5B
831

PREM 19/306

PART 2 ends:-

HMT to Ind 9.10.80

17/x

PART 3 begins:-

CST to S/S Energy 16.10.80

TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
E(NF)(80) 2	12/05/80
E(NF)(80) 3	12/05/80
E(NF)(80) 4	13/05/80
E(NF)(80) 1st Meeting, Minutes	16/05/80
E(80) 64	03/07/80
E(80) 24th Meeting, Item 2	09/07/80
E(NF)(80) 5	21/07/80
E(NF)(80) 6	21/07/80
E(NF)(80) 2nd Meeting, Minutes	24/07/80
E(80) 104	12/09/80
E(80) 34th Meeting, Item 4	17/09/80

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

Signed OWayland Date 29 July 2010

PREM Records Team

10 DOWNING STREET

Mr Nott's office &

Chancellor's office told of

PM's reaction.

Mr Nott may raise at a

breakfast same time

pa.

MP 17/x.

F

cc Prof Walters

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

9 October 1980

I Ellison Esq
Private Secretary
Department of Industry

Dear Ian

NATIONALISED INDUSTRIES: PRICES

The Chancellor has asked me to circulate a paper on nationalised industry prices recently prepared by Treasury economists. This analyses the reasons why the increase in nationalised industry prices during the current year has been so much faster than the movement of the retail prices index and attempts a forward look at 1981-82. Sections III, IV and particularly VI of the paper are directly relevant to the meeting on nationalised industry pay on 13 October (on which I wrote on 7 October).

However the paper as a whole goes wider than pay and it would be helpful to know whether Departments agree with the analysis in the paper (in particular the weight given to the different factors which have caused the rapid price increases) and also what is suggested about the outlook for 1981-82. However these wider matters are best pursued between officials in the Treasury and sponsor Departments; the Chancellor will not be looking for a response on these points at his meeting on 13 October.

Yours ever,

Peter

P S JENKINS
Private Secretary

cc PS/Energy
PS/Environment
PS/Scotland
PS/Wales
PS/Trade
PS/Transport
PS/Employment
PS/No.10

NATIONALISED INDUSTRY PRICE INCREASES

The object of this note is to quantify the main factors which are causing nationalised industry prices to rise faster than the RPI in 1980-81 and to give an early indication of the likely outcome in 1981-82.

I Nationalised Industry Prices

The component of the RPI which measures nationalised industry prices is currently showing increases on a year ago of 26%, which compares with an increase in the rest of the RPI of some 15% to 16%. This comparison, however, overstates the pressure which the nationalised industries are putting on the rest of the economy through higher prices.

The RPI covers only about two-thirds of the gross revenues of the nationalised industries. The other one-third includes, besides small industries such as Scottish Electricity and the British Transport Docks Board, three industries, namely steel, airways and shipbuilding, which face intense international competition and which, in common with much of UK manufacturing industry, are unable to increase their prices as fast as the RPI is rising. These three industries are putting pressure on the rest of the economy by higher borrowing rather than through higher prices.

The RPI covers prices to domestic users but not the prices charged to industry for bulk supplies. From Table 1, however, it will be seen that domestic and other prices are moving more or less together.

/Table 1

Table 1

Percentage price increases in the 12 months to 31 March 1981

	Domestic	Industrial
Coal	18	20
Electricity	29	28
Gas	29	32
Posts	18	18
Telecomms	22	18
Rail	19	-
Bus	20	-
All NIs listed above	25	-
All items RPI	14/15	

II The contribution of moves towards the economic pricing of energy

The largest increases are in Gas and Electricity and reflect a deliberate move towards economic pricing, taking account of the changes in world energy supply and demand during the 1970s, especially the rise in the price of oil. This latter affects other energy prices both directly (as a cost in electricity) and indirectly (by raising the demand for other fuels and hence their costs and prices).

The moves towards economic pricing are being implemented through the financial targets. Thus in the case of gas, the target to 1982-83 provides for an increase in domestic prices of 10% a year above the rate of inflation (there was a 17% 'inflation' increase in April 1980 and there will be in addition a 10% 'economic pricing' increase in October). The target for electricity (England and Wales) to 1982-83 provides for price increases of some 1½% a year over and above the increase in the industry's own costs as a move towards prices which will yield an adequate return on capital (ie to meet the RRR on investment). The driving force here, however, is fuel costs, which are estimated to rise by about a third during 1980-81; this accounts for well over half the 28% price increase. The higher coal prices shown were made possible by higher oil prices and reduce the NCB's losses and cash requirements.

III Pay and labour costs in the nationalised industries in 1980-81

As Table 2 indicates, labour costs per head have shown some tendency to rise faster in the nationalised industries than in the rest of the economy between 1970-71 and 1978-79. The rise was more or less continuous in coal and gas, the industries with the biggest relative increases. In the other industries the pattern was more mixed; but in all the nationalised industries labour costs per head were higher in 1978-79 than in 1971-72 relative to the rest of the economy (ie all the numbers in the last column are above 100).

Table 2

Ratio of labour costs per head in NIs to labour costs in the whole economy (mid-financial year 1970-71 = 100)

	1972-73	1975-76	1978-79
Coal	105	126	154
Gas	96	114	136
Electricity	105	106	105
Rail	102	108	102
Telecomms	113	120	109
Posts	111	119	105
All NIs listed above	105	108	108
Based on NI's accounts			

The increase in labour costs the nationalised industries are expecting between 1979-80 and 1980-81 is faster than that which is likely to occur in the private sector and thus represents a continuation of the trend:-

/Table 3

Table 3

Percentage increase in labour costs between 1979-80 and 1980-81

Coal	17
Gas	26
Electricity	26
Posts	25
Telecomms	27
Rail	23
Bus	22
All private sector industries	about 18

The relatively small increase in labour costs in the NCB has to be set in the context of the big increase in these costs in the period up to 1978-79. For gas, electricity, posts and telecomms the increases shown above include staged payments from the previous year's pay settlements.

IV The link between pay and prices

How much of the price increases in excess of the RPI increase can be explained by pay? Table 4 shows:-

i. The additional revenue each industry might expect to receive from the actual and prospective 1980-81 price increases over and above the revenue it would have received from an increase in prices in line with general inflation (as measured by the increase in the GDP deflator) on the anniversary of its previous year's increase;

ii. The costs borne by each industry in 1980-81 as a result of the 1980 pay settlements and the carry-over from the 1979 staged pay settlements, over and above the increases they would have incurred if their labour costs had increased in line with the average in the private sector on the anniversary of their previous year's settlement.

/Table 4

Table 4 £m

'Excess' revenue and 'excess' labour costs in 1980-81

Industry	(1) Excess Revenue Domestic and Industrial (see definition in text)	(2) Excess Labour Costs (see definition in text)	(3) Column 1 less Column 2
Rail	+ 40	+ 50	- 10
Bus	+ 30	+ 10	+ 20
Telecomms.	+160	+100	+ 60
Posts	+ 45	+ 90	- 45
Electricity	+400	+ 70	+330
Gas	+350	+ 50	+300
Coal	+135	- 15	+150

(2) These cost increases may have been anticipated to some extent and an allowance made for them in the price increases of the previous FY 1979-80.

The table shows that, in the case of posts and rail, labour cost increases higher than in the private sector more than accounted for the 'excess' price increases. In telecommunications they accounted for £100m out of a net figure of £160m.

V Other factors making for nationalised industry price increases

There are a number of factors other than the 'economic' pricing of energy and 'excessive' increases in labour costs which have contributed to the pressure on nationalised industry prices.

a. Government policy. Energy prices are not the only nationalised industry prices to be raised as a matter of Government policy. In particular, the telecommunications industry now has to meet a target return of 6½% on assets compared with the 5% achieved in 1979-80; and reduced subsidies are putting upward pressure on rail and bus fares.

b. Fuel prices have risen considerably faster than inflation in the past 18 months following the increases in oil prices. They are a significant factor in the electricity and transport industries.

c. Some industries have reacted to the pressures of EFLs and financial targets in part by raising prices and not solely by cutting costs. The electricity, telecommunications and transport industries appear to be in this category.

In practice the pressure of increased profit requirements, lower subsidies, higher costs or higher capital requirements are met not only by price increases but by a variety of other means - reducing costs by increasing efficiency, cutting services and delaying maintenance, reducing investment and disposing of assets. Thus the third column in Table 4 is the net effect of a wide range of adjustments. It is not possible to separate out the effects of all the (interacting) factors within the net figure.

VI Prospects for 1981-82

The prospects for nationalised industries' pay and price increases in 1981-82 are by no means comforting. The gas industry is set to increase domestic prices by 10% above the rate of inflation, as in 1980-81. The electricity supply industry might need a price increase of at least 20% next April. The Post Office is talking about a further 17% increase in postal charges in January 1982. It is likely that rail and bus fares will also increase faster than the RPI again in 1981-82.

Most of the industries are assuming that pay increases in 1981-82 will be considerably above single figures. Gas, Electricity and Rail are assuming an increase in earnings in 1981-82 of about 15-16%, Posts about 12%, premised on a 10% pay settlement in January, Telecommunications an increase of about 15% in average earnings assuming an 11% pay settlement next July. On the other hand, the NBC are hoping to keep their settlement down to around 5%, since in their case a higher figure would prejudice their investment plans and increase the pressure for earlier (though probably not larger) price increases.

VII Prices and the PSBR

Prices which are below those needed to reflect marginal costs and ensure that the nationalised industries' investment earns a return comparable with that of the private sector not only lead to waste in terms of resource allocation but also generate additional pressure on the monetary, PSBR and public expenditure targets.

Nationalised industry prices have a direct impact on public expenditure and the PSBR through the industries' financing requirements. For example, the effect on the gas and electricity industries' cash flows of prices lower across-the-board than they otherwise might be is:-

	£m (outturn) effect in 1981-82
Electricity	
a. 10% price shortfall (all customers)	700
b. 10% price shortfall (industrial only)	200
Gas	
a. 10% price shortfall (domestic)	150
b. 10% price shortfall (industrial)	30* (60m following year)

* effect of staggered contract renewals.

Taking nationalised industries as a whole, reductions in prices or failure to increase prices to economic levels would have considerable consequences for public expenditure and the PSBR.

VIII Conclusions

The increase in nationalised industry prices in excess of the RPI is the result of a number of factors. In the case of gas, and to a lesser extent electricity, the phased move towards economic prices has been the main element and will continue to be so in 1981-82. Pay settlements which exceeded average earnings in the private sector and included payments delayed from the previous pay round, were a significant factor in the big increases in prices for posts, rail and telecommunications in 1980-81. Increases in pay are expected to contribute to high price increases again in 1981-82. The other elements which are contributing to rapid price increases are diverse. They include big increases in fuel costs and the industries' response to the pressures exerted by external financing limits.

Restraining nationalised industry price increases arbitrarily would not only result in a waste of resources (because it would distort relative prices) but also put upward pressure on the PSBR and interest rates. The prospect then is of further increases in nationalised industry prices which it will be difficult to resist.

ANNEX

RAIL

Labour costs are about 60% of BR's operating costs. The large increase in labour costs has thus played a major role in the prospective increases in fares in November, only 10 months after the last increase. Other operating costs are expected to increase by 21% in 1980 - this higher than average increase mainly being due to large increases in fuel costs. The pressure which these cost factors has put upon BR are not entirely relieved by the November price increase, as Table shows. Moreover, falling demand has added to these pressures so that remedies other than fare increases have been sought - service withdrawals, frequency reductions, disposals and ultimately an increase of £40m in the EFL. But other things being equal, if BR had conceded a lower pay settlement this year the pressures for an early fares increase would have been considerably reduced.

BUS

Labour costs are over 2/3 of NBC's operating costs. The higher than average increases in labour costs have not arisen from the pay settlement which was in line with the private sector, but from the effects of the phased implementation of theEEC drivers hours regulations. Other cost increases are put at 18% in 1980-81.

NBC implemented fare increases above general inflation rate in 1979-80 and are expected to do so again this year. The problem has not been so much one of cost inflation as the need for NBC to maintain revenue in the face of falling demand and lower subsidies, which are being met in part by cutting services as well as above average fare increases.

TELECOMMS

Pay etc is only 40% of operating costs in telecomms. Nevertheless the combined effect of the staging of the 1979 settlement and the high (23% in a full year) settlement this year, on average earnings, is expected to be about 27%. This has clearly made a major contribution to theneed for an early and large price increase in November. Originally the Post Office were expecting that last year's price increase would be sufficient to see them through the whole of FY 1980-81; but that was premised

/on an

on an 11% pay settlement. Other factors which have been important include increases in working capital reflecting higher stocks "needed to maintain and improve service and launch much needed new customer apparatus" and non-pay cost pressures. Moreover the PO only made a 5% return on assets last year and are required to earn 6½% in the remainder of the target period.

POSTS

Pay etc is almost 80% of posts' operating costs. The large increase in labour costs in FY 1980-81 arises from the staging effect of the 1979 settlement and both the postal workers settlement this year and the repercussions of the telecomms settlement. The impact of the price increase is small relative to the pay increase since it comes so late in the financial year. But the PO are envisaging that they will fail to meet their financial target this year (£20m profit rather than £42m) but the EFL is pressing them to do so, since they are reducing their working capital needs from "careful cash flow management". It should also be noted that the £45m "additional revenue" is against a base which allows them a 15% increase in charges in February - whereas they were themselves assuming no further increase in the FY 1980-81. Against that base the additional revenue would be about £90m. It is clear then that price increases could have been avoided but for the excessive increases in labour costs.

ELECTRICITY

Since labour costs account for less than 20% of operating costs the effects of the high increase in labour costs is fairly small. The major factors behind the large real increase in electricity charges through this year has been the 36% increase in fuel costs (more than double the current inflation rate), although falling sales have played a small part. Price increases have only been a partial remedy - others have included cost savings and cuts in capital programmes.

GAS

Labour costs are about ¼ of operating costs so the effects of high wage cost inflation are muted. Increases in domestic charges have in any case been set by a formula of 10% plus the

/rate

rate of inflation at the beginning of the year and this is at present insensitive to cost increases. Cost inflation has put further pressure on industrial gas prices but it looks as though BGC will solve its EFL problems without recourse to pricing action. The additional revenue in the table arises almost exclusively therefore from government policy on gas pricing.

COAL

This year's miners' settlement was moderated by normal standards. Although NCB will be settling miners' pay in November they are currently forecasting only a 15% increase in their pay bill in 1980-81 and 1979-80. After allowing for some reduction in manshifts worked this implies only a 17% increase in labour costs per head. It is of course possible that a high settlement in the coming round above the going rate would present problems for NCB in 1981-82 aggravating the underlying losses.

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

2.

B

cc Mr Wolfson
Mr Duguid

Nat Industries

From the Secretary of State

Prime Minister
Mr Nott may touch on this with you some time
MP 13/x

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

6 October 1980

Dear Geoffrey

I agree with J.N.
MT.

WASTE IN GOVERNMENT

In our Election Manifesto we expressed the intention of reducing the extent of Government interference in the management of nationalised industries, while setting them a clearer financial discipline in which to work. During the last year we have refined the system of financial targets and external financing limits to this end but we do not seem to have done so well in allowing more freedom to the bodies concerned within the framework we have constructed for them. I have in mind particularly the requirement which is still laid on the nationalised industries (and the CAA is treated as such for these purposes) to seek my Department's approval, and the concurrence of the Treasury, before they enter into commitments on major capital investment projects. This requirement derives normally not from statute but from agreed arrangements.

When I ask why this is necessary, I am told that it has always been done; but at a time when we have announced our intention of reducing the size of the Civil Service, I think we ought to question the usefulness of what has traditionally been done and consider whether its continuation is consistent with the other objectives I have mentioned. I touched on this in my minute of 12 March to the

Prime Minister, in which I mentioned the need to carry further the devolution of responsibility to Departments and to consider the special position the Treasury occupy in this field.

Some of the projects for which Departmental approval has been sought are relatively small in financial terms. For example, there is, I understand, a protracted correspondence still in progress about whether British Airways should be allowed to retain the 7th Concorde, which they purchased for £1000. A rather larger project - though still small in nationalised industry terms - is the CAA's proposal to modernise the London Air Traffic Control Centre, which has only just been approved. At Treasury request, my officials spent some time with the CAA to try and provide an "economic assessment" of this project. But the level of charges levied on aircraft making use of these facilities is laid down by international agreement in Eurocontrol, and therefore outside the CAA's determination and it is hardly appropriate to judge the project as if the CAA were able to fix charges. When we have put these cases to the Treasury, we have been asked to provide additional information of a detailed nature, which we have to seek from the industry concerned. This all takes time, and I do not deny that those bodies have to bear some of the blame for the delay which occurs. But some of the questions raised seem to go very deeply into matters which I feel should properly be left to management whom we have appointed to run the business.

I am told the same sort of procedure will apply to the authorisation of British Airports Authority to start the construction of Heathrow's 4th Terminal. That project is an important part of our airports policy; we made that clear when we approved the recommendations of the planning inquiry in December 1979. Its construction has already been postponed because of the planning procedures, and my Department has had several meetings with the Treasury to discuss its place in the BAA's capital programme and how that programme is to be financed. (I myself have had three meetings with the Chief Secretary to discuss BAA's finances). I am frankly appalled at the thought that there may be months of further delay while our officials argue over details of BAA's proposals for building the Terminal.

In cases of this kind, I and my Permanent Secretary receive querulous letters and personal representations from the Chairmen of the bodies concerned, chiding us because we are taking so long to authorise the projects. I find it difficult to answer their criticisms satisfactorily; the present system certainly does nothing to assist the Department's relationship with the bodies concerned at a time when it is under strain because of the general economic pressure on us all.

So I think this is the right time to look very critically at the traditional practice, and ask ourselves whether it really serves a useful purpose, or whether we could manage as well - or perhaps better - by streamlining it. I shall be interested to hear the comments of colleagues, and am sending copies of this letter to Members of E Committee, Norman Fowler, Sir Robert Armstrong and Sir Derek Rayner.

You will recall the Economist article on the Questions set to you by your own Select Committee. I think Departments spend too much time answering similar "examination" questions set by the Treasury. Are we any better governed as a result? I think not.

Yours ever - John

JOHN NOTT

cc A. Duguid

Nat. Ind.

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

01 211 6402

B
8/10

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

29 September 1980

Dear John

1980 IFR - DEFERMENT OF MORECAMBE BAY GASFIELD

Thank you for your letter of 29 September agreeing that we should eliminate Phase I of the development of the Morecambe Bay gasfield from the option cuts which we are currently considering for BGC. I must however reserve my position on the question of Phase II and cannot agree at this stage to your proposal to reduce the baseline for BGC's IFR figures. We have not had an opportunity to consult BGC on the possibility of deferring Phase II, and although I will press for this it may be that they will produce compelling reasons against its deferment.

My officials will be consulting BGC as a matter of urgency and I hope that we will be able to resolve this question before having to take final decisions on this year's IFR exercise. I am copying this letter to the members of 'E' Committee and Sir Robert Armstrong.

Yours ever

David

D A R HOWELL

30 SEP 1980

cc A. Duguid

Mak Lud.

CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

R
2/x

The Rt Hon David Howell MP
Secretary of State
Department of Energy
Thames House South
Millbank
London SW1P 4QJ

29 September 1980

Dear David,

1980 IFR - DEFERMENT OF MORECAMBE BAY GASFIELD

In your absence abroad Norman Lamont wrote to me on 23 September setting out your assessment of BGC's proposals for the development of the Morecambe Bay gasfield. It may be helpful if I respond before our public expenditure bilateral tomorrow.

