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PREM 19/1193

PART 29.

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Confidential Filing

Public Expenditure and Cash Limits

ECONOMIC POLICY.

Pt 1: May 1979.

Pt 29: Oct. 1984.

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~29.10.84~~.							
1/11/84							
5.11.84							
— PART ENDS —							

PREM 19/1193

PART 29 ends:-

Energy to P Gregson 5.11.84

PART 30 begins:-

P Gregson to PM (P.01425) 6/11/84

TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
MISC 106(84)15, 16, 17and 18	19/10/84
LCA TO MISC 106(84) 6th Meeting, Minutes	19/10/84
MISC 106(84) 19, 20 and 21	22/10/84
LCA to MISC 106(84) 7th Meeting, Minutes	22/10/84
LCA to MISC 106(84) 8th Meeting, Minutes	22/10/84
LCA to MISC 106(84) 9th Meeting, Minutes	23/10/84
MISC 106(84) 22	23/10/84
LCA to MISC 106(84) 10th Meeting, Minutes	24/10/84
LCA to MISC 106(84) 11th Meeting, Minutes	24/10/84
MISC 106(84) 23	24/10/84
LCA to MISC 106(84) 12th Meeting, Minutes	25/10/84
LCA to MISC 106(84) 13th Meeting, Minutes	25/10/84
LCA to MISC 106(84) 14th Meeting, Minutes	26/10/84
LCA to MISC 106(84) 15th Meeting, Minutes	26/10/84
LCA to MISC 106(84) 16th Meeting, Minutes	29/10/84
LCA to MISC 106(84) 17th Meeting, Minutes	29/10/84
LCA to MISC 106(84) 18th Meeting, Minutes	30/10/84
LCA to MISC 106(84) 19th Meeting, Minutes	30/10/84
LCA to MISC 106(84) 20th Meeting, Minutes	31/10/84
LCA to MISC 106(84) 21st Meeting, Minutes	31/10/84
LCA to MISC 106(84) 22nd Meeting, Minutes	01/11/84
C(84) 32	05/11/84

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 CWayland Date 10 September 2013

PREM Records Team

46

01 211 6402

P L Gregson Esq CBE
Deputy Secretary
Cabinet Office
Whitehall
LONDON SW1

5 November 1984

Dear Peter

REPORT OF THE MINISTERIAL GROUP ON PUBLIC EXPENDITURE (MISC 106): GAS AND ELECTRICITY INDUSTRIES

Thank you for your letter of 5 November. I attach a redraft of your enclosure which reflects my Secretary of State's understanding of the latest position.

You will see that he is proposing to seek a rephasing of the figures as between different years in the light of his conversation with the Prime Minister this morning.

Yours
Michael

M F REIDY
Private Secretary

SECRET

20	70	50

(iii) Miscellaneous cost savings in the ESI of over £600m

(iv) Miscellaneous cost savings in the BGC of over £200m

5 The reductions in paragraph 3 would mean the following changes in the combined baseline for the two industries:

£ million		
1985-86	1986-87	1987-88
nil	nil	+48

Recognising the difficult overall public expenditure situation the Secretary of State for Energy has undertaken to seek the agreement of the industries to savings at this level in each year, including the phasing as between each year. He anticipates strong resistance from the industries and considers that additional savings beyond this level could not be achieved.

BRITISH GAS CORPORATION (BGC) AND ELECTRICITY SUPPLY INDUSTRY (ESI)
EXTERNAL FINANCING

	1985-86	1986-87	1987-88
Survey baseline			
- BGC	- 396	- 495	- 507
- ESI	-1022	-1337	-1370
Total	-1418	-1832	-1877

2. The industries submitted the following bids for additions to their external financing limits.

	1985-86	1986-87	1987-88
- BGC	+ 159	+ 237	+ 389
- ESI	+ 24	+ 298	+ 570
Total	+ 183	+ 535	+ 959

A significant part of these bids was to finance higher payments of corporation tax.

3. The Secretary of State for Energy has held discussions with the Chairmen of the industries and considers that the bids could be reduced, by a combination of efficiency and other savings and price increases, to the following extent.

	1985-86	1986-87	1987-88
Gas	- 115	-212	- 282
Electricity	- 68	-323	- 629

The price increases required to meet these figures are primarily a matter for the commercial judgement of the industries and no firm decisions have yet been taken. But the Secretary of State thinks it possible that there will be increases in electricity prices of 4½ per cent in 1985-86 and later years and increases in gas prices at a higher level through the period.

4. Other main sources of these reductions are as follows (post-tax):

(i) Extended use of electricity links with France, saving £45 million by 1987-88.

(ii) An assumption that the Sizewell project will be delayed by six months, saving

Gas and electricity industries

14 The industries submitted bids for additions to their EFLs totalling:

Gas	+159	+237	+389
Electricity	+ 24	+298	+570

Over 80 per cent of these bids was to finance higher payments of Corporation Tax.

15 The Secretary of State for Energy has held discussions with the Chairmen of the industries and considers that the bids could be reduced, by a combination of efficiency and other savings and price increases, by the following amounts (after allowing for extra corporation tax):

Gas	-115	-212	-282
Electricity	- 68	-323	-629

The price increases required to meet these figures are primarily a matter for the commercial judgement of the industries and no firm decisions have yet been taken. But the Secretary of State thinks it possible that there will be increases in electricity prices of 4½ per cent in 1985-86 and later years and increases in gas prices at a higher level through the period.

16 The reductions in paragraph 15 would mean the following changes in the combined baseline for the two industries :

nil	nil	+ 48

Recognising the difficult overall public expenditure situation the Secretary of State for Energy has undertaken to seek the agreement of the industries to savings at this level in each year, including the phasing as between each year. He considers that additional savings beyond this level could not be achieved. MISC 106 recommend that these proposals (ie those in paragraph 15) should be accepted.

010

CC/NO

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

From the Minister

CONFIDENTIAL

The Rt Hon Peter Rees QC MP
Chief Secretary to the Treasury
Parliament Street
London SW1P 3AG

N 8/11

5 November 1984

Dear Peter,

REPORT ON AGRICULTURAL DEVELOPMENT AND ADVISORY SERVICES

As foreshadowed ~~in~~ with request if required my letter of 9 October, to which you replied on 12 October, I now enclose the draft statement which I propose to make on publication of Professor Bell's report. I envisage publishing the report on Tuesday 13 November and replying to an Arranged Question on the same day.

In my statement I have of course taken full account of our public expenditure discussions and the indication I propose to give of the Government's aim is fully consistent with the figures which will eventually appear in the Public Expenditure White Paper with the reservation which we have agreed.

In publishing the report with my reaction to it, we shall also open up a process of consultation with all the interests concerned. With regard to the administrative arrangements necessary both for the introduction of charging and the enhancement of the role of IT in the advisory services, I propose setting up a small team within the Agricultural Departments. We shall of course keep the Treasury closely informed.

If you or others to whom I am copying this letter have comments on the draft announcement I should be grateful if I could have them by close of play on 8 November.

In view of the circulation given to your letter of 12 October, I am copying this to the Prime Minister, the Lord President, the Secretary of State for Trade and Industry, the Secretaries of State for Scotland, Wales and Northern Ireland, to the Deputy Chief Whip and Bertie Denham; and to Sir Robert Armstrong.

Yours Ever,

Michael Jopling

MICHAEL JOPLING

MINISTRY OF AGRICULTURE

FISHERIES AND FOOD

PLEASE PUT WITH LETTER DATED
5 NOVEMBER FROM MICHAEL JOPLING TO
PETER REES. APOLOGIES FOR OMISSION.

WITH THE COMPLIMENTS

OF

THE PRIVATE SECRETARY

WHITEHALL PLACE
LONDON, S.W.1

CONFIDENTIAL

Draft Statement by the Minister of Agriculture on the Bell Report

When Professor Ronald Bell joined my department as the new Director General of the Agricultural Development and Advisory Service, I asked him to give particular attention during his first six months to developing his views on the future shape and direction of ADAS. I asked him in particular to consider whether present ADAS priorities needed to be revised; whether some services could satisfactorily be provided by the private sector; and whether and how far there is scope for transferring to the user the cost of the services provided.

Professor Bell has consulted widely with interested organisations and individuals in the industry as well as in the Ministry and his report, which is published to-day, provides a clear view of the way in which the Service should develop over the next decade.

He concluded that ADAS was an effective and dedicated service held in high esteem by the industry to which it had rendered valuable service, but that certain changes of approach and style of operation are now needed. In particular he recommended:

(i) a reorientation and refocusing of the ADAS effort at present devoted to Research and Development so as particularly to concentrate on the Development end of the spectrum;

(ii) a commitment to the use of computer-based information technology as the method by which a great deal of information and advice is provided to the industry in the late 1980s;

(iii) consideration should be given to the possibilities of charging users for part or all of any service (including work under statutory schemes) where there is an identifiable benefit to the customer.

(iv) greater emphasis should be given to conservation and welfare work.

I endorse Professor Bell's view of the value of the work ADAS has done and I believe he has correctly identified the direction in which ADAS should move in the future. I therefore intend to proceed to a detailed examination of what would be involved in the implementation of his recommendations. The report raises a number of substantial questions which will need careful consideration. In particular, I endorse the conclusion that in principle it seems entirely appropriate that farmers and others in the industry who avail themselves of these services should contribute to their cost, and I believe that, if Parliament approved the necessary legislation, it would be reasonable to envisage roughly 20% of the total cost of ADAS being met in this way. But the necessity for primary legislation to give effect to this emphasises the need for further work before final decisions can be taken. Adequate time will be allowed for this and for the necessary consultations with the many interests concerned.

I am having this further work put in hand immediately and will welcome the views of the interests concerned so that these can be taken into account in the final decisions on the implementation of this report. I have arranged for copies of the report to be deposited in the Library of the House.

FROM: P L GREGSON CB, DEPUTY SECRETARY

COPY 8 OF 8 COPIES

45

CABINET OFFICE

70 Whitehall, London SW1A 2AS Telephone 01-XXXXXXXXX 233 8339

Mr Mike Reidy
Private Secretary to the Secretary of State
Department of Energy
Thames House South
Millbank

P.01424

5 November 1984

Covering SECRET: CMO (Until 31 December 1984)

Dear Mike

REPORT OF THE MINISTERIAL GROUP ON PUBLIC EXPENDITURE (MISC 106): GAS AND ELECTRICITY INDUSTRIES

I attach drafts of the section in the main MISC 106 report which deals with the gas and electricity industries and the relevant Annex (Annex H), which reflect the understanding reached between the Prime Minister and the Secretary of State for Energy this morning.

As your Secretary of State knows, the Lord President's paper to the Cabinet reporting the recommendations of MISC 106 has to be finalised this evening for circulation to the Cabinet first thing tomorrow morning. I must therefore ask for any suggested amendments to the draft to reach me by 4.00 pm this afternoon.

Yrs

Peter

P L GREGSON

bcc Mr Broadbent (PS/Chief Secretary)
Mr Paul Gray (Tsy)
Mr Steve Robson (Tsy)
Mr Buckley
Mr Dart

Covering SECRET: CMO (Until 31 December 1984)

Gas and Electricity industries

14. The industries submitted bids for additions to their EFLs totalling:

Gas	+159	+237	+389
Electricity	+ 24	+298	+570

A significant part of these bids was to finance higher payments of corporation tax.

15. The Secretary of State for Energy has held discussions with the Chairmen of the industries and considers that the bids could be reduced, by a combination of efficiency and other savings and price increases, to the following extent (after allowing for extra corporation tax):

Gas	-115	-212	-272
Electricity	-130	-408	-472

These reductions are likely to involve increases of 4½ per cent in electricity prices and 6 per cent in gas prices in 1985-86. The industries have not been explicit about price increases in later years; but the Secretary of State for Energy thinks it possible that there will be increases in electricity prices of 4½ per cent in both 1986-87 and 1987-88 and increases in gas prices of 7 per cent and 8 per cent.

16. The reductions in paragraph 15 would mean the following changes in the combined baseline for the two industries:

-62	-85	+215

Recognising the difficult overall public expenditure situation, particularly in the third year, the Secretary of State for Energy has undertaken to go back to the industries and seek their agreement to additional savings amounting to £215 million net in 1987/88 (probably amounting to around £250 million gross) so as to bring the industries back to their combined baseline in that year. The Secretary of State believes that this proposal for additional savings will be strongly resisted by the industries but will use every effort to persuade them to accept it. MISC 106 recommend that these proposals (ie those in paragraph 15 as revised in this paragraph) should be accepted.

