FROM: R C M SATCHWELL
DATE: 6 March 1989

MR G E N S WILSON

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
Sir P Middleton
Mr Anson
Dame A Mueller
Mr Monck
Mr Moore
Mr Bent
Mr MacAuslan
Mr Potter
Mr M L Williams
Mr Wood
Mr Judge
Mr M Newman
Mr Rayson
Mr Sheridan
Mrs Walker
Mrs Chaplin
Mr Call
Mr Hyett (T.Sol)
Mr Ballentine (GAD)

WATER PRIVATISATION: PENSIONS - UNFUNDED LIABILITIES

The Financial Secretary was grateful for your minute of 2 March which he discussed with you and Mr Bent. He is content with the approach set out in your minute.

R.C.M.S.

R C M SATCHWELL
Private Secretary

FROM:- R. HALLER
DATE:- 6/3/89
Reference .....

The following page is to be attatched to MR PORTES's minute of 3/3/89 entitled Water Privatisation: Market Research.

R Haller.

PE2 x4934.

CODE 18-78

6. It would have been unrealistic to have expected a significant improvement in these figures given recent publicity. We would now hope that the corporate advertising campaign, and better planned and coordinated public relations from Government and industry, would start to improve the industry's image.

7. Dewe Rogerson (our market research advisers), have submitted detailed advice on how this might be achieved: they emphasise that both Government and industry must make clear in public that they believe privatisation will be achieved on schedule, and that it will be successful. As I said in my submission of 5 December, we believe that an overstressing by DOE of the environmental aspects of the privatisation and the necessity for substantial capital expenditure has not helped the prospects for a sucessful flotation; we agree with Dewe's recommendation that all parties must make it clear that we intend to float profitable and sucessful businesses. In practice this redirection of the public relations campaign is unlikely to take place befor the the Bill leaves the Commons at Easter, and maybe not until Royal Assent in July.

8. We will continue to keep you in touch with developments.

J D PORTES

FROM: J P GRAYDON
DATE: 6 MARCH 1989

c PS/Chancellor
PS/FST
PS/EST
PS/Paymaster General
Mr Anson
Mr Monck
Mr S Wood
Mr Bent
Mr Meyrick
Mr Dodds

Approved in draft.

1. **MR BURGNER**
2. **CHIEF SECRETARY**

NITRATE IN DRINKING WATER

1. Mr MacGregor's letter of 2 March covers a paper by officials on a compensation scheme for farmers affected by nitrate restrictions and the means of funding it. This responds to the remit agreed by E(A) Committee on 19 October. A summary of the paper's recommendations is annexed to the letter. No 10 has asked Mr MacGregor to resolve any issues not agreed by officials (i.e. a nitrogen levy and responsibility for scheme administration) outside E(A) because of the pressure of work on that sub-committee. It is intended to table the necessary amendments to the Water Bill at Report Stage just before Easter. This submission offers advice on the main issues raised by the paper.

Background

2. E(A) on 19 October agreed that action would be needed to meet the limit of 50 mg per litre of nitrate in the EC Drinking Water Directive. A mixture of water treatment measures and agricultural restrictions will be necessary with the

mix varying in accordance with local circumstances. The Secretary of State for the Environment on the recommendation of the National Rivers Authority (NRA) will be responsible for designating Water Protection Zones in which certain agricultural restrictions may be applied.

3. Although the polluter pays principle would normally rule out compensation for a polluting industry, E(A) considered that nitrate pollution was a special case and agreed that "individual farmers should be compensated where they were subject to substantial restrictions which went beyond the imposition of good agricultural practice". The Minister of Agriculture was invited to develop a detailed compensation scheme urgently but also to explore further the possibility of a small levy of artificial nitrogen fertilizers to recoup the costs of compensation from the farming industry.

4. An official group was set up to fulfil this remit. The group was chaired by MAFF with DOE, DTI, FCO and Treasury representatives. The group reached a wide measure of agreement on the principles of the sort of compensation scheme which might be introduced, although much work on the details remains to be done. The main issues discussed in the report and the line we would recommend you to take on them are summarised in the following paragraphs.

Agricultural Restriction Options

5. The report suggests three main types of agricultural restrictions:

(i) conversion of arable land into unimproved grassland (ie set aside): this would be likely to have the greatest impact on nitrate leaching; would be relatively easy to enforce and should reduce production and thus expenditure on CAP support. Compensation would need to be paid at about £300/ha (compared with £200/ha under the present set aside scheme).

(ii) fertiliser limitation scheme: restricting fertiliser applications to, say, 80% of the levels recommended as "good agricultural practice" could have some beneficial effect on leaching but would be difficult to police and offer relatively small CAP savings. Compensation might be pitched in the range £15 to £25/ha;

(iii) more general application of good agricultural practice could itself reduce leaching. But this would not be subject to compensation.

6. The group agreed that these seemed the most appropriate forms of restriction for predominantly arable areas in the east of the country. Other schemes might have to be developed for areas where mixed farming predominates. It was agreed that as an initial step the Government should mount an intensive advisory campaign in nitrate affected areas to promote good agricultural practice (eg to reduce the wasteful use of fertilizers) but it should indicate that, if this failed, these principles should be introduced compulsorily without compensation. Compensation would be offered for those who volunteered to accept restrictions of types (i) and (ii) above. If the voluntary approach failed to achieve the desired results the Bill would provide for compulsory restrictions to be introduced. These would also be subject to compensation. It is recommended (**recommendation (i)**) that MAFF and DOE officials should hold formal consultations with all interested parties about these proposals. Given the lack of precise knowledge about the effects of various measures on nitrate leaching it is also recommended (**recommendation (ii)**) that restrictions be applied in pilot areas first. Both these recommendations are sensible.

Costs

7. The annexes to the paper by officials contain some illustrative costings of the various types of restrictions; an estimate of their administrative costs and of the directly attributable CAP savings resulting from reduced production. We have been consulted about these calculations and are content that they are the best that can be done on the information available. They are, however,

inevitably subject to wide margins of error. Broadly, the tables show that once protection zones had been designated covering some 250,000 ha (about 2.5% of the agricultural area of England and 6% of its total arable and cropping area) compensation costs might amount to about £24 million a year and administration costs to about £1.5 million a year but on current and foreseeable CAP policies these costs would be more than offset by savings on CAP market support ranging from £25m to £45m a year. It would of course take several years to process this number of designations, deal with any necessary public inquiries and set up the schemes, so the implications in the 1989 PES years are likely to be quite modest.

Nitrogen Levy

8. The report considers the option of introducing a small levy on nitrogenous fertilisers to fund the compensation scheme but adduces a large number of arguments against this course: for example

(i) it seems unlikely that other EC Member States will introduce similar levies so that if the UK set up a levy unilaterally we would be putting our producers at a competitive disadvantage;

(ii) there could be difficulties in introducing a new levy on imports in the run up to 1992;

(iii) a levy on fertilizers would affect all farmers including those who are not contributing to the nitrates problem. There would also be complaints from the fertilizer manufacturers;

(iv) presentationaly it might be difficult to justify imposing a new levy when the calculations suggest that compensation costs will in practice be more than offset by CAP savings.

9. There was no support for a nitrogen levy from other Departments represented on the group and we would not recommend that you press this idea further in this context. We recommend that you accept the alternative recommendation (**recommendation (iv)** for the compulsory introduction of good agricultural practice. But we suggest that in addition you seek a firm agreement that individual compensation schemes should be set up only where their costs are likely to more than offset by directly attributable CAP savings (calculated on the basis of prudent assumptions on the future level of CAP and world prices), and that, if the farming industry suggest that compensation on this basis is not sufficiently generous, they should be encouraged to set up a fund to supplement the compensation offered by the Government at their own expense.

Ensuring the correct local mix of agricultural and water measures

10. The paper concludes against allowing water plc.s to set up their own compensation schemes, subject to some degree of subsidy from Government, and recommends (**recommendation (v)**) that compensation schemes should be run on traditional lines with payments direct from Government to farmers. But the paper also recommends (**recommendation (vi)**) that water plc.s should be allowed to top up Government compensation payments if they wish. There would be some logic in letting the water plc.s take the decision on whether to introduce agricultural restrictions or to alleviate the problem through blending but there could be difficulty in ensuring that schemes run by the water plc.s would achieve good value for any subsidy offered by Government. These recommendations therefore seem acceptable.

Scheme Administration

11. The report reflects a dispute between MAFF and DOE about which department should be responsible for running compensation schemes. It sets out three options (options (i),(ii) and (iii)) for financial and administrative responsibility. Mr Macgregor has reached an agreement with Mr Ridley that option (iii) -MAFF to

assume statutory responsibility for both voluntary and compulsory schemes with technical advice from the NRA and Water plc.s on the areas to be designated- should be adopted but with both Ministers and the Treasury signing the necessary orders. This accords with our view that the Environment Secretary should be responsible for designating Water Protection Zones on the recommendation of the NRA and in consultation with MAFF. We also agree that it would be more appropriate for MAFF to set up and run compensation schemes because they have experience in running similar schemes and the funding will be transferred from another part of the agriculture programme (i.e. IBAP). I therefore recommend that you endorse the agreement reached with Mr Ridley which includes provision for the Treasury to be formally consulted on the details of any compensation schemes.

EC Proposal and Use of existing EC/Uk Agricultural schemes for Nitrate Control

12. MAFF have shown reluctance to press for amendments to the EC agricultural structures Regulation (797/85) to adapt existing schemes (eg set aside) so that they could be used to compensate farmers in nitrates areas with the benefit of some EC reimbursement. It seems a pity to forego EC receipts in this way. While we would not deny that it will be necessary to include an enabling power to pay compensation in the Water Bill, it would seem prudent to make it clear that in practice the Government may prefer to introduce schemes under EC vires. The new draft EC Directive to limit pollution by nitrate may provide another opportunity. The use of EC powers would not only avoid any risk of challenge on the grounds that compensation is an illegal state aid but could provide some EC reimbursement of the compensation costs.I therefore recommend that you endorse **recommendation (viii)** on officials holding informal dfiscussions with the European Commission about the UK proposals and **recommendation (ix)** on the UK as appropriate exploring the possibility of seeking a European Commission contribution to a UK compensation scheme. But it needs to be made clear in the latter case that you expect the possibility of EC reimbursement to be actively pursued.

