DO-CH/NL/0294
PART B

Part. B

CONFIDENTIAL

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MANAGEMENT - IN - CONFIDENCE

Begins: 23/11/87.
Ends: 31/12/87.

PO -CH /NL/0294

PART B

Chancellor's (Lawson) Papers:

THE PRIVATISATION
SEMINAR ON FUTURE
PRIVATISATION STRATEGY

Disposal Directions: 25 Years

20/10/95

PO -CH /NL/0294
PART B

MANAGEMENT IN CONFIDENCE

CABINET OFFICE

OFFICE of the MINISTER for the CIVIL SERVICE

pmp

FINANCIAL SECRETARY
REC. 25 NOV 1987
ACTION Mr Instone
COPIES TO PPS CST PMG Sir P. Middleton Mr FER Butler Mr Beastall Mr Hawtin Mrs Brown Mr F.K. Jones Mr Meadows Mr Call Mr Willacy (CUP) Mr Hyett (T. Sol)

The Minister of State
Privy Council Office
The Rt. Hon. Richard Luce MP

Horse Guards Road
London SW1P 3AL
***Telephone:* (01)-270 5929**

C87/5128

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

23 November 187

Dear Nicholas,

PRIVATISATION OF THE CROWN SUPPLIERS

Thank you for sending me a copy of your letter of 25 September to John Major. I have also seen Norman Lamont's reply of 12 November.

The main question of whether to pursue the possibility of privatisation is primarily for you and the Treasury. My officials have however been in touch with those in the Crown Suppliers (TCS) on the consideration that needs to be given to security issues in any process of privatising TCS, or contracting out its work.

You mention that three parts of the TCS do not seem suitable for privatisation. At first sight I agree that on security grounds there would seem good reasons for retaining the design and supply of security furniture within the public service. On the other hand, provided certain security conditions were met, I would not rule out privatisation of some parts of the Government Car Service, on security grounds at least. I cannot comment on the Palace of Westminster work. In addition, the privatisation of those parts of the IDS which carry classified documents would need very careful consideration.

Before information is sent to potential bidders it will be necessary to consider the criteria which any privatised service would have to meet in order to provide acceptable security. The subject is a complex one and not entirely in my department's hands.

It is therefore very important that your officials keep mine closely in touch as proposals for what might be privatised are worked up and, indeed, for the programme of improvements to be implemented pending any privatisation.

I am copying this letter to the Prime Minister, Lord Young, Norman Fowler and Norman Lamont.

Richard

RICHARD LUCE

42/2.BTW.4375/27

cc PS/Chancellor
PS/Economic Sec
Sir P. Middleton
Sir G. Littler
MR Monck
MR Moore
MRS Brown
MR Bent
Ms Leahy
Ms Pelham
MR Call
MR Hyett T.Sol.

FINANCIAL SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

Gordon Brown Esq MP
House of Commons
LONDON
SW1A OAA

25 November 1987

Dear Gordon

Thank you for your letter to Nigel Lawson about foreign ownership of shares in privatised companies.

I think you will agree that we have covered the ground on BP exhaustively over the last month or so in the House. Perhaps I could just add that BP actually wanted to increase substantially the proportion of their shares held overseas.

In general our policy is to seek to restrict foreign ownership of privatised companies post-privatisation where we believe that there are special security or defence considerations. British Aerospace and Rolls Royce, for example, both have 'special shares' which limit the extent of foreign ownership.

You quote some figures on foreign holdings in privatised companies. As regards Rolls Royce, the company has said that the 15% limit on foreign ownership has been exceeded. The Company's Directors have accordingly announced plans to disenfranchise and dispose of the excess foreign-held shares.

I am sure you will be aware that the management of both Rolls Royce and British Aerospace would actually prefer to see a higher level of foreign ownership in their companies than the Government has allowed. I hope, therefore, that you will accept that the establishment of these limits on foreign ownership does reflect the Government's concern that firms of such strategic importance as Rolls Royce and British Aerospace should remain in predominantly UK hands.

Yours ever

Norman

NORMAN LAMONT

MANAGEMENT IN CONFIDENCE

pmp

FINANCIAL SECRETARY
27 NOV 1987

MR Instone
PPS CST PMG
Sir P. Middleton
MR FER Butler MR Beastall
MR Hawtin MRS Brown
MR F.K. Jones
MR Meadows MR Call
MR Willecy (CUP)
MR Hyett (T.Sol)

2 MARSHAM STREET
LONDON SW1P 3EB
01-212 3434

My ref:

Your ref:

The Rt Hon Norman Lamont MP
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

26 November 1987

Dear Norman

PRIVATISATION OF THE CROWN SUPPLIERS

Thank you for your letter of 12 November. I am convinced that privatisation is the right course to take and I welcome your agreement in principle that we should press ahead with privatisation as quickly as possible through a competitive tendering exercise.

Our officials have arranged to meet to discuss a plan for improvements in the performance of The Crown Suppliers over the next 12 months and I agree they should report back before the end of the year. The Controller has already been working on a programme of improvements for implementation without prejudicing the prospects of privatisation.

I also agree that we need to prepare a timetabled action plan for dealing with the consequences for other Departments, including the Car Service and IDS.

As regards organisational arrangements, I agree that we need a unit outside The Crown Suppliers both to prepare legislation and consider organisational matters (including what could be quite burdensome negotiations over staff terms and conditions), and also I suggest to oversee the approach to potential bidders. I therefore propose to set up a unit under the Principal Finance Officer in PSA. There may also be a role for Samuel Montagu in this, as they have the advantage of having worked with Coopers and Lybrand in this area on their review.

I also agree that the preparatory work towards privatisation should be overseen by a steering group of officials. I would like our officials to explore further the need for "an implementation group with executive powers ...... within The Crown Suppliers".

I will be seeking authority for legislation in the 1988/89 session.

Yours ever
Nicholas

NICHOLAS RIDLEY

42/2.BTW.4375/47

pmp

FINANCIAL SECRETARY TO THE TREASURY

FROM: N M DAWSON
DATE: 27 November 1987

MRS M E BROWN

cc PS/Chancellor
PS/Sir P Middleton
Mr D J Moore
Mr Call

THE US COMMISSION ON PRIVATISATION

I have today arranged a meeting between the Financial Secretary and the Chairman and members of President Reagan's Commission on Privatisation for 4.00pm Wednesday 9 December.

2. Lawrence Taylor at the American Embassy will be contacting me next week to let me know who will be attending.

3. When we receive this information, could you please advise on what officials should be present and also let me have any briefing by Lunchtime Tuesday 8 December

Nigel Dawson

NIGEL DAWSON
Diary Secretary

CONFIDENTIAL

Caxton House Tothill Street London SW1H 9NF

Telephone Direct Line 01-213 6460..........
Switchboard 01-213 3000 GTN Code 213
Facsimile 01-213 5465 Telex 915564

pmp

CHIEF SECRETARY	
REC.	30 NOV 1987
ACTION	Mr Gray
COPIES TO	CX Mr Anson Mr Monck
	Mr Burgner
	Mr Call

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

27 November 1987

Dear Chief Secretary,

PROFESSIONAL AND EXECUTIVE RECRUITMENT

I am writing to tell you that I intend to make an announcement about the future operation of PER by means of a written Parliamentary Answer on Thursday 3 December.

... I enclose a draft of the reply I am proposing to make. I should be glad to know that you are content.

I am copying this letter to the Prime Minister's Office, to the Secretaries of State for Scotland and Wales and to Sir Robert Armstrong.

Yours sincerely,

Angela Wilkins

NORMAN FOWLER
(Approved by Norman Fowler
and signed in his absence)

CONFIDENTIAL

PROPOSED ARRANGED PARLIAMENTARY ANSWER

DRAFT QUESTION: To ask the Secretary of State for Employment, whether the Government is continuing to keep the operation of Professional and Executive Recruitment under review and will he make a statement.

DRAFT REPLY: Yes. Professional and Executive Recruitment (PER) provides specialised consultancy and advertising recruitment services to employers wishing to fill professional, technical, scientific, supervisory and managerial vacancies. It operates these services on a commercial basis, charging fees to employers and earning revenue from its free newspaper, Executive Post, which is sent direct to well over 100,000 jobseekers each week as part of PER's advisory and information service. PER's consultancy service extends from straightforward advertising to full recruitment assignments. It operates nationwide, from a network of 35 offices. It also offers redundancy counselling services to organisations and publishes "Candidate Focus" each month.

There is extensive and effective private sector provision in the activities which PER provides on a fee charging basis. The Government's view is that activities of an obviously commercial nature are in general better carried on in the private sector.

I have decided accordingly to seek professional advice about options for transferring PER out of the public sector. I have appointed Lloyds Merchant Bank Limited to act as my advisers and report to me early in the New Year.

PH1/193

PERSONAL AND CONFIDENTIAL

FROM: MOIRA WALLACE
DATE: 30 NOVEMBER 1987

MR CROPPER

cc Financial Secretary
Mr Tyrie
Mr Call

CPC

The Chancellor has seen and noted your minute of 27 November. He has commented that it is perfectly reasonable for Mr Fowler to do this, but it will of course have to be cleared by us.

MPW.

MOIRA WALLACE

FROM: MRS M E BROWN
DATE: 8 December 1987

FINANCIAL SECRETARY

cc Chancellor
Sir P Middleton
Mr D J Moore
Mr Bent

MEETING WITH US COMMISSION ON PRIVATISATION: 9 DECEMBER 1987

President Reagan established in September a 13-member bipartisan commission "to review the appropriate division of responsibilities between the Federal Government and the private sector". It is chaired by Professor David Linowes of the University of Illinois and is due to report by end-March 1988. The Commission is on a fact-finding visit to the UK.

2. Privatisation in the US embraces contracting out and the provision of vouchers in place of public services, as well as the full transfer of assets to the private sector. "Full" privatisation has made little headway: Conrail is the only major achievement, and Mr John Moore (when Transport Secretary) wrote to the Chancellor last April describing useful discussions he had had about that with Mrs Elizabeth Dole, US Secretary for Transportation. From reports of the President's latest initiative (attached) it sounds as though attention will focus on vouchers and contracting out, as a means of reducing federal expenditure.

3. You will work to point to achievements in the UK:

- 16 major businesses transferred to private sector since 1979, and c. 655,000 jobs;
- further plans announced for Steel, Electricity, Water;
- contracting out in central and local government and NHS has saved
  - over 22,000 posts and £31 million a year in central government
  - over £103 million so far from NHS in England.

- legislation to promote further competition in providing local authority services, including refuse collection, building clearing and catering.

Mary Brown.

MRS M E BROWN

ENC

TEXTLINE * * * 4TH SEP 1987.

REAGAN NAMES 13-MEMBER PANEL TO STUDY PRIVATIZATION

President Reagan named a 13-member commission to find ways to relieve the government of programs and functions that he believes can be provided more efficiently by private citizens, businesses and organizations.
The panel will spend six months studying "all current activities of the federal government", the White House said. It will then issue a report suggesting legislation or administrative actions.

SOURCES
DJNEWS WSJ DJNR

TEXTLINE * * * 18TH SEP 1987.

REAGAN ADMINISTRATION - PRIVATIZATION PANEL NAMED.