ANNEX H

BRITISH GAS CORPORATION (BGC) AND ELECTRICITY SUPPLY INDUSTRY (ESI)

EXTERNAL FINANCING

	1985-86	1986-87	1987-88
Survey baseline			
- BGC	- 396	- 495	- 507
- ESI	-1022	-1337	-1370
Total	-1418	-1832	-1877

2. The industries submitted the following bids for additions to their external financing limits.

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ESI	+ 24	+ 298	+ 570
Total	+ 183	+ 535	+ 959

A significant part of these bids was to finance higher payments of corporation tax.

3. The Secretary of State for Energy has held discussions with the Chairmen of the industries and considers that the bids could be reduced, by a combination of efficiency and other savings and price increases, to the following extent.

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Electricity	- 130	- 408	- 472

These reductions are likely to involve increases of 4½ per cent in electricity prices and 6 per cent in gas prices in 1985-86. The industries have not been explicit about price increases in later years; but the Secretary of State for Energy thinks it possible that there will be increases in electricity prices of 4½ per cent in both 1986-87 and 1987-88 and increases in gas prices of 7 per cent and 8 per cent.

4. Other main sources of these reductions are as follows.

(i) Full use of electricity links with France, saving £45 million by 1987-88.

(ii) An assumption that the Sizewell project will be delayed by six months, saving

	20	70	50

[(iii) Miscellaneous cost savings in the ESI of]

[(iv) Miscellaneous cost savings in the BGC of]

5. The reductions in paragraph 3 would mean the following changes in the combin baseline for the two industries:

£ million

1985-86	1986-87	1987-88
- 62	- 85	+ 215

Recognising the difficult overall public expenditure situation, particularly in the final year, the Secretary of State for Energy has undertaken to go back to the industries and seek their agreement to additional savings amounting to £215 million net in 1987-88 (probably amounting to around £250 million gross) so as to bring the industries back to their combined baseline in that year. The Secretary of State believes that this proposal for additional savings will be strongly resisted by the industries but will use every effort to persuade them to accept it.

10 DOWNING STREET

Prime Minister

The Chancellor wants to discuss the handling of Cabinet with you. He is worried partly about our inability to squeeze anything more out of PW; and partly that if he agrees to offer more at Cabinet, it will be subject to consultation with the industries. This would not allow the figures to be pinned down in time for the Autumn Statement on Monday 12 November.

AT
5/11

SECRET

44

NBPM

AT 5/11

PRIVY COUNCIL OFFICE
WHITEHALL. LONDON SWIA 2AT

5 November 1984

Dear Keith

MISC 106: AGRICULTURAL R & D EXPENDITURE

I have seen a copy of your minute of 1 November to the Prime Minister.

The report of the Ministerial Group on Public Expenditure (MISC 106) to the Cabinet will record the agreement reached with Michael Jopling that there should be not a separate line of reductions relating to agricultural R & D but a combined line covering both R & D and the Agricultural Development and Advisory Service (ADAS) providing for reductions of £10 million below baseline in 1986/87 and £40 million in 1987/88. These figures are moreover to be accompanied by the following form of words:

> "The figures for expenditure on agricultural research and development and the Agricultural Development and Advisory Service are provisional. They will be reviewed in the light of developments, and in particular of the Government's decisions on the recommendations of the Bell Report, and of the scope for possible change in the arrangements for financing agricultural research."

The considerations referred to in your minute would clearly be among those to be assessed before final figures were agreed.

I am sending copies of this letter to the Prime Minister, the Home Secretary, the Secretary of State for Scotland, the Lord Privy Seal, the Minister of Agriculture, Fisheries and Food, the Chief Secretary, Treasury and Sir Robert Armstrong.

Yours
Willie

The Rt Hon Sir Keith Joseph Bt MP

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SECRET

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MISC 106: LPO + CO (2)
CST DN
HO
SO
LPS

cc MASTER SET

43

10 DOWNING STREET

From the Private Secretary

5 November 1984

Dear Janet,

PUBLIC EXPENDITURE: GAS AND ELECTRICITY INDUSTRIES

The Prime Minister held a meeting today with the Secretary of State for Energy to discuss the gas and electricity industries. Mr. Gregson was also present.

The Prime Minister said that the decision reached after MISC 106's work was still very difficult, especially in 1987-88. Her understanding was that the Treasury had originally sought savings of £3.7 billion from the gas and electricity industries. The Secretary of State had pointed out that £1.5 billion of the industries' excess bids were attributable to higher corporation tax payments following the changes in the Budget. The Group had taken account of this in asking the Secretary of State for Energy to seek savings of £2.2 billion from the two industries over the three years of the survey. She understood that the Secretary of State for Energy had reported back to the Group saying that he could secure savings of £1.6 billion which could be extended to £1.9 billion. MISC 106 had been under the impression that this represented the effect on EFLs.

The Prime Minister said she believed the saving of £1.9 billion on the industry's EFLs could be extended to £2.2 billion. She accepted that it would be difficult to seek an increase in real gas prices beyond the one per cent which BGC appeared to be offering. Nevertheless, she believed that there was a good deal of scope for cutting costs. BGC's working capital was rising rapidly and it was buying more gas than needed with the balance being put into store.

On electricity, she believed that rather than increases of half a per cent less than the rate of inflation, prices could rise strictly in line with inflation. In addition, as last year's experience had demonstrated, there were substantial cost savings to be made. As it was the third year that was the most difficult, the savings for the two industries could be weighted towards that year.

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TMS.

The Secretary of State for Energy set out his understanding of the discussion with MISC 106. The £1.9 billion of savings he had offered to MISC 106 did not allow for corporation tax; when allowance was made for this the effect on EFLs would be about £1.6 billion. He believed the Treasury's methodology was faulty as it made no sense to seek savings of a specific sum from the industries and then require a further sum to cover the additional corporation tax bill that resulted. The Treasury was, in effect, seeking to be paid twice.

The Secretary of State for Energy explained the difficulties he had experienced in securing even the £1.9 billion gross (£1.6 billion on EFLs). The industries had complained that they had had very tough EFLs imposed on them last year which they were finding it difficult to meet. Yet the Government was now seeking to tighten the regime still further. The negotiations had proved extremely difficult and, in his view, any attempt to go beyond £1.9 billion (£1.6 billion on EFLs) would provoke the Boards into refusing to accept the settlement. Instead, they would invite the Government to impose it upon them. This would create a political struggle in which it would be difficult for the Government to prevail. The two industries were now contributing £3 billion to the Exchequer compared with £260 million in 1979. He had been through all the suggestions made by the Treasury for savings and did not believe it would be possible to go any further - indeed, he believed that to secure savings of £1.9 billion (£1.6 billion on EFLs) would represent a major achievement.

The Prime Minister pointed out that following the discussion in MISC 106, the combined bids for the two industries in relation to base line were: -62; -85; + 215. She urged Mr. Walker to seek further savings which would bring the industries to base line in the third year. Mr. Gregson estimated that to achieve a saving of £215 million on EFLs would require gross savings of £250 million.

The Secretary of State for Energy said the only way he could secure any further savings was by giving an assurance to the industries that the progressive squeeze on them was at an end. He would consider how the savings suggested by the Prime Minister could be found. His office would agree a draft passage with Mr. Gregson for the MISC 106 report which had to be completed that evening and circulated the following morning.

I am copying this letter to the Private Secretaries to members of MISC 106, to Michael Reidy (Department of Energy) and to Richard Hatfield and Peter Gregson (Cabinet Office).

Yours sincerely

Andrew Turnbull

ANDREW TURNBULL

Miss Janet Lewis-Jones,
Lord President's Office.

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SECRET AND PERSONAL

COPY NO 1 OF 2

PRIME MINISTER

PUBLIC EXPENDITURE

I told you this morning that after immense struggles, considerable hostility and a great deal of pressure, and to the surprise of my key advisers, I managed to obtain from the gas and electricity industries improvements on their bids of £1,600 million pre-tax.

My advisers, who include a number of very experienced practitioners in the game of public expenditure cuts, were very surprised that I went to the Star Chamber and said that I might, as a last ditch exercise, using every power and persuasion at my command, get a further £300 million pre-tax from the industries bringing the total figure to £1,900 million.

I well understand your requiring still more if it can be obtained. I do assure you, however, that there is no way you will obtain more without a colossal battle with both the gas and electricity industries - with all of their boards and consumer organisations mobilised against us. If we legislated to achieve what we required the legislation would be impossible. I can assure you I really have used considerable negotiating skills to push them thus far without making them decide to go in for a fight.

This morning you expressed to me your particular difficulty in the third year. I have urgently examined my proposals in depth and could rearrange events so as to improve the third year, switching £147 million from the previous years and taking a complete risk in undertaking to find an additional £20 million above what had been previously promised. This therefore means I am back to baseline in the first two years in spite of the enormous impact of

SECRET AND PERSONAL

Corporation Tax which accounted for virtually the whole of the excess above baseline. In the third year I am within £48 million of the baseline, in spite of the fact that in that year the Chancellor will benefit from £1.3 billion Corporation Tax.

As I told you this morning, in 1979 when we came to power the gas and electricity industries contributed a total of £283 million. Over the three years covered by these IFR proposals, if I achieve the target I am endeavouring to achieve, the Government will receive nearly £9 billion from these two industries. As you know I personally strongly question the justification for this. I have recognised however that it is the collective view of you and your Government, and I really have done much more to achieve that collective view than any of those surrounding me considered was possible.

I mentioned to you at the end of our meeting that, if for presentational reasons, you wish to do anything for any one of the years, including the third year, it would be possible to change the basis for the payment of the gas levy. This would have no economic effect but would improve the public expenditure figures by some £330 million in the year of the change without any effect on the PSBR. Were you to decide to do it in the third year it would of course be odd to take credit for doing it three years in advance. I in no way advocate this change but I mention it as a possible recourse at a time of difficulty.

If the Government decides to accept these proposals I would naturally do my best to speedily obtain the £1,920 million pre-tax I am hoping to obtain. I must state very clearly however that I not only think it impossible to obtain more, but, should such an attempt be made, quite a lot of the £1,920 million may disappear.