Water Bill amendments

13. The paper recommends (**recommendation x**) that, in the light of Ministerial decisions, instructions should be sent to Parliamentary Counsel with a view to amendments to the Water Bill being tabled at Report Stage. This is acceptable.

14. I attach a draft reply to Mr MacGregor.

James Graydon

J P GRAYDON

iae.st/Gr/276

DRAFT LETTER TO:

Rt Hon J MacGregor
Ministry of Agriculture, Fisheries and Food
Whitehall Place
LONDON SW1A 2HH

NITRATE IN DRINKING WATER

Thank you for your letter of 6 March.

I agree the approach recommended by officials in respect of agricultural restrictions. I regard it as particularly important that the initial step should be an intensive advisory campaign in affected areas to promote the voluntary application of good agricultural practice (GAP) with GAP being applied compulsorily without compensation if the campaign fails to produce the necessary changes in behaviour. I also agree with the conclusion that the first designated zones should represent a pilot sample of catchment areas in which a range of measures can be tested. Given the current imperfect state of our knowledge of the options we are considering these pilot schemes will be useful in obtaining further information on which to base more reliable costings.

In the light of the problems involved in introducing a nitrogen levy to recoup the costs of compensation from the farming industry, I am prepared to accept that this option should not be pursued, at least for the present. However, I regard it as important that schemes should as far as possible be covered by CAP savings. My agreement to not pursuing the nitrogen levy option is therefore conditional on an agreement that individual compensation schemes should only be set up where costs are likely to be more than offset by directly attributable CAP savings (calculated on the basis of prudent

assumptions on the future level of the CAP and world prices). If this level of compensation proves unacceptable to the farming industry we should encourage them to set up a fund to supplement the compensation available from Government. This approach will enable an element of the polluter pays principle to be applied and a precedent for it exists in the arrangements we introduced for compensating poultry farmers for Newcastle disease. I also agree that it is sensible as a further string to our bow to provide for the water industry to voluntarily make top up payments where CAP savings are insufficient to fund compensation fully.

I am happy with the agreement you have reached with Nicholas Ridley on departmental responsibility for scheme design and administration which provide for any statutory instruments introducing schemes to be subject to Treasury consent.

I support recommendations (viii) and (ix). We should pursue every opportunity to obtain European Commission reimbursement of our compensation costs either through the recently proposed draft nitrate directive on limiting pollution by nitrate or through amendments to existing schemes, such as set aside, which are made under EC Regulation 797/85. The latter Regulation is shortly to be reviewed and this should provide the opportunity we need to obtain amendments that enable us to obtain reimbursement. When the time comes I would like my officials to be closely involved with negotiations with the Commission.

Finally I would also like my officials to be involved with the drafting of the necessary amendments to the Water Bill and for the introductory speech to be cleared with them in draft..

I am copying this letter to Nicholas Ridley and David Young.

JOHN MAJOR

Ministry of Agriculture, Fisheries and Food
Whitehall Place, London SW1A 2HH

PPS PT

From the Minister

The Rt Hon John Major MP
HM Treasury
Parliament Street
LONDON
SW1P 3AG

CHIEF SECRETARY
REC. - 6 MAR 1989
ACTION Mr Grayden.
COPIES TO Cx Mr Alwen, Mr Burgner, Mr Selwood, Mr Bent, Mr Dodds

6 March 1989

Dear Chief Secretary,

NITRATE IN DRINKING WATER

At its 14th meeting on 19 October 1988 E(A) invited me, in consultation with the Secretary of State for the Environment and the Financial Secretary, Treasury, "to develop detailed proposals for a compensation scheme for farmers affected by agricultural restrictions, and to explore further the possibility of a levy on fertilisers to recoup the costs of such compensation, holding discussions with other European Community Member States and the Commission as necessary". It also invited me "to carry forward the recommendations on further publicity and education, research and the review of Government agricultural schemes on the basis recommended in the Note by Officials".

An inter-departmental working group has now considered these issues and I attach a copy of its report plus a list of the conclusions. As you know, Number 10 have asked me in view of the pressure of other business in E(A) to resolve the outstanding issues with you and Nicholas Ridley outside that forum. Officials have reached a large measure of agreement on many of the issues, although there are one or two which remain unresolved. A summary of officials' recommendations are annexed to this letter.

I invite you and Nicholas Ridley to endorse the conclusions and recommendations on which officials are agreed, namely recommendations (i), (ii), (v), (vi), (viii) - (x).

/I also recommend...

I also recommend that, in the light of the work of officials we should agree not to proceed with a nitrogen or any other form of levy. But I suggest that we should endorse recommendation (iv) as a way of applying the Polluter Pays Principle to farmers.

I have now been able to discuss the question of Scheme Administration with Nicholas Ridley. We are agreed that the best course would be to follow option (iii) but with both the Minister of Agriculture, Fisheries and Food, the Secretary of State for the Environment and a Treasury Minister signing the necessary orders. In order to be ... clear on what this option entails, I enclose a list of the main steps.

We are now hard pressed by the Parliamentary timetable if we are to fulfil our objective of tabling the necessary amendments to the Water Bill during its Commons stages. Lawyers have advised that instructions must be with Parliamentary Counsel as early as possible. I would therefore be grateful if I could have your agreement to the line I recommend above by close of play on Tuesday 7 March, if at all possible.

I am copying this letter to Nicholas Ridley. I am also copying it to David Young in view of his particular interest in the nitrogen levy.

When we have reached final agreement I would propose to inform the Prime Minister and other members of E(A) of its substance.

Yours sincerely,

S. J. Lambert

JOHN MacGREGOR
Approved by the Minister and signed in his absence

Main steps in scheme development and administration:

Option (iii)

1. NRA will select the areas;

2. MAFF will determine options for agricultural measures to apply therein, and NRA will determine options for water treatment;

3. MAFF will chair a Joint Committee including NRA, DOE, the Treasury to determine choice of water treatment and/or agricultural measures;

4. MAFF will secure PES provision;

5. MAFF lawyers will draft designation order which will be signed by MAFF, DOE and Treasury Ministers.

6. MAFF will police compliance with restrictions;

7. NRA will monitor water quality.

ANNEX

SUMMARY OF RECOMMENDATIONS IN NOTE BY OFFICIALS

AGRICULTURAL RESTRICTION OPTIONS (Para 5-15)

i. MAFF and DOE officials should hold formal consultations with farming, fertiliser, water (including NRA) and other interests on the detailed ideas for nitrate compensation schemes and on aspects of good agricultural practice which might apply generally throughout designated areas; and

ii. the first designated zones should represent a pilot sample of catchment areas in which a range of agricultural measures can be tested; and officials and the NRA should prepare proposals on the number, type and phasing of the introduction of such zones including an assessment of the additional manpower resources required.

NITROGEN LEVY (Paras 20-26)

iii. Ministers are invited to decide whether or not they wish to pursue further the option of meeting the gross cost of compensation payments through a nitrogen levy or raising contributions from farmers through levies raised by existing producer organisations; and

iv. if they do not, they are asked to indicate whether the Government should make it clear that, unless an intensive advisory campaign proves effective, it will introduce compulsory good agricultural practice measures (without compensation) in all designated zones in order to demonstrate that all farmers in the affected areas were contributing to a solution to the problem.

ENSURING CORRECT LOCAL MIX OF AGRICULTURAL AND WATER MEASURES (Paras 27-31)

v. the nitrate compensation scheme should operate on traditional lines, through direct payments from Government or NRA to farmers;

vi. but it should be understood that water PLCs might voluntarily top up Government compensation payments to the required level when it is cost effective for them to do so.

SCHEME ADMINISTRATION (Paras 32-35)

vii. Ministers are invited to consider options for financial and administrative responsibility.

EC PROPOSAL (Para 36-38)

viii. officials should hold informal discussions with the EC Commission to apprise them of the UK's proposals for a nitrate compensation scheme and to obtain early warning of any possible areas of infringement of EC state aid rules.

USE OF EXISTING EC/UK AGRICULTURAL SCHEMES FOR NITRATE CONTROL (Paras 39-43)

ix. the UK should as appropriate explore the possibility in Brussels of seeking a Community contribution to a UK nitrate compensation scheme taking account of the difficulties outlined above.

AMENDMENTS TO WATER BILL (Paras 44-45)

x. in the light of Ministers' decisions on the issues above, instructions be sent to Parliamentary Counsel with a view to the necessary amendments to the Water Bill being tabled at Report Stage (before Easter).

Susan 03.6.03.89

FROM: MISS S J FEEST
DATE: 6 March 1989

MR J D PORTES

cc Chancellor
Chief Secretary
Mr Monck
Mr Moore
Mr M Williams
Mr Holgate
Mr Judge
Mr Kelly
Mr P Morgan

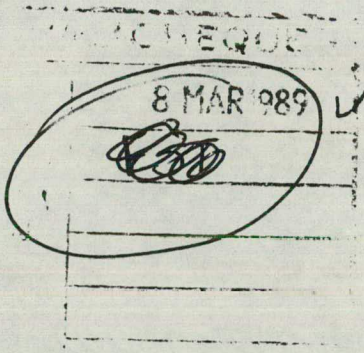
WATER PRIVATISATION: MARKET RESEARCH

The Financial Secretary was grateful for your minute of 3 March 1989 and has noted the contents.