President Reagan Sept. 3 appointed a 12-member President's Commission on Privatization, charged with studying ways to turn government operations over to private business. David F. Linowes, a Democrat who taught in the free-market-oriented economics department at the University of Chicago, was to chair the commission.
The group was given a broad mandate to examine what Reagan called "the entire dimension of government operations," and make recommendations within six months on privatization options. Reagan said that it would help him in his effort to "end unfair government competition and return government programs and assets to the American people."
Privatization of government assets had been a key Reagan administration theme since its first days. But so far few significant assets had been sold - the chief ones being the national freight rail system, Conrail, and the Landsat Earth-imaging satellite system. Recent efforts to sell off the Department of Housing and Urban Development's portfolio of mortgages on federally constructed housing had been stymied by concerns that the private owners would not be obligated to maintain the government's guarantees of low rent. Other privatization plans had been rejected by Congress.
The White House estimated that 38,000 government jobs had been turned over to contractors and consultants in the administration's six years, at an annual saving of $602 million.
Linowes said that the commission would look into turning federal housing projects, penal systems and health care facilities over to private owners or operators.
In a separate development, the Office of Management and Budget the same day established the post of associate director for privatization. Ronald Utt, an official of the US Chamber of Commerce, was named to the position.
Besides Linowes, other members of the commission included Garrey Carruthers, governor of New Mexico; Melvin R. Laird, a former Republican congressman and defense secretary in the Nixon administration; James T. McIntyre, former head of OMB; and Walter Wriston, former chairman of Citicorp.

SOURCES
FOF P677

THE PRESIDENT'S COMMISSION ON PRIVATIZATION WAS ESTABLISHED BY EXECUTIVE ORDER OF THE PRESIDENT ON SEPTEMBER 2, 1987 WITH THE STATED OBJECTIVE "TO REVIEW THE APPROPRIATE DIVISION OF RESPONSIBILITIES BETWEEN THE FEDERAL GOVERNMENT AND THE PRIVATE SECTOR" AND TO SUBMIT A REPORT OF FINDINGS AND RECOMMENDATIONS TO THE PRESIDENT BY MARCH 1, 1988. THE COMMISSIONERS HAVE IDENTIFIED A NUMBER OF PRIORITY AREAS OF STUDY FOR POTENTIAL PRIVATIZATION: HOUSING; LOAN PORTFOLIOS; AIR TRAFFIC CONTROL, AND OTHER FAA RELATED MATTERS; EDUCATION VOUCHERS; AND CONTRACTING OUT SERVICES INCLUDING PRISONS, MILITARY COMMISSARIES AND POSTAL SERVICE, AMONG OTHERS; AS WELL AS ASSET SALES, SUCH AS NAVAL PETROLEUM RESERVES, URANIUM ENRICHMENT AND COAL GASIFICATION FACILITIES AND THE RADIO FREQUENCY SPECTRUM.

THE EXECUTIVE ORDER CALLS FOR STUDY OF PAST AND CURRENT PRIVATIZATION EFFORTS BY THE FEDERAL GOVERNMENT, STATE AND LOCAL GOVERNMENTS, AND FOREIGN GOVERNMENTS, INCLUDING ASSET SALES BY THE FEDERAL GOVERNMENT.

SHORT BIOGRAPHIES OF THE COMMISSIONERS

DAVID F. LINOWES, OF ILLINOIS, IS CHAIRMAN OF THE COMMISSION. HE HAS BEEN BOECHENSTEIN PROFESSOR OF POLITICAL ECONOMY AND PUBLIC POLICY, AND PROFESSOR OF BUSINESS ADMINISTRATION AT THE UNIVERSITY OF ILLINOIS SINCE 1976. FROM 1975 TO 1977 HE SERVED AS CHAIRMAN OF THE U.S. PRIVACY PROTECTION COMMISSION. HE HEADED ECONOMIC DEVELOPMENT MISSIONS FOR THE U.S. DEPARTMENT OF STATE AND THE UNITED NATIONS TO TURKEY, INDIA, GREECE, PAKISTAN AND IRAN IN THE LATE 1960'S AND EARLY 1970'S.

ANNELISE GRAEBNER ANDERSON, OF CALIFORNIA, IS SENIOR FELLOW AT THE HOOVER INSTITUTION IN PALO ALTO. A NOTED ECONOMIST WITH THE PH. D. FROM COLUMBIA UNIVERSITY, SHE SERVED AS ASSOCIATE DIRECTOR FOR ECONOMICS AND GOVERNMENT AT THE OFFICE OF MANAGEMENT AND BUDGET FROM 1981 TO 1983.

MICHAEL D. ANTONOVICH, OF CALIFORNIA, IS ON THE BOARD OF SUPERVISORS FOR LOS ANGELES COUNTY, THE LARGEST LOCAL GOVERNMENT IN THE COUNTRY. ONE OF THE BOARD'S TOP THREE PRIORITIES HAS BEEN PRIVATIZATION, AND, SINCE 1980, THEY HAVE AUTHORIZED 645 PRIVATE CONTRACTS FOR A SAVINGS OF DOLLARS 100 MILLION.

WALTER F. BISH, OF WEST VIRGINIA, IS PRESIDENT OF THE INDEPENDENT STEELWORKERS UNION AT WIERTON STEEL CORPORATION, THE LARGEST EMPLOYEE-OWNED COMPANY IN AMERICA. HE RECENTLY SERVED AS A MEMBER OF THE PRESIDENTIAL TASK FORCE FOR PROJECT ECONOMIC JUSTICE, WHICH PROMOTED PRIVATIZATION AND EMPLOYEE OWNERSHIP AS AN ALTERNATIVE TO STATE SOCIALISM IN CENTRAL AMERICA.

SANDRA MITCHELL BROCK, OF WASHINGTON, D.C., IS GOVERNMENT RELATIONS ADVISOR FOR HERON, BURCHETTE, RUCHERT & ROTHWELL. IN BOTH HER CURRENT POSITION, AND HER FORMER POSITION AS VICE PRESIDENT OF GOVERNMENT AFFAIRS FOR AIR FLORIDA, SHE ACTED AS THE PRIMARY LIAISON BETWEEN GOVERNMENT AND THE PRIVATE SECTOR FOR EACH COMPANY.

GARREY E. CARRUTHERS, GOVERNOR OF NEW MEXICO, TOOK OFFICE IN JANUARY OF THIS YEAR, SINCE WHICH TIME HE HAS ESTABLISHED A PRIVATIZATION CABINET COUNCIL TO STUDY PRIVATIZATION IN STATE GOVERNMENT. AS FORMER ASSISTANT SECRETARY OF THE U.S. DEPARTMENT OF THE INTERIOR, HE LED THE EFFORTS ON PRIVATIZATION IN COAL LEASING.

RICHARD H. FINK, OF WASHINGTON, D.C., IS FOUNDER, PRESIDENT, AND CHIEF EXECUTIVE OFFICER OF CITIZENS FOR A SOUND ECONOMY. AS RESEARCH ASSOCIATE PROFESSOR OF ECONOMICS AT GEORGE MASON UNIVERSITY, HE FOUNDED, DIRECTED, AND CONTINUES TO CHAIR THE CENTER FOR THE STUDY OF MARKET PROCESSES. AN ECONOMICS CONSULTANT, HE TESTIFIED AT THE U.S. HOUSE OF REPRESENTATIVES GRACE CAUCUS HEARINGS ON PRIVATIZATION IN FEBRUARY OF 1986.

MELVIN R. LAIRD, OF MARYLAND, SERVED AS SECRETARY OF DEFENSE FROM 1969 TO 1972, AND AS DOMESTIC ADVISOR TO PRESIDENT NIXON FROM 1973 TO 1974. HE ALSO SERVED AS A MEMBER OF CONGRESS FOR MORE THAN 15 YEARS, DURING WHICH TIME HE WAS CHAIRMAN OF THE REPUBLICAN CONFERENCE AND A MEMBER OF THE HOUSE APPROPRIATIONS COMMITTEE.

JAMES T. MCINTYRE, JR., OF VIRGINIA, CURRENTLY A PARTNER IN THE D.C. LAW FIRM OF HANSELL & POST, SERVED AS DIRECTOR OF THE OFFICE OF MANAGEMENT AND BUDGET FROM 1978 TO 1981, AND AS DEPUTY DIRECTOR OF OMB IN 1977. HE ALSO SERVED AS DIRECTOR OF THE OFFICE OF PLANNING AND BUDGET FOR THE STATE OF GEORGIA.

GEORGE L. PRIEST, OF CONNECTICUT, IS PROFESSOR OF LAW, DIRECTOR OF THE PROGRAM IN CIVIL LIABILITY, AND DIRECTOR OF THE CENTER FOR STUDIES IN LAW, ECONOMICS, AND PUBLIC POLICY AT YALE LAW SCHOOL. HE HAS AUTHORED A NUMBER OF ARTICLES ON ECONOMIC POLICIES.

RALPH L. STANLEY, OF NEW YORK, IS SENIOR VICE PRESIDENT OF MUNICIPAL DEVELOPMENT CORPORATION. FROM 1983 TO 1986, HE SERVED AS ADMINISTRATOR OF THE URBAN MASS TRANSPORTATION ADMINISTRATION.

WALTER B. WRISTON, OF NEW YORK, IS FORMER CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER OF CITICORP, THE COMPANY WHICH HE HAS SERVED SINCE 1946. HE IS ALSO CHAIRMAN OF THE PRESIDENT'S ECONOMIC POLICY BOARD.

pp

FINANCIAL SECRETARY TO THE TREASURY

NOTE OF A MEETING HELD IN FINANCIAL SECRETARY'S ROOM ON WEDNESDAY 9 DECEMBER 1987 AT 4.00PM

Those present:	Financial Secretary	
	Mary Brown Richard Carpenter	) HM Treasury
	Mr D Linowes Mr M Antonovich Mr R Fink Mr G Priest Mr R Stanley Ms A Anderson	) Members of the American Commission on Privatisation
	Mr L Taylor	American Embassy

Mr Linowes explained that their purpose as a commission was to look into activities of programmes of Federal Government in order to decide which would be more appropriate for the Private Sector and then to consider how this could be put into effect. He asked how Britain's privatisation came about?

2. The Financial Secretary explained that it was a political decision that public sector organisations should be run in a more commercial manner ie. through the private sector. He wondered how Britain's experience could help USA and which areas were of particular interest.

3. Mr Linowes pinpointed the Housing and education issues and the Post Office.

Housing

4. Mr Linowes said the USA had 1.2 million properties in the public rented sector; the standards of which they hoped would improve under private ownership.

5. The Financial Secretary explained that Britain had a large stock of council accommodation which was sold to tenants under the "Right to Buy" Scheme. He pointed out that legal "right to buy" meant all local authorities had to sell to tenants if so asked.

Contracting Out

6. The Financial Secretary suggested that the Commission may be interested in this Government's contracting out of services. ie. in NHS and in military establishments (like the naval dockyards).

7. Mr Linowes asked how the unions reacted to contracted out.

8. The Financial Secretary agreed that there had been some adverse reaction from Unions; but the Government continued with implementation.

9. Mrs Brown pointed out that in some areas of contracting out the employees are free to tender for the work and compete for the it.

Education

10. The Financial Secretary did not see this as privatisation exactly. He pointed out that the idea has resulted from a lot of discontent with the present system and would effect the education system in 3 ways:

(a) maximise opportunities for parents to indicate their preference for a particular school;

(b) provision of schools to 'opt out' of the local authority's control and be answerable to central Government instead;

(c) implementation of a National Curriculum covering 70% of subjects and attainment tests for children.