Peter

Secretary of State for Energy

5 November 1984

- 5 NOV 1984

G. S. DART.

CONFIDENTAL

IFR 1984

DEPARTMENT OF ENERGY

19 OCTOBER 1984

CHART A

IFR – ENERGY INDUSTRIES

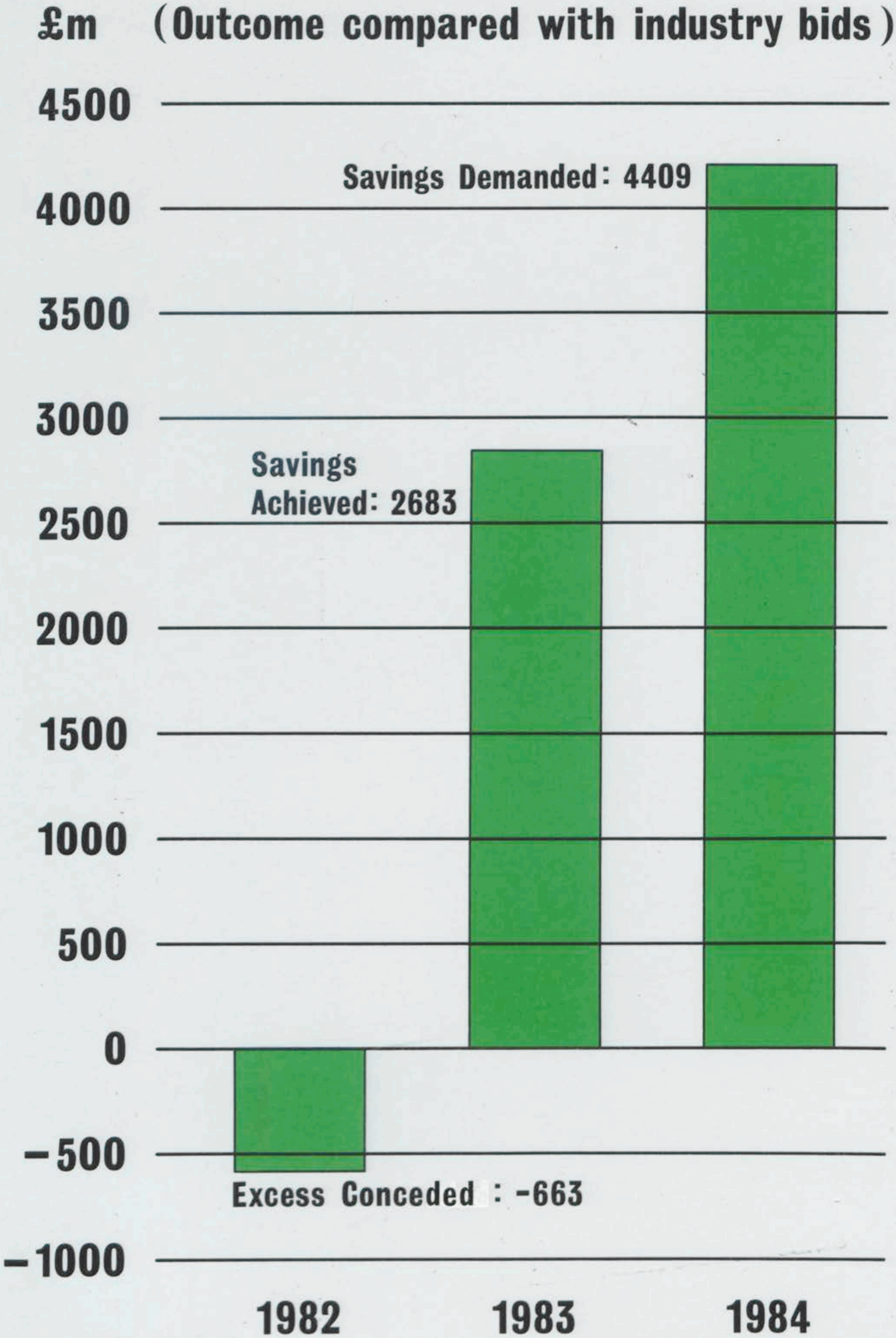


CHART B

THE VICIOUS SPIRAL

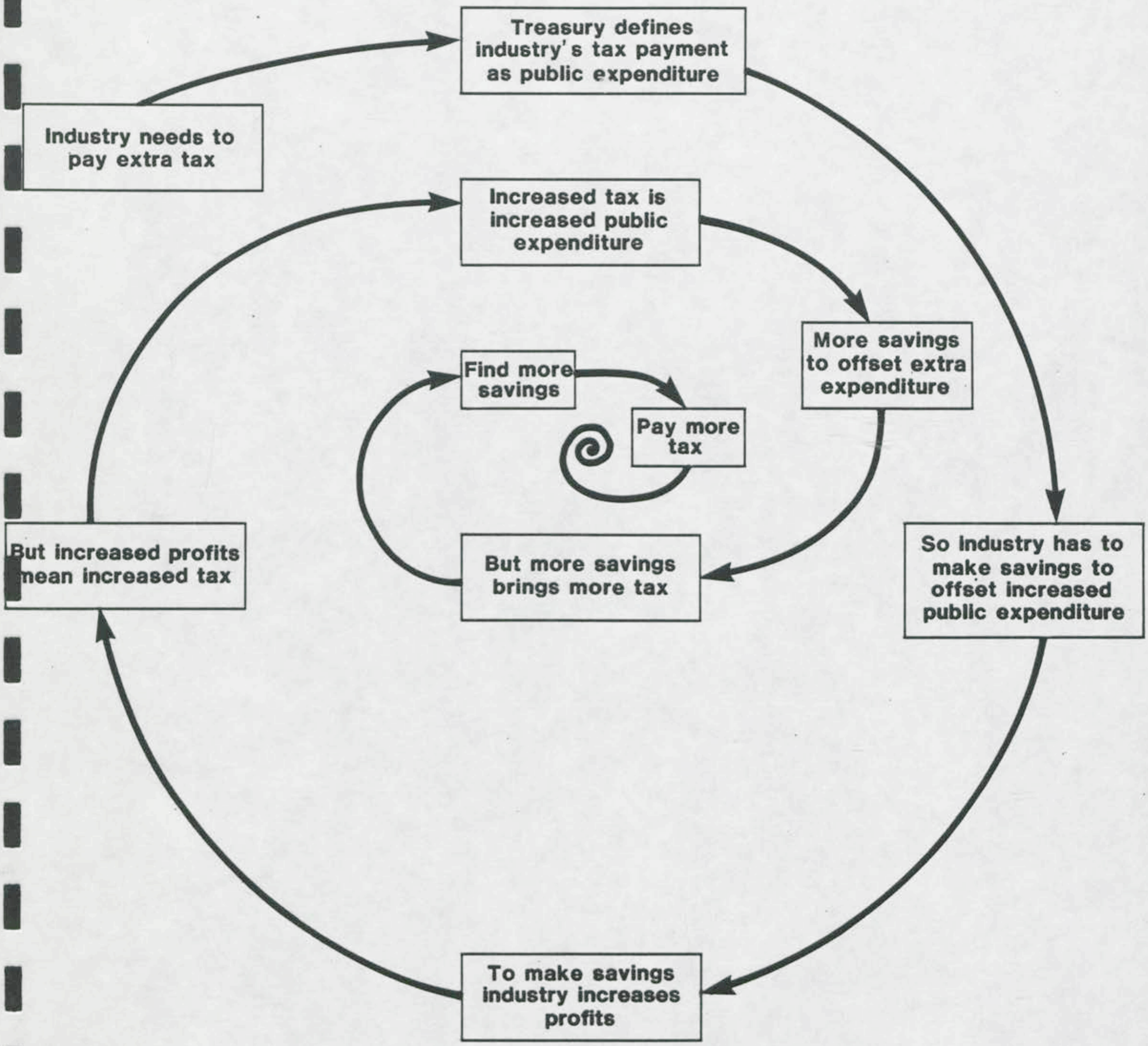
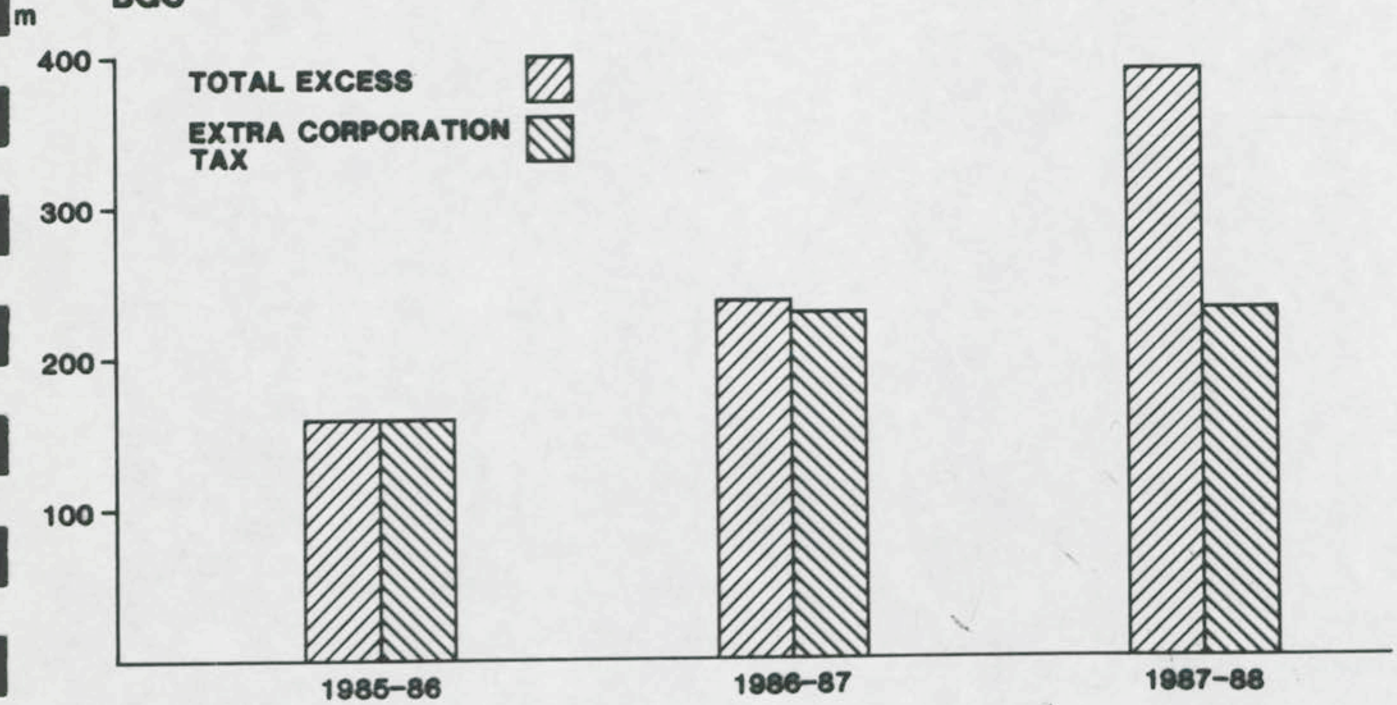