Susan

SUSAN FEEST

-8 MAR 1989

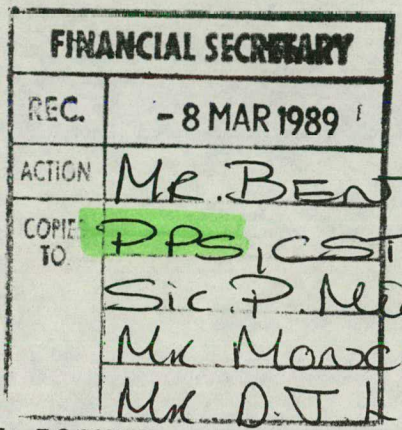


2 MARSHAM STREET
LONDON SW1P 3EB
01-276 3000

My ref:

Your ref:

Paul Gray Esq
Private Secretary to
The Prime Minister
10 Downing Street
LONDON
SW1A 2AA



7 March 1989

Dear Paul

WATER PRIVATISATION: BULL POINTS

At Cabinet last week, my Secretary of State promised to circulate to his colleagues "bull points" on water privatisation upon which they could draw as necessary for speeches etc in putting across the case for privatisation.

Accordingly, I enclose a set of such "bull points". I also enclose a copy of a recent article my Secretary of State placed in the Times, which sets out the arguments which he and Ministers in this Department are deploying in support of water privatisation, and which colleagues may also find useful source material.

Copies of this letter and enclosures go to the private secretaries to all Members of Cabinet, to Murdo MacLean and to Trevor Woolley in Sir Robin Butler's office.

Yours

R BRIGHT
Private Secretary

cc: Mr S Judge
Miss J Swift
Mr Tyrie
Mr Call

WATER PRIVATISATION: BULL POINTS

- The Water Industry is not an immutable part of the public sector. Some 25% of our drinking water in England and Wales has for a long time been supplied by private sector water companies. French water companies are private too - dynamic, skilful and efficient enterprises.

- The Water Bill is a radical and major step forward for the water environment. The National Rivers Authority will provide strong, new environmental controls. The Director General of Water Services will provide a tough regulatory framework to protect the consumer from excessive charges.

- Separation of environmental and economic regulation from those providing water supplies and sewage treatment is vital if conflicts of interest are to be avoided. The water authorities have hitherto been asked to be both poacher and gamekeeper. But the new National Rivers' Authority will be dedicated to pollution control, under Ministerial responsibility

- Only privatisation can separate ownership of the industry from its regulation. And only privatisation can unlock the door to access to private sector funds, ending the present position where spending on water industry infrastructure competes annually with hospitals and schools for a share of the public purse. Nothing could be clearer than the effect of the IMF paymaster on water authorities' investment, which was cut by a third between 1974 and 1979.

- The public rightly demands higher standards of water quality. These would have to be paid for whether the businesses are in the public or private sector. They can be provided most quickly by a private sector able to borrow

through the capital markets and smooth out increases in charges over a period of time. And they will be provided most efficiently and at minimum cost within the disciplines of the private sector.

- Capital spending by the water authorities is now at its highest level since 1973 - around £1.4 billion this year. Talk of doubling or trebling charges to pay for new environmental improvements is nonsense. The extra capital cost of accelerating the water authorities' existing programmes to meet the higher standards demanded of our bathing waters and drinking water, and to achieve full compliance with our sewage treatment standards, is at present estimated at about £2.4 billion.

- The daily measure of performance - and the market's view of performance - provided by the share price will in itself provide a discipline and a spur to management and to those of the workforce who have invested in their company, releasing the energies and entrepreneurial talents of the industry.

- For all these reasons the Government is firmly committed to the flotation in November of 10 thriving water and sewage businesses which will be attractive to investors, including a substantial number of their millions of customers. We are well and firmly on course.

'THE TIMES' Tuesday, February 21st 1989.
page 16.

Nicholas Ridley

Protecting our liquid assets

The case for privatizing the water industry gets stronger under the pressure of debate. In fact, it was the preparations for privatization which brought out for the first time the contradictions in the present situation, in which the water authorities are both gamekeepers and poachers in controlling quality standards.

We could not let a privatized company remain as the regulatory authority for pollution control, water quality, abstraction, discharge and the like, when such functions were clearly at odds with maximizing its efficiency and profits. So we decided that we had to set up the National Rivers Authority (NRA), keeping those regulatory functions in the public sector and under public control.

We led the field in this vital innovation. We have wide support, but the afterthought is that the industry could be left in public ownership now that its gamekeeping function is to be taken over by the NRA. The trouble is that leaving the commercial operation of water provision in the public sector effectively leaves the present anomalous situation unchanged.

It would still be the gamekeeper – the Government – which had responsibility for finding the money for the "poachers" to clean up the water environment (and we are talking about substantial sums of money). Any government is bound to take account of the financial consequences of its own regulatory standards.

This is all very well in times like this when the nation is prospering; we are currently investing in water heavily. But in less happy times, such as the late 1970s, when the International Monetary Fund was cutting back government spending, water industry investment was cut by half – not by lowering publicly the required standards, but by simply not producing the money. So the gamekeeper connived with the poacher to neglect investment.

The only way to deal with this problem is to separate ownership from regulation. That is what privatization will achieve. It is interesting that in the past private industry has been much more stringently controlled than the nationalized industries – interesting but not surprising.

In future the privatized companies will no longer have to wait their turn in a queue for capital investment inevitably headed by health, education and the like. For the first time they will have access to the capital markets for their investment needs. This will make it far easier to finance the heavy programme of work which is needed for environmental protection. It will also make it easier to spread such costs sensibly over time, rather than to have to raise most of the necessary resources year by year through increased charges. The consumer will therefore be better protected against sudden sharp increases in water charges, which might have proved necessary were the industry to remain in the public sector.

There are other powerful reasons why water privatization makes such good sense. The new companies will be required for the first time to draw up detailed plans for the management of their assets. And over a period of time the discipline of the private sector will ensure that those assets are managed much more efficiently.

The greater involvement and motivation of all employees through their ownership of shares will help to ensure this. Time after time privatization has shown what a transformation this can help bring about. There is no reason why these incentives should not have the same effect in the water industry as in others.

Of course, there has to be strict price regulation to prevent the exploitation of the water companies' inevitable monopoly position. That is why a director general of water services will be appointed to control the price of water to customers. Some people have suggested that dividend control would provide better protection for consumers than the price regime contained in the Water Bill. This argument is remarkably ill-timed: the private statutory water companies, now subject to precisely that regime, have just announced their intention to pre-empt price control with increases of as much as 50 per cent.

But there is another reason why public regulation of prices is the right way forward. The public will be presented with the results of higher quality and higher standards in the prices they are asked to pay. The river quality objectives will be decisions openly arrived at and endorsed by Parliament and the director general, who will be responsible for translating these decisions into the cost of water services.

This – not the Chancellor of the Exchequer – will make clear the trade-off between quality and cost. No longer will it be the covert, unregulated deal between industry and government on what can be afforded, as it always has been with the nationalized industries. Instead, Parliament will be invited to approve the standards, and the director general will have to provide for meeting the cost of achieving them in the price limits he will set.

The director general's job will certainly be difficult. He must analyse and justify allowable costs and investment requirements alongside an assessment of the efficiency of each company – what we call "comparative" competition. This has never been done before.

The new companies will not be allowed to load on to their customers the bill for inefficiency. Shareholders will benefit only if they are more efficient than their rivals. If they are not, it is their shareholders who will suffer. That is a fair and reasonable balance to strike.

Regulation will apply only to the "core" businesses: the new companies will be able to develop their businesses through diversification in other areas, such as recreation and overseas contracts.

Despite strict regulation to protect the consumer and to ensure that environmental standards are met, the companies will be able to benefit in other ways. Freed from constraints on public sector capital spending, they will be able to borrow from the capital markets. Managers will be able to manage their businesses independently of artificial national structures of wage-bargaining and the like.

Faced with these arguments, the critics now complain about the manner of privatization. It is even suggested that the Government dispossessed local councils of their water assets. Indeed in 1973 Parliament *did* dispossess them by statute – of the authorities' heavy debt burden and of the responsibility for meeting their huge need for capital investment.

Of course it is right that the taxpayers should benefit from the proceeds of the sale – they subscribed the investments of the past. The sale proceeds will be available, either to reduce the National Debt – which will save the taxpayer considerable sums in debt interest in the future – to increase spending on desirable public programmes or to reduce the burden of taxation.

And by selling shares to the public – including the customers and the employees of the water authorities – we will be giving the public the chance to participate as shareholders in the success of the new companies.

There is no inherent reason why the state should run any industry unless there is a clear public interest for it to do so. What is vital is that the state has the necessary powers of regulation. We have got this right with water, and I have no doubt that privatization will be good for the workers, good for consumers and good for the environment.

2 MARSHAM STREET
LONDON SW1P 3EB
01-276 3000

My ref:

Your ref:

Paul Gray Esq
Private Secretary to
The Prime Minister
10 Downing Street
LONDON
SW1A 2AA

7 March 1989

Dear Paul

WATER PRIVATISATION: BULL POINTS

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Yours Roger

R BRIGHT
Private Secretary

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- Only privatisation can separate ownership of the industry from its regulation. And only privatisation can unlock the door to access to private sector funds, ending the present position where spending on water industry infrastructure competes annually with hospitals and schools for a share of the public purse. Nothing could be clearer than the effect of the IMF paymaster on water authorities' investment, which was cut by a third between 1974 and 1979.

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Nicholas Ridley

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We led the field in this vital innovation. We have wide support, but the afterthought is that the industry could be left in public ownership now that its gamekeeping function is to be taken over by the NRA. The trouble is that leaving the commercial operation of water provision in the public sector effectively leaves the present anomalous situation unchanged.

It would still be the gamekeeper – the Government – which had responsibility for finding the money for the "poachers" to clean up the water environment (and we are talking about substantial sums of money). Any government is bound to take account of the financial consequences of its own regulatory standards.

This is all very well in times like this when the nation is prospering; we are currently investing in water heavily. But in less happy times, such as the late 1970s, when the International Monetary Fund was cutting back government spending, water industry investment was cut by half – not by lowering publicly the required standards, but by simply not producing the money. So the gamekeeper connived with the poacher to neglect investment.

The only way to deal with this problem is to separate ownership from regulation. That is what privatization will achieve. It is interesting that in the past private industry has been much more stringently controlled than the nationalized industries – interesting but not surprising.