He explained the decision to opt out would be made by partners and governors; but the Secretary of State would consult with the local authorities.

11. The Financial Secretary emphasised there were a number of difficult issues on this subject which he wasn't qualified to talk about.

Future Privatisations

12. Mr Priest asked if there were any areas which the British Government would consider inappropriate for privatisation?

13. The Financial Secretary explained generally the Government had only privatised commercial and industrial enterprises. There were obviously areas which would not be appropriate. He pointed out that there was some argument over the privatisation of utilities.

14. Mrs Brown explained that Government had not privatised industries with an element of subsidy, and that the Government had tried to make industries profitable before selling to the Public.

15. The Financial Secretary explained that in some cases public organisations had been sold which were not profit making but which had been bought with the expectation of making a profit. These were normally trade sales.

16. Ms Anderson highlighted the fact that there was no actual public ownership in the USA as there is and was in the UK. She explained that they have some Government-owned corporations. The USA have recently privatised the passenger railways and were considering privatising the 6 Power marketing organisations; but this had led to major opposition in Congress.

Social Security/Pensions

17. Mr Anderson asked if the Government was considering privatising the social security system. She said such an idea was politically taboo in the USA.

18. The Financial Secretary explained that we have basic pensions and state pensions which are earnings related and that employees can also contract out and contribute to an occupational pension. He pointed out that personal pensions allowed individuals to have their own pension funds separate from the firm they work for.

Electricity

19. The Financial Secretary said the exact privatisation programme was yet to be settled.

Railways

20. Mrs Brown said it would be difficult to privatise railways in UK as some areas are heavily subsidised ie. district railway lines. She pointed out that some areas of BR had been contracting out ie. catering.

Post Office

21. The Financial Secretary said that the Post Office was not on the agenda for privatisation.

22. Mrs Brown pointed out that the Government do however make an effort to improve efficiency and thereby reduce the Government funds needed to run the Post Office. There is already competition on parcels and haulage.

BBC

23. The Financial Secretary felt that there were already forces of competition on the BBC such as satellite broadcasting and increasing number of channels available.

British Steel

24. The Financial Secretary said this was a success story in making an unprofitable organisation profitable. This was done by setting clear performance targets on profits, efficiency and standards of service.

Susan Feest

SUSAN FEEST
(Assistant Private Secretary)
10.12.1987

cc PS/Chancellor
PS/Paymaster General
PS/Economic Secretary
P Cropper
Mrs M E Brown
R Carpenter
PS/IR

42/2.BTW.1234/29

RESTRICTED

FINANCIAL SECRETARY TO THE TREASURY

Next Prayer

Ch/ You have seen this minute before (Mr Davidson's of 18/11, enclosed)

FROM: J J HEYWOOD
DATE: 9 December 1987

PS/CHANCELLOR

cc PS/Chief Secretary

PRIVATISATION: BUSINESS SCHOOLS

The Financial Secretary has asked me to draw the Chancellor's attention to the attached minute. The Financial Secretary is personally quite sympathetic to the idea of privatising the business schools. He wonders whether the Chancellor and the Chief Secretary share this view.

JJH

JEREMY HEYWOOD
Private Secretary

748/17

Alex

FROM: R I G ALLEN
DATE: 14 DECEMBER 1987

MP

MR CROPPER

cc PS/Chancellor

PROFESSOR DONALD MACKAY

You asked for some information on Professor MacKay, a member of today's SWA delegation.

I enclose MacKay's Who's Who entry. An ex-economics professor at Aberdeen and Heriot Watt, MacKay now runs what, I gather, is a highly successful consultancy (PIEDA Ltd). He has worked, for example, on the privatisation of Rosyth Dockyards. My contacts tell me he is extremely close to Gavin McCrone, Secretary of the Industry Department for Scotland, and also will be well known to Malcolm Rifkind: Who's Who records him as having been a consultant to Secretaries of State for Scotland since 1971. Originally a bit leftish he has moved progressively rightwards, and he was described to me as being very sympathetic to current Government policies.

MacKay writes a monthly column for the Scotsman newspaper, a couple of recent samples from which are attached. These give the general flavour of his thinking.

RA

R I G ALLEN

Encs

MacKAY, Prof. Donald Iain; Chairman, PIEDA Ltd, since 1974; Consultant to Secretary
of State for Scotland, since 1971; *b* 27 Feb. 1937; *s* of William and Rhona MacKay; *m*
1961, Diana Marjory (*née* Raffan); one *s* two *d*. *Educ*: Dollar Academy; Univ. of Aberdeen
(MA). English Electric Co., 1959–62; Lectr in Political Economy, Univ. of Aberdeen,
1962–65; Lectr in Applied Economics, Univ. of Glasgow, 1965–68, Sen. Lectr, 1968–71;
Prof. of Political Economy, Univ. of Aberdeen, 1971–76; Prof. of Economics, Heriot-
Watt Univ., Edinburgh, 1976–82, Professorial Fellow 1982–. Lister Lectr, British Assoc.
for the Advancement of Science, 1974. Director: Edinburgh Financial Trust, 1983–;
Adam and Co., 1983–; Chm., Ainslie Investments Ltd, 1983–; City of Edinburgh Life
Assurance Co., 1984–. Indep. Mem., Sea Fish Industry Authority, 1982–; Mem., S of
Scotland Electricity Bd, 1984–. *Publications*: Geographical Mobility and the Brain Drain,
1969; Local Labour Markets and Wage Structures, 1970; Labour Markets under Different
Employment Conditions, 1971; The Political Economy of North Sea Oil, 1975; (ed)
Scotland 1980: the economics of self-government, 1977; articles in Econ. Jl, Oxford Econ.
Papers, Manch. Sch., Scottish Jl Polit. Econ., Jl Royal Stat. Soc. *Recreations*: tennis, chess,
golf. *Address*: Newfield, 14 Gamekeeper's Road, Edinburgh EH4 6LU.

A nastier year for Nigel?

ECONOMIC BRIEF

Prof. Donald MacKay

IF 1987 was Nigel Lawson's *annus mirabilis*, 1988 may be another matter. So, let us reflect on his past and present triumphs, and consider what pitfalls may lie ahead.

Next to Mrs T herself, the Chancellor could claim most credit for the Tory election victory. Any Government which goes into an election after a Budget which increased public expenditure, while reducing borrowing and taxation, is always going to be the odds-on favourite. And so it proved.

Yet, in the context of economic policy, it was the performance of the economy after the election which was the more remarkable.

The recovery and growth of the economy from 1981 onwards had already called into question the conventional wisdom of much of the UK's intellectual establishment. That had insisted that economic growth is best led by the rate of increase of government expenditure running ahead of the rate of increase of national income. The experience of 1988 finally laid that view to rest.

What Mr Lawson has proved is that sound finance is the best basis for sustained economic growth. By consistently applying the long-derided economic philosophy of the grocery shop, he has emerged with an economy whose performance has improved markedly relative to its major competitors. West Germany now looks the "sick man of Europe" and talk of the "English disease" is heard no more in our drawingrooms.

The facts speak for themselves. After the longest period of sustained recovery in the modern era, the UK economy still managed a growth rate of national income of some 4 per cent in 1987.

This was accompanied by the seventh successive year of substantial productivity growth and a fall in unemployment approaching half-a-million, together with a manageable position as regards the trade balance and price inflation.

The UK was the fastest-growing economy in the Western world and was expected to continue to outperform most economies in 1988.

In view of all this, it is hardly surprising that Mr Lawson received the accolade of Parliamentarian of the Year. His name even began to appear among the possible Tory successors to Mrs T, this being a welcome sign if you prefer your politicians to be cerebral and courageous, rather than callow and charismatic!

But squalls are ahead and, in politics, this year's winner can quickly become next year's has-been.

The point is not lost on Mr Lawson. In accepting his award, he noted that previous Parliamentarians of the Year include John Biffen and David Owen. The former has lost his Cabinet seat and the latter the major part of his political party.

The difficulty for Mr Lawson is that, while all the signs are that the UK economy will continue to perform well relative to the other major economies, this may be within a much more hostile external environment.

Even before Black Monday, the general expectation was that the UK growth rate in 1988 would be less than that achieved this year. Now, the continued prevarication of Washington threatens a serious recession and Mr Lawson's room for manoeuvre is strictly limited.

The UK would stand a major recession better than most but it could still suffer pain and, unfair though it would be, our Nigel would be held to account.

The signals for the US economy have been at red for some time and, as is usually the case, the markets recognised the danger signals before the professional economists.

Some eminent economists, including Milton Friedman and Sam Brittan, have even suggested that the US public-sector deficit cannot have been the cause of the crisis, as it was declining in size when the crisis occurred.

A simple example should demonstrate the obvious fallacy in this line of argument. Suppose I have an overdraft limit, based on my bank's estimate of my capacity to service debt. Suppose, further, that I approach that limit quickly at first and, then, rather more slowly. As I pass through the limit, should I believe that the bank will not call a halt to my borrowing?

Evidently not. And so it is with the US. Earlier this year, private-sector investors simply lost confidence in the willingness of the US authorities to curb their profligate ways. Very simply, the scale of US borrowing had become uncomfortably large relative to her perceived capacity to service it.

The evidence of this concern was the sharp rise in bond markets in the spring, this signalling the commencement of the "strike" by private investors.

Of course, the Louvre accord had pledged the Group of Seven to act together to help maintain the then exchange rate parities, this requiring concerted action to underpin the US dollar.

In consequence, central banks had to buy dollars in large quantities with two outcomes — a large increase in the domestic money supply in a number of countries, which threatens future inflation, and the postponement of the painful US adjustment necessary to cure the fundamental problem.

These events demonstrated what we should already have known from past experience. If the fundamentals are wrong, intervention by the central banks will be no more effective in stemming the tide than was Canute.

So it proved when Black Monday was visited upon us. It was the judgment of the market and the market was surely right.

The situation was insupportable and needed corrective action.

Such is the insularity of much of American political life that the writing on the wall is still only dimly perceived. And the markets remain impressed. Nor have the latest co-ordinated interest rate cuts in Western Europe helped the situation. These cuts are a clear sign of weakness, for they should have followed on from and not preceeded effective US action to curb the fiscal deficit.

So the markets wait for reassurance and there is little Mr Lawson can do but hope. He is already running a risk of a resurgence in the rate of inflation and he cannot go any further before the US authorities put their house in order.

He must now cross his fingers and hope that his luck holds. He, and we, will have need of it.

How crisis can turn into depression

ECONOMIC BRIEF

Prof. Donald MacKay

THE $64 billion question is — if the Great Crash of 1929 led to the Great Depression of 1929-32, what will follow the Great Crash of 1987? Answers, in a sealed envelope, to Mr Lawson.

Both crashes began in October on Wall Street, but the initial, sickening descent from Monday, October 19, 1987, was more severe. In both cases nobody had anticipated the speed of the collapse, though there were plenty afterwards claiming the 20/20 vision given by hindsight.

Then, as now, the financial crash occurred while real income and output were rising. Then, as now, the initial fall was followed by a phoney war when the financial markets displayed considerable uncertainty. Then, came the Depression. Now, what?