As you know, I hoped that it would prove practicable to defer the significant public expenditure costs of this project, even though it had always been expected that BGC would be able to show that it could satisfy the RRR criterion. We needed to be satisfied that the development really was necessary on BGC's timetable to avoid unacceptable risks of supply shortfall, and that there were not alternatives available which would impact less on public expenditure.

I think your officials' paper and Norman Lamont's letter show that it was right to probe BGC closely on these questions, and I am interested to note that you see potential disadvantages in at least Phase II of the project which run wider than its public expenditure costs - as you know, Geoffrey Howe and I are interested in the effects of BGC's monopsony more generally in just such areas as this.

On the basis of Norman Lamont's letter I accept that the case for Phase I of the project seems robust, and I reluctantly accept that there are no more attractive alternatives; I shall therefore be prepared not to look for specific savings in respect of this part of the development.

It is clear from Norman Lamont's letter that there is considerable doubt whether Phase II of the project should go ahead on the timetable BGC envisage, and I note that you are not inclined to seek approval for the project at this stage. I can only endorse this judgement. With so much uncertainty surrounding the development, it would in the present economic climate be inappropriate to include the project in our public expenditure plans, and I propose therefore to regard the baseline for BGC's IFR figures as reduced by the £35m, £45m and £50m estimated costs of Phase II in the three years from 1981-82. Of the investment option cuts in the IFR, this will leave for discussion at our bilateral the proposed further £20 million reduction in each of the three years.

I am copying this letter to the Members of E Committe and to Sir Robert Armstrong.

Yrs

John Biffen

JOHN BIFFEN

25 SEP 1980

CSAP

Nat Ind

DEPARTMENT OF ENERGY
THAMES HOUSE SOUTH
MILLBANK
LONDON SW1P 4QJ
Direct Line 01-211 4953
Switchboard 01-211 3000

From the
Parliamentary Secretary

Rt Hon John Biffen MP
Chief Secretary to the Treasury
Treasury
Parliament Street SW1P 3HE

P

23 September 1980

24/9

Dear John

1980 IFR - DEFERMENT OF MORECAMBE BAY GASFIELD

At E(80)24th, it was agreed that David Howell would make proposals on the timing of the development of the British Gas Corporation's Morecambe Bay Gasfield. In his absence abroad I am writing to you.

In consultation with your officials, my officials have prepared the attached paper on the subject. As you will see, it concludes that there is a strong case for giving BGC approval for the first phase of the development because:-

a. it will be a profitable investment which will meet the RRR criteria;

b. without it there is a serious risk that BGC will be 3m therms a day short of their forecast peak winter requirement in 1983/4, after having made allowance for their continuing to restrict supplies (primarily to industry) and assuming that the Rough storage project is commissioned to time. Furthermore, if Rough slips one year there will be an even greater deficit in 1984/5;

c. although there are other possible sources of supply, it is very unlikely that they could be developed in time to meet the 1983/4 and 1984/5 deficits;

and

d. although it would be possible in principle to reduce the forecast deficits by further supply restrictions, this could only be achieved by a massive cutback in industrial and commercial sales, which would reduce BGC's revenue by some £350m a year at 1980 prices. Because their gas costs could not be reduced prorata for contractual reasons the effects on their profits and hence the harm to the PSBR wou d, in fact, be greater than the cost of developing Morecambe.

On the other hand, there does not seem to be the same pressing need for developing the second phase because other options, such as the development of additional Southern Basin supplies, could well be able to replace it.

I agree with these conclusions. Apart from the opportunities for industry (including British Steel) that a project of this magnitude will give, we believe that we must take every step possible to enable

Rt Hon John Biffen MP
September 1980

BGC to remove their current restrictions on supplies to industry. Until this happens the UK energy market will not work efficiently and the pressures on coal and oil to keep prices down will be lessened. Admittedly there are signs that gas demand has fallen recently, but this is as a result of the recession in economic activity and is unlikely to have a significant impact on peak winter demand. In any event, I believe any easing in the supply constraints on BGC should be used to sell more gas to industry, rather than defer profitable capital investment.

Furthermore, we must recognise the risks we would be taking if we refused to allow the first phase of Morecambe to proceed. BGC have told us that without it there will be a serious risk that they will not be able to meet peak demand in 1983/4 and 1984/5. Even with it, a risk exists, but that would be due to a failure on the part of BGC and their suppliers rather than to explicit action by us. If we refused them consent, I have no doubt that the blame for any supply failures in those years would be laid squarel at our door.

The same risks may not apply to the second phase of Morecambe, because that will produce additional peak capacity after 1985 and there are other ways of achieving that within the timescale. In addition, we must take steps to encourage further gas exploration, particularly in the Southern Basin. On the other hand, if BGC did press ahead with Phase 2, there would be greater scope for them to increase their sales to industry and thus open up the energy market more. On balance, however, I am inclined not to give approval at this stage to the second phase, although the extent to which this is possible will depend on discussions we will have with BGC once we have agreed that the first phase must proceed.

I am therefore seeking your agreement to:-

a. deleting the first phase of development of the Morecambe Bay Gasfield from the list of possible option cuts in the 1980 Investment and Financing Review. This would probably reduce the cuts which we are considering for BGC to:-

1981/2	1982/3	1983/4
£20-55	£20-65	£20-70

b. opening discussions with BGC about the possibility of deferring the second phase of Morecambe Bay until negotiations for additional supplies are sufficiently far advanced to enable us to compare the benefits in national economic terms of developing those instead.

Rt Hon John Biffen MP
September 1980

I am copying this letter to the members of "E" Committee and Sir Robert Armstrong.

Y-

Norman

NORMAN LAMONT

CONFIDENTIAL

CAPITAL INVESTMENT REVIEW: MORECAMBE

British Gas is proposing to develop its Morecambe field in up to 3 phases each supplying a nominal 6 million therms a day at peak. Planning is currently to complete Phase I by the winter of 1983/84 and Phase II by 1984/85. No target date has yet been proposed for Phase III, which will drain a separate part of the field.

2. British Gas' estimate on cost of the first 2 phases of the development is:-

£m	1980/81	1981/82	1982/83	1983/84	1984/85
Morecambe					
Phase I	31	80	88	75	70
Phase II		35	45	50	44

The investment for Phase II is lower because it can make use of some of the facilities needed for Phase I. In fact Phase I output may be well above the nominal figure of 6 million therms a day depending on well productivity which will be known only after production begins. In that case Phase II may not be needed/ or needed on a smaller scale.

3. Since Morecambe gas is slightly lower in calorific value than that normally distributed it must be blended with other gas to make it suitable. BGC therefore plans that the additional transmission capacity which would in any case/ be needed to provide supplies from Scotland to the North-West and West Midlands from the mid-1980's should be provided by a pipeline down the west coast to pick up the gas from Morecambe. While BGC has not examined other means of providing this capacity it is thought that costs would probably be similar whatever the route. Onshore transmission has therefore been excluded from the costs quoted.

Discussion

large-scale source of winter supplies and that its development would produce a rate of return at least equal to the RRR. The question remains, however, whether it should be developed on the scale and to the timetable which BGC have proposed.

5. The case for deferment of all or part of BGC's plan for Morecambe relates to two main concerns:

i) Short term PSBR effects. The capital cost of Morecambe is high and a saving of some £240 million over the current PESC period could ostensibly be made by deferring Morecambe for 2 years, for instance;

ii) Depletion Policy. About 5-6 tcf of gas been discovered, but not proved or developed, in the Southern Basin. So long as these reserves remain uncontracted, there is little incentive to further exploration there. The poor response to the Southern Basin blocks offered in the Seventh Round is evidence of this. The development of Morecambe will, within a restrictive depletion policy, defer the development of that discovered Southern Basin gas and therefore further defer exploration for more. It is important for depletion policy reasons for us to have the best possible knowledge of the available reserves.

6. Supply and Demand

British Gas currently has excess supply capacity during the summer but an urgent requirement for additional capacity during the winter. The table below shows its forecast of peak supply and demand from 1983/84 which is the first year in which Morecambe could contribute.

CONFIDENTIAL

Peak Supply & Demand: 1989 Corporate Plan

(million therms/day)	1983/84	1984/85	1985/86	1990/91
Peak demand without marketing restrictions	116	122	126	135
Less:				
contracted supplies & Committed Storage (excl. Rough) *	105	105	100	70
expected but not yet contracted supplies at normal load factors	-	-	3	30
Remaining requirements for peak supplies	11	17	23	35

* Rough is excluded because of a real possibility that the project will slip significantly.

7. Current plans are to meet the very substantial deficits up to 1985/86 by a combination of marketing restrictions, development of the Rough storage and development of Morecambe.

Other Potential Peak Capacity

8. Provision onshore of peak capacity would, like Morecambe, add directly to the PSBR and would cost approximately twice as much.

As far as the Northern Basin is concerned there is no real prospect of obtaining additional seasonal supplies. The load factors on the Brent line and the new gas-gathering line will be high and their output cannot be raised above the levels which have been taken into account in the table in para 6. While in principle it might be physically possible by the addition of compression to the UK line to Frigg to increase supplies by around 3 m. therms/day by about 1983/84, we cannot rely on the licensees and the Norwegian Government to agree to the extra production from the field, and at best negotiations would be likely to be protracted. It is therefore only

CONFIDENTIAL

the Southern Basin which could replace all or part of the contribution from Morecambe.

9. Three possibilities for additional Southern Basin supplies have been examined in some detail.

i) a scheme, suggested by Amoco, for collecting gas from several small deposits. These deposits have not been proved, indeed the largest one concerned has been identified only by seismic survey. Not all are in the ownership of Amoco. This must be seen as a potential prospect for the later 1980s, not 1983 - 1986.

ii) the Sean field. This could be developed to give peak capacity of some 6 million therms a day for 5-6 years with first supplies in 1984/85 and peak output the following year. This scheme offers no help in 1983/84 and, because the field has not yet been fully proved, is less reliable than Morecambe as a contributor to supplies in 1984/85. It does however appear to be a potential substitute for Phase II of Morecambe. There are other fields which it might well be possible to develop on a similar timescale if BGC were to approach the producers with serious proposals soon.

iii) Hewett. The licensees have offered two possibilities :

a) to increase peak capacity by 2 million therms a day in exchange for a quadrupling of the price paid for existing contracted production. The latter would cost BGC around £160m a year from 1981/82 and since only 55% of this would be recouped via Corporation Tax and royalties there would be a net cost of £72m a year to the PSBR. In addition, the offsetting of the licensees' capital expenditure of around £100m against their profit for Corporation Tax purposes would result in a short-term loss of around £50m in tax revenue.

b) to store gas from other fields in Hewett during the summer to maintain the reservoir pressure and hence winter output capability. The licensees have not produced a detailed analysis of this option but the contribution to peak supplies might again be around 2m therms/day. The cost to BGC appears likely to be much greater than that for the equivalent output from Morecambe.

It must be added that besides being expensive additional supplies from Hewett must also be regarded as unreliable, both because of the performance of the field in recent years and because of past experience of the difficulties of obtaining agreement from the 13 licensees to new contract arrangements.

10. The indications are, therefore, that Hewett would be an inadequate and, in terms of PSBR, more costly substitute for Morecambe. The Amoco suggestions could not be implemented in time. Most probable timing for Sean would be a year later than Morecambe: it could not therefore substitute for Phase I of the Morecambe development but has promise as a substitute for Phase II.

Demand Restraint

11. A second possible option if Morecambe were deferred would be further to depress demand. But tariff demand up to 1983 is effectively determined by BGC's statutory obligation to supply and by the financial target and price decisions already taken. Only a massive increase in prices could have much effect on peak demand in the years 1983/84 to 1985/86. Any reduction in peak demand therefore has to be obtained in the industrial and commercial firm contract markets. But these markets are expected to grow very slowly over the next few years and to reduce peak demand by 6 million therms per annum would require not only a cessation of expansion but also a massive cutback in renewals of existing contracts. A reduction in annual demand of around 1400 million therms, equivalent to about 25% of current supplies to these

markets, would be needed. Even if this situation were acceptable the loss of revenue by BGC would amount to over £350 m a year at present gas prices, and because BGC is paying without taking for the gas, there would be very little corresponding reduction in total costs. The additional reduction in demand would not need to reach its full amount until 1983/84; but it would have to be phased in in the preceding years. It is very probable therefore that an additional planned restriction of demand of this magnitude would add more to the PSBR than developing Morecambe.

Supply/demand matching

12. Potential contributions to peak requirements in 1983/86 are, in m. therms/day:

	1983/84	1984/85	1985/86
A. Remaining Requirements (see para 6)	11	17	23
Existing marketing restraints	4	6	6
Rough	4	10	10
Morecambe Phase I	6	6	6
B. Sub-total	14	22	22
Morecambe Phase II	-	6	6
Sean	-	2	6
Potential Surplus if all succeed	+3	+13	+11

It must be borne in mind that the contributions from Rough and Morecambe I in 1983/84 and 1984/85 are somewhat uncertain. Because of the tight timescales there is a significant chance that either or both could slip by a whole year (and greater slippage is not impossible). The apparent surpluses shown in line B for 1983/84 and 1984/85 may therefore well not be achieved. A one year's delay in bringing Rough on stream would produce a deficit in each year of 1m therms/day, while a year's delay in Morecambe would produce a greater deficit (3m therms/day) in 1983/84 but a surplus of 5m therms/day in 1984/85. If a surplus is in fact achieved it will permit the removal of the marketing restrictions earlier than would otherwise be possible. The consequent expansion of sales will tend to reduce the PSBR, though because of the need to incur capital costs to distribute the additional supplies the effect in the first year of any phase of expansion is likely to be broadly neutral; thereafter the benefit could be around £50m/year per million therms/day of peak capacity.

13. The general picture which emerges is that if Morecambe I is deferred a year there will be a significant peak deficit in 1983/84 and again, if Rough should slip, in 1984/85. On the other hand Morecambe II appears only to be required on this timescale if Rough should slip by two years. After 1984/85 options such as the development of Sean may be able to replace Morecambe II's contribution to the expansion of supplies.

14. The development of Morecambe I would not defer the development of Southern Basin fields; the leading candidate for such development will, unless Morecambe II is also approved, be needed as fast as it can be developed. Approval of MorecambeIwill significantly reduce the risk of a supply shortfall in all 3 winter seasons considered. Above all if no approval is given for Morecambe, a failure of supplies, even if it would have occurred in any case, can and is likely to be blamed on the Government.

15. It is more difficult to make the same case for approving Morecambe II. It will not contribute to peak requirements in 1983/84. In 1984/85 and 1985/6 it is not essential to meeting peak demand provided Rough and Phase I do not slip and Sean is developed to time although the margin for error will be narrow if BGC's marketing restrictions are withdrawn. Furthermore if

the Government maintains the current restrictive gas depletion policy, development of Morecambe II could defer development of any new Southern Basin gas for at least a year. In these circumstances it is difficult to see licensees taking any initiative to explore the Southern Basin further until BGC has made a start on contracting those fields that have been discovered for 10 years or more.

CONCLUSION

16. The arguments both on PSBR and supply security grounds point to approval of the first phase of Morecambe now. This conclusion is the stronger in that, if approval is not given, shortages in 1983/84 will be blamed on that act of non-approval. There is less justification for approving Morecambe II now although the extent to which delay is possible cannot be resolved without detailed discussions with BGC. If, following these discussions, it is agreed that Morecambe II can be deferred without apparent risk, then not only could negotiations for Sean or other supplies proceed far enough for the costs of producing that gas to be compared with those of developing Morecambe II, but the Government would also have given itself time to decide on its gas depletion policy before approving Morecambe II.

23 SEP 1980

Nat Ind. 4

Ref: A03003

CONFIDENTIAL

PRIME MINISTER

Nationalised Industries' Contribution to Public Expenditure 1981-82 to 1983-84
(E(80) 104)

BACKGROUND

The paper by the Chief Secretary is in part a background to the Committee's discussions of steel, shipbuilding and rail and in part a call for further action on the other nationalised industries in order to eliminate the excess still remaining.

2. The overall position, in terms of additions to present public expenditure provision, is summarised in paragraph 12 of the paper. You will recall that in the discussions last July of the nationalised industries and of public expenditure it was assumed:-

(i) that the non-loss makers would require net additional finance, mainly because of gloomier assumptions on their market prospects; and

(ii) a further £470 million finance each year would have to be offset by savings on other public expenditure programmes.

The present table:-

(iii) takes credit for reductions subsequently agreed for the Post Office; and

(iv) assumes that the NCB and British Rail will find means to eliminate all their excess requirements, except for £50 million for British Rail in 1981-82; makes no provision for British Shipbuilders in 1982-83 and 1983-84; and, for British Steel, draws on the very provisional figures in Annex 2 of E(80) 102.

3. After allowing for these changes there remains an excess of:-

£million 1980 prices

1981-83	1982-83	1983-84
413	166	200

CONFIDENTIAL

To the extent that this is not eliminated by cuts on the nationalised industries it will have to be offset by yet further cuts on other public expenditure programmes. The Chief Secretary proposes therefore that it should be found from the option cuts listed in table 2 attached to his paper and that, insofar as these cuts are not forthcoming, the balance should be found by an across-the-board investment cut.

HANDLING

4. The Chief Secretary may wish to refer briefly to this paper at the beginning of the meeting in order to set the tone for discussion of the three particular loss-making industries. The Committee can then return to it at the end of the meeting in order to take decisions on the remaining excess in the light of the progress on the particular industries.

5. After the Chief Secretary has introduced the paper each of the sponsoring Ministers will wish to comment - the Secretaries of State for Industry Stw | Dub Shp and for Trade, the Minister of Transport and Mr. Lamont and Mr. Fletcher.

6. In discussion the main questions are:-

(a) Do Ministers agree that any remaining excess should be eliminated by offsetting measures within the nationalised industry programme?

If this is not done, and overall public expenditure is not to be increased, the savings will have to be found from other public expenditure programmes which are already under heavy pressure. Moreover, the Government will be vulnerable to criticism of failure to turn the finances of the nationalised industries round as assumed in the last Public Expenditure White Paper. Notwithstanding this, nationalised industry sponsoring Ministers may well protest against the possibility of further across-the-board investment cuts and point to the implications for employment and productivity. They might also be tempted to argue that the present assumptions could well prove wrong. On the other hand, while it is true that they are on a highly uncertain base, it would be imprudent to assume now that they are over-optimistic.

(b) If so, how should it be done?

Table 2 of the Chief Secretary's paper identifies a number of option cuts, and in the two later years these would be more than enough in total to offset the excess. However, I understand that so far in bilateral discussions the Chief Secretary has not secured all that he needs. If the Committee agree with the overall objective of eliminating the excess, the next step might be for officials to agree, in the further discussions on the 1981-82 EFLs, how the balance should be found. The Chief Secretary could deal bilaterally with Ministers on any difficulties and he is due to report in late October with his proposals for the 1981-82 EFLs. He could also report on how the excess for the two later years will be found.

CONCLUSIONS

7. In the light of the discussion, and with reference to paragraph 19 of the Chief Secretary's paper, you will wish to record conclusions:-

(i) on whether the objective should be for the remaining excesses to be offset by measures within the nationalised industry programme;

(ii) agreeing that the savings should be found by a combination of option cuts and across-the-board savings and inviting the Chief Secretary to report the outcome for 1981-82 in the context of his proposals for EFLs for that year and, separately, for the two later years.