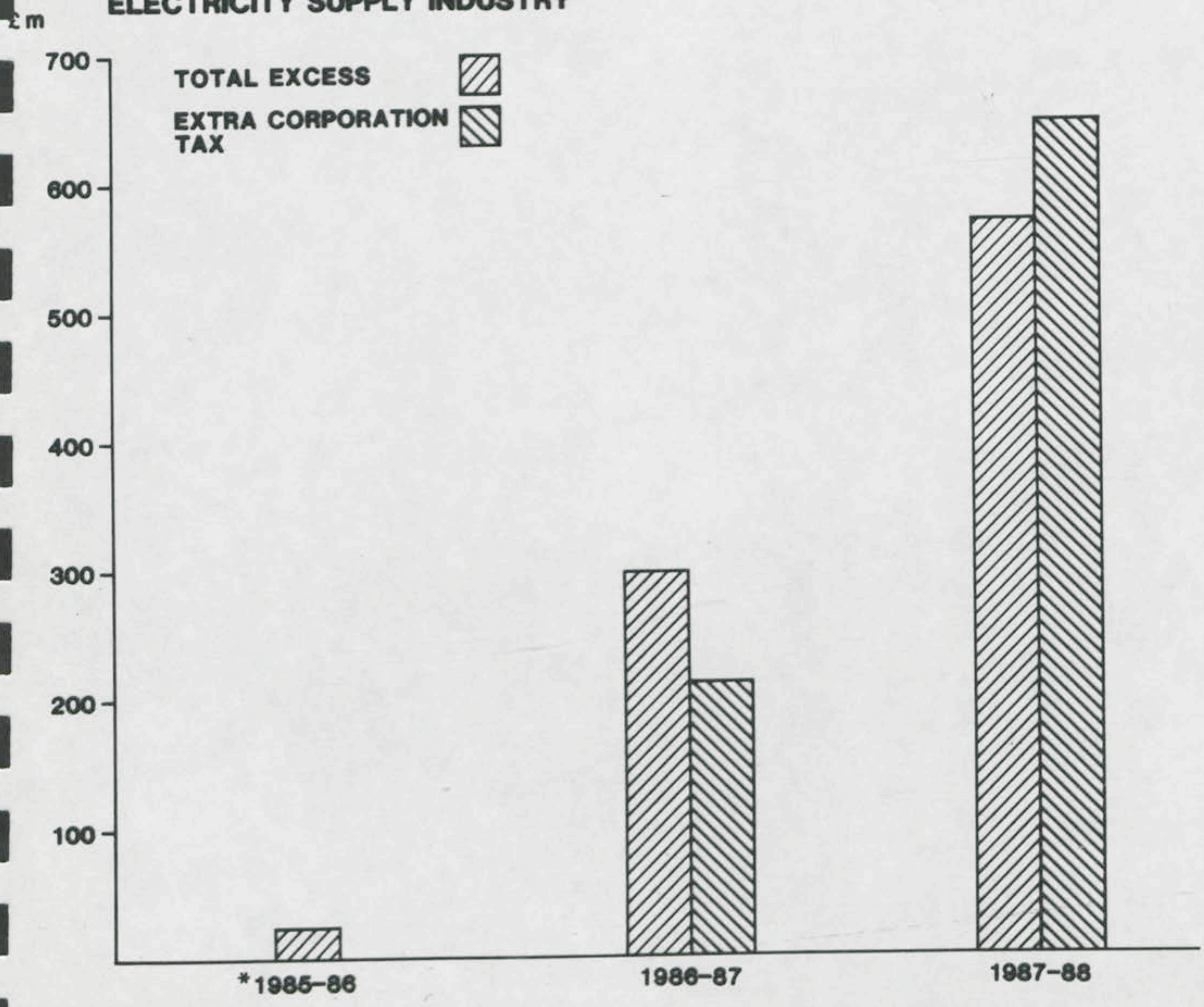
CHART 6

IFR 1984: ALMOST ALL THE EXCESS (88%) ABOVE BASELINE IS DUE TO EXTRA CORPORATION TAX

BGC



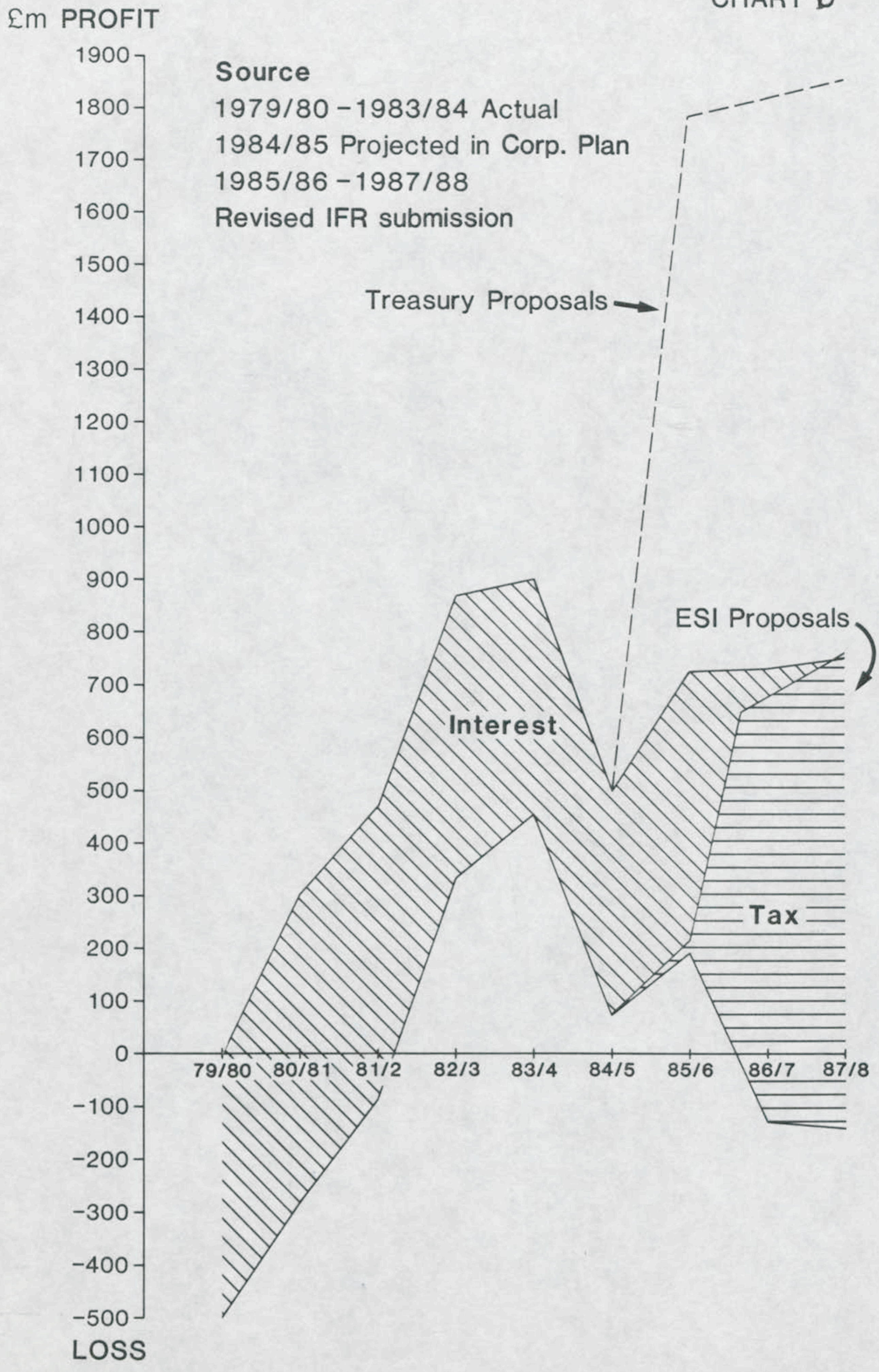
ELECTRICITY SUPPLY INDUSTRY



*No Corporation Tax payable in 1985-86

ESI Operating & Post-Tax Profit

CHART D



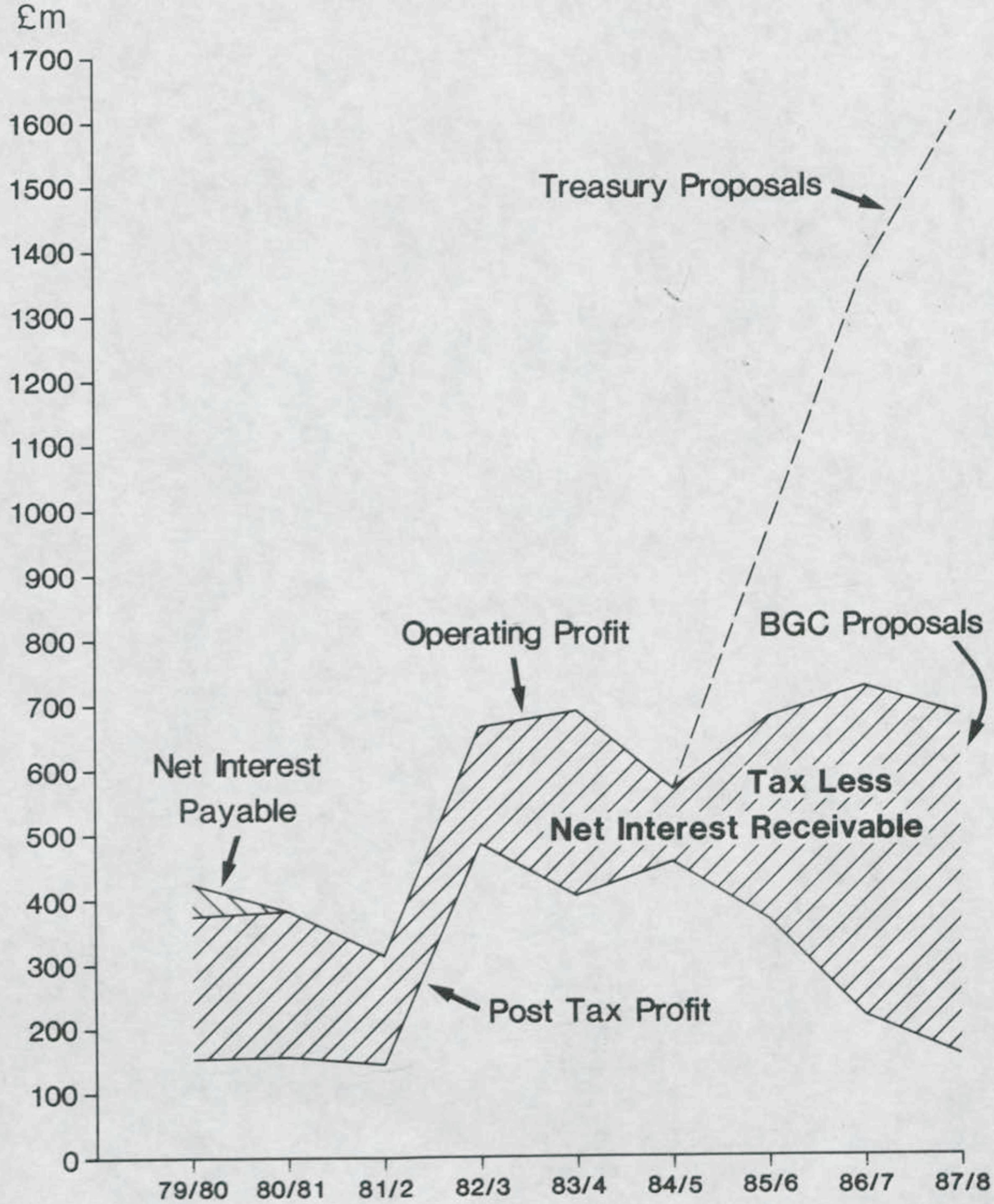
BGC Operating & Post-Tax Profit

CHART E

Source

1979/80 - 1983/84 Actual

1984/85 onwards : Corporate Plan/IFR



40

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

2 November 1984

Andrew Turnbull Esq
10 Downing Street
LONDON
SW1

Dear Andrew

PUBLIC EXPENDITURE: ENERGY

I am attaching, as agreed, Treasury briefing for the Prime Minister's meeting on Monday with the Secretary of State for Energy. It may be that the Prime Minister would find it useful to have an oral briefing on Monday morning. If so, Treasury officials would of course be ready to attend.

Yours ever
David

D L C PERETZ

BRIEF FOR PRIME MINISTER'S MEETING WITH MR WALKER ON MONDAY 5 NOVEMBER

Aim

1. To secure Mr Walker's agreement to public expenditure savings on gas and electricity such that, taken together with the maximum savings on housing likely to be agreed by Cabinet, will allow the overall public expenditure targets to be reached. This suggests, as a minimum, savings on gas and electricity totalling £1,900 million over the three Survey years taken together; or, better, the savings of £2,200 million on gas and electricity which Mr Walker originally undertook at MISC 106 as his aim; or - better still, to mitigate the severity of the politically difficult cuts on housing which will otherwise be necessary - savings of £2,500 million.

Background

2. The gap on gas and electricity between Mr Walker's original proposals and the savings required by the Chief Secretary to achieve the (E(A) target for nationalised industries as a whole was £3677 million. This was spread over the three years as follows:

1985-86	1986-87	1987-88	(£million)
583	1,135	1,959	

3. At MISC 106 Mr Walker first undertook to try to secure savings over the three years of £2,200 million; then, at the meeting on 31 October he offered to deliver £1,900 million. At the 31 October meeting he said this figure was on the same basis as the £3,677 million - ie it represented a saving in public expenditure of that amount.

FLAG A

4. He has subsequently, we understand, written to say that the £1900 million was not on that basis - but is equivalent to

public expenditure savings of only £1,600 million, because £300 million has to be deducted from the gross savings to compensate the industries for the additional corporation tax payments they would make as a consequence of their higher profits.

5. It will be essential to establish from the start with Mr Walker that all figures in the discussion are on a public expenditure basis - ie there is no deduction for tax payments. It is, of course, true that as these industries become more profitable they will pay more Corporation Tax, and that their liability to do so has increased as a result of the Budget. Thus, the higher the gross savings secured the higher the Corporation Tax liability; so that to achieve a given amount of public expenditure savings necessarily requires gross savings in excess of that amount.

6. Mr Walker may argue that the Treasury should exclude nationalised industries' Corporation Tax from public expenditure, as it comes back to the Treasury on the revenue side of the PSBR. But we could not possibly alter the definition of public expenditure in this instance alone: public expenditure is defined in this area (as in all others) on a tax-inclusive basis (nationalised industries' EFLs, for example, take acccount of their payments of VAT and vehicle excise duty, as well as their national insurance contributions and Corporation Tax). Excluding Corporation Tax would be seen by the markets as a fiddle and would bring discredit to the Government. Furthermore, it would amount to full compensation for, or the abolition of, Corporation Tax for state industries alone (and only for some of these; other nationalised industries have accepted the present position), while still imposing it on private sector firms - grossly unfair.