My own view is that there need not be another Great Depression and that the UK will ride out the recessionary tides better than most. Remember, however, that in 1929, John D. Rockefeller was wheeled out to announce: "... my son and I have been for some days purchasing sound common stocks."

I can't claim the same market power, and my son is a conscientious consumer rather than a saver, but I have been buying common stock since Friday October 23. This may appear to be tempting fate too far, particularly as, unlike Rockefeller, I could not claim that the "fundamental conditions of the country (the U S) are sound."

As J. K. Galbraith has observed, the Great Crash of 1929 was financial in origin. It was not preceded by a fall in income and output. That, of course, came later, the direction of causation being from the financial markets to the real economy. Events in the financial markets precipitated events in the real economy, rather than the reverse.

Now, while the basic circumstances of the U S economy were sound in 1929, the same could not be said today. As a direct consequence of Reaganomics, the U S has a high fiscal deficit, with its inevitable counterpart — a huge current account deficit.

This situation was sustainable so long as overseas investors, above all the Japanese, were prepared to buy U S stocks and bonds. But, failing corrective action by the U S authorities, these structural imbalances were bound to result, sooner or later, in a crisis of confidence.

Given that this has now materialised, in an *unsound* economy, must one conclude that we will witness another Great Depression? A financial crisis is turned into a major depression by mistaken policy and not by the automatic operation of a market economy.

In the 1930s, failure of the Federal Reserve Bank to act as "lender of last resort" resulted in a wave of U S bank collapses. In consequence, the money stock fell by one-third over 1919-33, resulting in a major contraction in output and employment in the U S.

The fall in U S imports, magnified by the adoption of the Smoot-Hawley tariffs in 1930, had a major impact on the European economies, leading to the abandonment of the gold standard and the general slide into protectionism.

It is, of course, possible that the Great Crash of 1987 will have the same impact on output and employment. After all, in a crisis of confidence there is no "Chinese wall" between financial markets and the real economy.

Yet, experience suggests that history will only repeat itself if we make the same or equivalent policy mistakes. If we have learnt from history then the extent of the recession can be contained, even in the U S. That is, a recession is turned into a depression only by the failure to adopt appropriate remedies.

The immediate link between a collapse in the value of financial assets and the real economy is provided by the "wealth effect." That is, the owners of financial assets can be expected to cut back consumption expenditure by some 0.5-1 per cent, given the fall in the value of financial assets which has occurred.

Much less quantifiable is the impact on business confidence, the latter being difficult to describe but easy to recognise when it disappears (if you see what I mean).

Lord Keynes argued that investment is heavily influenced by "animal spirits," and they do become dimmed when financial markets are in turmoil.

Moreover, because confidence is a fragile plant, it is important to take early action when a financial crisis does occur. In short, we come back to the central problem — the need to deal immediately with the U S fiscal and trade deficits.

In a potentially deflationary climate, it may appear odd to insist on the need for higher U S taxes and lower government spending to reduce the fiscal deficit, as the impact of these measures are deflationary. But only effective action of this nature will restore any confidence in the dollar.

It must be taken soon or it will be too late. The "right" action needlessly delayed is often little better than the "wrong" action at the "right" time. What is needed is effective action to reduce the deficit *now*, to prevent the large hike in interest rates which would otherwise be necessary to protect the dollar.

The counterpart of fiscal prudence in the U S, should be a more expansionary fiscal policy in Japan and West Germany, accompanied by lower interest rates. Both these countries should also reduce interest rates, as should the UK.

Given that the U S is the central problem, we should possibly think of a new form of lend-lease, and lend them Mr Lawson for a short period. Certainly, his handling of the situation has been quite exemplary, both strategically and tactically. Yet, while the UK is better able to stand a recession than the other major economies, it, too, must be affected if the U S authorities do not take the necessary measures.

In these circumstances it is no use looking to the Chancellor for salvation. The UK, through its rapid growth, is making its own contribution to righting the fundamental imbalances which exist.

For effective action in the U S we must rely on Mr Reagan. This is hardly a position of great comfort, but it does reflect the facts of economic interdependence in the modern world.

3977/48

Pup

FROM: P J CROPPER
DATE: 14 December 1987

PS/FINANCIAL SECRETARY

cc PS/Chancellor
Mr D J L Moore
Mrs M E Brown

PRIVATISATION SEMINAR

Mr Chown is still very keen to write a paper, and promises us a draft before Christmas. He is then away until 6 January.

2. He asked whether his would be one of several papers: I indicated it was more likely to be the only one, and that the other participants would probably be invited to speak to specific points on a pre-arranged agenda paper.

3. John does not see the BP affair as removing the necessity for a critical look at the cost of the underwriting/firm placing technique. He took the point that we were not proposing to use the occasion for a thoroughgoing BP post mortem - but that the subject of BP would obviously crop up.

4. Chown wondered whether he should include in his paper a section on the question about whether gas should have been privatised as a monopoly, and how electricity should be done etc. I said that the seminar was meant to be more about technical capital market issues than about competition policy.

P J CROPPER

12.4215

CHIEF SECRETARY TO THE TREASURY

pmp

FROM: J RUTTER
DATE: 15 December 1987

PS/FINANCIAL SECRETARY

cc PS/Chancellor

PRIVATISATION: BUSINESS SCHOOLS

The Chief Secretary has seen your minute of 9 December covering a note by Mr Jackson.

2. The Chief Secretary would welcome the privatisation of the business schools mentioned subject to the public expenditure endowment cost being acceptable. He believes that this option should now be seriously considered. He would be interested to see an estimate of the endowment cost and subsequent public expenditure savings over the longer term.

3. The Chief Secretary notes that if the concept involves the need to attract private sector capital the precedent of the CTCs is hardly encouraging, since they attracted far less capital than expected when the concept was orignally launched. He notes however that this may not apply to a proven concept such as business schools.

Jill Rutter

JILL RUTTER

42/2.BTW.4372/08

CONFIDENTIAL

FINANCIAL SECRETARY TO THE TREASURY

mp

FROM: J J HEYWOOD
DATE: 15 December 1987

MR BROOK

cc Principal Private Secretary
PS/Chief Secretary
Sir P Middleton
Mr Anson
Mr Monck
Me Kemp
Mr Gilmore
Mr Moore
Mr Revolta
Mr Call

MEETING WITH HARTLEY BOOTH

The Financial Secretary was grateful for your note of 11 December. Mr Booth wanted to bring two possible privatisation candidates to the Financial Secretary's attention:

(i) The Directorate of Telecommunications

(ii) The British Waterways Board.

Directorate of Telecommunications (D.Tel)

2. Your note provides the background to this organisation. The Financial Secretary said that he was keen for the Treasury to be involved in a study of this. Could you supply a draft minute to the Home Secretary in this sense?

3. Mr Booth said that he thought this was a good candidate for privatisation because:

(i) Although only 2,000 people were directly on the payroll, a further 30,000 employees were indirectly involved. There was ample scope for efficiency savings;

(ii) Once privatised the D.Tel could develop into an internationally competitive business;

(iii) The new Director had prepared the way - in a sense - for privatisation. D.Tel now had its own Budget and its own defined area of work;

(iv) It was "strategically important" to extend the privatisation programme into the heart of the Civil Service.

British Waterways Board (BWB)

4. Mr Booth said that he thought this was a very good candidate for privatisation - not least because a privatised BWB could play a key role in the regeneration of the inner cities (property development and leisure-related activities along canal banks).

5. He thought that the current annual £45m grant paid to the BWB (to finance its statutory obligations on servicing and maintenance) was inefficiently used and if the work were contracted out to the private sector there would be a saving either to the BWB or to its new private owner.

6. The book value of the BWB's property portfolio was £20m, but his guess was that the true value was in excess of £200m. An internal revaluation was currently underway.

7. Mr Booth reported that several companies were interested in buying the BWB including Trafalgar House.

8. The Financial Secretary would be grateful for Mr Moore's comment on this.

JH

JEREMY HEYWOOD

FINANCIAL SECRETARY TO THE TREASURY

FROM: J J HEYWOOD
DATE: 16 December 1987

MR JACKSON

pmp

cc PS/Chancellor
PS/Chief Secretary
Mr Monck
Mr Gilmore
Mr D J Moore
Mr Burgner
Mr Burr
Mr Call

PRIVATISATION: BUSINESS SCHOOLS

The Financial Secretary was grateful for your minute of 18 November.

2. The Financial Secretary is keen to take this further. But he would like to know what the longer term public expenditure savings and the estimated endowment cost would be.

J.H.

JEREMY HEYWOOD
Private Secretary

42/2.BTW.4372/25

pnp

FROM: MISS S J FEEST
DATE: 16 December 1987

MRS M E BROWN

cc PS/Chancellor
Mr D J Moore
Mr R I G Allen
Mr A Hudson
Mr M Call

I attach a copy of a letter from Stock Beech asking the Financial Secretary to contribute an article on "Why the privatisation flotations have been so successful and his thoughts on future issues" for their client magazine Portfolio.

2. As you can see from my letter of 15 December; the Financial Secretary has agreed to contribute to the February/March issue. The deadline for this is 19 February 1988.

3. I would be grateful if you could provide the Financial Secretary with a draft article of about 1500 words in length by Tuesday 16 February 1988.

Susan Feest

SUSAN FEEST
(Assistant Private Secretary)

ENC

42/2.BTW.4372/17

FINANCIAL SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

N G K Hutchen Esq
Director
Private Clients
Stock Beech
The Bristol & West Building
Broad Quay
BRISTOL
BS1 4DD

Your ref: NGKH/ET

15 December 1987

Dear Mr. Hutchen.

Further to my discussion with Ms Taylor at your office, I am writing to advise you that Mr Lamont will be pleased to write an article on privatisation flotation as suggested in your letter of 30 November 1987.

As I explained to Ms Taylor; your letter arrived too late for us to contribute to the December/January issue. However, I understand that you would still like a contribution to your February/March issue and that the deadline for this is 19 February 1988.

I will, of course, contact you in due course with the proposed article.

Yours sincerely

Susan Feest

SUSAN FEEST
(Assistant Private Secretary)

Stock Beech
Members of The Stock Exchange Established 1844.

The Bristol & West Building
Broad Quay
Bristol BS1 4DD

Telephone: 0272 260051
Telex: 44739
Fax: 0272 273138

Our Ref. Your Ref.
NGKH/ET

Right Hon Norman Lamont MP,
House of Commons,
Westminster,
London,
SW1A 0AA.

30 November 1987

14/12/87

Dear Mr. Lamont,

I much enjoyed your speech at the Unit Trust dinner about privatizations the other evening.

As you will be aware, Stock Beech has acted as Regional Co-ordinator for the West Country for all the main privatization issues since 1985. I was wondering whether you would be willing to contribute an article for our client magazine PORTFOLIO which is circulated bimonthly with our client newsletter STOCK UPDATE. This magazine is mailed to 25,000 Stock Beech clients, and has a readership well in excess of this figure.

An article on why the privatization flotations have been so successful and your thoughts on future issues would be much appreciated. I would be most grateful if you (or your people at Conservative Central Office) would be kind enough to write such an article, say 1,500 words in length. Copy deadline for our next edition is December 19th at the latest. A photograph of yourself and short biographical of details would also be useful.

We look forward to hearing from you.

Yours sincerely,

Nicholas Hutchen

N. G. K. Hutchen.
Director, Private Clients.

P.S. Although the stockmarket has been falling, you will be pleased to hear that Stock Beech has not yet cut out "the cheese course"!