In future the privatized companies will no longer have to wait their turn in a queue for capital investment inevitably headed by health, education and the like. For the first time they will have access to the capital markets for their investment needs. This will make it far easier to finance the heavy programme of work which is needed for environmental protection. It will also make it easier to spread such costs sensibly over time, rather than to have to raise most of the necessary resources year by year through increased charges. The consumer will therefore be better protected against sudden sharp increases in water charges, which might have proved necessary were the industry to remain in the public sector.

There are other powerful reasons why water privatization makes such good sense. The new companies will be required for the first time to draw up detailed plans for the management of their assets. And over a period of time the discipline of the private sector will ensure that those assets are managed much more efficiently.

The greater involvement and motivation of all employees through their ownership of shares will help to ensure this. Time after time privatization has shown what a transformation this can help bring about. There is no reason why these incentives should not have the same effect in the water industry as in others.

Of course, there has to be strict price regulation to prevent the exploitation of the water companies' inevitable monopoly position. That is why a director general of water services will be appointed to control the price of water to customers. Some people have suggested that dividend control would provide better protection for consumers than the price regime contained in the Water Bill. This argument is remarkably ill-timed: the private statutory water companies, now subject to precisely that regime, have just announced their intention to pre-empt price control with increases of as much as 50 per cent.

But there is another reason why public regulation of prices is the right way forward. The public will be presented with the results of higher quality and higher standards in the prices they are asked to pay. The river quality objectives will be decisions openly arrived at and endorsed by Parliament and the director general, who will be responsible for translating these decisions into the cost of water services.

This – not the Chancellor of the Exchequer – will make clear the trade-off between quality and cost. No longer will it be the covert, unregulated deal between industry and government on what can be afforded, as it always has been with the nationalized industries. Instead, Parliament will be invited to approve the standards, and the director general will have to provide for meeting the cost of achieving them in the price limits he will set.

The director general's job will certainly be difficult. He must analyse and justify allowable costs and investment requirements alongside an assessment of the efficiency of each company – what we call "comparative" competition. This has never been done before.

The new companies will not be allowed to load on to their customers the bill for inefficiency. Shareholders will benefit only if they are more efficient than their rivals. If they are not, it is their shareholders who will suffer. That is a fair and reasonable balance to strike.

Regulation will apply only to the "core" businesses: the new companies will be able to develop their businesses through diversification in other areas, such as recreation and overseas contracts.

Despite strict regulation to protect the consumer and to ensure that environmental standards are met, the companies will be able to benefit in other ways. Freed from constraints on public sector capital spending, they will be able to borrow from the capital markets. Managers will be able to manage their businesses independently of artificial national structures of wage bargaining and the like.

Faced with these arguments, the critics now complain about the manner of privatization. It is even suggested that the Government dispossessed local councils of their water assets. Indeed in 1973 Parliament *did* dispossess them by statute – of the authorities' heavy debt burden and of the responsibility for meeting their huge need for capital investment.

Of course it is right that the taxpayers should benefit from the proceeds of the sale – they subscribed the investments of the past. The sale proceeds will be available, either to reduce the National Debt – which will save the taxpayer considerable sums in debt interest in the future – to increase spending on desirable public programmes or to reduce the burden of taxation.

And by selling shares to the public – including the customers and the employees of the water authorities – we will be giving the public the chance to participate as shareholders in the success of the new companies.

There is no inherent reason why the state should run any industry unless there is a clear public interest for it to do so. What is vital is that the state has the necessary powers of regulation. We have got this right with water, and I have no doubt that privatization will be good for the workers, good for consumers and good for the environment.

cst.ps/6jm7.3/lets

cc:
PS/Chancellor
PS/FST
PS/EST
PS/PMG
Mr Anson
Mr Monck
Mr Burgner
Mr S Wood
Mr Bent
Mr Meyrick
Mr Dodds
Mr Graydon

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon John MacGregor OBE MP
Minister of Agriculture, Fisheries and Food
Whitehall Place
London
SW1A 2HH

7 March 1989

Dear Minister,

NITRATE IN DRINKING WATER

Thank you for your letter of 6 March.

I agree the approach recommended by officials in respect of agricultural restrictions. I regard it as particularly important that the initial step should be an intensive advisory campaign in affected areas to promote the voluntary application of good agricultural practice (GAP) with GAP being applied compulsorily without compensation if the campaign fails to produce the necessary changes in behaviour. I also agree with the conclusion that the first designated zones should represent a pilot sample of catchment areas in which a range of measures can be tested. Given the current imperfect state of our knowledge of the options we are considering these pilot schemes will be useful in obtaining further information on which to base more reliable costings.

In the light of the problems involved in introducing a nitrogen levy to recoup the costs of compensation from the farming industry, I accept that this option should not be pursued, at least for the present. However, it is important that schemes should as far as possible be covered by CAP savings. My agreement to not pursuing the nitrogen levy option is therefore conditional on an agreement that individual compensation schemes should only be set up where costs are likely to be more than offset by directly attributable CAP savings (calculated on the basis of prudent assumptions on the future level of the CAP and world prices). If this level of compensation proves unacceptable to the farming industry we should encourage them to set up a fund to supplement the compensation available from Government. This approach will enable an element of the polluter pays principle to be applied and a precedent for it exists in the arrangements we introduced for compensating poultry farmers for Newcastle disease. I also agree that it is sensible as a further string to our bow to provide for the water industry to voluntarily make top up payments where CAP savings are insufficient to fund compensation fully.

I am happy with the agreement you have reached with Nicholas Ridley on departmental responsibility for scheme design and administration which provide for any statutory instruments introducing schemes to be subject to Treasury consent.

I support recommendations (viii) and (ix). We should pursue every opportunity to obtain European Commission reimbursement of our compensation costs either through the recently proposed draft nitrate directive on limiting pollution by nitrate or through amendments to existing schemes, such as set aside, which are made under EC Regulation 797/85. The latter Regulation is shortly to be reviewed and this should provide the opportunity we need to obtain amendments that enable us to obtain reimbursement. When the time comes I would like my officials to be closely involved with negotiations with the Commission.

Finally I would also like my officials to be involved with the drafting of the necessary amendments to the Water Bill and for the introductory speech to be cleared with them in draft.

I am copying this letter to Nicholas Ridley and David Young.

Yours sincerely,

P. Wales

pp JOHN MAJOR

[Approved by the Chief Secretary and signed in his absence.]

SECRETARY OF STATE FOR THE ENVIRONMENT

2 MARSHAM STREET
LONDON SW1P 3EB
01-276 3000

My ref:

Your ref:

The Rt Hon John Major MP
Chief Secretary
HM Treasury
Parliament Street
LONDON
SW1P 3AG

8 March 1989

Dear Chief Secretary

NITRATE IN DRINKING WATER

I have seen John MacGregor's letter to you of 6 March. He reports on the proposals from the officials working group set up following E(A) to develop a compensation scheme for farmers affected by agricultural restrictions needed to reduce nitrate levels.

I endorse John's proposals. In particular, I am content with the arrangements for administration of the compensation scheme. I see the key points of the administration as:

a) NRA to be responsible for:

- identifying those areas where action is necessary;

- determining the options for water treatment in these areas;

- monitoring the effectiveness of the measures agreed.

b) MAFF to be responsible for:

- determining the options for agricultural restrictions;

- securing PESC provision and making payments to farmers;

- monitoring compliance by farmers with the measures agreed.

c) a joint committee of officials to agree the mix of measures to be introduced in each case, on the basis of assessments by MAFF and the NRA.

d) for the Orders designating zones and authorising compensation to be signed by DOE, MAFF and Treasury Ministers.

I shall be pursuing with John MacGregor the separate question of an early announcement of these proposals, so that officials can begin consultations with interested parties.

I am sending a copy of this letter to John MacGregor and to David Young.

Yours sincerely
R Bright

NICHOLAS RIDLEY

(approved by the Secretary of State and signed in his absence).

Ministry of Agriculture, Fisheries and Food
Whitehall Place, London SW1A 2HH

From the Minister

PWP

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

9 March 1989

Dear John,

NATIONAL RIVERS AUTHORITY: BORROWING POWERS

Now that Nicholas Ridley is about to announce provision for the NRA to borrow in exceptional circumstances for flood defence purposes, I would like to express my appreciation for your agreement on this point.

As you appreciate the issue had become a symbol of the NRA's ability to finance its affairs satisfactorily and it is important that it should enjoy public confidence from the outset.

I understand our officials have now agreed criteria to determine when borrowing would be appropriate and these can no doubt be made public during Report Stage of the Bill.

I am copying this to Nicholas Ridley and Wyn Roberts.

Yours ever,

JOHN MacGREGOR

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GWYDYR HOUSE
WHITEHALL LONDON SW1A 2ER
Tel. 01-270 3000 (Swistfwrdd)
01-270 (Llinell Union)
Oddi wrth Ysgrifennydd Gwladol Cymru

WELSH OFFICE
GWYDYR HOUSE
WHITEHALL LONDON SW1A 2ER
Tel. 01-270 3000 (Switchboard)
01-270 (Direct Line)
From The Secretary of State for Wales

The Rt Hon Peter Walker MBE MP

CT/4181/89

9 March 1989

Dear Nicholas

You will know of the interest that has been shown in Welsh matters in Standing Committee D's consideration of the Water Bill, a concern that is most commonly expressed by demands for a Welsh Rivers Authority. We will continue to resist this not least because if we are to maintain the principle of river basin management it is not sensible to have a Welsh Rivers Authority cutting across catchment areas.

The other expression of this concern that has been exhibited in Committee is the demand, that was repeated on Thursday 2 March, that the special advisory committee that will advise me on NRA matters affecting Wales should be made statutory and written into the Bill.

When this committee was originally proposed consideration was given to its status and it was decided that there were advantages at least initially in not making it statutory. Given the pressure that is now building up both inside and more particularly outside the Bill Committee for a Welsh Rivers Authority it seems sensible to introduce a clause into the Bill on report to make the special advisory committee statutory.