Mr Walker's Proposals

7. Mr Walker has given the following breakdown of his gross

savings of £1,900 million:

£ million

	1985/86	1986/87	1987/88	3 Years
Gas	115	250	350	715
Electricity	130	450	600	1180
TOTAL	245	700	950	1895

8. On electricity, Mr Walker's savings are consistent with real price reductions of ½ per cent in each year (or, as he prefers to put it, they are consistent with nominal price increases of 4½ per cent a year, given that the industry is assuming that their costs, and general inflation will rise by 5 per cent a year); and with a real rate of return on assets of 2.3 per cent in 1985/86, 2.9 per cent in 1986/87 and 3.1 per cent in 1987/88.

9. These price increases, it should be noted, are low even in relation to the views of the Electricity Consumer Council, who argue that price increases should not be higher than general inflation. Each extra real 1 per cent on electricity prices would save - net, in public expenditure terms - £75m in 1985/86 (and £65m a year thereafter).

10. On gas, Mr Walker's figures would mean real price increases of 1 per cent a year (or, as he prefers to put it, nominal price increases of 6 per ccent, 7 per cent and 8 per cent in the three years, given that the industry is assuming - with characteristic pessimism - that their costs and general inflation will rise by 5 per cent, 6 per cent and 7 per cent in the three years). They are consistent with a real rate of return of 5 per cent in each of the three years.

11. Even after these price increases (which are modest compared with the 10 per cent annual real increases achieved during three years in the last Parliament), UK gas prices would be well below European levels. Prices are 40-50 per cent higher ~~than~~ in France and Germany; UK prices would still be well below the 28p per therm BGC are paying for Norwegian gas. This means that BGC is selling gas to industrial consumers for less than it is paying to the Norwegians without taking account of the costs of transmission, distribution, storage etc. Each extra real 1 per

cent on gas prices saves net, in public expenditure terms - £55m in 1985/86, £70m a year theafter).

Assessment of Mr Walker's Proposals

(i) Electricity

12. The Chief Secretary proposed savings in operating costs rising to £620m a year by 1987/88, and a return on assets of 2.8 per cent, 3.6 per cent and 4.5 per cent in 1985/86-1987/88. The Treasury believes that it will be well within Sir W Marshall's ability to achieve cost-savings of this order (ie rising to about 6 per cent of present total costs) by 1987/88. On this basis there would be no need for any real electricity price increases over the period; and the real return on assets employed would reach the Government's general 5 per cent objective only at the end of the three-year period.

13. The gap between the Chief Secretary and Mr Walker is some £700m over the three years. Mr Walker should be pressed to close this gap, either by abandoning the idea of real price reductions, or by insisting on more rigorous cost-savings, or both. Maintaining prices at current levels in real terms would on its own contribute £230m towards closing the £700m gap over the three years. Cost savings would, of course, be additional to these.

(ii) Gas

14. The Chief Secretary proposed cost savings of £70m in 1985/86, £150m in]986/87, and £260m in 1987/88, (£480m over the three years), and average real increases in gas prices of 4 per cent a year, worth £220m in 1985/86, £440m in 1986/87 and £770m in 1987/88, (£1350m over the three years). This implies a (pre-tax) real return on asses of around 9 per cent.

15. Mr Walker will argue that these proposals would result in an unacceptably high level of profits in the industry. But, after paying their North Sea taxes, BP and Shell's return on assets in 1983 has, respectively, 8.7 per cent and 7.9 per cent; and, because two-thirds of BGC's gas comes from pre-1975 contracts

which are exempt from North Sea taxes BGC has an implicit subsidy from the Government of around £1½ billion a year. There is every reason why BGC's windfall North Sea profits should be creamed off for the benefit of the taxpayer at large, rather than exclusively for the 3 in 4 households who are consumers of gas. This was, of course, the rationale for the gas levy, and if Mr Walker did not agree to the Treasury's present proposals there would be a strong case for an increase in the levy.

16. It may also be suggested that it is desirable to hold gas prices down to encourage a shift away from coal-dependent electricity. This suggestion may be turned on its head, as an argument against the electricity price reductions Mr Walker is envisaging. In the present public expenditure situation we cannot afford to let up on gas prices. Furthermore, there are severe limitations on the extent to which electricity users can switch to gas: many users - both domestic and industrial - are tied to electricity by the nature of their present (and likely future) equipment.

17. Mr Walker should also be pressed to increase the total cost-savings he has offered - some £400m over the three years - towards the £485m sought by the Chief Secretary.

__Tactics__

18. If Mr Walker were to agree to savings, on a public expenditure basis, of £1,900m over the three years (ie the offer he made to MISC 106 on 31 October but from which he has subsequently resiled) we would fall short of the Cabinet's overall public expenditure targets by some £870m in 1985/86, £770m in 1986/87 and £1420m in 1987/88. It should be noted here that Mr Walker's present offer, of savings of £1,600m on a public expenditure basis fall some way short of bringing these industries back to the Survey baseline.

19. MISC 106 has proposed savings in __housing__ of £527m, £452m and £480m which, if accepted, would reduce these gaps to £344m

in 1985/86, £316m in 1986/87 and £944m in 1987/88 - figures which, if the Cabinet were to accept the less demanding overall target of keeping within the 1984 White Paper totals, would achieve this lesser goal.

20. But, as Mr Walker may accept, such large reductions in housing will be politically very difficult for the Government, involving as they do sensitive inner-city areas, and a large reduction in public sector capital expenditure.

21. To the extent, therefore, that Mr Walker can improve on his £1,900m offer, the severity of the cuts needed on housing can be abated. £2,200m - and, still better, £2,500m - would make a significant difference here. The Prime Minister may feel that, if he cannot be brought to agree to savings on a public expenditure basis of at least £1,900m - or, preferably, the £2,200m Mr Walker understook as his aim - the issue would best be ventilated at Cabinet, so that the political difficulties of the required savings in housing and energy can be weighed against each other.

SUMMARY

22. The best approach may be

(i) to ensure that Mr Walker is conducting the discussion on the basis which is relevant to the Public Expenditure Survey - ie on a public expenditure savings basis, so that his savings will count £1 for £1 as reductions in the industries' EFLs;

(ii) to explain the overall public expenditure position, and the need to close the remaining gaps either through housing or energy savings;

(iii) given the political difficulties in the very large reductions in housing which are envisaged, and the gaps which would in any event remain, to urge

- no real price reductions in electricity

- real gas price increases of at least 1% a year

- maximum cost savings in both gas and electricity.

MR BARCLAY

2 November 1984

ENERGY AND EXPENDITURE SAVINGS

In our note of 1 November to the Prime Minister, we drew attention to the scope for savings from BGC's working capital (forecast to increase by £900 million over the next 3 years) and capital expenditure running at around £1 billion per year. John Redwood suggested that we should amplify our concerns in this area.

Stemming from the major oil prices increase in the late 1970s, energy demand (including gas) has been depressed, whereas long-term supply arrangements have gone ahead. As for other fuels throughout the industrial world, UK gas supplies now exceed market requirements. Recent studies demonstrate that BGC will have a surplus of supply capacity - both average and peak - at least for the remainder of the 1980s. This has a cost, including the need for additional working capital. For example, BGC is likely to have to pay for £200 million more gas over the next 3 years than it can sell.

In our view, BGC are not confronting this situation with the right priorities. Instead of vigorously tackling the problem with a view of containing the increase of working capital and the cost of their operations, they are trying to dispose of their surplus supply capacity into additional low-grade industrial outlets; not usually, as it happens, displacing coal but heavy fuel oil. This represents the uneconomic use of a premium fuel. Why not negotiate with the producers for some relaxation of the take-or-pay provisions, using as a counter, a favourable price for incremental supplies when needed? Better save the gas for premium markets than squander it now in low-grade outlets only to be replaced later with very expensive Sleipner gas.

On capital expenditure, we would firstly question how much of it is justified by normal commercial criteria. The indications are that in testing the commercial benefit of capital expenditure proposals, BGC are less rigorous than the private sector. This reflects their inclination to place more emphasis on expanding markets than on making a commercial return on the assets. Secondly, we note that the Deloitte Haskins and Sells Report criticised the project management planning and control of the major Rough Storage and Morecambe Bay development projects. These were big prestigious projects tackled by dedicated teams. No doubt the scope for improvement is at least as great for the bulk of small capital projects.

JW

JOHN WYBREW

3.6] double
2.2] counting

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P.01420

PRIME MINISTER

Public Expenditure: Gas and Electricity EFLs

The Secretary of State for Energy "hopes to persuade" the gas and electricity industries to reduce their EFL bids by £1.6 billion over the three years (after allowing an offset for extra corporation tax to which the industries would become liable in making gross savings of £1.9 billion). A copy of Mr Walker's letter of 1 November setting this out is at Annex A.

2. It is suggested that your aim should be to persuade Mr Walker to increase this figure of £1.6 billion to £2.2 billion, ie to seek further savings of £600 million net from the two industries over the three years. The intention is however, unless Mr Walker is totally unyielding, to find a basis on which agreed recommendations can be put to the Cabinet on Thursday 8 November.

3. Annex B explains how far we have already moved from the Treasury's original ambition to achieve savings below baseline of about £2 billion. The Department of Energy started with bids to increase the combined gas and electricity EFLs by £183 million in 1985/86, £535 million in 1986/87 and £959 million in 1987/88. The offer which Mr Walker has made results in only modest reductions below baseline in the first two years and an increase in baseline in the last year as the following table shows:

£ million

1985/86	1986/87	1987/88
-62	-85	+215

It should be borne in mind that the turnover of the electricity industry in 1985/86 is expected to be around £10 billion and the British Gas Corporation in 1985/86 around £7 billion.

MAIN ISSUES

4. The main issues are:

i. how much more should the gas the electricity industries contribute?

ii. how should any extra savings be found?

How much more

5. On i. the important consideration is the overall public expenditure situation. On the basis of the agreements reached, assuming that MISC 106's very tough proposals on housing are accepted by the Cabinet in full, and assuming that the gas and electricity industries contribute no more than Mr Walker has offered, the public expenditure totals agreed by the Cabinet in July are likely to be exceeded by approximately the following amounts:

£ million		
1985/86	1987/87	1987/88
340	350	1250

Even if we get £2.2 billion for gas and electricity rather than the £1.6 billion Mr Walker has offered, there will still be a gap (say £250 million in 1985/86, £200 million in 1986/87 and £900 million in 1987/88) but it will be more manageable.

6. Mr Walker will tell you (see last sentence of his letter of 1 November) that it is "totally impossible to deliver more". He claims that his negotiations with the gas and electricity industry this year over their EFLs are the most difficult and contentious he has ever had with any nationalised industry in his Ministerial career. He will say that if he has to go back and ask for more he will lose the industries' cooperation totally.

7. You will have to judge how far Mr Walker can be pushed without provoking an unmanageable row in the Cabinet. Your line might be that the £2.2 billion target he agreed with MISC 106 was a reasonable one (on the assumption that it was net rather than gross) even though it fell far short of what the Treasury had asked for. You recognise his achievement in persuading the industries to accept £1.6 billion. However, in view of the difficult situation overall, you must ask him to press for another £600 million split between the two industries spread over three years.

8. I think that it is unlikely that you will be able to get him to commit himself to deliver £2.2 billion before the Cabinet discussion on 8 November. He is bound to say that he will have to go back to the industries and see what can be done. But it would be a major step forward to get him to undertake to try for £2.2 billion. That could be reported to the Cabinet as an agreed recommendation and would not require discussion.

How to make the extra savings

9. You may well find it difficult enough to persuade him to try for extra savings, without going on to constrain his and the industries' freedom of action in how to achieve the savings. The papers from the Treasury and the Policy Unit make a variety of suggestions, the Treasury leaning more in the direction of price increases and the Policy Unit favouring cost reductions.

10. On an objective assessment there would seem to be a case for pressing for a higher price increase for electricity. The industry's figure of 4.5 per cent in 1985/86 is on the assumption that inflation will be 5 per cent. It is therefore assuming a small real decrease, which is hard to justify. However, as you know, electricity prices have become a major political issue.

11. You may find it tactically best not to do more than float a few possibilities to show how further savings might be achieved, without getting into detailed figuring. In the last resort a commitment to try and achieve savings of the desired order is more important than the precise means.