3691/4/sh

CONFIDENTIAL

FROM: D J L MOORE

DATE: 17 DECEMBER 1987

FINANCIAL SECRETARY

cc PS/Chancellor
Sir Peter Middleton
Mr Monck
Mr Lomax
Mrs Brown
Mr Ilett
Mr Call

MERRILL LYNCH

Stanislas Yassukovich wrote to you on 30 November to suggest that Merrills could put forward innovative ideas for attracting and retaining individual shareholders in privatisation issues.

2. The theme is that, unlike our traditional UK advisers, Merrills are highly experienced in retail marketing and in particular at targeting individual prospective buyers who, if well chosen, are likely to retain their shares.

3. It is of course true that they are one of the world's biggest retail houses. But I do not think they have direct experience of promoting wider share ownership on UK lines. Their skills are directed much more to the relatively more sophisticated and well off private investor.

4. They refer to lack of interest in ideas they put forward for British Airways. You saw Merrills and others at the time and I attach a letter of 30 July 1986 you sent to Mr John Moore - see in particular the paragraph at the bottom of page 1 - and of your letter of 15 August to Barings.

5. Nevertheless, although Merrills may be barking up the wrong tree again, it would be well worth talking to them to see if they have got any ideas worth developing. I could do this in the New Year and report to you.

I attach a draft reply.

D J L MOORE

3691/5/sh

DRAFT LETTER FROM FINANCIAL SECRETARY TO STANISLAS YASSUKOVICH

Stanislas Yassukovich
Chairman and Chief Executive
Merrill Lynch Europe Limited
Merrill Lynch House
27 Finsbury Square
LONDON
EC2A 1AQ

Thank you for your letter of 30 November.

I am very grateful to you for your interest in my speech and for your offer to put forward new ideas for attracting and retaining individual shareholders.

As you know, from our response to the suggestions from you and others on the British Airways sale, the Government wants to be able to control the distribution of shares so as to be well placed to meet demand from individual retail investors. In particular, as part of our wider share ownership policy, we want to encourage new investors and to deepen the interest of the relatively new breed of investors who have bought in the privatisation issues.

Any ideas you have to help us promote these objectives would be very welcome and I suggest that in the first place you or some of your people should talk in January to David Moore, the Treasury Under Secretary responsible for the privatisation programme.

Norman Lamont

2155/09

cc CCARE
ASTONE
MR. HYMAN
MR. J. COLMAN

Treasury Chambers, Parliament Street, SW1P 3AG

27/31

The Rt Hon John Moore MP
Secretary of State for Transport
Department of Transport
2 Marsham Street
LONDON
SW1P 3EB

30 July 1986

Dear John

SALE OF BRITISH AIRWAYS

I recently saw Charles Irby and Robin Broadley of Barings, and Stan Yassukovich of Merrill Lynch at their request. They wished to seek my views on an idea they had had for privatising BA without a public offer for sale. They emphasised that if the idea were to be pursued then it would need to be developed much further. They wanted to know whether I thought that further work would be justified. I told them that I wished to consult you before replying to their question.

The essence of their idea was that instead of a public offer for sale, Barings and Merrill Lynch would undertake to dispose of all the shares in BA to buyers whom they would select. The operation would be similar to a placing but would be on a much larger scale, and involve many more buyers than in any normal placing, and the shares would be listed on the Stock Exchange.

Amongst the advantages that they saw in the proposal were that it could be achieved much more quickly than a conventional privatisation issue. They thought that much of the marketing and advertising could be dispensed with. They also thought that their idea would enable the buyers to be selected "more precisely". They were not very clear in explaining this concept, but it seemed to mean that the shares would go to serious, sophisticated, but not necessarily big or professional, investors. They said that in their view BA, as an airline, was not suitable as an investment for first-time or unsophisticated investors.

My own views on this proposal are that it is unlikely ever to be attractive to us. It would give Government no control over the distribution of the shares, and would rule out sale to the kind of small investors who remain shareholders in BT. I am sure that we cannot accept any suggestion that BA shares are in some way a worse investment for small investors than other privatisation issues. X

I have no doubt that Merrill Lynch and Barings are assuming that after the Big Bang the way will be open for all sorts of innovations in methods of sale. To bring off such an innovation on such a large and prominent sale as that of BA would be an enormous advantage to them, but I am doubtful whether we will wish to experiment so radically with the BA sale.

Unless you disagree, I propose to reply to Barings and Merrill Lynch accordingly.

Yours ever

Norman

NORMAN LAMONT

881.27.ms

CC MR Grimstone
MR Hyman
MR D Moore
MR Colman
MR Ross Goobey.

a/3

Treasury Chambers, Parliament Street, SWIP 3AG

14/21

Charles Irby Esq
Baring Brothers & Co Ltd
8 Bishopsgate
LONDON EC2

15 August 1986

Dear Charles

When you, Stani Yassukovich and Robin Broadley came to see me on 21 July, I said I would consult John Moore on the idea you outlined to me for privatising British Airways without a conventional public offer for sale.

We have considered your idea most carefully but I am afraid we have concluded that we would be unlikely to be able to use an extended placing of the sort you outlined. We appreciate your help in trying to find a solution to the problems which have meant we have not yet been able to set a timetable for the sale of BA. But I hope you will understand that, while it would not be appropriate for me to go into the detailed nature of those difficulties, your proposal would not in fact have helped us to overcome them.

When we are in a position to set a date, we are confident that a public offer for sale will enable us to privatise BA successfully. And, your proposal has one disadvantage for us compared with an offer for sale. We attach great importance, as vendor and as Government, to being able to control the distribution of shares in the face of the demand for them. A public offer for sale can give us that power, which is particularly useful in ensuring that if there is widespread retail demand then we can take steps to favour it. Under your proposal, a large class of potential investors would not have direct access to the shares. You said that in your view BA, as an airline, would be a riskier type of investment than some other privatised companies, but I do not think that BA shares would be in any way unsuitable for inclusion in the investment portfolio of small investors.

Once again, thank you for your offer to help, and of course we shall bear it in mind.

Yours ever

Norman

NORMAN LAMONT

853/32

FINANCIAL SECRETARY

FROM: MRS M E BROWN

DATE: 22 December 1987

cc Chancellor
Economic Secretary
Sir P Middleton
Mr Anson
Mr Monck
Mrs Lomax
Mr Ilett
Mr M L Williams
Mr Lyne
Mr Bent
Mr Neilson
Mr Jarvis
Mr Cropper
Mr Call

FST
I don't think this is right @ all. The purpose of the seminar is not to forecast the stock market – we can assume that conditions will be such as to make new issues possible – but to learn from the lessons of our privatisations & experience to date (what has gone right & what has gone wrong) so as to do even better in future. Thus a mix of the [illegible] to [illegible] consist essentially of III followed by II.

PRIVATISATION SEMINAR, 27 JANUARY 1988: ANNOTATED AGENDA

I attach a draft agenda. At our recent meeting you envisaged that this, together with the promised paper from Mr Chown, would be circulated in advance of the Seminar. I suggest they should go out in the week beginning 4 January.

2. The agenda is divided into four sections, which would be the basis for four sessions during the morning. There would be more general discussion over lunch, which would mark the end of the Seminar. You may feel that the first section on general prospects is too wide-ranging: but provided the discussion was tightly chaired, it would set the scene and bring in some important themes.

3. The other question to be considered is whether we ask any of the outside participants to be ready to speak for, say, 5 minutes each to kick off the discussion on each item. My nominations (deliberately excluding the most senior participants, and giving you a choice between one or two per item) would be:

Sessions are [illegible] for one morning. Other items (such as I (iv) & I (v)) could be discussed over lunch.
[illegible]

(i) General prospects: John Chiene (Wood Mackenzie), Alistair Ross-Goobey (James Capel);

(ii) Wider share ownership: Anthony Carlisle (Dewe Rogerson), Duncan Clegg (Lazards);

(iii) Pricing and offer structure: John Chown, John Mathews (County NatWest);

(iv) Costs and organisation: Ian McIntosh (Samuel Montagu), Stephen Carden (Cazenoves).

4. If you agree, we will sound out some or all of these candidates before you ask them formally to contribute.

5. This advice is agreed with FIM Division.

B. Kinahan

p.p. **MRS M E BROWN**

853/17

PRIVATE AND CONFIDENTIAL

HM TREASURY SEMINAR ON PRIVATISATION, 27 JANUARY 1988

ANNOTATED AGENDA

I. General prospects

We want to start by looking beyond the immediate future to the general outlook for selling privatisation stocks over the next 3 to 4 years.

We would welcome views on:

(i) possible trends in equity market conditions: have we entered a prolonged bear market, and if so what are the implications for us as vendors?

(ii) what can we assume about future demand (in general terms) for equities and for privatisation stocks in particular, from

- institutional investors
- retail investors
- overseas markets

(iii) we plan sales of water and electricity utilities in a relatively short space of time, probably from late 1989 onwards. Will the market be able to cope with the large demand placed upon it, especially in view of the relative novelty of the shares?

(iv) what structural changes in the markets should we be taking into account? What further developments from Big Bang can be expected over the next few years?

(v) are there other market developments which we should be anticipating, or seeking to promote? Should we, for instance, be considering privatisation bonds as well as equities?

II. <u>Wider share ownership</u>

Turning to the Government's specific objectives for privatisation sales, we would like to examine progress to date in promoting wider share ownership; and ways of developing that policy in future.

We are particularly interested to discuss ways of encouraging smaller investors to retain their shareholdings. We should like to examine, amongst other things:

- Retention patterns: are some groups of retail investors more likely to retain their shares than others? Should we target them more directly?

- Are loyalty bonuses and/or vouchers cost-effective?

- Should we give preferential treatment to purchasers who commit to retain their shares for a specified period? What would be the best way to achieve this technically?

- What are participants' views on setting minimum application levels and minimising dealing costs?

- What are the pros and cons of balloting to avoid excessively small allocations?

Are there other ways of attracting retail investors, or other sectors of the retail market which we have not fully explored? In selling the water authorities, for example, we may want to appeal more to regional markets: what special factors will we need to take into account?

How will TAURUS (Stock Exchange electronic share transfer scheme) and nominee schemes such as Barclayshare's affect the cost and complexity of future retail sales?

There has been criticism of share sale advertising campaigns. Do participants have views on the format and coverage of these? Need they be so costly?

How sophisticated is the retail investor becoming? How well can he cope with tenders rather than fixed price offers, or with more novel instruments such as options or warrants?

III <u>Pricing and offer structures</u>

Maximising sale proceeds will continue to be an objective of every share sale. We will want to assume in this discussion that recent market movements have been exceptional. In more buoyant conditions, the Government has been criticised for pricing privatisation issues too low, and for selling shares to institutional investors on excessively generous terms. A separate paper by Mr John Chown is being circulated, which reflects some of these points.

We would like to discuss how we can achieve tighter pricing, particularly in primary sales. Points to consider include:

- the role of tenders
- calculating and setting the discount on primary offers
- setting the discount on secondary offers
- linking the offer price in a secondary offer to the market price when the offer closes
- should the discount for professional investors be different from that for retail investors?

On the <u>structure</u> of sales, we would like to review:

- the effectiveness and operation of clawback

- the relative advantages of 100% and 51% sales

We would welcome participants' comments on the way in which past privatisation issues have been structured, and suggestions for the future.