RTA

(Robert Armstrong)

16th September 1980

cc A Duguid

C O N F I D E N T I A L

PRIME MINISTER

As I shall not be able to attend E Committee on 17 September because of my visit to Central America (Norman Lamont will represent me), I thought I should give you my views on the Chief Secretary's proposals.

In order to meet the problems of the loss-making nationalised industries the Chief Secretary is proposing that the further option cuts in the investments of profitable nationalised industries such as BNOC, the British Gas Corporation and the Electricity Supply Industry should now be implemented, or that there should be a general investment squeeze. (The position of the National Coal Board and the scope for cutting its capital expenditure will of course be dealt with along the lines agreed at E on Monday.)

As far as BNOC are concerned, deferment of the Clyde field will ease the pressure on their investment programme. Further cuts of the size suggested by the Chief Secretary would have serious implications for joint venture programmes to which BNOC are already committed.

As far as BGC are concerned, the Chief Secretary has suggested cuts in their Morecambe Bay project and other planned investments. These are going to be highly profitable and, with the possible exception of the second phase of the Morecambe project, they are an essential part of our all-out effort to increase gas supplies to industry, which is at present clamouring for gas but unable to get it until we increase investment. So cuts in gas supply investment go directly against our industrial strategy. Furthermore, BGC are committed to an extensive mains replacement programme which is essential if safety standards are to be maintained. We should not jeopardise this.

In the Electricity Supply Industry, the option cuts proposed would come on top of a cut already imposed this year to make way for the profitable Cross-Channel link. Substantial power station closures have already been announced, and substantial capital expenditure reductions are planned. Area Board investment has been at a low level for several years, and further cuts could begin to endanger the maintenance of the system, with possible safety implications. So I hope that these cuts would not be pressed either.

Can we not stick by the principle of requiring the industries concerned to make good their losses rather than financing them by cutting down on profitable investment elsewhere in the public sector?

pp SECRETARY OF STATE FOR ENERGY

16 September 1980

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

CONFIDENTIAL

Qa 05128

To: PRIME MINISTER

From: J R IBBS

Financial Realism in the Nationalised Industries

1. A key problem at present is how to instill in the Nationalised Industries the same sense of financial reality and urgency which events themselves impose on the private sector. Without this, they will not seek sufficiently vigorously the productivity improvements and other savings that are needed. Unless they cut down their cash demands it will be impossible within present policies to ease the pressure on the private sector through such moves as bringing down interest rates.

2. Tomorrow's discussion at E Committee should bring this home clearly enough to everybody present. It can be transmitted by Ministers to the Chairmen who respond to them but it needs also to pervade the management of the industries.

3. I suggest that an important influence on attitudes in the Nationalised Industries is the mass of contacts they have at working levels with sponsor Departments. A deliberate campaign within sponsor Departments to ensure that everybody who deals with a Nationalised Industry, even at a humble level, fully understands the need for a new realism on cash and costs in the industries, and the Government's determination to achieve it, would be a very useful influence. You may care to discuss with your colleagues how this could be achieved within these Departments.

4. I am sending a copy of this minute to the Chancellor of the Exchequer and Sir Robert Armstrong.

JRI

16 September 1980

CONFIDENTIAL

Nat Ind.

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Norman Fowler MP
Minister of Transport
Department of Transport
2 Marsham Street
LONDON
SW1

\ August 1980

Dear Norman

NATIONAL FREIGHT CORPORATION: DENATIONALISATION

You wrote to the Chancellor on 23 July proposing the early incorporation of the National Freight Corporation (NFC) on a wholly equity basis as the next step towards its privatisation.

I do not think it is realistic to think in terms of incorporating NFC on an equity basis at such an early stage. I entirely agree with your objective of moving towards privatisation as soon as possible, but this does not necessarily entail early incorporation and the considerable problems which would be associated with such a move. These were set out in general terms in Geoffrey Howe's letter of 8 July to Adam Butler on British Aerospace, which you have seen, and which in my opinion apply with even more force in the case of NFC. I am copying that letter to those who have not already seen it.

We are faced with particular uncertainties about the prospects for the sale of NFC in the immediate future. The Corporation will need to meet its testing profit forecasts if even the possibility of a sale in 1981 is to remain open, and the merchant bank involved has spoken of 1982 or 1983 as favourable years for a sale. Moreover, there are substantial deficiencies in the Corporation's pension funds which will have to be made good out of the proceeds. If, as seems quite likely, these deficiencies exceed the expected proceeds, it is difficult to see how a sale could take place in the foreseeable future. This is something we will not be able to judge until the New Year when we have the results of the actuarial valuation now under way. It seems inconceivable that we should take the step you propose without waiting to satisfy ourselves that this major potential obstacle to a sale can be resolved.

Since the uncertainties about timing are at least as great as in the case of British Aerospace, Geoffrey Howe's comment that the political arguments do not all point one way is also relevant to the NFC: since we cannot privatise now, it might seem that we were going for the shadow when the substance was unattainable.

Against this background, early incorporation offers few advantages. On the financial side it would lead to an effective subsidy from the tax-payer to the company without in any way guaranteeing that the prospects of an early sale would be improved. If the Corporation is in need of such financial assistance, then I would not choose to give it in this sort of open-ended way that has the effect of reducing our control over its less than strong financial position. If we are concerned simply to enhance the prospects for an ultimately successful sale, then incorporation seems unnecessary. We have always envisaged giving NFC an appropriate capital structure at the time of sale. To unnecessarily pre-determine this structure now will not only have financial repercussions but will reduce the options open to us at that time.

The problems of control which Geoffrey Howe set out in his letter to Adam Butler also seem to arise in particularly acute form in the case of NFC, where the interim period may be a long one. As you point out, we would need to maintain extremely tight control over the company's finances if there was to be no increase in public expenditure. You do not, however, outline how in practice you would intend to do this. As Geoffrey pointed out, past experience suggests that real problems arise in attempting to rest on the theoretical powers of a shareholder to dismiss the Board even where these are exercised through some memorandum of understanding with the company.

I am sure that early incorporation on a wholly equity basis would be welcomed by NFC itself, not least because the task of achieving profitability would be eased, at some cost to the Exchequer. But we cannot allow plans for privatisation to become in practice - though I know that is not your intention - an excuse for relaxing financial discipline. I hope that, whatever the status of the Corporation, the Board will continue to work towards getting the business into a shape in which it can be sold. In the meantime, I am sure we cannot made an exception to our general policy of incorporating only when definite sale arrangements are in hand.

I am copying this letter to the Prime Minister, Sir Keith Joseph, members of E(DL) and to Sir Robert Armstrong.

Yours
Nigel

NIGEL LAWSON

CONFIDENTIAL

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

8 July 1980

Hon Adam Butler MP
Minister of State
Department of Industry

Dear Adam

BRITISH AEROSPACE

You wrote to me on 17 June setting out what you saw as the advantages of early incorporation of British Aerospace - a course which you mentioned at our meeting with the Governor on 12 June - and enclosing a paper setting out how the company would operate and be controlled while it was wholly owned by Government.

I of course agree on the importance of making a move towards privatisation as soon as is possible. But before taking the step you propose, we must weigh the risk of the gesture appearing empty if, as you accept might be the case, there is a prolonged period before flotation. We would have to make clear that the Government retained control in the interim period and the very act of vesting would raise questions about the timing of flotation. In these circumstances, it might seem that we were going for the shadow when the substance was unattainable. The political arguments do not all point one way.

As you will recognise I am bound to be concerned in this case, as in others where early incorporation might be proposed, both in the immediate financial consequences and in the question of control over the company for PSBR and public expenditure purposes in the period before it can leave the public sector. I have seen the Governor's letter in which he advises that early incorporation per se would not affect the prospects of an eventual flotation and in which he also draws attention to very important questions about the control and financing of the Company during a 100 per cent ownership. These problems are much more substantial than your paper implies.

/On the financing,

On the financing, there are two main issues. First, there is the difficult question of setting the Corporation's CCD and the interest and dividend payments due on it noted in paragraph 2(iv) of your paper. The consequences of early incorporation for this need spelling out further. It would be difficult to defend unnecessarily putting ourselves in a position where the CCD was set at an artificially low level and the Exchequer forewent the appropriate interest and dividend payments. This is perhaps a point of propriety. Secondly, and still more significantly, there is the question of the Company's commercial borrowing lines which BAE have already negotiated. You suggest that it would be necessary for the Government to continue to stand behind the wholly owned company and you quote RR as a precedent. The Aerospace Act is silent on the status of liabilities incurred after vesting day and it is not clear to me how you would propose to indicate and implement any HMG backing for new liabilities undertaken by the Company. Parliament will have a strong interest in this and in the question of whether it would be appropriate for the Company to draw substantial sums on loan facilities the terms of which were negotiated for circumstances in which there would be no Government backing.

On control, I welcome and endorse your view that the Government's ultimate liability during a 100 per cent ownership means that controls over the Company must remain effectively at their present level while the Company remains in the public sector. This seems to me to cast some doubt on the contention that a company framework will have real advantages for the business. Moreover, although in theory it should be possible within a company framework to reproduce the same level of control as in the case of a statutory corporation, I am doubtful about this in practice, especially over what could be an extended period. Experience with Cable and Wireless suggests that even where a satisfactory memorandum of understanding has been negotiated, its implementation may well be less than satisfactory, moreover, as with Rolls-Royce, it may be difficult to negotiate a sufficiently restrictive memorandum. Over a long period there is bound to be conflict and tension between the directors' role and responsibility in a Companies Act framework and the Government's need to control the company for broader public sector reasons.

/If things go wrong,

If things go wrong, sanctions are very limited. Dismissal of the board is unwieldy and in a Companies Act framework, and there are a few intermediate forms of pressure.

Because of these problems, I believe that we should rule out early incorporation and should stand by our general policy of incorporating only when definite sale arrangements are in hand.

I am copying this letter to John Nott, to whom you copied yours and also to Norman Fowler who may be interested in connection with the National Freight Corporation, as well as to the Governor.

GEOFFREY HOWE

- 1 AUG 1980

CONFIDENTIAL

DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

MINISTER OF TRANSPORT

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

23 July 1980

Dear Geoffrey.

NATIONAL FREIGHT CORPORATION: DENATIONALISATION

I now have the necessary powers in the new Transport Act and we need to decide on the next steps to be taken towards the privatisation of the National Freight Coporation.

It is, I believe, of particular importance that we should move as speedily as possible towards our objective in this particular case, not only to fulfil an explicit manifesto undertaking but also to establish that we mean business with the further privatisation proposals in the transport field which I shall be putting to Parliament next session. Indeed, I am already coming under a good deal of pressure from some of our supporters to move now that I have the necessary powers.

CONFIDENTIAL

During the passage of the Bill I made it clear that our intention was complete privatisation, and that if there was to be any residual shareholding by the Government it would be a small one. I said, following advice from Schroeders, that flotation would not be possible before 1981 at the earliest. I refused to be drawn on the question of likely proceeds, but given NFC's modest trading results, the need to make good their pension deficit out of the proceeds and the generally depressed state of the market, it is well understood that the next capital receipt to Government will be small - probably well under £10m.

As I see it, there are in practice only two realistic options: to do nothing until much nearer the time of flotation (ie probably the Spring of 1981, but possibly a good deal later); or to go ahead immediately with incorporation on a 100% equity capital structure, as I would strongly prefer. Such a course would, I believe, increase the chances of a successful flotation in due course (and ease the Company's cash position in the meantime). It would however have the immediate effect of reducing the flow of income to the Exchequer which would otherwise have been due in the form of interest payments. I should have to explain the financial consequences to Parliament.

I must add that, on Schroder's best estimate, the size of the proceeds would not be increased by the full amount of the likely interest which the Echequer would forego. They estimate that if incorporation takes place on 1 October, and flotation on 1 May 1981, the interest foregone would be some £6.3m, against a likely increase in the proceeds of sale of some £2-4m. But you will recognise that even a small increase in the proceeds would be crucial for success. If flotation were delayed beyond May 1981, the net loss would, of course, increase. (The next opportunity for flotation would be some six months later.) Nevertheless, I am firmly of the view that our overall policy objective of early flotation justifies accepting a loss.

Although the market outlook is not particularly encouraging Schroders are sticking to their view that a successful flotation in 1981 remains a real possibility. I believe that it would be right to back this view by taking the bolder of the two options and making an early change to Company status on a 100% equity structure. This would strengthen NFC financially and provide a period before flotation in which the new Board, their managers and work force can adjust to the new conditions, a point to which Schroders attach a good deal of importance.

A further important point is that it would show that we mean business, and would thereby have an invigorating effect on the morale of the Company. The Chairman tells me that, at all senior levels, the NFC is now poised to make the most of the new and wider commercial opportunities which they see coming from incorporation, and in particular from the clear removal of the statutory duty under the 1968 Act to attempt to promote an integrated transport policy, and the removal of doubts as to how far they can properly move into such more profitable fields as cold storage and the provision of ancillary services to the road haulage industry at large.

There is a further important point which Schroders have been at pains to emphasise in their advice all along. In their view, the £9m a year which we are taking in fixed interest payments from the NFC is too big a drain on the undertaking. Their present assets and trading performance are not sufficient to support any more debt than they have already to leasing companies and to banks. During the run-up to flotation Schroders - as would I - would prefer to see this money used to strengthen the Corporation's cash position by reducing their indebtedness to the banks and leasing companies.

I know from your correspondence with Adam Butler that you are concerned about the problem of controlling a public sector company with 100% Government shareholding. Let me emphasise therefore that I envisage maintaining more or less the identical financial controls over borrowing and investment as we have at present. I would use these controls to ensure that NFC Ltd conformed with agreed external finance limits. In order to neutralise the effect on public expenditure, I would propose reducing these limits in recognition of the prospective loss in interest payments to the Exchequer. This would ensure that the money left in NFC would in fact increase their financial health, and hence saleability, by reducing their debt to leasing companies and banks. I see no difficulty at all about an amicable agreement with the NFC Board on this. The present Chairman and the Directors whom I would appoint to the new Company are already attuned to Treasury methods of control. The position of companies such as Rolls Royce that have been brought into the public sector in very different circumstances is not comparable.

I have of course considered whether the new capital structure might initially consist largely of convertible loan-stock. In that way, we could maintain until flotation our interest payments at or about their present level. But the Corporation would not then get any financial benefit from the change of status. Indeed they might lose. Once the new Company is set up, I shall no longer have power to guarantee their borrowings. This would have an immediate, small, effect on their rate of borrowing, probably about half per cent, which could add about £150,000 per annum to their expenses.

Finally, I propose, in making a statement to the House explaining the development of our policy, to make it clear that the Company and the Government would work for the earliest possible flotation, but in the meantime the Government had deliberately decided to go for an all equity structure, despite the financial loss inherent in that decision, on the grounds that it would significantly contribute towards our main policy objective.

I hope you agree with this proposal, and that you will also agree that in order to make quick progress, I should make an announcement to the House before the Recess. I would envisage doint this by means of a written answer.

I should be grateful if, as a matter of urgency, our officials could proceed to work out the details on the following basis:

i. The Corporation should be turned into a Company as soon as possible, on a wholly equity basis.

CONFIDENTIAL

24 JUL 1980

ii. Appointment should be made to the Board of the team most likely to carry conviction with the City at flotation, including the present Chief Executive, and several of the other members of his Executive Team.

iii. I should make a statement to the House, making it clear that the Company and the Government would work for the earliest possible flotation but that in the meantime I had deliberately decided to go for an all equity structure, despite the financial cost to the Government.

Copies of this letter go to the Prime Minister, Keith Joseph, members of E(DL), and Sir Robert Armstrong.

Yours ever,

Norman

NORMAN FOWLER

CONFIDENTIAL

Nat. Inds

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

22 July 1980

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

R 24/7

Dear Secretary of State,

NATIONALISED INDUSTRIES : FINANCIAL CONTROL

We asked the group of officials under Bill Ryrie who have been talking to NICG about possible changes in the system of financial control to report to us before the Recess. I am sending you a note by Treasury officials reporting the Group's discussions together with a covering note by Bill Ryrie.

The Group has made useful progress in identifying some limited but nevertheless helpful changes in the direction of greater flexibility, within the essential overall control. The NICG representatives have welcomed these proposals and have said that they will do this publicly if we endorse the proposals. There are clearly some among the Chairmen who would like the more radical changes which we ruled out in present circumstances. They will no doubt want to come back to this as paragraph 2 of Bill Ryrie's covering note makes clear.

You will see that officials have suggested some amendment of your proposal that the statement about EFLs should say that there should be a presumption that any increases agreed in EFLs should be deducted the following year. I myself feel that the new text should adequately meet your anxieties, which of course I share.

I also agree with officials that we cannot accept the Chairmen's proposals that the arrangement for end-year flexibility should be two-way, and should come into operation in 1980/81. I could not accept an additional claim on the Contingency Reserve this year; and a two-way scheme would double the potential call on the Contingency Reserve in

/later

later years and bring an unacceptable degree of uncertainty into our public expenditure planning and control.

I think we should approve the recommendations in the note by Treasury officials (summarised in paragraph 17). I hope we can clear this by correspondence as we have a substantial agenda at E(NF) on Thursday, including the preparation for our meeting with the Chairmen of the main industries on 28 July. But, if necessary, we can discuss any points of difficulty then.

I am copying this letter to other members of E(NF), Robin Ibbs and Sir Robert Armstrong.

yours sincerely

[signature]

for GEOFFREY HOWE

(Approved by the Chancellor & signed in his absence)

22 JUL 1980

CONFIDENTIAL

NATIONALISED INDUSTRIES: FINANCIAL CONTROL

Covering Note by the Chairman of the Joint Group

1. At the meeting of E(NF) on 16 May we were asked to report before the Recess on discussions with the Nationalised Industries' Chairmen's Group on possible changes in the system of financial control. The note by Treasury officials below contains this report. It has been seen by the NICG members of the joint group who felt that it was a balanced document which did their arguments justice, although they have not been asked to endorse it word for word. The Chairmen's representatives have not seen this covering note.

2. The discussions have been constructive and we have been able to agree on the four modest changes in the present arrangements which we recommend in paragraph 16 of the report. The Chairmen's representatives welcomed these as improvements given the present policy framework and would say so publicly. But the Group continue to feel that the Government over-estimate the importance of the PSBR for monetary policy and interest rates, and will continue to press this case at least in private and some individual chairmen will probably do so publicly.

3. Ministers authorised us in June to discuss the text of a statement about external financing limits. This included some discussion of the circumstances in which EFLs may have to be adjusted. Our intention throughout was not to propose any departure from present policies but to offer some modest reassurance to the chairmen by explaining the Government's approach to this question somewhat more fully. The text which is annexed to the report safeguards the Government's position adequately, in my view, and can be accepted. The passages dealing with the possible adjustment of EFLs are in line with what was done about the Post Office and electricity last year.

4. Ministers also authorised us to discuss a proposal for a limited measure of end-year flexibility, which is also referred to in the proposed statement. The Chairmen's representatives welcomed this suggestion, although we did not feel able to accept two further requests which they made - that the arrangements should come into

force in 1980/81 and that in order to avoid encouraging full use of the EFLs it should allow for flexibility in both directions, underspending and overspending. The first would imply an additional call on the Contingency Reserve which is in any case likely to be under extreme pressure this year. The second would double the maximum potential addition to public expenditure in due course and in view of the large sums involved would introduce too much uncertainty in the planning of public expenditure to be acceptable in our view. The NICG accepted the first point but are not convinced by the second.