CONCLUSIONS

12. However the meeting goes, it will be vital to know precisely where we stand at the end of it. The Lord President's paper for the Cabinet will have to be finalised on Monday afternoon for circulation on Tuesday morning. We shall therefore need to know whether:

i. the reductions in the gas and electricity industries' EFLs are to be £1.6 billion (net) on the basis set out in the Secretary of State for Energy's letter of 1 November;

or ii. greater reductions are to be sought and, if so:

a. whether the target should be £2.2 billion or some other figure;

b. what is the nature of Mr Walker's commitment to this target;

and iii. the energy programme is to be presented as agreed or disagreed in the Lord President's report to the Cabinet.

PLG

P L GREGSON

2 November 1984

ANNEX A

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ
01 211 6402

SECRET

The Rt Hon Lord Whitelaw CH MC
Lord President
Privy Council Office
Whitehall
LONDON
SW1A 2AT

1 November 1984

Dear Willie

IFR 1984

As you know, I made it clear at yesterday's discussion of MISC 106 that I hope to persuade the gas and electricity industries to reduce their EFL bids by finding further savings between them totalling £1.9 billion pre-tax. I understand that you would find it helpful to know the corresponding after-tax figure.

I have to say that I will have great difficulty persuading the industries to find the last £300m of the £1.9 billion I was asked to do. Neither industry has yet agreed what is wanted and the issues involved are very thorny. On electricity for instance the industry have made it clear that they will only agree the figures if their proposed financial target and performance aim are agreed.

Against this background it is naturally difficult to give post-tax figures with any confidence. The amount of tax payable will depend on how the savings are found. The whole difficulty with the treatment of this tax as public expenditure in the EFLs is that it adds to uncertainty and unpredictability. But on the understanding that the figures are subject to revision in the light of the final outcome, my Department's own best estimate at present is that reductions of £1.9 billion pre-tax would amount to £1.6 billion post-tax. On the same illustrative basis, the assumed breakdown between industries, before and after tax, would be as follows:

	1985-85	1986-87	1987-88	Total
Gas				
Before tax	115	255	345	715
Tax	nil	43	73	116
After tax	115	212	272	599
Electricity				
Before tax	130	450	605	1185
Tax	nil	42	133	175
After tax	130	408	472	1010

SECRET

ANNEX A
(Contd)

SECRET

I confirm that I believe that I can, with great pressure and difficulty, deliver the £1.9 billion. I confirm also that it is, in my opinion, totally impossible to deliver any more.

Yours ever
Peter

PETER WALKER

ANNEX B

PUBLIC EXPENDITURE SURVEY 1984: GAS AND ELECTRICITY EFLs

STARTING POSITION

	£ million 1985/86	1986/87	1987/88
Survey baseline (negative External Financing Limits)			
BGC	-396	-495	-507
ESI	-1022	-1337	-1370
D/Energy's proposed changes to baseline			
BGC	+159	+237	+389
ESI	+24	+298	+570
Treasury's proposed changes to baseline			
BGC) ESI) combined	-400	-600	-1000

DISCUSSION IN MISC 106

2. As the table above shows the Treasury started by asking for total reductions on the industries' combined EFL bids of £3.7 billion over the three years. The Secretary of State for Energy made much of the industries' sense of grievance about extra Corporation Tax which they would be paying, amounting to about £1.4 billion for the two industries over the three years. He said that, if this could be taken into account, the industries would be willing to cooperate in making savings. He was pressed to quantify what he thought it would be reasonable to aim at from the industries. The figure which emerged in discussion was £2.2 billion, ie (approximately) the Treasury's original bid for overall savings of £3.7 billion less the industries' extra Corporation Tax bill of £1.4 billion.

3. When the Secretary of State for Energy reported back to MISC 106 on 31 October he said that, on the basis of discussions with his industries, he hoped to be able to produce savings of £1.9 billion compared ~~combined~~ with his aim of £2.2 billion. It emerged however from his letter of 1 November that the effective reduction in the industries' EFL bids would be only £1.6 billion because of a <u>further</u> offset for Corporation Tax.

4. The Secretary of State for Energy has said very little about <u>how</u> the savings are to be achieved. He has indicated that the bulk will come from cost savings. On electricity prices he thought that the increase would be 4.5 per cent in 1985/86 and possibly of a similar order in the two later years. On gas prices he thought that the increase would be 6 per cent in 1985/86, and possibly 7 per cent in 1986/87 and 8 per cent in 1987/88.

5. Mr Walker also said that the electricity industry would make the necessary savings only if the Government agreed to the industry's proposals for its financial target over the next three years. The present financial target (pre-interest current cost on net assets) is 1.4 per cent for the two years to March 1985. The electricity industry's proposals are:

per cent

1985/86	1986/87	1987/88
2.3	2.9	3.1

The Treasury had been looking for a higher target as follows:

2.8	3.6	4.5.

Cabinet Office

2 November 1984

ECON POL: Public Exp Pt27

cc Broadbent HMT
Mr Gregson CO

Foreign and Commonwealth Office

London SW1A 2AH

2 November 1984

Dear Andrew,

FCO Expenditure

The Secretary of State has seen your letter of 31 October recording the outcome of the Prime Minister's meeting. He has two comments on your account.

He thinks that in paragraph 3 of the letter the word "amendments" should read "commitments".

More importantly, he does not accept that the statement at the end of the penultimate paragraph that "after discussion the Foreign Secretary agreed to accept the Chief Secretary's formulation" is an accurate record of the conclusions of the meeting. In the course of the discussion the Foreign Secretary was presented with two options and invited to choose. The first option was as stated in your letter. The second was as stated in Charles Powell's letter of 23 July to John Gieve and, more fully, in the Foreign Secretary's minute to the Prime Minister of 11 July. The Foreign Secretary explained several times that while he could see the possible attraction in the short-term for the first option since the pound is likely to strengthen, he believed it would be irresponsible of him to accept. The only way in which the diplomatic vote could be managed in the long run was as stated in the second option. The Foreign Secretary has asked me to say that he is in no doubt that this represents the accurate conclusion of that part of the discussion.

Yours ever,

Len Appleyard

(L V Appleyard)
Private Secretary

Andrew Turnbull Esq
10 Downing Street

SECRET

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3,6

1 November 1984

PRIME MINISTER (2)

ENERGY AND EXPENDITURE SAVINGS

We agree with Cabinet Office's recommendation that you should aim for £2.2 billion of savings from gas and electricity.

The outstanding issue is the balance between gas and electricity, and between cost reductions and price increases. Unlike Treasury, we would prefer more emphasis on cost-cutting and less on price increases.

Should we continue to overlook the potential large contribution from selling retail activities and the upstream gas assets? These might be an unallocated part of the overall figure for general asset sales, but would make an important contribution to total public spending targets in future years.

On price increases, we would settle for Peter Walker's 1 per cent per annum real price gas increase, and no real increase in electricity. This means we need further additional cost-saving measures to get to £2.2 billion, and to pocket the Corporation Tax at the same time.

SECRET

SECRET

British Gas Corporation

BGC has a £3 billion gold-plated cost structure. We agree with the Treasury that savings can be achieved by reducing gas supplies (although we would be more cautious than the Treasury on this); and in phasing out R&D into synthetic natural gas.

We believe more could be squeezed out of land sales. We would suggest £10m, £15m, £15m in 1985-86, 1986-87 and 1987-88 respectively.

On capital expenditure, we think the Treasury are far too modest. More effective project management, procurement and cost control on this £1 billion per annum programme should deliver more than £0m, £40m, £55m. Remember that some of the North Sea expenditure could be reduced (without full privatisation) by farm-outs (dilution of licence interests) and we agree with Treasury on the scope to cut the peripheral expenditure items. BGC should not be nationalising any more of the North Sea, as they are currently planning.

On working capital, again the Treasury line is modest. A working capital increase of £900 million over 3 years should be a prime target for substantial cuts. Working capital has already escalated from 12 per cent to 21 per cent of

SECRET

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turnover over the last 5 years - a new high. BGC should now be asked to correct it vigorously.

They also have much more scope on trading costs. Out of a total of £2 billion, we can do better than £10m, £20m, £30m.

Electricity Industry

Again, Treasury are being pessimistic on the scope for reducing working capital. The electricity industry has £3 billion tied up. We would suggest much tougher action.

The industry's operating expenditure is approaching £10 billion. Fuel costs account for roughly half. In looking for savings, we would arrive at much the same end-point as the Treasury - progressive reductions reaching £620 million per annum by 1987-88, but via a somewhat different route. Like them, we would want to see full use made of CEGB's nuclear capability and the new links with France and Scotland. However, we are very nervous about the proposed real reduction in the level of earnings of the 100,000 so-called non-sensitive staff in the industry. Nor would we feel happy with an explicit programme to achieve a more rapid rundown of manpower. This should not in itself be a target, but the natural consequence of vigorous management efforts to contain operating expenditure by reducing waste and inefficiency, and improving productivity as turnover increases.

SECRET

Conclusion

We are suggesting the following increases in cost-cutting (compared to Treasury numbers):

	1985-86	1986-87	1987-88
			£m
Gas			
Sale of assets: land	5	5	5
Reduced Capital expenditure	50	60	45
Reduced working capital	20	70	70
Reduced trading costs	30	60	90
Electricity			
Working capital	30	30	30
Operating costs		unchanged	
Total	£135m	£225	£230m

Asset sales of retail and contracting (gas est. £160m; electricity est. £100m) and of upstream gas reserves (est. £2bn) would also help.

JMW.

JOHN WYBREW

SECRET

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10 DOWNING STREET

Prime Minister (1)

The Public Expenditure Scorecard

Line 4 shows the position in relation to baseline if

(i) MAFF accept the MISC 106 offer

(ii) Mr Jenkin yields the housing savings in full

(iii) Mr Walker delivers £1.9 billion on EFLs, ie with no waiving of corporation tax.

The gap can be bridged in two ways

(i) By returning to the PEWP figures, which means adding back the benefit of NIS which the Treasury had knocked off in constructing baseline. This can be justified by pointing to corporation tax moving in the other direction

(ii) by upping 1987-88 by $2\frac{1}{4}$ per cent rather than 3 per cent.

In your discussions with Mr Walker you will want to push him past £1.9 billion. This would allow some relief to be given to Mr Jenkin. An extra £100 million a year would allow Mr Jenkin £200 million extra in years 1 and 2.

If Mr Walker is difficult eg by trying to clawback even some of the £1.9 billion, you might consider doing a deal with Mr Jenkin and leaving him as the one to go to Cabinet, though this would be a high risk option.

AT

1/11

£2.2bn EFL's £600m

Baseline? -62 -85 +218

OUTCOME

		1985-85	1986-87	1987-88
1.	Net effect of agreed/expected programmes (scorecard attached)	211	525	-671
2.	Required change from other programmes to get to baseline	-211	-525	+671
	Programmes agreed in MISC etc			
	Defence	105	0	300
	FCO/ODA	0	0	0
	DOE other	-29	9	-1
	Urban programme	-30	-55	-55
	Health	198	286	597
	Social Security	519	296	1,327
	Outstanding MISC proposals			
	Housing	-527	-452	-480
	AFF	-36	-88	-112
	Territorial consequences	0	-30	+30
	Gas and Electricity	-67	-175	9
3.	Total	+133	-209	1,615
4.	Distance from Survey baseline (3-2)	344	316	944
5.	Return to PEWP figures	451	436	[450]
6.	Distance from PEWP	-107	-120	[494]

memo item
3.25 growth in 1987-88 — 340

Subject

cc John Redwood

SLH 35

cc Master

10 DOWNING STREET

From the Private Secretary

1 November 1984

PUBLIC EXPENDITURE: DEFENCE

The Prime Minister held a meeting today to discuss the defence programme. Present were the Lord President, the Chancellor of the Exchequer, and the Secretary of State for Defence.

The Lord President said his group had reached agreement with the Secretary of State for Defence on his programme in 1985/86 but the provision for 1986/87 and 1987-88 was still not agreed. The Secretary of State for Defence was seeking a further £94 million in both years. The group had proposed a form of words stating that the provision for later years would be kept under review in the context of the Government's expenditure plans, taking account of military commitments and of other relevant factors. The Secretary of State had suggested an alternative formulation which stated that it was the intention to hold defence expenditure after 1985-86 broadly level in real terms, with the cash provision in 1987/88 subject to review in the light of price movements and other relevant factors.