IV Costs and organisation

We need to be able to demonstrate after every sale (in Parliament and elsewhere) that costs have been kept to a minimum consistent with the Government's objectives, and that the sale has been efficiently and effectively organised. We are often criticised for excessive or unnecessary expenditure on the following:

- firm placing commissions (where appropriate)
- advertising
- engaging regional co-ordinators, and the level of commissions paid to them.

What are participants' views? Are there other items where we could reduce sale costs - or where we could maximise overall proceeds by <u>increasing</u> expenditure on particular items?

H M Treasury
January 1988

45a/2/PAS/3649/42

* & see my comments N.

CONFIDENTIAL

FROM: P CROPPER
DATE: 23 DECEMBER 1987

MR D MOORE

Ch, see also Mrs Brown's draft annotated agenda, behind. JF 23/12

cc PS/Chancellor
PS/Financial Secretary
Mrs M E Brown
Mr Call

PRIVATISATION SEMINAR

This has just come in from Mr Chown, who is off abroad until 7 January. He would appreciate our comments on his return. I will read it over Christmas and consult you in the New Year.

P CROPPER

ENC

PJC/ This will not do as it stands, for the reason we have explained to JFC before. The £1.4 bn figure to dynamite, ie bound to take (as well as being highly questionable, esp post BP). Nor is it the only way [illegible] lessons we wish to reach the conclusions set out on pp 16-18.

*

I have rewritten some cuts: with these cuts made the [illegible] would remain a highly provocative but very useful paper for the seminar. N

J F · CHOWN
& Company Limited

PLTCRPTS/47 22nd December, 1987.

DRAFT

PRIVATE AND CONFIDENTIAL

PRIVATISATION AND THE PUBLIC PURSE

A CRITICAL ANALYSIS

JOHN CHOWN

SUMMARY

Most public discussion on privatisation has been between enthusiasts and opponents. Very few of us have taken the stance of friendly critics, thoroughly supporting the general aims of policy, but looking very critically at the details of implementation.

~~This paper deals mainly with one aspect which has received surprisingly little public discussion. It suggests that some £1.4 billion, or 11% of the gross proceeds of five widely offered privatisation cases discussed, was unnecessarily lost to the public purse with no corresponding political or other policy benefit. It was essentially written before the BP issue. The lessons of this, discussed below, actually confirm rather than contradict its main conclusions.~~

Four out of the five issues analysed were seriously underpriced, but in all cases a significant part of the benefit went, not to public applicants, but to certain privileged institutions treated as "priority applicants". Stock

Exchange rules seek to prohibit placings of issues over £15 million, on the grounds that these are unfair both to vendors and to the general investing public. These unprecedentedly large issues, ranging in size from £900 million to over £5 billion were, in fact thinly disguised placings of between 30% and 55% of the total issue, with this proportion of the benefit of underpricing going to priority applicants.

This method of issue was unnecessarily expensive to the taxpayer, and created a serious conflict of interest between the Government and its advisers. Pricing decisions were unduly influenced by those who stood to benefit, directly or indirectly, from underpricing.

The key figures are set out, on a fully paid basis, in Table 1.

TABLE 1 THE TRUE COSTS OF PRIVATISATION (£ MILLION)

	PROCEEDS TO HMG (NET)	OPENING MARKET VALUE	WINDFALL TO GENERAL PUBLIC	WINDFALL TO PRIORITY APPLICANTS
British Telecom	3700	5200	443	793
British Gas	5260	6120	228	240
British Airways	850	1210	121	170
Rolls Royce	1280	1675	131	158
BAA	1225	1443	110	51
	12315	15650	1033	1422
TRUE TOTAL "COST"		3335		

The rest of the total gap of £3,335 million between government receipts and opening market value was mainly accounted for by disclosed expenses (about £500 million) and by benefits to employee applicants.

This paper begins by summarising some general principles of privatisation, goes on to discuss its main point, and describes the methods used in the new issue market. It then analyses the issues: British Telecom (in some detail) British Gas, BA, Rolls Royce and BAA (in summary) and finally BP which throws some new light on the debate. It concludes with some recommendations.

SOME GENERAL PRINCIPLES

The UK was well represented at a conference in Vancouver in July 1987. This concluded that we had two lessons for other countries.

1. We made a lot of mistakes, and
2. The underlying benefits of the policy were such as to make it a success, even after the cost of these mistakes.

It followed that:

3. Other countries should go ahead with enthusiasm, but having studied and learned from our mistakes.

Three main aims of privatisation are:

1. To eliminate State monopolies, enhance competition and make the industries concerned more accountable. This should result in more efficient use of resources and a major improvement in services to the public.

2. To raise money. A more rational analysis can be made if the proceeds are treated as an alternative means of financing the public sector borrowing requirement rather than as a means of reducing it. Government has to compare the expected net present values both of the change in the borrowing requirement and of the flow of profits "sold" to the private sector.

3. Encouraging wider share ownership.

These three aims obviously conflict. Specifically, if we are to achieve (3) we have to forego some part of the benefits of (2). It is for discussion whether, and how much, the "public as investor" should benefit at the expense of the "public as taxpayer". There is indeed an argument, which has been made by Sam Brittan and others, for actually <u>giving away</u>

shares in previously state owned enterprises on a per capita basis to all citizens. Some underpricing was, arguably, actually desirable if it helped to encourage a new breed of small investor.

There has been rather more public discussion on the conflict between (1) and (2). Many have argued that the British government had been too ready simply to transfer a public monopoly into a private monopoly. In several cases it might have been better to have broken up the companies concerned into smaller units, enhancing competition at some expense of prospective profits and capital receipts to the Exchequer is becoming. Undue attention appears to have been given to the personal preferences and prejudices of senior management of the companies concerned. British Gas, the issue which comes off best in the analysis below of the offer procedures, is perhaps the worst when looked at from this point of view.

THE MAJOR CRITICISM - THE PUBLIC OFFER PROCEDURES

A good case can therefore be made for accepting lower privatisation receipts in the interest of other policy objectives. The loss of £1.4 billion, nearly 10% of gross proceeds, analysed in this paper conferred no such benefit, and indeed ran counter to a stated government policy of removing any bias favouring institutional, rather than individual, investment.

In total, the five privatisation issues (British Telecom, British Gas, British Airways, Rolls Royce and BAA) raised some £12.3 billion net of expenses, but the opening market value exceeded the issue price by £2.4 billion. Of this profit to applicants, less than half went to the general public who, it could be argued, are a good cause. Over £1.4 billion accrued as a windfall profit to "priority applicants". This procedure cost the Exchequer some 11% of proceeds, served no public purpose whatsoever, and created an unacceptable conflict of interest. How did the procedure manage to survive the scrutiny of disinterested, competent, advisers? How can we, in future, capture this extra 11% for public purposes?

Pricing a new issue is a difficult art, and, particularly in a bull market, some underpricing is inevitable. The criticism is of the method of issue, not the underpricing as such, although the two are not unrelated.

METHODS OF ISSUE

There are three main ways of selling a company to the public. These are:

1. A tender offer, by which the company is sold at the highest price offered by investors who (collectively) offer to buy all the shares on offer. The normal practice is that all such investors are allotted shares at the lowest market-clearing price and there is usually a small opening premium over the striking price. A variant was used in the partial tender element of BAA.

2. An offer for sale, by which all applicants have an equal chance (subject to the basis of allotment) of securing shares at a pre-determined price. This price is customarily (but need not be) underwritten by institutions who, in return for an underwriting commission of around 1%, undertake to purchase any shares not applied for by the public.

3. A placing, where shares are placed at a fixed price with investors chosen by the sponsoring bank or brokers.

The correct method of calculating the cost of issue is to compare the net proceeds of the issue to the vendor, net of expenses, with the market capitalisation of the company at some time after dealings commence. This is long-established text book practice, as well as according with common sense. The method is used in an article in the Bank of England Quarterly for December 1986, but receives hardly a mention in the National Audit Office. (CHECK REF)

Tenders are (nearly always) the most, and the placings (generally) the least, beneficial to the vendor: in this case the government. From the point of view of the sponsoring banks or brokers the order of preference is reversed: placings give the most, and tenders the least, scope for patronage, for allocating the profits from under-pricing into selected, friendly hands who are likely to offer reciprocal favours. From the point of view of the general public, without friends at court, offers for sale are clearly very much fairer than placings.

Tender offers generally maximise the proceeds to the vendor. Why are they so rarely used? They are said to be unpopular with investors, but the arguments are unconvincing. They are certainly unpopular with sponsoring banks and brokers, to whom they offer few opportunities for the indirect but very real profits in addition to the agreed fee or commission.

Standard undergraduate text books refer to placings as being appropriate only for small issues. (This used to mean less than about £250,000, but times have changed! The figure is now about £3 million.) The Stock Exchange Council has always been reluctant to permit placings except for very small issues, on the grounds that they were unfair to the general body of investors and unfavourable to the vendor client. All five issues appear to be in clear breach of both the letter and the spirit of the Stock Exchange. "Yellow Book" provisions eg para 1 (3).

The first four of the privatisation issues, discussed although in form "offers for sale", were in substance placings to the extent of (more or less) half the issue. Three out of the four were also seriously under-priced - a fact which is probably not a coincidence. The fifth issue, BAA, experimented with a partial tender, but one quarter, even of that, was still a "placing".

Offers for Sale

Sub-underwriters normally exact a reward of 1% to 1.5% of the amount nominally at risk, a customary reward which is arguably excessive and unnecessary. David Walker, of the Bank of England, addressing pension fund managers, (Bank of England Quarterly June 1987) said:

> "I cannot forbear from observing that your enthusiasm to move away from the fixed commissions you pay has been matched only

> by your enthusiasm to maintain cartelised fixing of the fees that you yourselves receive for sub-underwriting."

The Economist (June 27th 1987,) in an article headed "Primitive Privatisation", states:

> "In Britain the Government could start to save the taxpayer money by paying City firms less ... And it could save money on underwriting fees, which currently stand at 1.5% of the issue's value."

Both criticisms miss the real point. The sub-underwriters, in these cases, were the beneficiaries of placings, and actually made far, far more than just the fees disclosed in the prospectus and in parliamentary answers. The normal practice with an offer for sale is for the underwriters to receive a commission to compensate them for their obligation to take up stock in the event of a flop, but for them to have to take their chance with everyone else on applications. In the case of all the privatisation issues discussed, the underwriters were given a guaranteed and privileged slice of the issue, while public applications were massively scaled down.

Rewards were not the allegedly "excessive 1% to 1.5%," but ranged from 4% to 33% with an overall average of about 13%! The detailed figures are given in Table 2. In the first three cases, the overseas underwriters exacted even better terms than the UK institutions.

TABLE ~~2~~ 1 UNDERWRITERS' TOTAL PROFIT AS % OF RISK

	UK	OVERSEAS
British Telecom	19.8	33.1
British Gas	4.0	7.2
British Airways	17.5	27.1
Rolls Royce	12.6	
BAA	5.5	

These figures are expressed as a percentage of the fully paid price. They would be higher a proposition of funds immediately committed. There was no overseas offering in Rolls Royce and BAA.

J F · CHOWN
& Company Limited

ANALYSIS OF THE ISSUES

BRITISH TELECOM

British Telecom was a pioneering issue which probably had to be treated in an unorthodox way. The officially disclosed "cost" of the issue was £190 million, or 4.75% of proceeds. The real cost was £1600 million, or 41% of proceeds.