5. The Chairmen's representatives also set considerable store by the presentation of figures of their borrowing in the FSBR and we think it should be possible to meet them on this point as recommended in the report, though the detail on this is still subject to discussion. We have also been able to agree on a more flexible approach to borrowing from the NLF. One loose end which remains to be dealt with is the idea that, subject to certain restrictive conditions, some industries might be permitted to issue stock on the markets in their own names. We intend to report further on this in September.

6. Ministers will need to consider how and when these conclusions should be made public. The points affecting administration of EFLs including end-year flexibility should be reported to the House of Commons, as should the proposals for greater flexibility in nationalised industry borrowing from the NLF. The changes are relatively minor and would not appear to call for a White Paper; on the other hand they are too detailed to be dealt with in a Written Reply. One possible solution might be for the Chancellor to write to Sir Derek Ezra, as Chairman of the NICG, sending him two notes, the first containing the text of the proposed statement on EFLs and the second the points agreed about borrowing from the NLF. These could then be placed in the library of the House in response to a Written Question. Some slight editing may be needed before that, partly to reflect later detailed comments by the NICG.

NATIONALISED INDUSTRIES: FINANCIAL CONTROL

Note by Treasury Officials

1. At the meeting of the Ministerial Sub-Committee on Nationalised Industries' Financing on 16th May 1980 (E(NF)(80)1st Meeting) Ministers instructed officials to begin discussions with the Nationalised Industries' Chairmen's Group (NICG) on possible changes in the system of financial control for the industries. This followed agreement in February to a joint examination with the NICG of three specific topics:

(i) improvement of the way in which external financing limits (EFLs) are set and administered;

(ii) the possibility of a presentational change to identify within the PSBR borrowing for profitable investment by the industries;

and (iii) the sources of finance open to the industries.

We have now held a number of meetings in a group consisting of Treasury officials and representatives of the main sponsoring Departments and a small NICG team led by Sir Francis Tombs*. This Note reports our progress.

External Financing Limits

2. This has been the major topic. Our starting point was that there was no scope for radical change in the existing system because of the need to retain effective control over public finance. We therefore concentrated on changes within the present framework which would recognise the situation of the industries as trading enterprises. The NICG representatives accepted the continuing need for EFLs to exert control and concentrated on means of eliminating the distortions to which they felt the present system gave rise and which impaired the efficient management of the enterprises. They were principally concerned to clarify the basis on which EFLs would be set and the circumstances in which they might be changed.

3. We discussed the draft of a statement of the Government's understanding of the purpose of external financing limits and an indication of how they are intended to operate. This included an

---

*See Appendix for list of NICG representatives.

attempt to define, in broad terms, the circumstances in which the Government would be prepared to consider adjusting EFLs. It also included the suggestion for allowing a small margin of flexibility at the end of each financial year.

4. Although the NICG representatives generally found these suggestions helpful, they reacted strongly against the suggestion that if any EFL were changed for reasons of the kind discussed in the draft there should be a general presumption that an equal amount will be deducted in the following year. They argued that the circumstances in which it was contemplated that an EFL might have tc be adjusted, together with the safeguards which the draft statement also contains, meant that there should not also be an assumption of an equivalent cut in the following year. We suggested that, subject to approval of Ministers, the text should say that a decisic would be taken, in all such cases, as to whether the adjustment should be deducted from the following year's EFL. The text, incorporating this suggestion, is at Annex A.

5. We also discussed the suggestion that, subject to clearance with Departments in each case, industries should be permitted to exceed their EFLs by up to 1% of their gross turnover in any year, with the amount of any such excess being automatically deducted from the following year's EFL. We agreed, subject to Ministerial approval, to two suggestions by the Chairmen's representatives. First, to meet their point about the possible effect of fluctuations in capital expenditure, the 1% margin should cover both fixed investment expenditure and turnover. This will not increase the margin significantly. We have also tried to reflect in the text of the statement the circumstances in which end-year flexibility would operate and the differences between these arrangements and the broad undertakings about the adjustment of EFLs in certain circumstances. This takes account of the NICG view that its principal use would be to accommodate self-correcting fluctuations in external financing requirements, eg changes in timing of payments or receipts over the year end, where corrective action could not be taken by 31st March without harmful consequences.

6. The NICG representatives also made two further proposals in this connection which we were not able to accept. First they would

have liked the arrangements to come into operation in the current financial year. This would of course mean an additional claim on the Contingency Reserve in 1980/81. The second suggestion was that flexibility should apply in both directions ie, the industries should be able to carry forward underspend and add it to next year's EFL as well as anticipating and deducting from the following year's EFL. The NICG argued that in practice this concession would be unlikely to add to public expenditure totals since not all industries would make use of the facility in the same direction at the same time. This could double the potential claim on the Contingency Reserve resulting from the arrangement in any particular year. Both proposals have a certain commonsense appeal; but we feel bound to conclude reluctantly that they cannot be accepted because of the potential claims on the Contingency Reserve involved and the degree of additional uncertainty they would bring to planning public expenditure.

7. The NICG representatives said they intended to produce a draft "code of practice" which would not be definitive or exhaustive but would describe the way in which the principles set out in Annex A would be applied. We pointed to the difficulty of going beyond what is in Annex A but agreed to further discussions at official level about the possibility of establishing such a code.

Presentation of PSBR Figures

8. Although the NICG representatives regard the status of the PSBR as more than a presentational issue, they attach great importance to the presentation of the statistics for their borrowing. They felt that this influenced perception by the press, public and Parliament of the industries' contribution to the economy and also influenced Government attitudes towards their borrowing.

9. The NICG representatives suggested that the presentation of financial statistics relating to the nationalised industries in the Financial Statement and Budget Report (FSBR) was misleading. In particular they took exception to the reference to the words "financial deficit" as applied to the public corporations in Table 14 (Public Sector Transactions by Economic Category). This phrase in fact is not intended to carry any prejorative meaning

- it is commonly used when describing the financial flows between major sectors of the economy. But the Chairmen's Group felt that it gave a distorted view of the industries' position by suggesting loss-making rather than borrowing to finance productive investment. They also suggested that Table 17 (Financing of Capital Requirements of the Nationlised Industries) concentrated undue attention on the industries' external financing requirement without indicating the full extent of the profits earned by many of the industries.

10. We have tried to meet their concern as far as possible by drawing up a revised layout and wording of the relevant part of Table 14 and Table 17. These are attached at Annex B. In Table 14 the phrase "financial deficit" has been replaced by "excess of capital expenditure over available funds" and in Table 17 provision has been made for the industries' internal resources to be set out in greater detail, separately identifying the profit figure for individual industries. Given the restriction on the space in the FSBR, this has had to be at the expense of the detailed breakdown of sources of external finance which will in future be given in a footnote. NICG representatives are still considering the detail and practical questions raised by the new presentation eg, the provision of current cost profit figures by all industries and the format in Annex B cannot be regarded as final. We are also considering a further NICG suggestion to amalgamate the nationalised industries and other public corporations figure in Table 15.

Sources of Finance

11. A separate working party of Treasury and Bank officials and nationalised industry finance members was set up to consider proposals put forward by the Treasury for changes in the maturity rules for lending from the National Loans Fund and for improving the flow of information from the industries about the timing of their borrowing needs. In the light of their discussions we were able to agree with the NICG representatives on both issues.

12. The change proposed in the rules governing the maturity period of borrowing from the NLF (set out in Annex C) would allow individual industries to move towards a desired maturity pattern for the liabilities side of their balance sheets over a period of years. This pattern would be agreed with their sponsor Department and the Treasury. It would mean agreeing a maturity mix to be applied to future gross borrowing year by year (or refinancing where an industry was not

a net borrower) which would take the industry towards the balance sheet objective. Agreement to an industry's mix in any particular year would be subject to an annual assessment of the implications of the aggregate maturity pattern for the Exchequer. These arrangements would provide a more varied and flexible mix of maturities for individual industries' borrowing than the present rule (which is that all borrowing, except for a possible 20% tranche of medium term borrowing, should be for a maturity corresponding to asset life). The changes are compatible with the provisions of the National Loans Act, and, provided the maturity mix is agreed in advance, should not give rise to criticism that the industries were benefitting at the expense of the Exchequer. The consequential reduction in the industries' interest burden will not affec output, investment or price decisions which should continue to be determined by the pre-interest financial target and by the RRR.

13. For their part, the industries have agreed to improve the information which they provide to the Treasury and the Bank about the timing and amount of their borrowing from the National Loans Fund. They have also agreed to provide information for the first time about the expected borrowing of major industries from the banking system. The new arrangements are set out in Annex D. Improved forecasting should help the monetary authorities in their task of monetary control, with ultimate benefits in the form of more stable interest rates.

14. We have also told the Chairmen's Group that we shall be prepared to recommend legislation to enable variable rate loans for say 5 to 7 years to be made from the National Loans Fund, analogous to what many private companies are able to get from the banking system. This might be achieved by means of a provision in the 1981 Finance Bill although, since it would require a special procedure resolution, Treasury Ministers would clearly not wish to legislate unless there were a clear demand for a significant amount of such borrowing from the industries. This proposal was welcomed in principle by the NICG representatives.

15. Subject to Ministers' approval, discussions with individual industries could start immediately with a view to implementing the new arrangements at the beginning of 1981/82. We envisage that the extent of the industries' interest in variable rate loans would be established in the course of the discussion.

16. Finally, we offered without commitment to investigate further possibility that some industries might be permitted on occasion to issue stock in their own names in the market. We made it clear tha any arrangements of this sort would be subject to a number of restrictions ie

(a) the borrowing would count against the EFL;

(b) the stock would be issued without Government guarantees and without underwriting by the Bank of England; and

(c) the issue would be subject to the Bank of England's advice on timing.

The NICG have expressed interest in market borrowing on these terms and the question is to be considered further by the Treasury and Bank. One important point will be how far the advantages of the change to the industries will outweigh the additional cost to the public sector, which may well be criticised by the PAC.

Conclusions

17. We recommend that Ministers should approve the following changes in the arrangements for controlling and financing the nationalised industries, which would be welcomed by the Chairmen's Group.

(i) the proposed statement setting out the Government's approach to setting and operating EFLs, including provision for end-year flexibility to come into effect in 1981-82 which would allow industries to exceed the current year's EFL within limits on condition that a compensating deduction was made from the following year's EFL, as at Annex A;

(ii) the revised presentation of the industries in Tables 14 and 17 of the FSBR, on the lines of Annex B;

(iii) the proposed changes in the arrangements governing the maturity period of nationalised industry borrowing from the National Loans Fund based on moving towards an agreed maturity pattern on the balance sheet of individual industries as at Annex C;

(iv) improved arrangements for the provision of forward information on the industries' borrowing from the National Loans Fund and also, for major industries, information on their borrowing from the banking system, as at Annex D.

In addition, we shall report further in September on the question of market borrowing by the industries.

Appendix

NICG REPRESENTATIVES

Sir Francis Tombs	(Chairman, Electricity Council)
Mr J H Smith	(BGC, Chairman, NICG Finance Panel)
Mr R H Orson	(Electricity Council, Chairman, NICG Economic Panel)
Mr J Driscoll	(Director, NICG)

ANNEX A

EXTERNAL FINANCING LIMITS: DRAFT STATEMENT BY GOVERNMENT

This statement amplifies what the Government have already said about its approach to external financing limits (EFLs) for the nationalised industries as a basis for setting and operating EFLs in 1981/82.

General

2. EFLs are one element in the framework of financial discipline within which the Government wish the Boards and managements of the industries to be as free as is possible for public sector bodies, several of which are monopolies, to manage their business in a commercial way. The other main elements in the framework are medium-term financial targets; the annual review of investment and financing for 3 years ahead which should include demonstration that investment plans will meet the RRR; and performance aims for costs or standards of consumer service.

3. Nevertheless the Government regard EFLs as an essential instrument for controlling in the short term the amount which the nationalised industries contribute to public expenditure and the PSBR and for exerting pressure to prevent nationalised industry financing from accommodating unforeseen increases in pay or price inflation. It is a corollary of all forms of cash control that real reductions in expenditure or financing may be required if costs or prices rise faster than expected.

5. Like the previous administration, the Government's view is that since the nationalised industries are trading organisations with large flows of expenditure and revenue, the EFLs cannot be immutable; but that equally there can be no presumption that a financing deficit would be met, as happened before 1976, by a further injection of external finance. In other words, as their name implies, the EFLs are limits and the industries should take whatever measures are needed to stay within them, unless exceptionally the Government ask the industries not to take those measures in which case the limits will be increased appropriately.

Setting the limits

5. For most industries the EFL represents the difference between capital requirements and internal resources, but, in the case of industries with large cash flow revenue deficits before grant, the EFL represents the sum of capital requirements and that deficit. It will normally be set in the autumn of each year following the Investment and Financing Review for the subsequent Government financial year on the basis of up to date forecasts from the industrie It will be preceded by the fullest possible consultation with the industries.

6. The starting points for discussions of the main elements in the EFL should be derived from the medium term objectives and policies. In particular

(a) internal resources should be at the level implied by the financial target and the annual path to its achievement which has been agreed between industries and the Government; and

(b) the fixed investment element should normally not be less than the level given interim approval in the previous year but may be higher if the industry has demonstrated that a higher figure will earn the required rate of return (RRR), a condition which is not currently satisfied for all industries.

7. The process of setting the EFL will inevitably involve an element of judgement, particularly if the industry considers it will not be able to hold the agreed annual path for achieving its financial target. In that event the Government will need to take a decision on the extent to which the external finance should be sufficient to finance the propose investment programme in the light of an assessment of the reasons for the reduction in internal resources and of the case for the full investment programme. In addition it will have to take account, as the Chairmen's paper of 18 October 1979 recognised, of its own financial constraints.

8. The Government has accepted that the assumptions on which

[th]e EFLs are based should be recorded and notes the industries' wish to decide themselves after discussion with Departments what the assumptions should be. The assumptions should cover economic variables, sales volumes and costs including labour costs. The EFL should be a best estimat on the stated assumptions. It would also be useful, where this is not already done, to agree on sensitivities ie, on the effect of varying the macro assumptions by x%. These estimates clearly need to be based on firm evidence.

9. Once set, the EFLs for individual industries will be published by means of a Parliamentary announcement and ultimately included in the Public Expenditure White Paper and FSBR.

Administering the EFLs

10. It is the industries' responsibility to ensure by regular and up to date monitoring and forecasts and by taking early action that they can live within their limits. Where this involves major departure from the industries' medium term commercial interests or damage to explicit Government objectives, consultations will be needed.

11. If an industry's internal resources are lower or capital costs higher than assumed in setting the EFL, there will be no presumption that extra finance will be available to shelter nationalised industries from pressures that will also be affecting the private sector and its investment intentions. If economic circumstances differ significantly from assumptions made at the time the limits were fixed, the industries (or the Government) would be able to initiate consultations if keeping within the original limits raises issues of the kind described in paragraph 10 above. There would be no automatic adjustment of the EFL in such cases, but the Government accepts that in such cases an industry can reasonably expect the Government either

(i) to look for and accept the need for such industrial or commercial action by the industry as would enable it to stay within the original limit, or

(ii) if adequate corrective action cannot be taken, or is not acceptable to the Government, to adjust its external financing limit by an appropriate amount. In all such cases a decision would be taken on whether all or part of the adjustment should be deducted from the following year's EFL, in the light of the factors giving rise to the adjustment and of the scope for remedial action.

12. In some circumstances a combination of both courses might be appropriate. In reaching a decision the Government would need to weigh the overall macro-economic situation and the severity of comparable pressures on the private sector with the commercial interests of the industry in question, in particular its ability to achieve its medium-term financial target. Subject to the overall financial constraint, the Government would seek to avoid restricting profitable investment to an extent that would have a substantial adverse effect on the industry's ability to meet its target or impede desirable demanning schemes; to avoid forcing disruptive changes at short notice in investment programmes or price increases to a level above that required to meet the financial target in the next full financial year.

13. In recognition of the difficulties of fine-tuning an industry's financing requirements so as to keep within a particular figure on a particular day, increases in short term borrowing from the NLF at the end of a year would be allowed in excess of that year's EFL, within 1% of forecast turnover and fixed investment expenditure and on condition that the amount of the excess would be deducted from the following year's EFL. This arrangement would be intended to avoid disruption arising from short term factors, which would be self-correcting or which could be offset within a few months eg, the timing of particular payments, which can distort cash flows at the end of the year. This facility would be available in the last three months of the financial year subject only to clearance with Departments of the amounts involved. Adjustments of this nature with compensating deductions from next year's EFL under paragraph 11 would count against this facility.

Annex B

Revised section of Table 14 of FSBR

	1979-80		1980-81
	Budget forecast	Estimated outturn	Forecast
PUBLIC CORPORATIONS(1)			
Capital expenditure			
Gross domestic fixed capital formation	5,119	5,567	6,729
Increase in stocks	547	311	615
Total capital expenditure	5,666	5,878	7,344
Internally arising funds			
Gross trading surplus	6,052	5,827	7,089
Rent and other non-trading income	813	897	1,016
Interest and dividend payments to:			
General government	-2,008	-1,739	-2,023
Other	-857	-790	-580
Taxes on income	- 64	- 68	- 90
Total internal funds	3,936	3,927	5,412
Capital receipts from:			
General government	445	404	411
Other	70	101	92
Total available funds	4,451	4,432	5,915
EXCESS OF CAPITAL EXPENDITURE OVER AVAILABLE FUNDS	-1,215	-1,446	-1,429

(1) Further details for the nationalised industries are shown in Table 17, which is presented in terms closer to those of commercial accounts.

TABLE 17—*(continued)*. FINANCING OF CAPITAL REQUIREMENTS OF THE NATIONALISED INDUSTRIES(1)

B. 1980–81 Forecast

£ million

Nationalised industries	Capital requirements(2)			Financed by(3)							
				Internal Resources					External finance		
	Fixed assets in the U.K.	Other	Total	Current Cost Operating Profit	Interest(i), Dividends and Tax	Depreciation etc (3)	Other Receipts and Payments	Total internal resources	Government grants(4)	Net borrowing issues of PDC and leasing	Total(5)
National Coal Board	812	−18	794					−40	−253	581	834
Electricity (England and Wales)	961	335	1,296					1,109	6	181	187
North of Scotland Hydro-Electric Board ...	52	39	91					32	16	43	59
South of Scotland Electricity Board ...	131	17	148					75	—	73	73
British Gas Corporation	589	155	744					1,144	—	−400	−400
British National Oil Corporation	300	28	328					528	—	−200(6)	−200
British Steel Corporation	250	70(7)	320					−130	—	450(7)	450(7)
Post Office	1,541	139(8)	1,680					1,615	—	65(8)	65(8)
British Airways Board	390	3	393					163	—	230	230
British Airports Authority	99	—	99					79	1	19	20
British Railways Board	366	−110	256					−494	661	89	750
British Transport Docks Board	20	2	22					32	—	−10	−10
British Waterways Board	7	—	7					−23	26	4	30
National Freight Corporation	48	4	52					28	4	20	24
National Bus Company	71	2	73					−12	64	21	85
Scottish Transport Group	15	—	15					6	13	−4	9
British Shipbuilders	30	21	51					−69	38	82	120
Deduction for shortfall	−130	—	−130					—	—	−130	−130
TOTAL	5,552	637	6,239					4,043	1,082	1,114(9)	2,196

(1) No figures are included for British Aerospace in view of the assumption, subject to the passage of the British Aerospace Bill, of a sale of shares in a successor company in 1980–81.