The Rt Hon Nicholas Ridley MP
Secretary of State for the Environment
2 Marsham Street
LONDON SW1P 3EB

/I think this

I think this would take the steam out of the growing demand for a Welsh Rivers Authority and help allay concern in Wales about the supposed centralisation of power in the NRA. There would be presentational advantages in having a statutory all-Wales body and of proposing it now, rather than waiting for further pressure which might force us to accept it. It would only be formalising the position of a committee that we are to have anyway and it will have no impact upon the position in England.

My purpose in writing is to tell you that my officials have instructed Parliamentary Council to produce the necessary clause(s) which can be introduced at report stage to make the special advisory committee statutory and to seek your agreement to this course of action.

I am copying this letter to Nigel Lawson, John MacGregor, Richard Luce and to Sir Robin Butler.

m37

CONFIDENTIAL AND COMMERCIAL IN CONFIDENCE

FROM: A M WHITE
DATE: 9 March 1989

CHIEF SECRETARY

cc Chancellor
FST
Sir P Middleton
Mr Anson
Mr Hardcastle
Mr Monck
Mr Phillips
Mr Moore
Miss Peirson
Mr Bent
Mr Revolta
Mr Ingles
Mrs Burnhams
Mr Hyett (T Sol)

SHORTS: PROGRAMMING THE SALE

Following his meeting yesterday evening with Mr Hartmut Mehdorm and Mr August Ackerman of MBB, the Secretary of State will be announcing this afternoon at Question Time that he has added MBB to the list of those competing to acquire Shorts from Government.

2. So we are now in the satisfactory position of having a three horse race.

Access to the company and to Government

3. Each of the competitors (Bombardier, GEC/Fokker, and MBB) have now been provided with accountants long form reports on Shorts, and other specialist legal and valuation reports. Each is being allowed one working week of access to the company to supplement this material by their own investigations.

4. Bombardier are in this week, GEC/Fokker next, and MBB's team will be in for the week before Easter (which is a full working week in Belfast).

5. Each has accepted that they are working to a timetable that will require final offers by 30 April, and has been advised that the Government team is available to them for discussion. I would

expect each to wish to complete their work in Shorts before opening any serious discussion with Government. So care will need to be taken that Bombardier, being the first in, do not gain advantage by being ready to talk before the others are.

Structuring the sale

6. The prime consideration in evaluating offers will be to achieve a sale at least cost consistent with Government objectives.

7. The Secretary of State's clear preference would be to sell the business as a single entity. But as he has studied the initial proposals, and spoken to the interested parties, he has became more open to the thought that, providing both businesses were continuing, it might be acceptable to see missiles separated from aerostructures and aircraft at or shortly after the point of sale. (He is particularly impressed by the financial strength and marketing network that GEC could bring to missiles, and realises how little experience of missiles Bombardier has). The additional negotiating flexibility this will provide is welcome.

Negotiating brief

8. Work is in hand with KB and Northern Ireland officials to develop a full negotiating brief. I have got and will be circulating separately (not to all) KB's initial note on a negotiating strategy which Northern Ireland officials and I agree needs more work within Government - not least because if is at present a menu without prices - before being approved by the Secretary of State and you. I am pressing for this work to be completed as rapidly as possible next week so that approval can be given before the Easter break.

9. As negotiations develop I shall keep you in touch with emerging issues, and will consult colleagues here on a need to know basis - using security stationery to protect the commercially sensitive information that will be involved.

10. The following paragraphs set out the keynote points that I would expect to be raised by those now competing and which should therefore be covered in the negotiating brief.

Basis of sale

11. Government has already stated its intention to eliminate Shorts' debts. It is entirely reasonable that we should therefore insist that one feature of the sale should be a payment by the chosen purchaser for the net asset value of the business. We should seek to get pound for pound for that as established by Shorts audited consolidated balance sheet at 31 March 1989 (a later date if negotiations are unexpectedly extended). That might at maximum be some £130 m (and we may need to consider some form of deferred or staged payment).

12. Beyond that, it will clearly be necessary to address the financial implications of proposals that those bidding for Short's will generate, and to provide (insofar as we are willing to) assurances or certain aspects of Government policy.

13. Assistance is likely to be sought for a programme of capital expenditure. Here we should seek to rely on existing (generous) Northern Irish selective assistance schemes. Those both provide a limit to the level of support offered, tied to progress on investment, and are likely to ease clearance of the eventual package with the EC.

Launch aid is likely to be sought for new projects in the aerostructures field (and for aircraft if any purchaser decides to continue the manufacture of whole aircraft in Belfast - as Fokker have hinted they might). If possible, we should seek to use the Northern Ireland Support for Innovation scheme, which involves less of an up front commitment and avoids some of the drawbacks of conventional launch aid.

14. Redundancy costs are bound to arise, and we should be prepared to fund an agreed plan to be executed within the period immediately following disposal.

15. Finance for future losses/working capital. Shorts will take some time to turn round, even with good management in place. Losses are bound to arise in future from existing, unprofitable contracts. We should seek to limit payments to offset these by providing, when possible, for such future losses in the completion balance sheet. While this will depress the payment we get for Shorts net assets, it will be presentationally helpful in reducing the consideration we pay over in cash to the purchaser.

16. On tax losses, our position should be that the existing tax losses of Shorts should be extinguished by Section 400 of the ICTA. Unlike KB, I see little advantage to be gained by showing flexibility on this point.

17. Bombardier have already raised the question of an employee shareholding scheme, knowing that such schemes have featured in offers for sale here, and in Canadian privatisations. They have suggested that both a limited number of free shares and a matching offer on shares purchased by employees should be considered. I propose to resist this as this as an unworkable feature of a trade sale (we certainly could not issue any form of prospectus, which would be unavoidable in selling shares to employees) but indicate that we would not be opposed to the new owners introducing such a scheme. The risk there is that they will seek to get us to fund the initial free offer of such a scheme by accepting a lower price for Shorts assets - but we can take that pressure as part of the general negotiation.

18. As all three offers involve overseas companies we are bound to be faced with requests for assurances on MOD work, covering both orders of existing products and those in development at Shorts, and continued eligibility for defence work. DED are consulting MOD on these points, and I have asked to be kept closely in touch.

19. We may also be faced with requests for warranties and indemnities. Here I would propose to resist strongly any proposal to warrant the information given about the company or its products. There may be other proposals which it may be more difficult to resist. For example, Bombardier, having been caught by rising environmental concern in Canada, have made it clear that they would wish to be indemnified against future costs that may be imposed on them if they are required to clean up past pollution of the Shorts site. (I am seeking advice on this point but my instinct is to resist).

Points which Government will wish to secure from a purchaser

20. We will wish to take the occasion of sale to withdraw for the future the Parliamentary assurances given to those doing business with shorts while the company has been in Government hands. But that will not affect our exposure on commitments given before sale. On those we will wish to secure our position by making sure that the new owner stands between us and those with an actual potential claim on Short's under those assurances.

21. Most of those, trade indicators, will rapidly be extinguished, but claims under contracts to major customers could potentially arise for many years ahead - so we have a strong motive to ensure that the purchaser's resources must be available to meet them before any call could be made on Government. But this will be a very difficult and potentially costly part of the negotiation on which a detailed negotiating position will be required.

22. We will also want to ensure that the future development of the business takes account of Government's exposure under sales financing agreements for Shorts 360 (and other 300 series) aircraft. At a minimum we will want the purchaser to continue logistic and spares support for these, even if manufacture is stopped. But even given that there will be a substantial liability which either we will need to extinguish by paying a lump sum to the purchaser in return for them accepting full liability or which Government will need to retain. Again a difficult negotiating point.

23. It will also be important to secure reasonable undertakings about the continuation of manufacturing activity in Northern Ireland. KB have suggested that this might be done by some form of special shareholding or loan stock.

24. I would argue strongly against any continuing Government shareholding, even of this special nature. In so far as possible we should seek to achieve this point through conditions attached to selective assistance provided at or after the point of sale. But I would not rule out at this stage making part of the 'dowry' such a loan stock (which might also make it easier for the EC to swallow).

25. I will minute further when I have developed a negotiating brief with Northern Irish officials. In the meantime I would be grateful if you could let me know if you are content with the way I am pursuing on these issues in my discussions with Northern Irish officials.

ALUN WHITE

dti

the department for Enterprise

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

S D Lambert Esq
Private Secretary to the Minister for
Agriculture, Fisheries and Food
Whitehall
LONDON
SW1A 2HH

Department of
Trade and Industry

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London SW1H 0ET

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CHIEF SECRETARY

REC. [illegible]

ACTION Mr Grayden,

COPIES TO Cx, FST, Mr Anson,
Mr Burgner, Mr Elwood
Mr Bonney, Mr Bent
Mr Dodds, Mr Call

Direct line 215 5422
Our ref PB5AWI
Your ref
Date 10 March 1989

Dear Steve,

NITRATE IN DRINKING WATER

This is to confirm that my Secretary of State is content with the proposals set out in Mr MacGregor's letter of 6 March to the Chief Secretary.

I am copying this letter to Deborah Lamb and Carys Evans.

Yours,

GARETH JONES
Private Secretary

the Enterprise Initiative

FROM: MRS T C BURNHAMS
DATE: 10 MARCH 1989

PS/ CHIEF SECRETARY

cc PS/Chancellor
PS/Financial Secretary
PS/Sir P Middleton
Mr Anson
Mr Hardcastle
Mr Phillips
Mr Moore
Miss Peirson
Mr Revolta

SHORTS

The initial note prepared by Kleinwort Benson on a negotiating strategy referred to in Mr White's submission to the Chief Secretary of 9 March has now been circulated on a very restricted basis, with a request that no further copies should be taken. Further papers on this subject will be circulated on a strictly need to know basis.