This cost arose from the unorthodex underwriting arrangements, giving underwriters 55% of their commitment as privileged applicants. On that occasion, given that there had been fears the issue would flop, it could be excused as an error of judgement, although as it happened it was an "error" that greatly benefitted the "judges".

It is always easy to be wise after the event, and this was a notoriously difficult issue to price. In the circumstances it was inevitable that placing commissions should be generous, and probably desirable that the issue should be priced so as to ensure a good opening premium (say 10 pence). Adding another 10 pence for a margin of error suggests that the issue price should have been at least 155 (rather than 130) on a 'fully paid' basis. The 'loss' arising from <u>avoidable</u> under-pricing therefore reduces to about £700 million.

What needs close analysis is the unorthodox method of underwriting. The principal underwriter underwrote 2,597 million shares "the UK portion" at 0.375% on 130p.

Sub underwriting was then allocated on the basis of a 1.65% underwriting commission <u>on the fully paid price of £1.30</u>. The total <u>formal</u> reward of the "UK portion" underwriters was therefore:

TABLE 2 FORMAL UNDERWRITING COSTS OF BT

£ Million

Underwriter	12.66
Sub-underwriters	55.71
	68.37

This is a fairly normal figure, and is all that is disclosed in the subsequent Parliamentary answer. However because the underwriters were allotted 55% of their underwriting commitment 'firm'(1428 million shares) "firm" only the balance of 1168 million was left available for applicants. Of these, 137 million of them went to employees and 1037 million to the general public.

Substantial profits therefore accrued to the underwriting group as a whole. They made 2.145 p per share directly, and a 43p immediate profit (whether realised or not) on 55% of their commitment. For every 1000 shares underwritten (£1300 at risk) the total gain (first day basis) was:

TABLE ~~4~~ 3 ACTUAL UNDERWRITING REWARDS (BT)

DIRECT

sub-underwriting commission	21.45
INDIRECT	
profit on 'firm' shares (first day only)	236.50
TOTAL	£257.95

The indirect benefit from sub-underwriting came to more than ten times the direct profit. On 2.597 million shares it totalled £670 million. ~~This figure was not reflected in the Parliamentary answer~~.

In the event the issue was three times oversubscribed and the underwriters made a cool £800 million, instead of their nominal and disclosed £68 million. From almost any point of view it was surely then unnecessary to use the "pseudo placing" method again. There was one exception: from the point of view of the institutions, the temptations of arranging a repeat were enormous, and such temptations were not resisted.

It may be argued that these profits went to "public interest" institutions such as pension funds, life funds, and unit trusts, and therefore benefitted the general public. To an extent this is true, but it was surely perverse to confer a benefit on pension funds in preference to individual investors just at a time when the Chancellor was seeking a politically acceptable means of taxing them! We do not know what precautions, if any, were taken to ensure that allocations were passed on to such public interest funds rather than being taken for house account or for directors' or partners' personal names. The source and direction of the cries of pain heard in connection with BP may suggest some inferences.

NOTE. Brief reference to overseas offering probably needed here.

BRITISH GAS

The procedure was in fact used again, slightly modified, for British Gas. Shares were again allocated to underwriters, as "priority applicants" but as a concession to the critics, some of these were made subject to a "clawback" arrangement. This merely limited, rather than removed the serious leak of public funds: the underwriters still finished up with 30%, instead of 60%, of their commitment. The pricing was more accurate, and the loss to the Government was much reduced. Nevertheless, the UK underwriters finished up with four times their normal reward at £250 million, almost as much, in total, as the more publicised profits (£280 million) to "Sid"! Public attention was distracted, whether deliberately or not, by the relentless pursuit of multiple applicants. Nevertheless, the critics then assumed that the government was on a learning curve, and hoped that, with the next issue, the 'pseudo placing' element would be eliminated altogether.

BRITISH AIRWAYS

Unhappily they were wrong. In British Airways, the City really struck back. The UK underwriters were given privileged applicant status for 48% (after clawback) and the offer was again seriously underpriced. Their profits, although nominally less than 1%, were in fact 17.5%: foreign underwriters did even better with 27%.

Public applicants made a windfall of £120 million: priority applicants made £170 million. In percentage terms, and even after allowing for "clawback", the latter's profits were very nearly back up to the British Telecom level.

ROLLS ROYCE

In Rolls Royce the underwriters' "firm" stake crept up even higher, this time to 50%, and although the issue was less seriously, and given then ruling market conditions more excusably, underpriced, the total gain to priority applicants, and loss to HMG, was £158 million, or 12.5% of a rather larger issue.

Given the timing of the last two issues, it was difficult for the critics of the "pseudo placing" procedure to make public their views without giving ammunition to those opposed to the very principles of privatisation.

BRITISH AIRPORTS AUTHORITY (BAA)

This was an issue of 500 million shares, partly at a fixed price of 245p with 100p payable on application, with a quarter of the shares offered by tender.

Of the total 460 million shares were underwritten in the UK. Of these 125 million were made available by tender. "Priority applicants" were not to be denied their rewards. They still received 25% (115 million shares) firm, ie still as a placing. The balance of 230 million commitment shares, half the total, were available at a fixed price to the public. This, at least, was half way to a solution, but even so the windfall on 25% of the shares (only a slight improvement on the British Gas 30%) went to the insiders. From their point of view, as the premium was higher, the overall windfall actually rather better.

In the event the tender offer was six times over-subscribed. Shares applied for in the tender offer at 282 pence or over were allotted in full. This required a first payment of 137 pence. The opening price was

144 pence, partly paid, implying a "fully paid" price of 289 pence. This was an initial profit of 7 pence for tenderers at the minimum price.

The fixed price offering was 8 times oversubscribed. Applicants for up to 1000 shares were allotted 100 shares: applicants for larger amounts were allotted nothing.

Do we know how many shares were allotted at above the minimum tender price? This will have brought in an extra profit for HMG. Do we know at what price tenders would have absorbed the whole issue? That would be correct figure for the optimum result to HMG. (CHECK)

It would, incidentally, be interesting to analyse the arguments for and against the non traditional tender method used. U.S. experience queries whether it actually brings in higher proceeds. It has the advantage that non-specialist fingers might be burned. If that happened, tenders as such, rather than the particular method, might be given a bad name.

BRITISH PETROLEUM

The BP issue differs from the other five privatisation issues discussed, in two ways:

1. The shares were already listed, establishing a market price.

2. The market collapsed between the date the price was set and the closing date for applications.

In spite of (1) it was clearly intended to use the opportunity to attract a substantial body of the public as new investors.

The offer was of 2194 million shares at 330 pence per share, with 120 pence payable on application, 105 pence payable on 30th August 1988 and 105 pence payable on 27th April 1989.

The shares offered were:

The whole of HMG's 31.5% holding	1735 million
PLUS "New money" issue by BP	459 million
	2194 million

Of these 1094 million were made under the Fixed Price Offer, which, may, in defined circumstances, have been increased by 275 million to 1379 million. The balances of 1100 million, which could be reduced, in the same circumstances, to 825 million, constituted the International Offer. All the shares, save for 68 million retained for the share bonus arrangement, were underwritten.

On 15th October, when the price was fixed the price of BP shares was about £3.52. The underwritten shares were nominally priced at £3.30 but because of the deferred payment terms this was actually equivalent (for a gross fund) of about £3.06. An individual investor subscribing for up to 1,500 shares, would be entitled to 1 bonus share for 10 after two years: if he firmly intended to hold for that period he would actually find it cheaper to subscribe at the offer price than to buy in the market at more than £2.80.

Indeed, had the price held, a long term individual holder of 1500 shares could have picked up about £1050 by selling his existing holding and applying for new shares.

Underwriting commission was limited to 0.018%. There has been some press comment on the fact that this was very low: this payment was not the reward for risk taking, but for organising the sub-underwriting. To the extent to which the underwriters chose to retain sub-underwritingfor their own book, they were in the same position as other sub-underwriters.

Sub-underwriters were paid 1%, ie 3.3 pence, for a risk then valued, using the traded options market as a guide, at less than 1 penny.

Indeed, it would have been possible to (over) protect the position by buying a put on FTSE at 2200 for a premium of 13 pence. This would have been equivalent to 1.8 pence per share underwritten: about half the commission.

NOTE: The final version will include more precise information on option pricing and volatility. This full analysis will take account of events after 6th January 1988, when the Bank of England support ends.

THE MARKET COLLAPSE

The above on information was available on October 15, when pricing decisions were made. On that day the FTSE 100 index closed at 2326. October 19 was "Black Monday" when prices collapsed: the BP price fell to 286, almost exactly in line with the FTSE which fell to 1801.

At this point, the underwriter who had hedged with FTSE could have sold his put for 250 pence: his overall position per 100 shares would have been:

	PENCE
Underwriting commission	330
Cost of option	180
"RISK FREE" PROFIT	150
LOSS ON UNDERWRITING	(2000)
(306 - 286)	3461
GAIN ON OPTION WINDFALL	1461

The sub-underwriters (assuming they had not hedged) appeared to be earning their keep. Some lost heavily. Should the issue have been pulled? Were the underwriters justified in complaining? The lessons from UK and overseas experience may be different.

The Government very properly took the line that there was no question of the underwriters being released from their obligations. To have done so would have been equivalent to giving insurance companies the right to disclaim storm damage on the grounds that the Meteorological Office had not warned them of the gales! Those who are in the business of taking risk should accept the consequences, especially where, as in the case of underwriting, they are normally overpaid for their services.

Against all this, there were two arguments for pulling and postponing the issue. First, there was a risk that a lot of BP shares would be dumped on the market, especially if the underwriting had indeed been taken up by financial intermediaries in the hope of a quick profit instead of being placed with than long term investment fund clients. In the circumstances this was probably undesirable, although not necessarily disastrous from the point of view of those who believe that markets are markets. Second, the wider share ownership benefit of privatisation would be lost. How could we avoid the first, and revive the prospects for the second?

In the event, it was announced that the Bank of England would, for a limited period underpin the price of the partly paid shares at 70 pence. This support was to be for at least one month, and was in fact extended until 6th January 1988. The Chancellor's initiative achieved two out of three possible objectives. It did not let the underwriters off the hook, it did remove the risk of another pressure on a sensitive stock market. It did not achieve the third, which was to recreate an opportunity for the wider distribution of the shares. The possible lever into this was the one for ten loyalty bonus.

THE UK UNDERWRITING

In the UK sub underwriting is traditionally taken up by pension funds, unit trusts and insurance companies (representing small savers) and to the extent to which the underwriting was spread broadly across such institutional investors it would represent only a 1% increase in their exposure to the equity market, and increase by only 1% the paper losses incurred on Black Monday. Pressure to fall the issue does not appear to have come from these institutions.

Those who did complain seem mainly to have been financial intermediaries, principal underwriters, fund managers and others, who have decided to keep the underwriting on their own books instead of placing it with institutional clients. They suffered a more serious loss because they allowed themselves temporarily to take on extended risk of a risk of a fall in the equity market. This actually confirms the impression that a significant part of the substantial profits from earlier privatisation "underwritings" (really partial placings) were enjoyed by market professionals, and not spread around the institutional savings media.