(2) The capital value of leased assets is included.

(3) Including cost of sales adjustment, monetary working capital adjustment and other items not involving movement of funds.

(4) Shows subsidies and capital grants to be received in the year.

(5) Except in the case of BNOC, the figure shown against each industry is its external financing limit for the year.

(6) Includes BNOC's net payments into the National Oil Account.

(7) Excludes an amount to be brought forward from 1979–80 in respect of liabilities which the BSC have been unable to settle during the steel strike, currently estimated at £150 million.

(8) The PO figures will be adjusted when the final figure for the effect of the billing dispute is known. The latest estimated effect is −£360 million.

(9) Of which:

Government loans	...	600
Overseas borrowing	...	−35
Other domestic borrowing/lending	...	−260
PDC issues and other issues under Section 18 of the Iron and Steel Act 1975	...	650
Leasing	...	160

(i) The figure for interest alone is £ million.

ANNEX C

FN(WG)(80)4 Revise

NATIONALISED INDUSTRY FINANCING

WORKING GROUP WITH NICG REPRESENTATIVES

Maturity Period for NLF Lending

Note by HM Treasury

This revised note sets out the proposed future arrangements for determining the maturity period of Nationalised Industry borrowing from the National Loans Fund reflecting the discussion of the original pa at the Working Group's meeting on 26 June.

2. The essential changes envisaged are that:-

i. for the future the maturity period for a Nationalised Industry's drawings from the NLF should be determined by a view about what seemed an appropriate maturity pattern for its liabilities, rather than by the asset life criterion;

ii. provided there is sufficient demand to warrant making the necessary statutory change, medium term variable rate loans should be available to industries from the NLF.

These proposals are agreed, subject to Ministerial endorsement. However, one point referred to below, is to be the subject of further discussion in this Group, before the proposals are implemented.

Determination of the Desired Maturity Pattern

3. It is envisaged that proposals for the desired maturity pattern of the liabilities side of the balance sheet of each of the Nationalised Industries should be drawn up in the first instance by the Board concerned, and then agreed with the sponsor Department and the Treasury.

At the formative stages, it might, of course, be sensible for there to be informal discussions with officials before a proposalwas put to the Board. The aim of this determination would be to arrive at a broad pattern for the respective proportions within the liabilities side of:-

a. long term debt, ie with a maturity of more than 15 years;

b. medium term debt, ie with a maturity of 5-15 years;

and c. short term debt, ie with a maturity of up to 5 years.

4. The Treasury have suggested that it would be sensible to work in terms of residual maturity rather than original maturity. This would mean that, for example, a 20 year maturity loan borrowed in 1963 would now be classified as short term debt, since it is repayable in 1983. Also it would mean that "long term loans" repayable by annual instalment would be split between the categories from the outset. However some of the NICG representatives consider that this might be over-complicated, and would prefer to work on an original maturity basis. It is agreed that this will be studied further on the basis of some arithmetical examples.

5. In considering what should be the desired maturity pattern, it would of course be necessary to take into account the other items on the liabilities side - on the one hand PDC where it exists, and reserves and on the other temporary debt, including bank borrowing, trade credit and other short term borrowing. The decisions would clearly have to take into account:-

i. the nature of the business, and its time horizons;

ii. within that asset life, although this would no longer be applied automatically - some industries with very long term asset life would clearly want a debt structure which included significantly shorter debt, while other industries which had relatively short asset lives, might want debt with a longer term than their average asset life to reflect the fact that they were an on-going business;

iii. any known properties of the future pattern of cash flows;

iv. the extent of any variable interest debt which might be taken up - although its maturity of, say, 7 years might put it in the medium term category, the volatility of the interest charge would be the same as on short term debt, so that this would affect the proportions which might be appropriate on medium term and short term debt.

This list of considerations is illustrative, rather than exhaustive, and particular Boards may wish to take other considerations into account, and to suggest to the sponsor Department and the Treasury that it would be right to do so.

6. While the proportions of each type of debt, and the longest maturity in the "long dated" category would be suited to each industry, there would be a presumption that in every case there would be a reasonable spread between each type of debt. (The proportions which would be appropriate clearly depend on whether the classification were by original maturity or residual maturity.) In particular, it would seem desirable to avoid over-reacting to the present situation, in which most industrie have arguably too long a maturity pattern, to one in which most industries have too high a proportion of debt either short term, or temporary, which would expose them to the effects of sharp swings in interest rates.

Pattern of Future Borrowing

7. The second stage would be to agree the maturity mix to be applied to future borrowing (gross) from the National Loans Fund which would, over a period of years, bring the maturity pattern of oustanding borrowing on the balance sheet close to the desired pattern. The method of deriving this might start from considering the likely amount of outstanding debt on the balance sheet in 5 years time, consistent with the agreed investment plans and financial targets, and applying to this the desired proportions of different maturities. This could

then be compared with what the maturity pattern would then be of the debt now outstanding, in order to reach a view on the broad maturity pattern for borrowing over the next 5 years. This view would, however, not only have to take into account the desired change in the structure the industry's balance sheet, but also whether the resultant pattern seemed sensible both in relation to the industry, and an aggregate for the industries in relation to the Exchequer. For example, on the forme ground, it might not be sensible to exclude completely any long term element from new borrowing by an industry, even though the aim was to reduce over time the proportion of outstanding borrowing which was long term. The need to assess the overall implications of the resultant changes for the pattern of borrowing by the Nationalised Industries fro the Exchequer in the next few years would mean that the Treasury's agreement to the proposals from any one industry would have to be provisional, until such time as it was possible for the Treasury to look at the aggregate effect.

8. In some cases the conclusion from this exercise might be that the present maturity pattern for borrowing produces a sensible pattern of liabilities: in such a case the industry would presumably wish to propose to the sponsor Department and the Treasury that there should be no change in the pattern of borrowing.

9. In other cases, the expected scale of drawings from and repayments to the NLF might be such that it would not be possible to achieve the desired shift in the maturity pattern of outstanding debt in the foreseeable future. If it appeared that not correcting this would cause significant problems for the financial management of the industry, the Treasury would be prepared to consider a proposal for the premature repayment of some existing borrowing, and re-borrowing for a different maturity. Such repayments would have to be on the normal terms for premature repayments to the NLF, with a discount or premium reflecting any difference between the rate of interest on the outstanding loan and the corresponding rate then ruling.

10. Clearly, the new arrangements will have to be subject to review by both sides - the Government and the Nationalised Industries collectively

But subject to their proving generally satisfactory, the expectation would be that the view about the desired overall structure of the balanc sheet would not be varied until some fundamental change of circumstances whether in those of the industry, or of methods of financing, occurred to justify revision. On the other hand, the "mix" of new borrowing ought perhaps to be reviewed annually, shortly after the EFL had been set. It is not however envisaged that this would be "fine tuning" from year to year: a change would only be made if it became clear that it was necessary to achieve the desired shift in balance sheet pattern over a reasonable period.

11. Once the maturity pattern for new borrowing in a year was agreed, each tranche of borrowing from the NLF would normally contain maturities in accordance with that pattern, in a manner analogous to the present 20% arrangement. If however an industry gave 3 months notice that it wished a different mix for a particular drawing, that would be acceptabl subject to it being compatible with achieving the agreed mix for the year as a whole.

Variable Interest Loans

12. Treasury officials are prepared in principle to recommend to Ministers legislation to enable variable rate loans for, say, 5 or 7 years, to be made from the National Loans Fund. This could be achieved by means of a provision in the 1981 Finance Bill, although it would probably require a special procedure resolution. Treasury Ministers would clearly only wish to trouble the House with such legislation if there were a clear demand for such borrowing from the Nationalised Industries. It would therefore seem sensible for the review of the maturity pattern suggested above also to cover whether the industry would wish to include such medium term loans from the NLF in its financing. This would mean that by the turn of the year, Treasury Ministers would be able to assess the actual volume of demand for such loans from the industries, and to decide whether to take provision in next years Finance Bill.

Timing of Changes

13. It is suggested that the new arrangements should be introduced from the beginning of the next financial year, with, say, the determination of the proposals for each industry taking place between now and the turn of the calendar year, so that the Treasury could look at the aggregate results during January, and any adjustment required to the individual patterns could then be agreed by, say, the end of February. The introduction of variable rate loans would, of course, have to wait for enactment of the Finance Bill in the late summer.

HF GROUP
HM TREASURY
17 July 1980

ANNEX D

NN(WG)(80)3 (Revise)

NATIONALISED INDUSTRY FINANCING

WORKING GROUP WITH NICG REPRESENTATIVES

Improving Information Flows
Note by HM Treasury

This version of the Treasury paper has been revised to take account of the discussion of the original paper at the meeting on 26 June. It sets out the basis agreed then for improving the flow of information from the industries which would particularly help the monetary authorities in their task of monetary control, including both managing their own funding programme and their money market operations from day to day. One of the consequences of better information could be lower average interest rates for the public sector as a whole. It would be helpful for these purposes, to the Bank and Treasury both to have improved information about Nationalised Industries' intentions for drawings from the National Loans Fund and, for the first time, an indication of the likely pattern of changes in borrowing from the banking system under their temporary borrowing limits - whether by way of overdraft or otherwise.

The Present Arrangements

2. The Government and Bank base their decisions on monetary policy on three main groups of forecasts:-

i. the full National Income Forecasts carried out two or three times a year. These forecasts are used as a basis for the Budget judgement, the setting of monetary targets, the determination of fiscal policy, and for analysis of the main policy options;

ii. rolling quarterly forward looks at the prospects for the money supply. These are prepared as soon as some outturn information is available for one banking month to cover the current banking month and the two immediately following: these are used for the main day to day and week to week decisions on Government operations in the markets;

iii. the forward forecasts of Exchequer transactions. These are used for the purposes of the Bank's management of the money markets.

3. The information in respect of Nationalised Industries for the NIF is based on the information already provided by Nationalised Industries to the sponsor Departments and the Treasury in relation to financial targets, investment reviews, EFLs, and the monthly monitorin reports. Proposals for improving information in these rather different purposes are not considered further here.

4. The second forecast consists essentially of a systematic analysis of what information there is available to the Government about the likely variations from banking month to banking month in the main counterparts of £M3 - the CGBR, bank lending to the rest of the public sector, and to the private sector, etc. These forward looks are used as a basis first for assessing whether recent variations in the monthl money supply figures indicate a change in trend, which might require corrective action by the authorities, or whether they are likely to be reversed and of no significance. They are also used as a basis for tak a view of what pattern of gilt-edged sales would, if market conditions permitted it to be achieved, tend to produce a more even path for the future growth of the money supply. Finally, they can be used for the assessment of whether money market and reserve asset pressures are like to develop, and hence whether there is a case for calls or releases of special deposits etc.

5. At present, information about Nationalised Industries' borrowing from the National Loans Fund, which affects the CGBR, is derived from the information which they provide for a period of 7-8 weeks ahead, together with such indications as particular industries may have given

to Treasury Accounts Branch about drawings beyond that period. What we lack at the moment is information from Nationalised Industries about the likely pattern of their drawings from the banking system. This is particularly important for the £M3 forecast because this counterpart is both very volatile and of a size where it can significantly affect the accuracy of the forward looks. There have been several occasions during the last year when the changes from month to month have been greater tha £300 million, a figure comparable to the average fluctuations from month to month in the growth of £M3 as a whole.

6. For the third set of forecasts, the industries currently provide information for a period of 7-8 weeks ahead and, with the exception of one major industry these forecasts are reasonably accurate on both timin and amount. So, with that exception, for this purpose those forecasts suffice - the problem is that they do not systematically go forward far enough for the purpose of the 3 month forward looks.

The Agreed Proposals

7. It is therefore proposed that several amendments be made to the existing reporting procedure. One change would be to modify the existing arrangements for giving notice of intended borrowing from the NLF (and where appropriate, other loans and issues of PDC) so that the industries provide, on the last day of each calendar month, (or the first of the next month), forecasts for the 13 weeks ahead for borrowing from and repayments to the central government. As at present, these forecasts would indicate the day of drawing although, initially at least that would only be critical when the day was close to the end of a banking month (the third Wednesday of every month, except December when it is the second Wednesday). The present arrangement for a weekly updat would be continued, by industries notifying any changes in the forecast by midday each Wednesday. It would be helpful, where there was a change, some indication could be given of whether it merely reflected a change i the timing of the needs for central government finance, or whether it involved a change in the split between central government and other borrowing, or even a change in total borrowing. There would be no chang in the present arrangements whereby final commitment on timing and amount of funding would not be until 7-10 days before the event.

8. This extension of the existing arrangements in relation to borrowir from the central government would then be complemented by major industries providing on the same montnly timetable forecasts for the expected char in the level of their outstanding short term borrowing and of overseas borrowing in the then current banking month, and the two following banking months. Ideally, as explained above, the figures for short ter borrowing would identify separately what the take-up was likely to be from the banking system as a whole. But it is recognised that in pract it might only be feasible to provide forecasts of total temporary borrowing with a qualitative view about likely use of sources outside t banking system (including the public corporations and superannuation funds).

9. It is fully recognised that the forecasts would never provide a wholly accurate picture of future borrowing, since there are inevitabl large unpredictable variations from day to day. Indeed, for an individual industry, this "noise" in the statistics may totally swamp the size of the items which are predictable. But nevertheless the nois may well cancel out for the system as a whole and information about whether or not there are expected to be large month-to-month swings cou be of crucial importance in identifying in advance large potential movements in the money supply. It is suggested that, in the first instance, the information might be provided on a regular basis only by the industries which have the largest temporary borrowing facilities - Electricity, Gas, Coal, the Post Office, British Rail and British Airways, but with an understanding that other industries would provide information when they anticipated exceptionally large swings in either direction in their short term borrowing from the banking system - for example that might apply to the Regional Water Boards.

10. However, it would be helpful if the forecasts were accompanied by figures for the outturn for the banking month just completed, split by source of borrowing. It is suggested that those immediately concerned with the returns in the individual industries should confer directly wi statisticians in the Bank and HM Treasury (contact through Mr J Shields HM Treasury, 01-233-4700) at an early stage in the setting up of the reporting procedures so that the definitions of gross borrowing, and of the various categories etc are correctly aligned. It was agreed that t

industries concerned would, at the outset, provide past data (for a 12 month period) which would be a great help in matching any definition at the outset, and in establishing the relationship between the information provided by the major industries with that for the public corporations as a whole derived from banking sources.

Conclusion

11. These proposals derive essentially from what we at present see to be weaknesses in the present system: the Bank and Treasury are grateful to the Nationalised Industry representatives for agreeing to make these changes. It would clearly be sensible to review the arrangements after say, a year to see whether the information was proving helpful, to establish whether it justified the additional work involved in providing it, and whether the arrangements should be changed further, whether in the direction of more or less information.

HF GROUP
HM TREASURY
16 July 1980

Ref. A02575

Arat Ind

PRIME MINISTER

The Nationalised Industries: 1980 Investment and Financing Review
(E(80) 64)

BACKGROUND

The Chief Secretary's paper covers a report by officials summarising the main issues in the 1980 Investment and Financing Review. You do not need to look at the detailed annexes, which serve as a quarry for more detailed further work.

2. The Review is, as usual, presented separately from the main Public Expenditure Survey. It is the basis for three sets of decisions which will be taken between now and the Autumn:-

i. The aggregate external financing requirements borrowing and grants of the nationalised industries from 1981-82 to 1983-84 which form part of the public expenditure planning totals;

ii. the External Financing Limits (EFLs) for 1981-82 which will be negotiated and set in the Autumn with reference to the volume (1980 prices) figures determined in this exercise; and

iii. Approvals for capital investment commitments in the three years - NB. the capital investment, as distinct from the net financing requirement, is not an input to the public expenditure figures.

3. The provisional figures in the present review show a substantial and worrying increase over those assumed in the last Public Expenditure White Paper, Cmnd 7841. The details of the changes are set out in Table 2 on page 3 of the report by officials. In summary the position is:-

£ million 1980 Survey price.

	1981-82	1982-83	1983-84
Cmnd 7841	747	203	- 523
Now	1,220	619	77
Increase	+473	+416	+600

4. This deterioration arises for three main reasons:-

i. There are major uncertainties over the four loss-making industries - steel, shipbuilding, coal and rail. Pending reviews of these four to establish some realistic forecasts, these uncertainties cannot be resolved. But there is little doubt that the figures will be significantly worse than in Cmnd 7841 and, to cover this, credit is no longer taken for any of the £470 million shortfall allowance assumed for the nationalised industries in each year in the White Paper.

ii. In the other industries there are net changes with additional bids from the Post Office, the British Airports Authority and the British National Oil Corporation (low assumptions for North Sea oil output) and some offsetting reductions from electricity, airways and gas. But it is thought that the economic assumptions underlying these figures for these industries are on the optimistic side; and that reinforces the case for removing the £470 million annual shortfall provision.

iii. At the time of Cmnd 7841 it was assumed that British Aerospace would be privatised in 1980-81. Because of the current uncertainties over the timing of its flotation its external financing figures are now added back for each of the years - £108 million, £78 million, and £57 million respectively.

5. The Chief Secretary recommends that the Ministers concerned should bring forward papers as soon as possible on the four loss-makers. In the meantime he wishes to pursue the option cuts on the other industries set out in Table 3 on page 9 of the report by officials. These total:-

£ million 1980 Survey price

1981-82	1982-83	1983-84
317-517	415-640	547-762

In the highly unlikely event of all these savings being realised they would more than offset the increases shown in the table in paragraph 3 above.

Insofar as these increases are not offset there will have to be savings in the departmental programmes covered by the main PES report. In the meantime the Chief Secretary's paper on the 1980 PES (C(80) 40), which will be discussed by Cabinet on Thursday assumes that it will be necessary to offset no more than the loss of the £470 million shortfall.

6. As soon as the volume figures for 1981-82 are settled, in the light of the reviews of the loss-makers and of decisions on the option cuts on the rest, there will be a basis for moving on in September/October to discussions of the 1981-82 EFLs. But this is not a question which the Committee has to discuss at this stage.

7. It would be customary to let the industries know in the summer what levels of investment they could commit for the three years ahead; and to give 100 per cent approval of the 1981-82 figures. But it will not be possible to give firm decisions for 1981-82 investment until after the Recess when the option cuts and the EFLs will be settled. In the meantime they will have to make do with the 85 per cent approval given last year.

8. Departments are not satisfied about the cooperation given to them by the industries in this year's review and some proposals for improvements are in paragraphs 16-17 of the report by officials. The Chief Secretary asks for agreement to pursue these further.

HANDLING

9. After the Chief Secretary has introduced his paper I suggest that you deal first with the two general recommendations in paragraphs 7(a) and (b) of his cover note -

i. The commissioning of papers on the four loss-makers
The Secretary of State for Industry should undertake to report in September on steel and shipbuilding. He cannot do so any earlier because on both he needs the advice of the new Chairmen. The Secretary of State for Energy should be invited to put in a paper on

coal to E before the Recess; provisionally we have earmarked time for a meeting in the week beginning 21 July. The Minister of Transport should also report on rail, if possible before the Recess and at the latest in September. You might stress that it is extremely important to get on with these four reviews in order to get a clearer picture of the sums at stake, since these have a major impact on the main PES exercise.

ii. Improved arrangements for future reviews

Paragraphs 16-17 in the Report by Officials set out some ideas for improving the assessment of investment. There is no need to spend time at this meeting in discussing them. I suggest that you invite the Committee to agree that the possibilities for improvement should be pursued, and that the industries should be pressed to give their full cooperation. Insofar as this work needs to be monitored and discussed further, this could be done in the Chancellor of the Exchequer's ENF Sub-Committee.