The Secretary of State for Defence said he was not arguing that Britain's defence needs could not adequately be met within the provision recommended by MISC 106. The problem he faced was a political one, both at home and abroad. If he accepted MISC 106's recommendations, it would be clear that the programme was declining in real terms in years two and three. In the eyes of the US, the UK would be placed in the camp of those countries seeking to cut defence expenditure. It would make it easier for other NATO allies to scale down their contributions to NATO. The figure of £94 million would not only hold the programme constant in real terms in 1986/87 but it would also produce the same figure as that established in the 1984 PEWP. Since there was no published base line for 1987/88 the risk of adverse comparisons was less. His form of words was intended to reinforce the message from the figures that the programme would be held constant in real terms.

In discussion, it was argued that what mattered was not the finance available to the Defence Budget but what it

/delivered.

delivered. The management techniques being applied by the Secretary of State for Defence were capable of delivering substantial improvements in defence even while in statistical terms, the defence programme was declining in real terms. The Secretary of State for Defence accepted the validity of this but observed that if discussion in NATO were allowed to shift from financial provision to the quality of defence offered, the scope for NATO allies to disguise a scaling down in their commitment would be increased.

In further discussion it was argued that the form of words offered by MISC 106, which was not being made available to any other programme, should provide the Secretary of State for Defence with adequate defence against criticism.

The Secretary of State for Defence said that if he accepted the group's offer on figures and words, it would be essential to present the Government's case to the defence constituency with greater vigour (he pointed out that he would be shortly facing an examination from the Select Committee on Defence). The Prime Minister assured him that he would have the full support of colleagues in this. On this basis, the Secretary of State accepted the proposal of MISC 106 that the defence programme should be £18564 million in 1986/87 and £18867 million in 1987/88, and that the programme should be qualified by the form of words suggested by the group.

Discussion then turned to manpower. The Secretary of State for Defence said the Government was easing off in its search for manpower savings and the targets suggested for other departments were insufficiently ambitious. He believed he was capable of delivering very substantial savings. But he was reluctant to quantify this until it was clear what other departments would be offering. To do so would create management difficulties for him in the Ministry of Defence. In discussion, it was pointed out that the Treasury needed to have a figure for publication. If an ambitious figure were offered for the Ministry of Defence, it would help the Treasury to put pressure on other departments in future years. The Secretary of State for Defence agreed to offer a figure. This was left for discussion with the Chief Secretary.

I am copying this letter to Private Secretaries to Members of MISC 106, to Richard Mottram (Ministry of Defence) and Richard Hatfield (Cabinet Office).

Andrew Turnbull

Miss Janet Lewis-Jones
Lord President's Office

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NBPM

AT 1/11

PRIME MINISTER

MISC 106: AGRICULTURE R AND D EXPENDITURE

A 28

1. I have now seen a copy of Andrew Turnbull's minute of 15 October to Miss Janet Lewis-Jones and the accompanying comments from Dr Nicholson; and of Michael Jopling's response to you of 26 October.

with AT ?

2. As you will know, for the reasons set out in my letter of 3 August to Peter Rees and copied to you, reductions in MAFF's R and D commissions with AFRC could have serious consequences for the Science Budget and for the Council. Even on present planning figures, AFRC will have to abolish several hundred posts over the next three years. Any further reductions, even less than a million, will inevitably mean more job losses; reductions of the order mooted in the correspondence - running to tens of millions - would have massive structural consequences for the Council.

3. I would simply ask, at this stage, that any recommendation by MISC 106 for reductions in R and D spending by the agriculture departments should explicitly provide either that commissions with AFRC are excluded or that any consequential costs - as for redundances - should be met from sources entirely outside the Science Budget. I would also ask that if any cuts recommended exceed more than say 5% in 1987-88 and there is no explicit exoneration of commissioned work, we should ask officials for an assessment of the likely impact on the structure of the AFRC before taking a final decision.

4. I am copying this minute to Michael Jopling and other recipients of his minute.

KJ

1 November 1984

Subject

file RFJ 33 AAB

cc Master

10 DOWNING STREET

From the Private Secretary

31 October 1984

Dear Janet,

Public Expenditure Survey 1984

The Prime Minister held a meeting this evening to review the state of play on the 1984 public expenditure survey. Present were the Lord President, Chancellor of the Exchequer, Chief Secretary, Mr. Bailey, Mr. Gregson and Mr. Redwood.

The Lord President said the group had reach agreement with the Secretary of State for Social Services. All the Government's pledges had been observed and sufficient savings had been found without foregoing the uprating of child benefit for which it would have been difficult to secure Parliamentary approval.

He was hopeful of reaching a settlement with the Minister of Agriculture close to the group's original recommendations. This would create difficulties on capital grants and arterial drainage. On ADAS it had been agreed that savings should be offered on account, anticipating the implementation of the Bell Report.

The Secretary of State for Defence had argued successfully for additional expenditure in 1985/86 to meet the NATO commitment. He was seeking an additional £94m. in years two and three beyond the group's recommendation. He was also seeking a form of words which would imply a commitment to maintain the programme in real terms rather than cash. This would in effect reverse the outcome of last year's survey.

In discussion it was agreed that Mr. Heseltine's form of words was not acceptable. The difficulty he was facing was not so much that there was insufficient finance to meet defence commitments, though concern about the cost of the Trident programme was beginning to surface but rather that it would be difficult to defend politically, at home and abroad, small real reductions in the real programme. Large savings on procurement should enable commitments to be met with a lower real programme.

It was agreed that the Prime Minister, the Lord President and the Chancellor should meet Mr. Heseltine in an effort to secure agreement before Cabinet. This has been arranged to take place immediately after this week's Cabinet.

The Lord President reported on the difficulties encountered in discussion with the Secretary of State for the Environment. While the urban programme had been agreed, as recommended by MISC 104, nearer to the Chief Secretary than to the Secretary of State for the Environment, no agreement had been reached on the housing and other environmental service programmes. For housing the group recommended reductions of £527m. and £542m. and £480m. below base line in the three years. This would imply new public sector building of 14-20,000 a year compared with the 40,000 which Mr. Jenkin regarded as the minimum. Mr. Jenkin also considered the reductions in improvement grants to be excessive. The impact on the construction industry would be serious.

Mr. Jenkin had indicated to the group that he wished to argue his case in Cabinet. In these circumstances it was unlikely that he would wish to reach a settlement beforehand with the Prime Minister. Nevertheless the Lord President suggested that it would be helpful if the Prime Minister met him beforehand to familiarise herself with his arguments and to indicate that she would not be supporting him. The Prime Minister agreed to do this probably on Tuesday or Wednesday next week.

The Lord President said the Secretary of State for Energy had agreed to seek savings in the EFLs in the gas and electricity industries of £2.2b. over the next three years. After discussion with the industries Mr. Walker reported that savings of £1.6b. could be found which he believed could be pushed up to £1.9b. He did not believe they could be increased beyond that point.

The committee had been under the impression that his figures referred to the effect on EFLs. Subsequently Mr. Walker had indicated that his offer did not cover the additional corporation tax which the savings would produce so that the effects on the EFLs would be smaller. The Lord President said most of the group thought they would not be able to get Mr. Walker to agree to savings beyond £1.9b. but it was possible that Mr. Walker might be prepared to agree to go further in discussion with the Prime Minister. She agreed to meet him privately on Monday in an effort to seek an agreement before Cabinet.

The Chancellor said he was anxious to settle public expenditure in one go at Cabinet on 8 November. This was essential if the Autumn Statement were to be produced, as intended, by 12 November. He believed this would be possible if Cabinet were faced with no more than one, or at most two unagreed programmes.

I am copying this letter to David Peretz (HM Treasury), Richard Broadbent (Chief Secretary's Office) and Mr. Gregson (Cabinet Office).

Yours sincerely

Andrew Turnbull

Andrew Turnbull

Miss Janet Lewis-Jones
Lord President's Office.

Subject

SECRET

FILE
MFJ AHA

cc: MISC 106: LPO
CST
HS
SO
LPS
DTI
+ FCO.
bcc: J Redwood

CC Master

32

10 DOWNING STREET

From the Private Secretary

31 October 1984

Dear Janet,

FCO Expenditure

The Prime Minister held a meeting this evening to discuss FCO expenditure. Present were the Lord President, Foreign Secretary, Chancellor of the Exchequer, Chief Secretary and Mr. Gregson.

The Lord President reported on the outcome of the discussions in MISC 106. The group had recognised the difficulties facing the Foreign Secretary but against the background of public expenditure as a whole and the difficulties which were having to be taken on the other domestic programmes, the group did not feel it could recommend any increase over the combined base line for ODA and FCO.

The Foreign Secretary set out what would be involved in meeting the MISC 106 recommendations. The aid budget had suffered a substantial reduction in real terms and the bilateral component even more so. There were substantial amendments e.g. to India. In addition a number of political commitments e.g. Grenada and the Falklands had been added recently. If further cuts were made the Government would have no margin in the bilateral aid programme to respond to new policy demands.

The Prime Minister commented that public expenditure as a whole had risen by around 8 per cent under this Government. The fact that programmes such as defence and social security had increased substantially more meant that other programmes had to be held back. The combined programme of £1.8b. was large enough to accommodate the additional demands being made upon it. The Foreign Secretary said the problems facing the diplomatic wing were particularly acute and some of the issues e.g. the British Council and the BBC were highly political. The demand for FCO services was rising rapidly. In his view the FCO

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TMS.

programme should receive compensation from the Treasury when the exchange rate fell and should yield up savings when the exchange rate rose. The Prime Minister accepted that UK diplomatic staff abroad should be well housed. The Chief Secretary accepted that, in principle, it was difficult for the FCO programme to bear the brunt of exchange rate movements but in a year such as this one when the public expenditure position was particularly acute he had to ask for additional costs to be absorbed.

The Foreign Secretary said the additional cost of exchange rate movements after allowing for the savings he was offering was £18m. This should be added to the combined base line on the understanding that if the exchange rate rose the benefit should be returned to the Treasury. The Chief Secretary suggested that the combined programmes be held at base line on the understanding that the Foreign Secretary would be able to retain the benefit of a strengthening in the exchange rate and would be free to apply such savings wherever he wished within the combined programme. After further discussion the Foreign Secretary agreed to accept the Chief Secretary's formulation.

Summing up the discussion, the Prime Minister said that on the understandings offered by the Chief Secretary, the Foreign Secretary's combined programme would be reported to Cabinet as being agreed at base line.

I am copying this letter to Len Appleyard (Foreign and Commonwealth Office), to the Private Secretaries to other members of MISC 106 and to Richard Hatfield (Cabinet Office).

Yours sincerely

Andrew Turnbull

Andrew Turnbull

Miss Janet Lewis-Jones
~~Home Office~~
Lord Presidents Office.

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AT

31

SECRET

P.01418

PRIME MINISTER

Public Expenditure: Defence

This note is to summarise where things now stand in the exchange between MISC 106 and the Secretary of State for Defence on his programme. I attach the following:

... i. Minute from the Secretary of State for Defence to the Lord President dated 24th October.

... ii. Letter from the Lord President to the Secretary of State for Defence dated 29th October.

... iii. Minute from the Secretary of State for Defence to the Lord President dated 30th October.

2. The figure for 1985/86 of £18,060 million is agreed. The differences relate to the figures for the two later years and the form of words relating to them which will appear in the Public Expenditure White Paper.

	£ million 1986/87	1987/88
MISC 106 proposal	18,564	18,867
Defence Secretary's proposal	18,658	18,961
Gap	94	94

3. The two alternative forms of words are:

MISC 106 proposal:

The provision for 1985-86 meets the Government's commitment to plan to implement the NATO aim of real increases in defence spending of 3 per cent per annum up to that year. The cash provision for later years will be kept under review in the context of the Government's expenditure plans, taking account of our military commitments and all other relevant factors.

Defence Secretary's proposal:

The 1985/86 provision is in line with the NATO aim of real annual increases in the region of 3 per cent. Thereafter the intention is to hold defence expenditure broadly level in real terms: the cash provision in 1987/88 will be subject to review in the light of price movements and other relevant factors.