TERESA BURNHAMS

SECRETARY OF STATE FOR THE ENVIRONMENT

2 MARSHAM STREET
LONDON SW1P 3EB
01-276 3000

14 MAR 1989

CONFIDENTIAL

My ref:
Your ref:

CHIEF SECRETARY
REC. 14 MAR 1989

FINANCIAL SECRETARY
REC. 14 MAR 1989
ACTION Mr R. Bent
COPIES TO PPS, Sir P. Middleton, Mr Monck, Mr Moore, Mr S. Judge, Miss J. Swift, Mr Tyrie, Mr Call

Paul Gray Esq
10 Downing Street
LONDON
SW1A 2AA

13 March 1989

Dear Paul,

WATER METERING

Thank you for your letter of 19 February asking about the scope for competition in the supply and installation of water meters, including safeguards should water companies themselves decide to manufacture and supply meters.

At present there are three main companies who supply approved water meters to the UK market. All of them are foreign owned, and only one - Kent Meters a subsidiary of Asea Brown Boveri - manufactures meters in the UK. The others are Neptune Meters - part of the US Schlumberger Industries - and SOCAM - part of the French conglomerate Groupe Saint Gobain - who manufacture meters in France and Belgium but have said that they will manufacture in the UK if demand requires. Thorn/EMI and a Japanese firm Kimmon have also expressed an interest in supplying meters for the UK market. Together these companies should be able to produce a sufficient number of meters to meet the foreseeable needs of the UK water industry.

As far as we are aware no water authority or company is currently considering manufacturing meters, or setting up a company to install meters on a large scale. There must however be a strong possibility that some water service companies will want to set up meter installation companies because of the neat fit with the core business and the expertise already in the industry.

Just as in its choice of contracting practice for the bulk of its civil engineering and maintenance work, this is an area in which the core business will be free to choose who should execute the work. Water customers will be protected in three ways. First, the conditions of appointment will ensure that the Director General will receive detailed transparent accounting information about transactions between the core business and any other business of the appointee or a related company. Second any cross-subsidy, as with cross-subsidy between subsidiaries of companies already in the private sector, would be subject to normal competition law. Third, in setting the charges limit for the appointed water business, no allowance will be made for cross-subsidy to other businesses.

In particular, the meter installation costs which the water service companies will be able to pass on through customers charges will be strictly controlled through the cash ceilings to be set by the Director General. There will be incentives therefore to have the work carried out at least cost so that the declared metering programme can be progressed to plan. But if the company can itself provide a cheaper more efficient service, then both customers and shareholders will benefit. There will therefore be scope for competition, and safeguards against abuse.

I am copying this letter to the Private Secretaries to the other members of E(A) Murdo MacLean, Stephen Catling, Nick Gibbons and Trevor Woolley.

Yours,

Deborah Lamb

pp R BRIGHT
Private Secretary

1.5 NI prices

[Autumn Statement forecast shows NI prices forecast to rise 6¼ per cent to 1989Q4.]

Reflects both increases already announced and estimates of increases resulting from decisions not yet taken by industries. Most increases will take effect in last quarter of 1988-89. NI average close to increase in all items RPI for 1988Q4. (See below for individual industries.)

In the year to January 1989, NI prices rose by 7.8 per cent, compared with RPI increase of 7.5 per cent.

3.1 Electricity price increases

Increases from April 1988 for all users averaged 8.8 per cent - 8.6 per cent for domestic consumers and 9.1 per cent for industrial users. (Represents increase in industrial costs of only one sixth of one per cent.)

For industry, not Government, to decide electricity prices in the light of EFLs, financial target and the industry's ability to cut costs. But can note that:

- prices have fallen in real terms over the last 5 years by over 8 per cent for domestic customers and 10 per cent for industrial customers

- October edition of International Electricity Prices Quarterly (published by The Electricity Council) showed domestic electricity prices in England and Wales third lowest in European Community, and industrial prices in the mid range of European prices.

Financial target set bearing in mind the need for all NIs to earn adequate return on taxpayers' investment.

6.1 Water charges

[Minister for Water announced 1 February that water charges would rise by between 7 and 13 per cent, with average increase less than 10 per cent.]

Price rises reflect very large (20 per cent) increase in investment, primarily to reduce pollution. Average water charges still very low.

6.2 Statutory Water Companies to raise prices by up to 50 per cent because of privatisation?

['Financial Times', 6 February, claimed SWCs were planning to increase charges by 30 to 50 per cent because of regulatory framework to be introduced with privatisation.]

Government very concerned both by level of increases and by reasons for increases advanced by SWCs. Minister for Water met those considering rises of more than 10 per cent. Accounts of companies proposing increases between 30 and 50 per cent to be scrutinised by Government-appointed accountants, to assess validity of claims that increases needed to finance investment. New regulatory system will take long-term approach to prices and investment. Price rises allowed in future will take into account any excessive increases which may be made before introduction of new regulatory system.

Average 9.4% in Jan 89

7.9 Fares Increases

For BR to determine level of fares, and to comment. BR see strong case for travellers rather than taxpayers bearing most of the cost of their rail services - especially Inter City travellers who enjoy greater advantages than other travellers. BR also believe it reasonable for Network Southeast and provincial travellers to pay for substantial investment programme designed to improve quality of service by paying slightly higher fares.

8.5 Fare increases

As from January 1989 LRT fares risen on average by 12.5 per cent. For LRT to determine level of fares, and to comment. LRT see a strong case for raising real level of fares in future to finance increased investment to enhance capacity and quality of service. Government believes it is right for consumers to contribute in this way.

SCOTTISH OFFICE
WHITEHALL, LONDON SW1A 2AU

CONFIDENTIAL

The Rt Hon John Major MP
Chief Secretary to the Treasury
HM Treasury
Parliament Street
LONDON
SW1

CHIEF SECRETARY	
REC.	13 MAR 1989
ACTION	Mr Griffiths
COPIES TO	CX, FST, Sir P Middleton, Mr Anson, Mr Phillips, Miss Peirson, Mr Moore, Mr Edwards, Mr Bent, Mr Sanders, Mr Judge, Mr Call

13 March 1989

Dear John,

FLUORIDATION OF WATER SUPPLIES

Thank you for your letter of 6 March. I am grateful for your agreement to my offering to the water authorities in Scotland the same limited extension to the indemnity in respect of negligence as has been agreed for England.

I note the two conditions attached to this. As I have already indicated, I do not think it likely that I would need to invoke any powers of direction. I do, however, accept the need to put the indemnity on a statutory footing and I will be taking the necessary steps to do so inn the Water Bill.

I am copying this letter to Nicholas Ridley, Kenneth Clarke, Peter Walker, Tom King, Michael Howard and to Sir Robin Butler.

Yours ever,

MALCOLM RIFKIND

HMP068M3.026

BULL POINTS

1. Investment

DTI Investment Intentions Survey (December) projects 11 per cent rise in manufacturing investment in 1989. Autumn Statement forecasts growth of 10 per cent in 1989.

Total investment expected to have grown by at least 12 per cent in 1988, more than twice as fast as total consumption.

Over past 5 years total investment grown by getting on for twice as fast as total consumption. Under Labour, consumption grew by only 2 per cent a year, while investment hardly grew at all [¼ per cent a year on average].

Since 1981 investment outpaced consumption growth in every year except one. In 1980s total investment grown faster than in any other EC country.

Private investment in 1988 expected to be highest proportion of GDP since records began in 1955.

2. Output

GDP output measure up 5 per cent in year to 1988Q3.

UK grown faster than all other major EC countries since 1980. Bottom of this league table in 1960s and 1970s.

Manufacturing output in fourth quarter of 1988 at highest ever level; up 10 per cent on 1979H1. Fell between 1974H1 and 1979H1.

Profitability in 1988 expected to be at level not seen since early 1960s.

3. Jobs

Adult unemployment (seasonally adjusted) fallen to below 2 million for first time since February 1981. Continuous fall for 30 months in a row, by over 1.1 million in total. Fall in unemployment longest and largest since War.

Unemployment has fallen in all regions over the last year. Long term unemployment has fallen faster than unemployment as a whole in all regions.

Employment risen by over 2¼ million since 1983; performance over last five years best since War. Now at highest ever level.

4. Public finances

PSDR in 1988-89 (ie budget surplus) for second successive year, first time this has happened since the beginning of the 1950s. PSDR in 1988-89 forecast to be biggest surplus since early 1950s.

Since 1982-83, general government expenditure (GGE), excluding privatisation proceeds, fallen by 7 percentage points as a share of GDP. In 1988-89 less than 40 per cent of GDP for first time for over 20 years. Planned to fall further by 1990-91 to less than 39 per cent, lowest since 1966-67.

INFLATION.

No. 1. John Home Robertson. If he will make a statement on the current rate of inflation. (Taken with 3,5 and 12).

Points to make in supplementaries.

- Will my RHF take no lessons from Labour on the control of inflation, especially when the lowest rate of inflation achieved by the last Labour Government (7.5%) was equivalent to about the highest rate under this Government since 1983?

- Is it not a fact that the underlying rate of inflation (excluding mortgage interest payments) is even now about 2 points below the lowest rate that it reached under the last Labour Government?

- Is it not clear that my RHF's policy of monetary tightening is beginning to work, since there are already some signs of a slowdown in consumer spending and of the rise in house prices beginning to level off?

WORK PLACE NURSERIES.

No. 2. Ken Livingstone. What is his estimate of the amount of revenue raised in the last financial year from those with children attending work place nurseries. (taken with 9).

Points to make in supplementaries.

- Would my RHF not agree that allowing tax relief on work place nursery costs is an inefficient way of encouraging women with children to take jobs? Is not the Government's policy of reducing income tax rates a much better incentive?

- Would my RHF not agree that such tax relief would only benefit a minority of taxpayers and would be very unfair on those parents who pay for childcare out of after tax income?

- Would my RHF not agree that it is up to employers to attract women with children back to work by paying them enough to make it worthwhile rather than by the Government providing a new tax relief which would only help a very small minority?

LONG TERM UNEMPLOYMENT.

No. 6. Gerald Bowden. What was the total fall in long term unemployment in the year to October 1988.

Suggested Supplementaries.

- Is it not a sign of the success of the Government's economic policy that long term unemployment has fallen in all regions, and that the number of long term unemployed aged between 18 and 24 fell by half in the two years since October 1986?