10. You might then turn to the other industries and use table 3 on page 9 of the Report by Officials, which lists option cuts, as an annotated agenda. You might group the industries by their sponsoring Ministers. They can then in turn make any general points they wish on their industries, and either accept the cuts or agree to further discussions with the Chief Secretary on the basis, where necessary, of papers they would put to him in the first instance. The Committee might then invite the Chief Secretary to put in a further paper in September reporting those cuts which have been agreed and any outstanding issues which need to be resolved. Where the latter involve major policy questions the sponsoring Minister concerned should be ready to put in a paper himself.

11. I suggest that so far as possible the Committee should keep in play most, if not all, of the options. At the end of the day it may not be necessary to use them all. But in the meantime the possibility remains that further work on the loss-makers will reveal even greater increases than at present assumed. Sponsoring Ministers may argue that the investment of nationalised industries is different from that of Government Departments

in that it is commercial in character. There is some force in this. But the fact is that the borrowing of the nationalised industries is a part of the public expenditure planning total; and not all of their investment is commercially imperative. Private sector industry is subject to squeezes too and they have to sort out their priorities. Against this background you might then turn to the table of option cuts and to the sponsoring Ministers.

Secretary of State for Energy

12. For electricity and gas the assumption is that the industries will stick to the financial targets now set and make the associated price increases. There are two qualifications to this. Under Option 1(a) it is proposed that credit should be taken for real increases in tariffs after the present financial target expires in 1982-83. Under Option 3(a) industrial gas would be charged at full oil-related prices; though this would take BGC over their financial target and would bear hard on industrial costs.

13. The other energy cuts are on investment. Those on electricity - 1(b) and (c) - are relatively modest and should be negotiable. The Secretary of State for Scotland will wish to comment on the Scottish electricity cut. The investment cuts for BGC, involving the deferment of the development of the Morecambe Bay gas-field, and of BNOC investment are more contentious and the Secretary of State may want to bring forward papers on these possibilities following bilateral discussions with the Chief Secretary.

The Secretary of State for Industry

14. The Telecommunications options can be left for discussion under item 3 of the agenda when the Committee will be looking at the Secretary of State for Industry's separate paper (E(80) 65). The cuts on postal investment - option 8(c) - would affect postal mechanisation but should be manageable.

15. The British Aerospace figures are relevant only if flotation is delayed beyond 1980-81. Ministers could argue that these figures should not be in at all. The Chief Secretary can comment on this. But whatever view is taken of British Aerospace, the overall uncertainties on the nationalised industries' figures are such that it would be unwise at this stage to aim for a lower total of cuts on the grounds that British Aerospace could be excluded.

Secretary of State for Trade

16. The Secretary of State is in Nigeria and is represented by Mr Tebbit. He may argue that, if British Airways is to be privatised, there is no need for the Government to be concerned about cuts in its investment - option 6. The Chief Secretary will argue that there is scope for ordering fewer (American) aircraft; and that less forward capital commitments will make the Corporation a more saleable proposition.

17. A miscellany of cuts are proposed for British Airports - option 7. These are in line with cuts proposed in the main PES report for activities by the Civil Aviation Authority.

Minister of Transport

18. The cuts for buses and the Docks Board - options 8(a) and (b) - are relatively small. But those for buses could lead to increases in fares above those now assumed.

CONCLUSIONS

19. In the light of the discussion you will wish to record conclusions:-

i. Commissioning from the Ministers concerned papers on the four loss-makers, in July if possible for coal and rail and in September for steel and shipbuilding.

ii. Approving the review of the arrangements for future dealings with the industries, as in paragraph 16-17 of the report by officials, and leaving ENF to deal with any follow-up work.

iii. Recording those option cuts agreed at the meeting.

iv. Recording those option cuts to be pursued in the first instance in bilateral meetings between the Chief Secretary and the sponsoring Ministers, and inviting the Chief Secretary to report back in September on the outcome, and the sponsoring Ministers to put in papers on particular items where necessary.

In the meantime the industries will not be given new investment approvals for 1981-82 and the volume figures for borrowing will not be set until September when they will form the basis for further work on the EFLs.

RA

ROBERT ARMSTRONG

8 July 1980

CONFIDENTIAL

Qa 05071

To: MR LANKESTER

From: J R IBBS

The Nationalised Industries: 1980 Investment and Financing Review (E(80)64)

1. The Chief Secretary's memorandum urges his colleagues to adopt now major cuts to the investment programmes of the profitable nationalised industries. He adds that if, in the event, these cuts are not required to offset overspending by the loss-makers, the savings could be used to reduce the burden on other public expenditure programmes. The CPRS questions this ordering of priorities, particularly as information is incomplete.

2. We have consistently supported the need to take a tough line with any industry that is in prospective breach of its EFL. And a tough line is particularly essential when dealing with the four loss-makers - steel, coal, rail and shipbuilding. But we do question whether, save in quite exceptional circumstances, it is right to impose cuts in strategic profitable investment by the wealth-creating nationalised industries when most of them are not in prospective breach of the borrowing requirements assumed in the Public Expenditure White Paper (Cmnd 7841).

3. These profitable industries are not at the heart of the Chief Secretary's problem. The Review itself shows that broadly speaking the fourteen profit-makers should observe their Cmnd 7841 limits in 1981/82 and 1982/83 (after a collective overspend of only £3m. in 1981/82, they are expected to be £54m. below their collective limit for 1982/83). The need to find additional savings has instead been brought on largely by:

(i) overspending by the four loss-makers. Their combined overspend will be well in excess of £½ bn. this year;

(ii) absence of the standard shortfall which the Treasury were counting on for 1981/82 and beyond at the rate of nearly £½ bn. a year. The Cmnd 7841 figures have been set too tightly for this to materialise.

4. At least £$\frac{1}{2}$ bn. a year has to be found from somewhere. But is a squeeze on profitable investment the correct response? The CPRS is concerned that the Chief Secretary's list of option cuts could, if accepted:

(i) prejudice the longer term health of profitable state industries by removing strategic items from their programmes, and also injure their private sector suppliers whose own health is just as important to the economy;

(ii) undermine the discipline of the EFL system by cutting deeper into investment programmes of those industries who are actually observing the rules and look like keeping within the figures for which provision was made in Cmnd 7841. This would merely invite them to build in fat in future years.

5. Ministers must be satisfied that there is no less damaging alternative. The CPRS would ask:

(i) Is it time to break the ring fence around nationalised industries? At present the Treasury tries to ensure that overspending by some of the nationalised industries is offset by underspending by others, i.e. the industries are in competition with each other for funds, but far less so with other public expenditure programmes. There may be other programmes from whom savings may cause less enduring damage to the economy as a whole. Perhaps strategic profitable investment in the nationalised industries should rank higher than other sectors of public expenditure?

(ii) Could the nationalised industries find less damaging sources of improving their cash position? If it is essential for the nationalised industries to be treated in isolation, the revenue-raising alternatives to investment curbs may deserve a more thorough examination. For example, there must be opportunities for further reductions in costs and working capital. Also, prices that temporarily exceed the economic level or that would result in financial targets being exceeded might have a less lasting and less injurious impact on the economy. Have such possibilities been adequately examined by the Treasury?

6. <u>Conclusion</u>. In our view, cuts to strategic profitable investment by wealth-creating industries should be among the savings of last resort. We believe that alternatives should be explored further before agreement is given to the Chief Secretary's list of option cuts.

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

JRJ.

8 July 1980

Nat Ind.
~~2 file~~ TL(OR)

CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

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

R
27/5

27 May 1980

Dear Secretary of State

BGC: EXTERNAL FINANCING LIMIT 1980-81

I understand that early in March BGC informed your Department that they foresaw a prospective excess in their EFL of around £110 million, and that this is still their view.

I know that you have had a word with Geoffrey Howe about this and we both recognise that there will be difficult decisions in dealing with this excess. But I am sure that we ought to bring matters to a conclusion quickly since as time goes by, our freedom of manoeuvre for tackling the excess is reducing. Could I therefore ask that you should bring forward proposals, just as you did for the electricity industry, so that we can come to decisions very early in June.

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

Yours sincerely

R. Watts

PP JOHN BIFFEN

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

21 MAY 1980
21 MAY 1980

X (OR)

R

27/5

Treasury Chambers, Parliament Street, SW1P 3AG

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

22 May 1980

Dear Secretary of State

will report if required.

NCB EXTERNAL FINANCING LIMIT 1980-81

Thank you for your letter of 19 May about the prospect of the NCB keeping within their EFL for this financial year.

I am glad to know that the Board's whole internal budgetary and financial control system is being directed to living within their EFL and that they have identified, on a contingency basis, four main courses of action which they could take if they seemed to be in danger of exceeding their limit. In view of this I am content to await your further report on their EFL at the beginning of July.

I have noted your comments about pit closures and I certainly agree that we do not want to be saddled with the public responsibility for them. But I do not think that we can avoid the fact that closures have the twofold advantage of saving public expenditure at least in the medium term (because of lower stocks and losses) and improving the Board's profitability. In other words, if the Board has a public expenditure problem through excess stocks, pit closures are the obvious means of tackling it over the medium term, rather than by their increasing prices (with obvious consequences for the electricity consumer) or by taking action to cut costs which reduces productivity.

I am sending a copy of this letter to Members of E Committee and to Sir Robert Armstrong.

Yours sincerely

R. Watts

pp JOHN BIFFEN

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

COVERING COMPANY IN CONFIDENCE

01-828 7777

Henry L. James C.B.

Vickers House,
Millbank Tower,
Millbank,
London, SW1P 4RA.

23 April 1980

Dear Tim

I mentioned to you the other evening - and in passing to the Prime Minister - that I have had to draft a critical contribution to the forthcoming statement by my Chairman (on 3 June in the Annual Report and Accounts) on the vexed question of compensation for nationalised businesses.

In courtesy I have sent a copy of this to the Secretary of State for Industry, and I thought you might like to see it.

With best wishes.

Tim Lankester Esq
10 Downing Street
London SW1

25 APR [illegible]

. . . .

The cost of borrowing was greatly increased. This reflects both higher rates of interest and the absence of further significant payments on account, or agreement of compensation, for our shipbuilding and aircraft businesses, which were nationalised three years ago.

. . . .

COMMERCIAL IN CONFIDENCE

THE NATIONALISED BUSINESSES

Last year Lord Robens wrote, "It is regrettable that I have had to make this a central theme of my statement for five consecutive years". I had hoped that matters would have been substantially settled by this time. Unfortunately it remains a central issue in determining the future course of the Company, and I have to report another frustrating year.

It will be remembered that at vesting dates, the shipbuilding and aircraft activities accounted for rather more than half our profits and a substantial part of the capital employed. In addition, of course, we lost important and leading positions in major technologies. Nationalisation disturbed the balance of the Company and left us to support both the equity and borrowings of the whole business until such time as compensation had been received and deployed to create new earnings to replace those lost.

Furthermore, doubts have emerged as to whether "fair" compensation, repeatedly promised by members of both Houses of Parliament, will in fact be paid. This has inevitably led to an uncertain stock market price effectively barring the Company from raising new equity to finance growth and development during a period of high inflation.

Stockholders who attended the Annual General Meeting in 1978 may recall that Lord Robens explained that we had, in anticipation of substantial compensation, borrowed heavily in order to ensure the extension and rebuilding of existing businesses, the maintenance and replacement of existing plant, and the acquisition of new businesses and technology. In the event, during 1978 and 1979 we had to curtail this programme in the absence of reasonable compensation and there was growing uncertainty on the timing of receipt. The Company has therefore been through periods of 'Stop', 'Go', then 'Stop' again, with relatively high borrowings at a time when interest rates have been very high, indeed much higher than the effective interest rate which will apply to compensation when agreed and paid.

During the year under review, we received the Government's final offer for our shipbuilding interests. Our Stockholders' Representative felt unable to recommend this offer to the Board and the Board equally felt unwillin to recommend it to Stockholders. We therefore decided that we must refer the matter to arbitration. Subsequently, in March 1980, the Government made a further progress payment of £3.15 million. Unfortunately, the time taken in arranging for the process of arbitration even to begin has, in our opinion, already been unreasonably long. More than seven months have gone by since the referral and no date has yet been set by the Government for a hearing.

When the present Government came to power last May, it seemed reasonable to suppose that there might be a short delay before an offer was made for our aircraft interests. We did ask the Secretary of State to consider legislation to change the method of determining compensation, to provide as an alternative the valuation of the businesses at the date of vesting. The Secretary of State advised us that, whilst he recognised that the existing provisions dealt extremely harshly with the Company, he was unwilling to promote new legislation and felt that he had no alternative but to implement the existing Act.

In these circumstances, we had reason to expect the Government's offer of compensation for our aircraft interests by the end of 1979, but it is still awaited. Naturally we very much hope that an acceptable offer will be made soon and that the matter can be quickly concluded. It cannot be too strongly emphasised that, even during the life of this Government, the value of any settlement has already been devalued as a result of inflation by more than 20%.

In the case of our aircraft interests it must be bluntly stated that the payments on account are completely unsatisfactory.

The Government took office with this undertaking: "We will offer to sell back to private ownership the recently nationalised aerospace and shipbuilding concerns, giving their employees the opportunity to purchase shares."

COMMERCIAL IN CONFIDENCE

COMMERCIAL IN CONFIDENCE

To implement this policy, the Government was proposing to market shares in British Aerospace. We were concerned that the Government might find itself in the position of offering to sell to the public and institutions, shares in British Aerospace before compensation has been paid to its former owners whose shareholders are likely to be much the same groups and institutions who would be offered the new shares. It is now known that the Government's proposals have been deferred, at least until the Autumn, and we hope that this situation will be avoided.

This saga, which must surely be unique, has been very damaging to the stockholders of Vickers Limited. What is not always recognised, however, is the extent of the damage to our ongoing businesses, not only because of financial uncertainties, but through the loss of opportunities for internal group trading. Thus, job opportunities and future prospects have both been diminished and put at risk. It has absorbed an immense amount of time and energy among our senior executives and professional advisers.

Our accounts have been distorted and profits diminished by some millions of pounds in each of the last three years because we have not yet been fully compensated.

In addition to the damaging effects I have mentioned - uncertainty, continuing devaluation of any finally agreed settlement, and the need to borrow money at higher interest rates than those attached to a settlement - we have also to bear in mind that we are apparently to be offered simple rather than compound interest on the very large sums withheld.

We can only urge the Government to use its powers to act quickly in bringing forward an acceptable offer for our erstwhile aircraft activities and in speeding the process of arbitration of our shipbuilding interests.

Nat Ind

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

21 March 1980

21/3

The Rt. Hon. Sir Keith Joseph Bt., MP.

Dear Keith

EXTERNAL FINANCING LIMITS FOR NATIONALISED INDUSTRIES 1980/81

will repeat if required.

Thank you for your reply to my letter of 13 February. You will have seen the replies from other colleagues setting our the position in the industries for which they are responsible and the steps they are taking to improve the prospects of keeping within the external financing limits set last November.

The 1980/81 limits will be published next week in the Public Expenditure White Paper and FSBR. I recognise that there will be difficulties for a number of industries. But we must do all we can to keep industries to the agreed figures.

The only current proposal to increase a 1980/81 EFL is in respect of the STG to accommodate the increased grant to the ferry services announced by George Younger in February. I am asking John Biffen to consider separately with George the timing of any announcement of this.

Both you and David Howell raised the point that the risks of excesses in 1980/81 had been increased by our decisions to set the limits earlier than in previous years in order to influence pay negotiations. I am very conscious of these problems and we will be looking at them in the work now in hand on the arrangements for operating the external financing limit system.

I am copying this letter to the Prime Minister, the Secretaries of State for the Environment, Scotland, Trade and Energy, the Minister of Transport and Sir Robert Armstrong.

Geoffrey

GEOFFREY HOWE

21 MAR 1980

Nat Ind

DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

MINISTER OF TRANSPORT

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

19 March 1980

Dear John.

R 20/3

BRITISH RAILWAYS BOARD (BRB)
EXTERNAL FINANCING LIMIT 1979/80

Thank you for your letter of 13 March.

I have, as you know, impressed on the Board the importance of keeping within their external financing limit for the current year. The economies which I mentioned in my letter of 11 March to Geoffrey Howe show that they are making every effort to do so. They have sought to minimise the effect of the steel strike on their finances by reducing the resources employed on this part of the freight business and by careful cash management.

I will press the Board again, but there are clearly limits to what they can properly do at this stage in the year, and I cannot rule out the possibility that they will overshoot by a small amount. I am, as you know, about to embark on discussions with Peter Parker about the Board's Corporate Review; and Nigel Lawson and I will be stressing the importance of holding the external financing limit for 1980/81.

Copies of this letter go to the recipients of yours.

Yours ever
Norman

NORMAN FOWLER

20 MAR 1980

ccAD

Nat Ind : Policy Pt2

with Tim
2pp's

CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

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

13/3

13 March 1980

Dear Norman,

BRITISH RAILWAYS BOARD (BRB) EXTERNAL FINANCING LIMIT 1979/80

In your letter of 11 March to Geoffrey Howe about the external financing limits for 1980/81 for the four nationalised transport industries, you proposed that the British Railways Board should be allowed to breach its 1979/80 external financing limit by up to £10 million on account of the steel strike and that the Board should be told that we were not, certainly not at this stage, prepared to consider any adjustments to the 1980/81 external financing limit.

I quite agree that we should give the Board no indication that we would be prepared to increase their 1980/81 limit to accommodate the effects of the steel strike.

So far as 1979/80 is concerned, I recognise that there is a balance of argument here and that the Board have already taken a number of unpalatable steps to keep within their limit. But the size of the 1979/80 problem suggests that it could be accommodated by deferring payment and that with a full 12 months in which to make the adjustment the extra £10-£12 million falling on 1980/81 would be manageable. You say that were it not for the current BSC strike there would be no reason why the 1980/81 external financing limit should not be met.

In these circumstances I think that we should do all we can to avoid another breach this year. Even if we were to adopt your proposal that there should be no formal adjustment of the limit now, I do not think that we could avoid a statement at a later date about the size of the breach and our attitude towards it. This could not but have damaging effects on the authority of the external finance limit system. I hope therefore that you will agree that the Board should be pressed to take all possible steps to keep within their 1979/80 external financing limit.

I am sending copies of this letter to the Prime Minister, the Secretaries of State for the Departments of Industry, Trade, Energy, Scotland and the Environment and to Sir Robert Armstrong.

Yours

John Biffen

JOHN BIFFEN

14 MAR 1980

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

2

MO

Prime Minister
To note.
T
11/3

PRIME MINISTER

NATIONALISED INDUSTRIES FINANCES 1979/80:
CLAIM ON THE CONTINGENCY RESERVE

Following the procedure described in C(79)4, this minute reports to you and other colleagues a substantial claim on the Contingency Reserve this year (1979-80) of £136m at 1979 Survey prices. It arises from increased net borrowing by the nationalised industries as a result of the decisions to increase the Post Office and Electricity Council external financing limits in 1979/80.