THE FOREIGN UNDERWRITING

The overseas underwriters had no similar machinery for laying off their underwriting. They had a real problem. Against this, all the evidence is that foreign underwriters largely took their share of the earlier issues for house account. Given the different rules applying in different markets, the value of having any formal overseas offering is questionable. (NOTE. Could be expanded)

CONCLUSIONS

HANDLING FUTURE ISSUES

1. The "partial tender" is surely discredited. It must not be repeated. Underwriters should take their chance on a popular new issue like everyone else.

2. The best method, from the public policy point of view, would be a combination of a fixed price offer for sale (directed at the public) with an orthodox tender offer. A proportion of these shares, perhaps half (i.e 500 million), would be intended for the general public, would be offered at (a fixed price and it might be strongly hinted that allotment would favour the small investor.

   The balance would be offered by tender and so would be available on equal terms to all investors, individual or institutional, large or small, British or foreign, and not just a selected few. The general public, as well as the institutions and overseas investors, would be encouraged to tender. They would be entitled to their 'one per applicant' chance at fixed price shares, and could also top up their holdings with a tender application.

3. There should be no formal "overseas offering". (THIS NOTE, UNLIKE PREVIOUS VERSIONS, OMITS ANALYSIS OF THE OVERSEAS ELEMENT. SHOULD WE EXPAND?)

4. Should the issue be underwritten? If the Treasury minded to be really innovative, it would be possible to reduce this cost as well. The minimum tender price could (for instance) be <u>below</u> the fixed offer price which would make the risk of failure trivial: the Bank of England could act as "underwriter of last resort" at some really low price. Underwriting could be the subject of a preliminary auction or "tender". Institutions could be invited to bid competitively to fix the lowest commission at which they would accept underwriting. This should ensure that the fee was fairly priced to match the risk: it could be priced off the traded options markets. Indeed, that market could be used to write suitable put options on behalf of the government, as a more cost effective and competitive substitute for underwriting.

5. Is there such a good case for giving some benefit to the public as small investors at the expense of the public as taxpayers? Experience now suggests that even this may need reexamining. Public offerings have been allocated in very small holdings causing administrative complications. A substantial part of the £1 billion plus of profit that nominally went to the public must have disappeared in dealing charges. (This, unlike the gain to the underwriters, was not money for old rope but reflects a great deal of labour intensive administration). Is the public well served by the arrangements available to them for sale? Is there any evidence that the public is deterred by the recent market fall? Wider share ownership may have been bought at a high price: it may be that the price was worth it.

6. Should we use the "loyalty bonus" as a major part of the inducement? Somcone enjoying an instant paper profit of 30% on a few shares may prefer to take it rather than hold on for an extra 10%. Suppose he could invest up to say £2000 about market price with the promise of a 1 for 10 after six months, and a further bonus after two years? This 20% discount would be cheaper, and might encourage more genuine investors, than the arrangements actually used.

SECRETARY OF STATE FOR THE ENVIRONMENT

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My ref:
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FINANCIAL SECRETARY
REC. - 4 JAN 1988
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MR. MONCK
MR. D. MOORE MR. BENT
MR. TARKOWSKI
MS. C. EVANS
MR. CROPPER MR. TYRIE.

The Rt Hon Norman Lamont MP
Financial Secretary
HM Treasury
Parliament Street
LONDON
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31 December 1987

Dear Norman

WATER PRIVATISATION: TIMETABLE

Thank you for your letter of 16 November. You will already have seen Willie Whitelaw's letter to me of 18 November, covering the possibility of achieving Royal Assent for the main Privatisation Bill before July 1989. We have of course secured advance drafting authority for the Bill, and the first tranches of instructions have been sent to Parliamentary Counsel. So we expect to have a Bill ready for introduction at the start of the next Session, and would hope to be able to achieve Royal Assent to the main Privatisation Bill by July 1989, though this must remain subject to the imponderables of the Parliamentary Timetable.

The main thrust of our flotation strategy must be to ensure that all authorities are capable of being floated, at prices which will secure an acceptable return to the Government. This was, of course, the principal theme in this year's Investment and Financing Review. To ensure flotability, action has to be taken on a number of fronts. In some cases authorities are financially weak, and charges have to rise. We are politically constrained from pushing up charges unless the increases are fully justified, and even where higher charges are justified, there are constraints on the rate at which they can be increased. Action is also necessary to ensure that investment levels are sufficient to meet level-of-service objectives and statutory requirements, and to provide adequately for maintenance and renewal of assets. All authorities are still refining their projections of long-term investment needs which we have requested for the end of March 1988. The flotation prospects of individual authorities will depend in large part upon the outcome of that exercise, on the successes of management over the coming months in meeting financial objectives, and on external factors such as the impact of new obligations arising from actions in Brussels. The largest and most difficult is the outcome of the currently threatened legal proceedings on drinking water.

You will remember that the Financial Assessment Committee used the financial model, WATMO, last summer to take a first look at the flotability of individual authorities. You discussed the results with Lord Belstead in September. The results suggested that three authorities appeared flotable as they stood, four presented some problems because they were cash rich, and the remaining three were investment heavy. These results now need refinement, in the light of the latest financial position, the action taken in the IFR, and the forthcoming assessment of investment needs. The model will also need some modification. This should give us another set of results in the Spring. It will not be until the Autumn that we are able to produce a set of results which takes account of the need to split the NRA from the utility companies.

The need to separate out the National Rivers Authority, its functions, responsibilities and assets, from the existing water authorities soon after Royal Assent, is another major factor. My earlier letter touched on this. It will be necessary to have completed this task for all water authorities, regardless of their position in the flotation queue by a common date, so that the NRA can assume its functions and the new PLCs, still under Government ownership, can assume theirs on a single day, probably in September, 1989. We should not under-estimate the complexity of this task, work on which will have to start very soon, well in advance even of establishing the NRA in shadow form. And the more requirements we impose on the NRA when it is established, or on water authorities in preparing for that, the more likely we are to upset the whole applecart. My officials are in touch with yours, and with OMCS, about the manpower and expenditure implications of this.

The ultimate flotation strategy will also have to take account of market conditions once the authorities have been vested. Events over recent weeks have served to illustrate that it is unwise to make assumptions too far in advance.

Given that we have advance drafting authority for the Bill, and that a start can be made early next year by the water authorities and by ourselves on the separating-out of the NRA following our recent announcement, I would hope to achieve Royal Assent by July, 1989, with the opportunity for one flotation at the end of November, 1989. Even so, as you will have gathered, the timetable would be extremely tight. We would then have to wait until after the Budget for further flotations. Hopefully, it should be possible to float all of the other nine authorities in the financial year, 1990/91. However, this working assumption, (I do not think it should be called a plan) will have to be reviewed in November, 1988, in the light of the latest financial assessments, and of progress with preparing for the NRA.

The consideration of receipts introduces yet more uncertainties. Your officials played a full part in the work of the Financial Assessment Committee, and are aware both of the range of possible totals of sale proceeds which emerged in that work and the qualifications which must be attached to them. The proceeds will also be heavily dependent on market conditions at the time of flotation, and in present market conditions the FAC figures would be significantly too high. Much depends on financial developments in the meantime, as emphasised in the second paragraph of this letter. As a working assumption it might be reasonable to assume proceeds of £1bn in 1989/90 and £5bn in 1990/91. I would attach a wide range of uncertainty to these figures, perhaps £0.5bn - £1.5bn in 1989/90 (if one flotation can be achieved) and £2.5bn - £7.5bn in 1990/91.

In the light of all of the uncertainties which were clear in your discussion with Lord Belstead, I do not think it would be productive to attempt any more detailed analysis at the present time. We must now proceed with our preparations of all authorities, and take stock of the position at key points in the timetable, such as July, after reviewing water authorities' Corporate Plans, and particularly in November, after the IFR, and in the light of progress on separating out the NRA activities. In the meantime, I hope that the guidance in this letter will be of some help to you.

Copies of this letter go to the Prime Minister and other members of the Cabinet, and to Sir Robert Armstrong.

Yours ever
Nicholas

NICHOLAS RIDLEY

ps3/41T

CONFIDENTIAL

pmf

FROM: J M G TAYLOR

DATE: 31 December 1987

MR CROPPER

cc PS/Financial Secretary
Mr D J L Moore
Mrs M E Brown
Mr Call

PRIVATISATION SEMINAR

The Chancellor has seen your minute of 23 December, enclosing a paper from Mr Chown.

2. He has commented that this will not do as it stands, for the reason we have explained before to Mr Chown. The £1.4 billion figure is dynamite, and bound to leak (as well as being highly questionable, especially post-BP). Nor is it in any way needed in order to reach the conclusions set out on pages 16-18.

3. He has suggested some amendments, which are set out below. He thinks that, with these amendments, the paper would remain highly provocative but that it would make a very useful contribution to the seminar.

4. The amendments are:

Page 1, second paragraph: delete.

Page 1, third paragraph: first sentence to read: "Four out of the five issues analysed were seriously under-priced, but ...".

Page 2, paragraph 3, and table 1: delete.

Page 4, paragraphs 3 and 4, and sub-head: delete.

Page 8: amend "table 3" to read "table 2".

Page 9: amend "table 4" to read "table 3". Delete sentence: "This figure was not reflected in the Parliamentary Answer".

JT

J M G TAYLOR

ps3/41T

CONFIDENTIAL

FROM: J M G TAYLOR

DATE: ~~18 Novembe~~r 1987

31/12

MR CROPPER

cc PS/Financial Secretary
Mr D J L Moore
Mrs M E Brown
Mr Call

PRIVATISATION SEMINAR

The Chancellor has seen your minute of 23 December, enclosing a paper from Mr Chown.

2. He has commented that this will not do as it stands, for the reason we have explained before to Mr Chown. The £1.4 billion figure is dynamite, and bound to leak (as well as being highly questionable, especially post-BP). Nor is it in any way needed in order to reach the conclusions set out on pages 16-18.

3. He has suggested some amendments, which are set out below. He thinks that, with these amendments, the paper would remain highly provocative but that it would make a very useful contribution to the seminar.

4. The amendments are:

Page 1, second paragraph: delete.

Page 1, third paragraph: first sentence to read: "Four out of the five issues analysed were seriously under-priced, but ...".

Page 2, paragraph 3, and table 1: delete.

Page 4, paragraphs 3 and 4, and sub-head: delete.

Page 8: amend "table 3" to read "table 2".

Page 9: amend "table 4" to read "table 3". Delete sentence: "This figure was not reflected in the Parliamentary Answer".

J M G TAYLOR

ps3/34T

RESTRICTED

PWP

FROM: J M G TAYLOR
DATE: 31 December 1987

PS/FINANCIAL SECRETARY

PRIVATISATION SEMINAR, 27 JANUARY 1988: ANNOTATED AGENDA

The Chancellor has seen Mrs Brown's minute of 22 December, enclosing a draft agenda.

2. He does not think that this is right at all. The purpose of the seminar is not to forecast the stock market - we can assume that conditions will be such as to make new issues possible - but to learn from the lessons of our privatisation experience to date (what has gone right and what has gone wrong) so as to do even better in future.

3. He thinks, therefore, that a new agenda is required, consisting essentially of III (pricing and offer structures) followed by II (wider share ownership). Two sections are in any event enough for one meeting. Other items, such as I(iv) and I(v), could be discussed over lunch.

JT

J M G TAYLOR