- Is it not clear that the main reason for this welcome news has been the strong growth in output and employment under this Government, which has produced over 2¼ million new jobs since 1983?

- Do not these welcome figures show that the fall in unemployment in this country has compared very favourably with the experience in other industrialised countries over the same period?

FOREIGN INVESTMENT IN THE U.K.

No. 8. Allan Roberts. If he will make a statement on current foreign investment flows into the U.K.

Points to make in supplementaries.

- Does not the strength of these capital inflows reflect great international confidence in the U.K. and in the sound economic policy being pursued by HMG?

GENERAL GOVERNMENT EXPENDITURE.

No. 10. James Arbuthnot. (taken with No. 11. Bowen Wells).
If he will make a statement on the path of general Government expenditure over the period 1982-3 to the latest available date.

Suggested Supplementaries.

- Is it not the case that this Government's firm control of public expenditure has helped to create the conditions for this country's economic success? Does not the recent White Paper also show that the Government intends to maintain that control in future, while providing for real growth in our priority programmes?

- In the context of public expenditure, would not my RHF agree that the sharp reduction in Government borrowing and more recently the repayment of public debt has led to a reduced burden of debt interest and hence more room for extra public expenditure on our priority programmes?

- Can my RHF confirm that the welcome 7% fall in the ratio of general Government expenditure to GDP is the largest and longest sustained fall since the unwinding of the war-time economy? Has this not helped to limit the burden upon the taxpayer and so contributed to our sound fiscal position?

TAX AND PRICES INDEX.

No. 14. David Martin. What was the increase in the tax and prices index in the 12 months to December 1988.

Suggested Supplementaries.

- Does not the figure just given by my RHF underline the fact that under this Government the average annual increase in recorded inflation has been less than half what it was under Labour (7.6% as compared with 15.5%)? Does this not emphasise that my RHF need take no lessons from the party opposite on the control of inflation?

- To get a sense of perspective on these matters, can my RHF give the House any estimate of the likely inflationary consequences of Labour policies of spending, borrowing and taxing, if the party opposite were ever returned to power?

est.ld/james/14 Mar/nfr

FROM: S M A JAMES
DATE: 14 MARCH 1989

NOTE FOR THE RECORD

cc: PS/Chancellor 2
PS/Chief Secretary
Mr Anson
Mr Monck
Mr Scholar
Mrs Lomax
Mr D J L Moore
Mr Culpin
Mr Bonney
Mr Gilhooly
Mr S Wood
Mr Bent
Mr Potter
Mr M Richardson
Mr Michie
Mr Devereux
Mr Graydon
Mr Cotmore
Mr Call

PS/C&E
Mr Wilmott - C&E
Mr Hewett - C&E
Mr Ruston - C&E

NATIONAL RIVERS AUTHORITY (NRA): SECTION 20 VATA 1983

The Economic Secretary discussed Mr Hewett's submission of 27 February and Mr Michie's note (not copied to all) of 2 March with Customs and Treasury officials.

2. The Economic Secretary asked officials to set out the origins of Section 20 and the reasons for restricting the number of bodies allowed to benefit from it. Mr Michie explained that when VAT was first introduced in 1973, there was a pledge that it would not be allowed to become a burden on the rates or rate support grant. Section 20 was enacted to meet this pledge and this provided for full refund of VAT in respect of non-business activities. Mr Michie explained that most (but not all) of the bodies included in the section were of a local government type and were funded from

the rates. Ministers reviewed the operation of Section 20 last year, and concluded that it should continue to be restricted to bodies which performed local government-type functions and were funded directly from the rates or rate support grant. At that time Ministers recognised that they would come under increasing pressure to extend section 20 because of the blanket nature of the VAT relief it offered. By way of contrast, Government departments (none of which were included in Section 20) had to bid for funds to cover their expenditure including VAT in the Survey. **Mr Michie** illustrated the difference in treatment by explaining added that in the Survey last year it had been agreed that where Government bodies were tenants of landlords who had opted to tax their rents, there would be no compensation for public sector tenants. Section 20 bodies, on the other hand, received automatic relief.

The NRA

3. **Mr Hewett** explained that the DOE functions of the NRA were likely to fulfil the criteria for 'business' activities and therefore input tax in respect of them could be accommodated within the normal VAT rules. However the MAFF activities, notably land drainage and flood protection, were non-business. Unless Section 20 status were to bee allowed substantial amounts of irrecoverable VAT would be incurred. **Mr Hewett** said that these non-business activities would be funded by local authorities and although the NRA would not be a precepting body, it was clear that if all of the related VAT were to be disallowed, these would be substantial knock-on effect on the rates.

4. **Mr Hewett** said that two points had to be decided; firstly should the qualifying criteria apply to all the NRA's activities or to the non-business activities only, and secondly should the "funded directly from the rates test" be taken to mean that the applicant must be a precepting body. On the first point both FP and Customs agreed: as Section 20 status could benefit non-business activities only, then it was right that qualifying criteria should apply to those non-business activities alone. If that were the

case, the NRA's non-business activities were 90 per cent rates-funded and that particular test was satisfied.

5. The second point - whether the applicant must be a precepting body - was less easy to decide. Customs had explored whether this criterion could be interpreted as having a statutory right to local authority funding. It seemed that this would be a workable option.

6. **Mr Michie** said that FP had been concerned that interpreting the qualifying criterion for Section 20 in terms of being a precepting body was an innovation rather than simply a clarification. A number of current members of Section 20 did not fulfil this criterion nor was this an interpretation approved by Ministers in last year's Section 20 review. The Chief Secretary had not mentioned this in his NRA correspondence with MAFF and DOE, and it would be odd to introduce this at such a late stage.

7. The **Economic Secretary** said we needed to be clear that we were not opening the floodgates to applicants for Section 20 status. At the same time any clarification of the qualifying criteria needed to be consistent with discussion the existing membership of Section 20. **Mr Hewett** believed both concerns could be met. We were reviewing but not relaxing criteria; the 'statutory entitlement' definition was likely only to allow in those bodies which would be admitted under the current definitions.

8. **Mr Michie** said that it was reassuring that Customs were satisfied that no unfortunate precedents would be set by this fine-tuning of the qualifying criteria. FP could discuss with Customs the mechanics for operating the revised criteria.

9. The **Economic Secretary** summing up said that he was content that the qualifying criteria be applied to an applicant's non-business activities only, and that the "funded from the rates" test be interpreted as meaning there must be a statutory entitlement to rates-sourced funding. Since the NRA's non-business activities would be 90 per cent funded from the rates by a statutory entitlement, he was content that the NRA should be admitted to Section 20. He noted Customs views that this interpretation would

not lead to an opening of the flood gates for Section 20 treatment, and that Customs were satisfied that the clarification of entry criteria could be squared with past decisions on other bodies' eligibility.

S M A JAMES
Private Secretary

pe.sh.djlm.mins.9.3

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FROM: D J L MOORE
DATE: 14 MARCH 1989

1. SIR PETER MIDDLETON

2. CHANCELLOR

cc: Sir T Burns
Mr Anson
Mr Monck
Mr Scholar
Mrs Lomax
Mr Odling-Smee
Mr Peretz
Mr Sedgwick
Mr Bent
Mr M Williams
Mr S Kelly
Mr Neilson
Mr Call
Mr Tyrie

Miss Wheldon TSOL

cc attached for:

Chief Secretary
Financial Secretary

WATER PRIVATISATION: IMPACT DAY

This note examines the options for the Water privatisation Impact Day, with the offer closing 2 weeks later. We need to decide on this soon, preferably by the end of the month, but otherwise as soon as possible after Easter. This is because of the need to reserve printing capacity for this mammoth operation and to avoid the costs of booking to cover options.

2. The water companies could not be ready for sale before November. There are problems with each option in November, and with January, and we will face these problems againwhen we come to some of the Electricity sales. But on balance we recommend Wednesday 22 November. DOE agree and they are advising Mr Ridley accordingly.

3. In reaching this conclusion, we have tested the options against 3 constraints: the likely timing of the Autumn Statement, which we have discussed with Mr Anson; the publication on about 27 November of the October trade figures; and the possible logistical problems of running too close to Christmas. Annex A shows the timetable for the options, and Annex B the main economic indicator announcements in the period.

The Autumn Statement

4. Our general policy is to have sales after the Autumn Statement, to avoid possible disclosure problems and market uncertainties shortly before the Statement. It may well be that the Statement will not have any material bearing on the Water **prospectus** (and I assume that the nation's demand for water and sewage services does not greatly vary with its judgement of Treasury economic forecasts). But the Industry Act forecasts, and the general reception of the Autumn Statement, might have an unsettling effect on financial markets. Prior to the Statement, uncertainties over the forecasts could lead to pressures for cautious pricing and to marketing problems. If stock were left with the underwriters, and they attributed that to the Autumn Statement, they could challenge us on failure to meet disclosure obligations.

5. In making assumptions on the likely date of Water and of the Autumn Statement, it is important not to weaken the Chief Secretary's negotiating position by choosing a date which will unduly compress the timetable for the Survey. In each of the last three years the Autumn Statement has been made in the first week in November. Rather unusually, however, the last two Surveys have not required a final round of collective discussion in Star Chamber. It would not be prudent to count on this happening a third time.

6. This year we may face the combination of a relatively difficult Survey with the introduction of a new planning total and a new system of local government finance. In these circumstances, failure to allow time for a last minute round of discussions in Star Chamber or even E(LF) will put pressure on the Chief Secretary in the final stages of the Survey and make it more difficult for him to obtain a satisfactory outcome. It would also be sensible to allow more time for getting the presentation right in the special circumstances of this year - even last year, the timetable was generally felt to be excessively tight.

7. This suggests that it would be unwise to assume that the Autumn Statement will be earlier than the week of 13 November. It might even be later, although there would be obvious difficulties in that and the timing agreed now for Water will be a constraint on the timing of the Statement.