2. Although its precise size remains uncertain, the Post Office breach attributable to the billing dispute is currently put at about £360m (at outturn prices). The Secretary of State for Industry announced last October that the Post Office external financing limit for 1979/80 would be increased and that for 1980/81 reduced by whatever the backlog finally proved to be. In addition it has been agreed that the Electricity Council's external financing limit for 1979/80 should be increased by £300m (also at outturn prices). Our best estimate is that the remaining industries should be able to keep within their 1979/80 limits, although the position of some other industries will remain difficult.

3. Because of the inevitable fluctuations in the needs of individual industries, the public expenditure provision for lending to them is normally looked at as a whole. This means that the size of the claim on the Reserve depends not only on the size of the increases in the external financing limit described above but also on the extent to which such increases can be offset by shortfalls in other industries. The figure of £136m takes account of likely shortfall in other industries, notably in BNOC and BSC, due to its inability as a result of the strike to pay 1979/80 bills worth about £150m until 1980/81.

4. Taking all these factors into account, a claim of about £136m seems inevitable and the forthcoming White Paper reflects this. It leaves a balance in the Reserve of £84 million, which is less than I hoped but is sustainable.

5. I am sending a copy of this minute to the other members of Cabinet, the Minister of Transport and to Sir R. Armstrong.

(G.H.)

11 March 1980

11 MAR 1960

LH

SECRETARY OF STATE FOR THE ENVIRONMENT

2 MARSHAM STREET
LONDON SW1P 3EB

My ref: H/PSO/11408/80

Your ref:

10 March 1980

Dear Geoffrey

EXTERNAL FINANCING LIMITS FOR NATIONALISED INDUSTRIES 1980/81

I received a copy of your letter of 13 February to Keith Joseph. It may be helpful to explain how matters stand with the water industry. There is no need, however, for any special action of the kind your letter asks us to consider before the start of the financial year.

The water authorities' external financing limit for 1980/81 will be extremely tight for two reasons (i) increases in the cost of capital works since the limit was set, and (ii) the effect of the current pay round. Their charges are set once a year and those for 1980/81 have been determined.

The EFL of £395 million was based on a 35% repricing factor to convert approved capital programmes from 1979 Survey Prices to 1980/81 out-turn prices. However the latest available figures suggest that the factor will be of the order of 43%. This means that capital programmes will have to be cut back overall by between £30m and £40m at out-turn prices. The authorities are aware of the latest movement in the repricing index, and my officials will ensure that the implications of these movements are borne in mind when control budgets, against which authorities' performance during 1980/81 will be monitored, are drawn up.

The second factor which must give cause for concern is the effect of the current wages round. The EFL was based on a 13% year on year wages increase, and the water authorities have used a figure of 17% in drawing up their revenue budgets for 1980/81. However the actual settlement figure will clearly be well in excess of this which means that authorities will have to bridge the gap by increased efficiency, lower standards of service to the consumer or further reductions in capital programmes.

Tom King has already made it clear to the industry that the EFL will not be relaxed to accommodate the wages settlement, and that we are looking to all authorities to achieve significant improvements in efficiency in 1980/81, particularly in regard to the use of manpower. He will be stressing this in a series of meetings he is arranging with individual water authority chairmen over the next month or so.

I entirely accept your point about the importance of efficient monitoring. The position on this is that each authority is required to submit a monthly return showing in detail their actual budget position to date plus a forecast of the year-end position. This allows my officials to ensure that authorities do not set a course which would cause them to breach their EFL, and should the need arise, authorities are asked to take appropriate corrective action to ensure that this does not happen.

I am copying this letter to the Prime Minister, the Secretaries of State for Industry, Scotland, Trade and Energy, to the Minister of Transport and to Sir Robert Armstrong.

Yours ever

Michael

MICHAEL HESELTINE

The Rt Hon Sir Geoffrey Howe QC MP

11 MAR 1980

JH

CONFIDENTIAL

Nat Ind

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

Secretary of State for Industry

10 March 1980

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
London SW1

Dear Geoffrey,

EXTERNAL FINANCING LIMITS FOR NATIONALISED INDUSTRIES 1980/81

Thank you for your letter of 13 February. I fully agree with you that we must bend every effort to ensuring that our savings in public expenditure are not put at risk by large excesses in nationalised industry EFLs in 1980/81.

As you recognise steel is a case of particular difficulty and I shall need to keep in touch with you separately on that.

I foresee no problem with British Aerospace, in what I hope is the unlikely event of the flotation not proceeding as planned. Nevertheless I have asked the Chairman to let me know before any pay offer is made that could put the contingency EFL for 1980/81 at risk.

The tough attitude we have taken with the Post Office since this year's problem first became apparent has, I believe, made their management much more alive to the importance we as a Government attach to EFLs. In fact we have been grappling with the Post Office's threatened excess since July; it was not, therefore, a case of an excess only emerging late in the year, as your letter suggests. The problem was initially to persuade management that the Government was in earnest in holding the corporation to its limit despite the highly unpalatable and commercially undesirable tariff measures involved. I shall of course continue to impress the message on Sir William Barlow for next year. I have already written to him to say that if he considers that the pay assumptions in his September forecasts underlying his external financing limit are likely to prove optimistic, he must prepare contingency measures to enable him to stay within the limit including in the last resort the possibility of further tariff increases.

Barlow continues to maintain that the £65m limit we set him is not adequate for his requirements, in particular for the telecommunications investment programme, in which he has already

/had ...

had to make cuts of at least £125m. The main risk we run is, as before, that pay settlements or the cost of a pay dispute will be such as to require tariff increases before the end of calendar 1980, which would be strongly resisted by Barlow on commercial grounds. The prospects for the pay negotiations are not yet clear and I will discuss them with Barlow when I next see him in a week or two.

The PO's current problems in budgeting to meet next year's EFL lead me to feel, like David Howell, that we may need to review the timetable for fixing these limits, though there are still strong grounds for setting them earlier than used to be the case. The September investment assumptions on which the PO's limit for 1980/81 was fixed were based on the investment review they carried out in November 1978. Now that the PO have the results of their November 1979 review forecasting investment requirements some £180m higher, it is quite clear that they will have the utmost difficulty in budgeting to meet their limit even before taking account of changes in other assumptions like pay, GDP and inflation generally. If I am to succeed in holding the management fully committed to achieving the £65m limit it is therefore very important that we should not be seen to be making exceptions too readily in other cases. I have electricity particularly in mind.

British Shipbuilders' (BS) limit for 1980/81 is at risk despite the low pay settlement which should be broadly self-financing but at this stage we are not able to assess the probable outcome. There are major uncertainties not least on orders, including naval orders. BS is also vulnerable to the steel strike which is beginning to bite.

The risk of having to draw on the £30m set aside for closures over and above their present strategy appears to be diminishing to some extent, since the major yards all have work until at least the autumn but I would not rule out the possibility of some further contraction after that since BS's intake of orders at present is both insufficient and expensive. However the timing of further contraction is speculative and when we have a new Chairman for the Corporation he will no doubt have views on BS' strategy.

I agree with you about the importance of efficient monitoring and we will be giving this the highest priority.

I am copying this letter to the Prime Minister and other recipients of your letter.

Yours ever, Keith.

CONFIDENTIAL

MS

Nat Ind

10 DOWNING STREET

From the Private Secretary

6 March 1980

Previous correspondence filed on:
NAT IND : BSC : Pt 5
and NAT IND : El + Gas : Sept 79

Nationalised Industries' EFLs for 1979-80 and 1980-81

The Prime Minister has now considered the Chief Secretary's minute of 4 March on the above subject; she has also read the letter of 29 February from the Secretary of State for Energy, and the letter of 4 March from the Secretary of State for Industry.

The Prime Minister agrees with the Secretary of State for Industry's proposal for transferring £150 million of BSC's EFL for 1979-80 to 1980-81, which the Chief Secretary has endorsed. She also agrees with the arrangement proposed by the Chief Secretary for the electricity industry's EFL for 1979-80, and she agrees that the present EFL for 1980-81 of £187 million should now be accepted and confirmed in the Public Expenditure White Paper. However, she does not think it would be right at this stage necessarily to accept that the only way of living within the 1980-81 EFL is to put up electricity prices by 10% in July. Instead, she would like the Secretary of State for Energy to bring a full paper to E Committee with recommendations on the ways in which the industry might stick to its EFL. This paper should look at all the options, including the possibility that working capital requirements might be lower next year on the assumption that it may not be necessary to spend so much on building up fuel stocks as in 1979-80 and it should be ready for discussion in E Committee immediately after the Easter Recess.

I am sending copies of this letter to the Private Secretaries to the members of E Committee, Godfrey Robson (Scottish Office) and David Wright (Cabinet Office).

T. P. LANKESTER

A.C. Pirie, Esq.,
Chief Secretary's Office.

CONFIDENTIAL

cc A Arguird CONFIDENTIAL

DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

MINISTER OF TRANSPORT

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

11 March 1980

Dear Geoffrey.

NATIONALISED INDUSTRIES EXTERNAL FINANCING LIMITS 1980/81

As requested in your letter of ~~13~~ 14 February to Keith Joseph, I have now reviewed the external financing limits for 1980/81 for the four nationalised transport industries.

So far as I can judge the position at present I am reasonably confident that there should be no problem with NFC and BTDB. NFC have already adjusted their capital investment plans by postponing £6m worth of investment from 1980, to take account of the most recent economic forecasts. They have completed their pay negotiations for this round, and, as a comparatively small part of a large industry, they tend to follow the general lead both in pay and pricing. I think they should have sufficient room for manoeuvre if economic prospects were to deteriorate further. In the case of BTDB, the most immediate effect of a recession is likely to be a reduction in their capital investment plans (as happened in 1979/80) since all their major projects are based on firm contracts with customers. If the BSC strike were prolonged

CONFIDENTIAL

this might start to pose problems for the Board but they should manage, by deferring a certain amount of work, to stay within the 1979/80 limit and I hope they should be able to do so similarly, if need be, in 1980/81.

For NBC the picture is less clear. Although they have now negotiated their main pay settlement, there is still uncertainty over future levels of local authority revenue support. On the other hand you will recall that when we decided to set the EFL for 1980/81 at £85m we explicitly took account of the deteriorating economic outlook at the time, and the company themselves still expect that they will be able to meet it. If their trading position begins to look worse than expected they have some opportunity to recover through a further fares increase in the summer.

This brings me to BRB. As with NBC, we explicitly took account of deteriorating economic prospects when we agreed their EFL of £750m. Their pay settlement is towards the end of the pay round, and so long as the steel strike continues it is difficult to forecast the likely outcome. There is at present no provision for a second passenger fare increase during 1980, so the possibility of this should provide some scope for recovery, if wage and other costs turn out worse than those forecast in the Budget. Were it not therefore for the current BSC strike I would say that there seems no reason why the 1980/81 EFL should not be met.

The strike however is causing problems. The Board's latest estimate is that assuming that the strike lasts until 24 March and then ceases, they will suffer a net cash shortfall of £11m in 1979/80 and a further £9m in 1980/81. (The latter figure takes account of additional traffic expected to arise following the end of the strike). If the strike continues up to the end of March, the effect in 1979/80 would be £12m.

The Board have a good record of keeping within cash limits, and indeed you will recall that they took special steps earlier this year to stay within the 1979/80 limit. These included a decision not to purchase an additional ship, the deferment of some track relaying, the postponement of certain pay increases to staff and a temporary ban on recruitment. These measures save £19m, which would have been sufficient, with careful cash management, to enable them to hold the EFL. But there is no room for them to meet the extra net cash loss resulting from the steel strike, particularly at this late stage in the year, within the financing limit.

We have always made clear that nationalised industry EFLs, being the difference between two very much larger sums, cannot be regarded as immutable, and that when some unforeseen contingency arises, outside the control of the industry, this ought to be taken into account. What I would therefore propose is that we should tell the Board that, on account of the steel strike, we would be prepared to see them overshoot their EFL for 1979/80 by up to £10m, but that we are not, certainly at this stage, prepared to consider any adjustments to the 1980/81 EFL. I would propose to make this clear in my forthcoming talks with the Chairman. But I do not think it would be either reasonable or sensible to force them to carry forward the cost in 1979/80 into the succeeding year. I would not propose formally to adjust the 1979/80 EFL, but simply to tell the Board that an overshoot of up to £10m can be accepted.

CONFIDENTIAL

Your letter also raises the question of monitoring the industries' financial performance. I am satisfied that my Department's arrangements are adequate. For BRB the Department receives regular monthly returns which are discussed at my officials' monthly meeting with the Director of Finance. The information the Department receives from the smaller industries is also I think adequate, bearing in mind their comparative insignificance in relation to public expenditure totals.

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

Yours ever
Norman

NORMAN FOWLER

12 MAR 1980

CONFIDENTIAL

4F

Nat Ind

SCOTTISH OFFICE
WHITEHALL, LONDON SW1A 2AU

CONFIDENTIAL

The Rt Hon Sir Geoffrey Howe MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

28 February 1980

R 29/2

EXTERNAL FINANCING LIMITS FOR NATIONALISED INDUSTRIES 1980/81

Thank you for sending me a copy of your letter of 13 February to Keith Joseph.

My officials will be discussing with the Scottish Electricity Boards and the Scottish Transport Group (STG) within the next few weeks their investment and financing forecasts for the years ahead, and I shall ensure that in these discussions the importance of adhering to the 1980/81 external financing limits and carefully monitoring and reporting developments in this area is clearly brought home to the industries. I think we must recognise, however, the difficulty which the industries face in predicting their external financing requirements. While I have no reason at this stage to anticipate that the Scottish Electricity Boards will find it difficult to keep within their 1980/81 external financing limits, the borrowing needs of the Boards depend very much on movements in fuel prices and on the timing of major payments to contractors. Last year the Scottish Boards' borrowing forecasts changed dramatically, for reasons largely beyond their control, between the early Spring and the late Summer. I am afraid that even if closer examination of the forecasts at this stage suggests a possible excess, the Boards would be very reluctant to take sharp corrective action because of the inherent uncertainty of the borrowing forecasts, and I would find it difficult to press them to do so.

STG will be in a rather different position. Their EFL assumes a fairly substantial repayment of debt but no borrowing in 1980/81. I do not expect this in itself to give rise to problems, but I fear there may be difficulties because of the large grant component in the EFL. John Biffen and I have already exchanged letters about the need to adjust the limit in order to accommodate my increased grant to STG's shipping operations. The same difficulty may arise again later in the year should the regional councils, as seems distinctly possible, decide to increase the level of their revenue support to STG's bus services. This indicates clearly I think, the difficulties of applying the present definition of the EFL to an industry where grant support for fares and services, which is effectively outwith the industry's control, forms such a large part of the EFL. Although it is unlikely to happen, problems could also arise I imagine if grant payments were to be much lower than estimated and STG sought approval to increasing its borrowings from the NLF to make up the difference.

While I accept that we must endeavour to ensure that the external financing limits for 1980/81 are not exceeded, I believe that in general the solution to this dilemna lies, as David Howell and others argued at our meeting on 13 February to discuss the report by officials on nationalised industry policy, in regarding the EFLs of at least some of the nationalised industries as targets, rather than absolute limits, and allowing the industries a degree of latitude to exceed or fall short of the target figure in the light of their circumstances during the year. If we continue to operate the present system in an absolutely rigid manner, I think that there may be a danger of the industries reacting by inflating their forecasts to avoid the possibility of exceeding the limits, and that the limits will thus increasingly come to be regarded as an unrealistic instrument of control.

I am copying this letter to the recipients of yours.

GEORGE YOUNGER

CONFIDENTIAL

01 211 6402

R 29/2

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
London SW1P 3AG

28 February 1980

Dear Geoffrey

EXTERNAL FINANCING LIMITS FOR NATIONALISED INDUSTRIES 1980/81

Thank you for copying to me your letter of 13 February to Keith Joseph.

I agree with you, of course, on the desirability of the nationalised industries doing everything reasonably practicable to keep within their EFLs. However, we have always recognised the need for some flexibility when applying financing limits to these industries, particularly to those like gas and electricity with the characteristics of a public utility. A number of the assumptions underlying the EFLs which were set last November have already been overtaken by events. It is only realistic to expect that there will be further changes outside the industries' control. There can be no guarantee that the cumulative effect of these changes will not exceed any adjustments which it would be practicable for the industries to introduce and which could take effect in time. Even where such adjustments are possible, they may well have damaging industrial and economic consequences in the longer term, together with adverse indirect effects on the PSBR itself in the shorter run because of the way in which higher prices lead, with some delay, to higher public expenditure.

In the fuel industries, timing is always likely to be particularly difficult. EFLs represent the difference between very large flows of costs and revenues and so show large responses to small percentage variations in these flows. The fuel industries' performance against EFLs is highly sensitive to winter weather. Forecasts of EFL outturn must therefore remain uncertain until so late in the year that the scope for remedial action is very limited. This is particularly true of gas and electricity, since tariff increases to quarterly consumers only begin to affect cash received during the year if they are made in or before early December.

For these reasons, as Frank Tombs made clear when we saw the NICG last Wednesday, Chairmen of the fuel nationalised industries could ensure that they remained within their EFLs with or without the help of subsequent remedial action, only if they built very substantial contingency allowances into their tariff proposals. Because of its wider implications this, like some forms of corrective action that might be proposed during the year, could well be unacceptable to the Government.

There is also, as we agree, a relationship between EFLs and financial targets. Whilst they may initially be set together in conformity, changing circumstances could mean that to insist on rigid adherence to an EFL would force the industry off the path towards its financial target; and the extent of such a departure may require public abandonment or revision of the target. For example, the agreed path towards the electricity industry's financial target includes CCA return on assets of 0.9% in 1980/81. The tariff increases required (17% in April and either 15% in July or 21% in October) to keep it within its EFL of £187m in that year could give a return between 1.8% and 2.2%. Meeting the financial target over the whole period to 1982/83 would then require falling real electricity prices after 1980/81. Given that the targets for gas and electricity have only just been set, their credibility, and also our fuel pricing policy, would be seriously undermined if we ignored them when considering whether an EFL must be adhered to.

I agree that we should take any sensible steps to improve the prospects of industries being able to live within their EFLs, but, because of the difficulties outlined above, I do not believe we can expect complete success. Nevertheless, the fuel industries have been left in no doubt of our concern and of the fact that we look to them to take effective action if difficulties arise; and I can see some advantage in encouraging them to prepare contingency plans in cases where such difficulties seem likely.

I agree, too, on the importance of monitoring arrangements. I believe that, taking account of the basic problems to which I have referred, those in respect of the fuel industries are reasonably satisfactory. They could no doubt be made more rigorous, but, apart from the additional staff cost of this, it could have an adverse effect on the Government's relations with the industries. However, I am very willing to consider any specific suggestions that you or your officials may have for improving our arrangements.

As I mentioned at our meeting last Tuesday, and as this letter indicates, some of these difficulties have been made particularly acute for us by this year's early fixing of

1980/81 EFLs. I recognise the reasons why we took this course, but I wonder if the price, in terms of the greater risk of EFLs being upset by changes in circumstances, may not be too great. I suggest that we should in due course review this question of timing in the light of this year's experience, before we become committed to setting the 1981/82 EFLs as early as Autumn this year.

I am copying this letter to the Prime Minister and other recipients of your letter.

Yours ever

David

D A R HOWELL

28 FEB 1980

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

From the Secretary of State

R 24/2

CONFIDENTIAL

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
Treasury Chambers
Parliament Street
London, SW1P 3AG

28. February 1980

Dear Geoffrey

EXTERNAL FINANCING LIMITS FOR NATIONALISED INDUSTRIES 1980-81

In your letter of 13 February on this subject, you asked sponsoring Ministers to consider whether anything should be done before the start of the financial year to ensure that industries are able to keep within the external financial limits which have been set.

My industries regard the cash limits as sacrosanct, and do everything possible to keep the external financing requirement on target, adjusting everything else as necessary. Some years ago British Airways used the sanctity of cash limits as an argument in dealing with a strike, and consequently cancelled an order for a Boeing 747. In the current year when gross profits are less than half what was expected, they are still maintaining their external borrowing requirement.

British Airways are expecting considerably better figures in 1980-81. But the main uncertainty is whether aviation fuel prices will increase more than expected, and, if so, whether they will be able to increase fares to cover the increased costs quickly. A great deal of money was lost this year because of the long procedures of IATA and CAA for increasing fares. Arrangements are now being made to speed up those procedures. I do not think there is any action we can take to

CONFIDENTIAL

From the Secretary of State

CONFIDENTIAL

help British Airways, short of finding some way of freezing the price of fuel. But we shall certainly examine their Corporate Plan with care when it is available.

The British Airports Authority budgeted for 1980-81 on the basis that it will keep within its external financing limit of £20m. In order to achieve this it is raising its user charges by 35% on 1 April 1980 and curtailing its investment programme. It will find difficulty in meeting its targets if the traffic through its airports grows less than expected, which would result from the airlines increasing their fares to cover increased fuel costs.

Both bodies have reached a reasonable pay settlement, and are getting increasing productivity.

As regards monitoring, we already receive monthly financial returns from both industries on their financial position and future prospects.

I am copying this letter to the recipients of yours.

Yours

John

JOHN NOTT

CONFIDENTIAL

28 FEB 1980

CONFIDENTIAL

DSG

File

Nationalised Industries.

~~SS~~ Cabinet May 79. Committee Structure + membership.

MR. WRIGHT
CABINET OFFICE

NATIONALISED INDUSTRIES: FINANCIAL CONTROL

The Prime Minister has read your note of 22 February and has agreed the proposed terms of reference and composition for the new sub-committees to be chaired by the Chancellor and the Secretary of State for Industry.

T. P. LANKESTER

25 February 1980

KRD

CONFIDENTIAL

CONFIDENTIAL

Prime Minister

Agree ?

1

cc Cabinet May 79
Committee Structure + membership

Ref. A01500

MR. LANKESTER

R 22/2

Nationalised Industries: Financial Control

In your minute of 14th February, you reported the Prime Minister's agreement to proposals that the Chancellor of the Exchequer should chair a new Committee to discuss Nationalised Industry Financing Questions and that the terms of reference of the E(DL) Committee on the Disposal of Public Assets, now under the chairmanship of the Secretary of State for Industry, should be extended to cover "Privatisation". You asked for proposed terms of reference and membership for these two Committees.

2. I enclose terms of reference and composition for the new Sub-Committees to be chaired by the Chancellor, and revised terms of reference for the Sub-Committee on Disposals, now to be chaired by the Secretary of State for Industry. These have been seen and approved by the Secretary of the Cabinet. If they are acceptable to the Prime Minister, they will be circulated.

Agreed MR.

D.J. Wright

D.J. WRIGHT

22nd February, 1980

CONFIDENTIAL

CONFIDENTIAL

THIS DOCUMENT IS THE PROPERTY OF HER BRITANNIC MAJESTY'S GOVERNMENT

E(NI)(80) 1 COPY NO

February 1980

CABINET

MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

SUB-COMMITTEE ON NATIONALISED INDUSTRY FINANCING

COMPOSITION AND TERMS OF REFERENCE

Note by the Secretary of the Cabinet

By direction of the Prime Minister a Sub-Committee has been constituted with the following composition and terms of reference:-

COMPOSITION

Chancellor of the Exchequer (Chairman)
Secretary of State for Industry
Secretary of State for the Environment
Secretary of State for Scotland
Secretary of State for Trade
Secretary of State for Energy
Chief Secretary, Treasury
Minister of Transport

TERMS OF REFERENCE

"To consider the financial requirements of the nationalised industries and the means of financing them; and to report to the Ministerial Committee on Economic Strategy from time to time."

SECRETARIAT

The Secretaries are Mr P le Cheminant, Mr P Mountfield and Mr G D Miles, Cabinet Office

Signed ROBERT ARMSTRONG

Cabinet Office

February 1980

CONFIDENTIAL

CONFIDENTIAL

THIS DOCUMENT IS THE PROPERTY OF HER BRITANNIC MAJESTY'S GOVERNMENT

E(DL)(80) 1

February 1980

COPY NO

CABINET

MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

SUB-COMMITTEE ON DISPOSAL OF PUBLIC SECTOR ASSETS

REVISED COMPOSITION AND TERMS OF REFERENCE

Note by the Secretary of the Cabinet

By direction of the Prime Minister the composition and terms of reference of the Sub-Committee have been revised.

COMPOSITION

The Composition is now:-

Secretary of State for Industry (Chairman)
Minister of Agriculture, Fisheries and Food
Secretary of State for the Environment
Secretary of State for Trade
Secretary of State for Energy
Chief Secretary, Treasury
Financial Secretary, Treasury

Other Ministers will be invited to attend as appropriate

TERMS OF REFERENCE.

These are now:-

"To consider and keep under review all arrangements for the disposal of public sector assets including land and buildings, and for the introduction of private capital into the nationalised industries, and to report as necessary to the Ministerial Committee on Economic Strategy."

SECRETARIAT

The Secretaries are Mr P Mountfield, Mr G D Miles and Mr A S D Whybrow, Cabinet Office.

Signed ROBERT ARMSTRONG

Cabinet Office

February 1980

CONFIDENTIAL

CONFIDENTIAL

Prime Minister
To glance
MBPHR

RECORD OF A MEETING BETWEEN MINISTERS AND THE NATIONALISED INDUSTRIES CHAIRMEN'S GROUP : HELD IN THE CHANCELLOR OF THE EXCHEQUER'S ROOM AT H.M. TREASURY AT 4.00 P.M. ON TUESDAY, 20TH FEBRUARY 1980

Present:

Chancellor of the Exchequer	Sir Francis Tombs
Secretary of State for Industry	Sir William Barlow
Secretary of State for Employment	Sir Humphrey Browne
Secretary of State for Energy	Sir Derek Ezra
Chief Secretary to the Treasury	Sir Anthony Griffin
Minister of Transport	Sir Peter Parker
Mr. W.S. Ryrie	Lord Donnet
Mr. N. Monck	Mr. J. Driscoll
Mr. M.A. Hall	Mr. P. Wilkins

...... The agenda for the meeting is attached.

2. Welcoming the Chairmen, the Chancellor said the purpose of the meeting was to go over the more important ground in the Chairmen's document "Framework of Financial Discipline" forwarded to the Chancellor with Sir William Barlow's letter of 18th October 1979. This was an important analysis of intractable problems, on which he and the Chairman of the NICG had since been in correspondence.

3. Sir Francis Tombs thanked Ministers for this opportunity to discuss the nationalised industries' financial arrangements. The Chairmen wished to concentrate on three main issues:-

(a) The Chairmen thought that it was not in the interests of the public, the Government or the nationalised industries for their borrowing to be included in the Public Sector Borrowing Requirement. This essentially presentational point was an important element of the Chairmen's case.

(b) The role and consistency of the nationalised industries' financial targets and external financing limits.

(c) Sources of finance for the nationalised industries

Inclusion of nationalised industry borrowing in the PSBR

4. The Chancellor observed that this was more than a presentational point, and lay at the heart of the relationship between the industries and the Government. There was no escaping the fact that the Government was the nationalised industries' banker of last resort. This made the issue of public concern.

5. Sir William Barlow said that the Chairmen well understood the Government's commitment to control the PSBR. They recognised too that there was an important issue of substance. But the presentational aspects were important to the Chairmen, who would like the Government to consider what could be done to meet their concern. In the first place, the inclusion of their borrowing in the PSBR meant that the nationalised industries were being restrained from profitable investment. Other countries had found ways of distinguishing between the Government's own needs and those of Government-owned industries. The Chairmen believed that the present arrangement was against the national interest, and would like to work jointly with the Treasury to see whether progress could not be made towards identifying nationalised industry borrowing as a separate category. Sir Francis Tombs noted that even within the category of nationalised industry borrowing, there was an important distinction to be drawn between borrowing for revenue and borrowing for investment.

6. The Chancellor said that Ministers well understood the Chairmen's strength of feeling on this. He was content for joint work to proceed on looking at ways of meeting the Chairmen's difficulties on this point. But he had to remind the Chairmen that the cash restraint on their industries' borrowing, whether for revenue or investment purposes, was inescapable.

CHANCELLOR OF THE EXCHEQUER

7. Sir Derek Ezra said that the Chairmen were increasingly sensitive to the suggestion that investment by nationalised industries was somehow a wrong application of funds. Many of the nationalised industries were growth sectors of the economy. Their investment projects were pursued only after careful scrutiny; and yet there was an implied stigma attached to their investment activities. This stemmed in large part from indiscriminate inclusion in the PSBR aggregate. The Chancellor reminded the Chairmen that it was for this reason that he now referred in public to the"enterprise" rather than the "private" sector.

8. The Chief Secretary said that the Government might well be prepared to move in a purely presentational way towards separately identified figures for nationalised industry borrowing. But such borrowing was incontrovertibly an "integral part of the borrowing requirement". It would be a mistake to expect a change of front by the Government on the substantive issue. Sir Francis Tombs confirmed that it was the presentational aspects with which the Chairmen were concerned. Within the total of nationalised industry borrowing, separately identified, they would like a further sub-division between revenue expenditure and loan capital. The Secretary of State for Industry commented that whatever the categorisation, it would be the market's perceptions which counted. Sir Francis Tombs accepted that a different classification would have little bearing on the Government's capacity to market public debt; but it might imply a different market reaction from that which would have met an undivided PSBR; and it might help the industries in their efforts to gain access to the capital markets (see paras 18-23 below). The Secretary of State for Industry said that the proposals for involving private equity capital which the Government had already put to the Chairmen gave them a degree of scope. They were more than just cosmetic. Sir Francis Tombs accepted that these arrangements would be useful, but said they did not tackle the problem at its root. Sir William Barlow thought the new arrangements would be of relatively little help to the Post Office.

9. It was agreed that officials concerned with financial arrangements for the nationalised industries should consider the scope for identifying nationalised industry borrowing separately from the PSBR, and within that category differentiating between borrowing for revenue and for investment purposes. Mr. Ryrie would keep in touch with the Chairmen through Mr. Driscoll as the work progressed.

External financing limits

10. Sir Francis Tombs said that EFLs were of necessity derivative from the nationalised industries' financial targets. The Chairmen found EFLs valuable in imposing commercial disciplines on their industries. But to manage their affairs so as to meet their EFLs there were three important underpinning elements - the financial targets; a stable investment programme; and an orderly pricing policy. Problems and distortions were now arising because the Government had elevated EFLs to an objective in their own right. The Chairmen found the concept of EFLs confusing. Were they intended to be like a bank overdraft ceiling? If so it was necessary for the nationalised industries to live well within them, and make suitable dispositions. Or were they mid-point estimates, aimed at, but not necessarily observed to the letter? The Government appeared to switch inconsistently from one to the other? The EFLs had considerable value as a short-term management tool. But they were positively unhelpful as a short term regulator. Admiral Griffin observed that the present regime of EFLs created peculiar and severe problems for manufacturing and exporting nationalised industries.

11. The Chancellor accepted that EFLs were clearly related to the financial elements Sir Francis had listed. But at the end of the day the Government had to keep the aggregate of EFLs within prescribed limits. The Post Office billing dispute had for instance greatly worsened the PSBR for the current year. More was involved than the Government's

role as banker of last resort to particular industries. What would be the position if the Post Office's overrun had been the pattern for the other industries as well?

12. Sir Derek Ezra said that nationalised industries tended to perceive the danger of overrunning their EFLs towards the end of the financial year. This was in great part because major industrial disputes tended to occur in the winter. Taking the National Coal Board as an example, they had suffered badly a year ago as a result of the transport dispute. They had improved their financial position during the first part of the current year, but now their finances were threatened by the steel dispute, as the end of the financial year approached. There was no time to circumvent the impact of such extraneous events on a rigid EFL. The Chancellor agreed with Sir Francis Tombs that the swings and roundabouts principle frequently applied. But it could not be relied upon, and the Government must concern itself with the aggregate of EFLs, within the PSBR.

13. Sir William Barlow said that the EFL was a residual total which was highly sensitive to changing external economic circumstances. When such developments necessitated a change in policy to avoid an excess over an industry's EFL, decisions were taken which were harmful both to the business and to its customers. In the Post Office profitable investment in the telcommunications business had been cut back and the reduction of manning slowed down. Compared with the overall budgets of the industries, the figures by which EFLs were exceeded were small, and well within the normal operating margin of error for a commercial enterprise of comparable size. Rigid control through EFLs would inevitably inhibit nationalised industries' ability to meet their financial targets eg by restricting investment. Sir Francis Tombs noted the absurdity of delaying payment of debts to the next financial year and thus incurring an interest charge. In this sense the nationalised industries were already borrowing from alternative sources in order to meet their external financing limits. In response

to a question from the Secretary of State for Employment, the Chairmen emphasised the looseness of the link between financial targets and EFLs. Additionally EFLs covered financial years but the financial targets of some industries cover calendar years. Sir William Barlow said the discipline of the EFL amounted to getting the figures right at midnight on 31st March. There were indeed occasions with some EFLs that the limit was breached in the course of the year on condition that the end-year figure fell within it. Sir Humphrey Browne urged Ministers not to form the impression that the Chairmen opposed the concept of EFLs. They thoroughly welcomed the present emphasis on cash rather than relying only on return on capital. In his view, the main key to the issues under discussion at this meeting was that the nationalised industries should have access to alternative sources of capital. Sir Peter Parker said he found the EFL very useful in his dealings with trade unions. But it should not become the dominant strand in the nationalised industries' financial framework.

14. The Chancellor said the Government did not dissent from the Chairmen's assessment of the crucial importance of the nationalised industries' financial targets. But when faced with a shortage of cash, even private industry had to curtail its investment plans. Sir William Barlow thought that in practice a large private sector company would never find itself unable to borrow sums of the order of £200 million for sound investment purposes. Sir Peter Parker noted that private sector companies faced with cash flow problems would resort to leasing. This route was barred to the nationalised industries. He hoped the leasing aspect could be studied.

15. Sir Francis Tombs regretted that EFLs had come to be regarded as the same as cash limits. There was a crucial difference, in that EFLs were necessarily residuals, whereas cash limits were global budgets. Whilst not disputing this, the Chancellor noted that on the criterion the PSBR was the biggest EFL of all.

16. Sir Francis Tombs said that the Chairmen would like guidance on how the Government saw the role of EFLs. They would

like to set up some kind of joint work to define more clearly the role of EFLs and to consider improvements in their operation. The Chancellor agreed that Mr. Ryrie's official group could also look at this problem. They would examine whether there was any scope for flexibility in the application of EFLs. The idea of carry-over was currently being considered in respect of certain central government cash limits, and was worth examination in this context also. The Secretary of State for Energy commented that it was very valuable that there should be a clearer common understanding of EFLs, even if at the end of the day it was unpalatable to the Chairmen.

17. It was therefore agreed that Mr. Ryrie would be in contact with the Chairmen's Group in due course when officials had taken further their study of EFLs. Within the tight limits necessarily set by the Government's responsibility for controlling the aggregate of public sector borrowing, they would examine what scope there might be for flexibility in the application of EFLs, and seek, with the Chairmen, to arrive at a clearer mutual understanding of the role EFLs should play.

Access to capital markets

18. Sir Derek Ezra said that although there had been great advances in the functioning of financial markets, the Treasury had over the years refused to modify twenty-year old arrangements for borrowing by nationalised industries. The Chairmen would like the possibilities to be explored firstly of the circumstances in which it might be possible to widen the range of access by the nationalised industries to sources of finance other than the Government, and secondly for making the arrangements for borrowing from the NLF more flexible, particularly with regard to the time-scale. He also felt that the Government should provide more equity finance for nationalised industries. There was a degree of risk in their activities, and it was only fair that the owners should share it. It was unreasonable for the Government to expect a fixed return on risk capital.

19. The Chancellor said that whilst he saw the force of Sir Derek's analysis, the fact was that all borrowing by the nationalised industries was on the Government's credit in the last resort. The ultimate solution to the Chairmen's problem was full privatisation. Now the Government had offered a half-way house in the shape of "semi-privatisation".

20. Sir Peter Parker thought that apart from the essentially marginal projects which might benefit from the new arrangements suggested by the Government, there were major separable projects - e.g. electrification of the railways, and the Channel tunnel, which he thought could be financed in new and more imaginative ways. Sir William Barlow saw it as imperative to tap other sources. Limitation to one source within strict limits pushed the nationalised industries into raising their prices. Lord Donnet supported this view.

21. The Secretary of State for Industry again emphasised the value to the nationalised industries of the new possibilities for semi-privatisation proposed by the Government.

22. The Chancellor asked Mr. Ryrie whether he thought his official Group could throw any new light on this perennial problem. Mr. Ryrie said that if nationalised industries, e.g. the Post Office or the Electricity Council were to borrow in their own name, perhaps by issuing bonds, the effect would probably be wholly cosmetic. They would be tapping the same market as the Government, and the Government would have to take a close interest in the size, timing and marketing of nationalised industry debt because of its effect on monetary aggregates and the Government's own funding programme etc.

23. The Chancellor said that the Government had little control over the activities of the private sector, which had an impact on the exchange rate, the monetary aggregates, and other important indicators. The Government and the nationalised industries had a special relationship whether they like it or not, not least because of the Government's role as banker of last resort. But he was content for Mr. Ryrie's Group to examine whether it was possible to give the Chairmen more flexibility at the margin as they had suggested. Mr. Ryrie would be in touch with the NICG, and would report back to a further meeting between Ministers and the Chairmen in due course.

Envoi

24. The Chancellor said that at worst, it looked as thought there might be room for some purely cosmetic changes which would go some way to helping the Chairmen over the problems they had raised; at best, there might be some practical improvements. The work set in hand should help in thawing the present reluctant embrace between the Government and the nationalised industries.

25. Mr. Ryrie would discuss with Sir Francis Tombs arrangements for consulting the Chairmen on the studies set in hand, and would report back to a further meeting between the NICG and Ministers in two to three months' time.

(M.A. HALL)
21st February, 1980

Distribution

Ministers and officials
PS/Prime Minister
PS/Secretary of State for Scotland
PS/Secretary of State for Trade
PS/Secretary of State for the Environment
Financial Secretary
Sir Douglas Wass
Sir Anthony Rawlinson

Mr. Ridley
Mr. Cardona
Mr. Mountfield (Cab. Office)

Mr. Robson
Mr. Butler
Mr. Moore
Mr. F. Jones
Mr. Middleton
Mr. Littler
Mr. Byatt
Mr. Bridgeman
Mr. Wicks
Mrs. Case
Mr. Norton

26 FEB 19[illegible]

PART 1 ends:-

Industry to TPL of 18.2.80.

PART 2 begins:-

Mtg record, Ministers / Chairmen of Inds 20.2.80

~~Wright to TPL (A01500) of 22.2.80.~~