The Trade Figures

8. The DTI has not yet published the timetable for publication of the trade figures in the second half of the year. They will not do this for another couple of months or so but we are taking Monday, 27 November as the probable date, with the possibility that it could be a day later. Whatever Impact Day we choose, trade figures outside the range of market expectations will cause us trouble. If we price with confidential knowledge of those figures, we are in a situation similar to that for Steel last November. In any event bad trade figures coming within an offer period, and particularly towards the end of it, will cause us difficulties.

9. The US trade figures will be released on 16 November. Obviously they will not give rise to disclosure obligations. But, as for the UK figures, they could unsettle the markets if they are outside the range of expectations. In the past only the two sets of trade figures seem to have significantly affected the markets. But markets could be more sensitive to other indicators by the time of the Water sale. A list of the key economic indicators in the period is at Annex B.

10. The rest of this paper tests different timetables against the constraints of the Autumn Statement, the trade figures, and the logistical problems of dates near to Christmas.

Wednesday, 22 November (Offer closes 6 December)

11. This should be after the Autumn Statement.

12. The offer would be priced and underwritten on 20/21 November and would close on 6 December. If the October trade figures (27 November) were outside the range of market expectations we

would be back in the Steel position, though with these differences:

i. You and Lord Young would have to agree that DOE Ministers and, say, 2 officials should be told before the pricing decision either the provisional global trade figures or that this was not something to worry about.

ii. Our defences will be sturdier if we have successfully negotiated a clarification of the underwriting agreement. But, although work is now in hand, we are not there yet; indeed we do not yet have the Law Officers' response on how the clarification should be handled. The negotiation of the change will be tricky and we are not in a strong position to force it on reluctant underwriters. We would be in a very difficult position if we had proposed the change, failed to get the underwriters to accept it, underwrote on the existing terms, and then had bad trade figures followed by a challenge on disclosure. Moreover, even if the underwriting agreement were amended, it would not necessarily stop the underwriters, in particular the overseas', taking action against us if there were a stick.

13. It is interesting that Rowe and Pitman, the advisory brokers, want 22 November. They think the market will take comfort from assuming that Ministers would know the trade figures in advance and, as shown by Steel, price accordingly. This date has the added advantage for them that the next 2 weeks or so are free from key announcements.

14. If we go for 22 November, you also have to consider two logistical problems, though we think they are manageable: delays in the Christmas post and the problems of getting Water into the Talisman system.

15. Before Sid can deal he needs his document of title (the old RLA). And, if his bid has been scaled down, he wants his return cheque for the balance as soon as possible to minimise the time he is out of funds and losing interest. We are advised that if no more than 5½ million apply (compared with 4½ m for Gas and just

over 2 m for BT) the documents and the return cheques can be despatched two days before the last posting for Christmas. Most, if not all, should then arrive by Christmas. The prospectus will say that this is the intention. I think 5½ million applicants would be a very successful offer. But if there were more the posting will be at least two days later (and under Stock Exchange requirements all the documents must go out on the same day). In that case they would not be received until after Christmas. Ministers would then be liable to flak from disgruntled Sids. But you would be able to point out that the delays were a result of the enormous success of the offer. Moreover, as the markets are normally very quiet over the Christmas/New Year period, it is questionable whether any Sid wishing to deal quickly would lose badly.

16. The second logistical problem is that the Receiving Banks will not want to staff for Water so close to Christmas, and perhaps after it. We will therefore have to bring pressure on them to do so, and the overtime could push up our costs. In particular we have to be satisfied that early trading in Water can be done through the Talisman new issue system (the option that has come out of the Treasury joint group with the Stock Exchange). The worry is that, by losing the Christmas weekend, the Receiving Banks could not have the share registry in place by the time the first seven day rolling settlement occurred, as they would have been able to do with normal weekend working. If this happened it would be particularly embarrassing for the Treasury because we would be simultaneously condoning an Impact Day which ruled out use of Talisman and urging the Stock Exchange to speed up improvements in its settlement system. But we are now advised that the Stock Exchange would be prepared to slip the first settlement day for Talisman new issues into the New Year so solving this problem. This is subject to formal clearance by a SE committee, which may not meet for a few weeks. But on the assumption they give clearance, as expected, the Talisman problem will be solved.

Monday, 13/15 November (Offer closes 29 November)

17. These dates would be early enough to avoid the Christmas logistical problems.

18. The issue would most probably be priced and underwritten shortly before the Autumn Statement came out, assuming this is in the week of 13 November.

i. When pricing the issue we could try to take account of the likely impact of the AS on markets. If there were an adverse impact there would be a chance for it to wear off before the offer closed on 29 November.

ii. But this timing would lead to possible Autumn Statement disclosure problems: either pressure to disclose or reassure before the event or to challenges on failure to disclose if the offer went badly.

iii. If we went for this week, it would be preferable to have at least one clear day between the AS and Impact Day. The advisers may prefer to have Water on Monday/Tuesday 13/14 November in order to distance it from the US trade figures which come out on 16 November. In that case it would be desirable for the AS to come out no earlier than the Wednesday or Thursday (15/16 November).

19. But the more telling difficulty with this date is the relationship with the UK trade figures.

i. When we priced Water (at the latest on 14 November) we would not presumably have any confidential knowledge of the likely trade figures. But we would do so a few days later and could find that we had priced badly.

ii. The trade figures would then be published on 27 November, very shortly before the offer closed on 29 November. The institutions would hold off from applying until the last moment. If the figures were indeed bad, and the market fell badly, they would not apply. Sid might similarly delay, and then not apply. But in practice he has to apply rather earlier and, if so, he could be caught with a disappointing opening price. This could be politically embarrassing, and damaging to the Electricity sales. Moreover, the advice we have had on the extent of our

prospectus obligations to disclose might then be tested, by the public or by the underwriters if there were a stick.

iii. Even if the trade figures turned out to be acceptable, market worries over them could be damaging to the pricing and marketing of the offer.

Wednesday, 8 November (Offer closes 22 November)

20. There are no Christmas logistical problems.

21. On present expectations it would be a week before the Autumn Statement.

i. We cannot be confident but we doubt whether there are **prospectus** disclosure problems. It seems unlikely that there would be anything new in the Autumn Statement which would have a direct impact on the Water industry and its 1989-90 profits forecast.

ii. Rather the worry is whether an Autumn Statement in the offer period would have an adverse effect on markets or would be thought to have such an effect. Underwriting could be difficult ahead of a Government Statement which might affect the market and it could be difficult to get a good price.

iii. If things go badly, the underwriters would be looking for opportunities to challenge us on disclosure obligations. But, as with the trade figures problem, it is our aim to strengthen our defences by clarification of the underwriting agreement.

iv. If nevertheless we were to adopt this timetable it would help the marketing if the AS was published as soon as possible in the week of 13 November, so that the markets could settle down before the offer closes.

22. The trade figures also pose worries.

i. We would have no confidential knowledge of them at the time of the pricing, though we would do so before the offer

closed on 22 November and could then find that we had a problem.

ii. The trade figures would be published after the offer closed but probably the day before trading started (28 November). This worries the advisers. If the market is expecting bad trade figures the institutions will not apply because they will not want to be locked into a falling market, any more than would be required from them as subunderwriters. The press could also advise Sid to be cautious. Because of this worry the advisers think there could be an adverse effect on pricing the offer. Again we could be challenged on the interpretation of our prospectus disclosure obligations.

A January sale

23. The worries over any of these alternatives lead to the question of why not postpone it until January. The problem is that, because of the disruption to marketing by Christmas and the New Year, the sale would need to be around the end of January: perhaps Wednesday 31 January. I would be surprised if this timing gave rise to Budget disclosure worries. But the offer would be priced and underwritten when the Government had confidential knowledge of the trade figures published in January (ie, the same situation as with a 22 November Impact Day).

24. The other main worry is that a January sale could also have damaging implications for the sale of the electricity distribution companies, planned for April/May 1990. A postponed water sale would shorten the time available for the distcos' marketing campaign, if the two were not to conflict. Moreover, some time will be needed after the water sale, to assess market perceptions, before the distcos' final marketing campaign can be determined - particularly as regards the emphasis to be put on the industry share.

25. It would also be necessary to guard against criticism that we had postponed into 1990 because things were going so badly with Water.

Conclusions

26. If we can assume an Autumn Statement in the week of 13 November, an Impact Day of 22 November jumps that hurdle. It carries risks if the trade figures are bad, and we cannot be confident of revising the underwriting agreement (paragraph 12ii). It runs near to Christmas but we think the postal risks are acceptable, and that the Stock Exchange will enable Water to be done through the Talisman system from the outset. Subject to those points, 22 November is our recommendation.

27. 8 or 15 November would be easier on the logistical matters. But both carry the twin risks of moving ahead of the Autumn Statement and of running up against bad trade figures.

28. Even if you saw serious disadvantages in all the November dates, there are also problems with the end of January 1990: risks of disclosure problems over bad trade figures; and damage to proceeds because of the interruption to the marketing campaign. But if it were to be a runner Mr Parkinson would need to be brought in to the discussions because of the consequences for Electricity.

D J L MOORE

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TIMETABLES

Pathfinder	11/18 Oct	18/25 Oct	25 Oct/1 Nov
Impact Day	8 Nov	13/15 Nov	22 Nov
Offer Closes	22 Nov	29 Nov	6 Dec
First Trading	28 Nov	5 Dec	12 Dec
Latest dates for posting			
(i) 5½ m allocations	4 Dec	11 Dec	18 Dec
(ii) 8 m allocations	6/7 Dec	13/14 Dec	20/21 Dec

The continuous line shows the most likely date for the UK trade figures, 27 November. The dotted line shows the date of the US figures, 16 November.

TIMING OF OTHER ANNOUNCEMENTS

November

Tues 14	index of production
Thurs 16	US trade figures
	unemployment and average earnings
Thurs 16	PSBR
Fri 17	RPI
Mon 20	money supply
Mon 27/Tues 28	UK trade figures

December

Thurs 14	index of production
Thurs 14	unemployment of average earnings
Fri 15	US trade figures
	RPI
Mon 18	PSBR
Wednesday 20	money supply
Fri 29	UK trade figures