PLG

P L GREGSON

31 October 1984

MO 8

LORD PRESIDENT OF THE COUNCIL

THE DEFENCE PROGRAMME

You invited me at the meeting of MISC 106 on 18th October to consider the following defence expenditure figures:

£ Million cash

1985/86	1986/87	1987/88
18055	18514	18767

2. In 1981 (Cmnd 8288) the Government committed itself to plan to implement in full until 1985/86 the NATO aim of real growth of 3% a year in defence expenditure. The intention was stated of setting 1985/86 defence provision 21% higher in real terms than actual expenditure in 1978/79. Following the Falklands war, we further committed ourselves to providing a supplement to the defence budget, in addition to 3% annual growth, to meet the extra costs of the garrison and of replacing equipment lost during hostilities.

3. In last year's PES settlement, owing to reduced provision and higher than expected inflation on the defence programme, we fell short for the first time of our 1985/86 objective of 21% real growth (Falklands-exclusive) over 1978/79 (the figure was 19%), although we could, and did, represent the settlement as in line with our commitment to plan to implement 3% real growth a year. But the real growth rates implied by the cash provision shown above are (Falklands-exclusive):

	1985/86	1986/87	1987/88
Year-on-year	2.7	-0.8	-1.0
Over 1978/79	18.3	17.4	16.3

4. So far as 1985/86 is concerned this represents a further shortfall on earlier plans and could not be presented as in line with a commitment to plan to implement 3% annual growth in full.

5. For 1986/87 and 1987/88 the figures represent real decreases. I see very serious objections to this. The decision we took last year not to extend 3% real growth beyond 1985/86 has been criticised domestically and is the subject of a major forthcoming enquiry by the House of Commons Defence Committee. It has been received with great reluctance in NATO, on the basis that there will nevertheless be some continuing real growth. If we were now seen to be planning for a progressive real reduction in defence expenditure after 1985/86, I do not see how we could sustain our position domestically or internationally. At home we should be severely criticised by our own supporters and be vulnerable to criticism from our political opponents in the run up to the next election. We should have thrown away one of our strongest cards at the last election in order to save quite small sums of money. The need for greater investment in conventional force improvements is now generally accepted - yet we should be reducing expenditure at the very time that Trident expenditure builds up towards its peak with the potential problem, for which I have sought no compensation, of finding large additional sums because of sterling's weakness against the dollar. The effect on US sentiment, where burden-sharing is an increasingly live issue, could only be extremely damaging, and the repercussions in NATO very serious.

6. Against thisbackground I am not able to accept the figures proposed which I regard as very damaging politically, in terms of defence capability, and for our international position. The minimum

that I should be prepared to contemplate would be full 3% growth in 1985/86 and level real provision thereafter.

[text approved by and signed on
behalf of the Defence Secretary]

Ministry of Defence

24th October 1984

SECRET

PRIVY COUNCIL OFFICE
WHITEHALL. LONDON SW1A 2AT

29 October 1984

CABINET OFFICE
A 8214
30 OCT 1984
FILING INSTRUCTIONS
FILE No. ....

Dear Michael

MINISTERIAL GROUP ON PUBLIC EXPENDITURE (MISC 106):
THE DEFENCE PROGRAMME

Thank you for your minute of 24 October, which you discussed with MISC 106 earlier today. We are all most grateful for the helpful suggestions you made at the meeting.

For 1985-86, you said that you would accept a figure only £5 million higher than the Group's previous proposal, ie £18,060 million. For later years you thought that the figures should be £18,695 million for 1986-87 and £19,138 million for 1987-88 (inclusive of Falklands), subject to a deduction of around £35-40 million a year to reflect the provisional agreement reached on the 1985-86 figure. You explained however that you would be willing to consider lower figures for the two later years provided that there was an agreed form of words indicating that the figures were provisional.

As I promised, I am writing to set out the recommendations which MISC 106 are now minded to put to the Cabinet, on the basis described below.

First, we are prepared to recommend, as you proposed, a figure of £18,060 million for 1985-86, as part of a settlement covering all three years of the survey.

Secondly, for 1986-87 and 1987-88 we are prepared to recommend the baseline figures (adjusted for pay clawback), with the agreed addition for Falklands expenditure in the final year. That is equivalent, in rounded terms, to £18,564 million for 1986-87 and £18,867 million for 1987-88.

The Rt Hon Michael Heseltine MP

Thirdly, we propose the following form of words for use in publicly presenting the figures.

> 'The provision for 1985-86 meets the Government's commitment to plan to implement the NATO aim of real increases in defence spending of 3 per cent per annum up to that year. The cash provision for later years will be kept under review in the context of the Government's expenditure plans, taking account of our military commitments and all other relevant factors.'

I should emphasise that we regard these proposals as a package. If you were not able to accept it, MISC 106 would feel free to reconsider their recommendations. Since time is now very short, I should be grateful if you could let me have your response by close of play tomorrow, 30 October.

I should also be grateful if you could put forward a specific proposal on manpower numbers.

I am sending copies of this letter to the members of MISC 106 and to Sir Robert Armstrong.

MO 8

LORD PRESIDENT OF THE COUNCIL

PUBLIC EXPENDITURE SURVEY

Thank you for your letter of 29th October.

2. The new figures you propose for defence expenditure represent some improvement over those we considered yesterday. But they still fall short of maintaining defence provision level in real terms after 1985/86:

	1985/86	1986/87	1987/88
Cash	18060	18564	18867
Real growth (Falkland-exclusive)			
a. year-on-year	2.8	-0.5	-0.7
b. over 1978/79	18.4	17.8	17.0

To eliminate the shortfall the additional cash required is:

		94	233

3. As I indicated in my minute of 24th October the political and international implications of appearing to plan for a real reduction after 1985/86 would be serious. Not only shall I be having to cope with the growing pressure of the build up of Trident costs against a deteriorating exchange rate, which is now widely perceived (including by our own back benchers), but there is also the international pressure led by the US Administration in the face of Congressional demands for a greater European contribution to the burden of Alliance defence. For the British Government to be seen at

this time to be planning a conscious reduction in defence expenditure would be a source of considerable concern. Given that we have come so close to resolving our differences, I cannot believe that a reduction of £94 million on defence set in the context of total public expenditure is worth the disadvantages I have described.

4. The £94 million difference also represents the cash reduction from the figure established in the 1984 PEWP and would therefore be especially difficult to explain as other than a cut. I hope therefore that I can persuade you to let me retain the £94 million and carry it forward to 1987/88. This would leave a difference between us of only some £140 million in 1987/88. Here I would agree to pursue the solution of agreeing a form of words for publication. This has the virtue of assisting the arithmetic of public expenditure while leaving it open to us to make the essential political judgements about defence expenditure in the pre-election period closer to the time.

5. If we are to proceed on this basis we need however to devise a form of words that is less open than your suggestion to any interpretation that the reader wishes to place on it. I propose the following:

> The 1985/86 provision is in line with the NATO aim of real annual increases in the region of 3%. Thereafter the intention is to hold defence expenditure broadly level in real terms: the cash provision in 1987/88 will be subject to review in the light of price movements and other relevant factors.

6. I shall even so be accused of cutting the defence budget at a time of mounting Trident costs. I realise that my Cabinet colleagues are taking difficult decisions in their own fields and that perhaps concern about the domestic implications of expenditure reductions in other areas may obscure the international implications

of reducing defence expenditure which I perceive so clearly. I therefore believe that, in the context of her relationship with President Reagan, the Prime Minister will wish personally to consider the implications of decisions on defence expenditure.

7. I am looking further at the civilian manpower figures and hope to let you have proposals in a day or two.

8. I am copying this minute to the members of MISC 106 and to Sir Robert Armstrong.

[illegible]

[Approved by the Defence Secretary & signed in his absence]

Ministry of Defence
30th October 1984

1 MR BUTLER ✓ 31 October 1984

2. PRIME MINISTER Nothing on disregards.

SOCIAL SECURITY PROGRAMME

I attach two notes:

- a summary table

- details of savings agreed in bilaterals and MISC 106.

Whilst Mr Fowler is now committed on the total size of these savings he is still deciding the detailed allocation of the further cuts agreed at MISC 106.

This is all rather like old times!

David Willetts

DAVID WILLETTS

SOCIAL SECURITY EXPENDITURE (£m)

	1984-85	1985-86	1986-87
Baseline	39,400	41,520	42,560
* Additional bids	+737	+881	+2,062
Savings agreed in bilaterals	-113	-250	-350
Further savings agreed in MISC 106	-105	-335	-385
Net change	+519	+296	+1,327
	39,919	41,816	43,887

* Largely estimating changes and effects of revised economic assumptions

SOCIAL SECURITY SAVINGS (£m)

	1985-86	1986-87	1987-88
Agreed in bilaterals			
i. 2 year deferral of abolition of pensioners' earnings rule (leaving provision for a staged abolition in the Nov. 1987 and Nov.1988 up-ratings. The present timetable has never been announced	30	105	195
ii. changes in SB heating additions and increase in available scale margin	25	70	70
iii. changes in SB rules for people in board and lodging	35	50	50
iv. treating attendance allowance as income for SB recipients in residential homes	6	7	7

	1985-86	1986-87	1987-88
v. pay invalidity allowance net of add'l component for invalidity pensioners under pension age and restor 5% abatement of invalidity pension	10	15	25
vi. residual savings from 1984 uprating package	7	3	3
<u>Agreed at MISC 106</u>			
vii. extension of employer's statutory sick pay scheme from 8 to 28 weeks	-	200	200
* viii. further reductions in SB board and lodging expenditure			
* ix. payment of incapacity benefit in arrears	105	135	185
* x. tighten up students' eligibility to HB and SB			

* Detailed costings still to be calculated

HEALTH AND PERSONAL SOCIAL SERVICES (£m)

	1985-86	1986-87	1987-88
Baseline	13,954	14,658	15,024
Additional bids	+289	+464	+741
* Agreed savings	-105	-160	-216
Total	14,138	14,962	15,549

* Comprising:

- Prescription charges increased to £2 in 1985-86 and by a further 20p in each of the following years.

- Increasing dental charges from approximately 45 per cent of cost to about 60 per cent.

- Further savings in the Pharmaceutical Price Regulation Scheme by reducing allowable promotion expenditure.

- Restricting GPs' prescribing of minor proprietary drugs.

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PRIME MINISTER 31 October 1984

FCO EXPENDITURE PROGRAMMES

Geoffrey Howe has revised his additional bids as follows:

	1985-86	1986-87	1987-88
ODA	6	25	35
Diplomatic Wing	34	43	44
Total	40	68	79

In view of the very unpopular measures other Departments have accepted, such as the withdrawal of grants to students with better-off parents, it is difficult to see how any overspending by FCO can be accepted. Why not reduce the aid programme sufficiently to accommodate some of the increases in diplomatic costs and keep to baseline?

ODA PROGRAMME

Treasury point out that there is no technical difficulty about reducing the bilateral programme by £60 million (or 12%). The uncommitted proportion of bilateral aid is 21% in 1985-86, 32% in 1986-87, 45% in 1987-88.

We suggest that savings should be at the expense of "programme aid", energy sector projects, and India; and that

ODA make greater use of voluntary agencies.

Programme Aid

This took £51 million in 1983 and is growing. It is essentially designed for short-term balance of payments problems. An internal ODA review of 4 of these programmes in the 1978-81 period (Jamaica, Ghana, Zambia, Bangladesh) concluded that this form of aid was ineffective in influencing recipients' economic policies (indeed, it could have encouraged the Manley Government to continue its disastrous policies). No evidence was forthcoming that this aid was spent well. Most of it was absorbed by the "parastatal" organisations. Why not reduce this provision?

Project Aid

ODA is increasingly focussing project aid on particular sectors. The rationale for this is sensible but out of the £300 million spent on project aid in 1983, over £100 million was spent on energy projects, compared to £40 million on agriculture, £10 million on irrigation, £20 million on manufacturing. If the energy spend was brought into line with the others, we could save £50 million a year. Project aid is largely a subsidy to British contractors, and ought to be trimmed back in line with other industrial subsidies.

India

If Mrs Gandhi's death does not rule out a review of this item, it is worth asking:

Does India need aid of £110 million? You are not committed to this figure. India's per capita income is low but India feeds itself, has enormous technical expertise and a vast, educated class of administrators. India itself provides technical assistance to other countries. It is not obvious that our major contributions - energy projects, agricultural credit and slum clearance schemes - offer anything distinctive to India's development that Indians could not manage themselves.

Voluntary Agencies

ODA would probably admit that VAs can offer a much more effective way of providing real help at the village level than ODA staff, with all their associated costs. This year we provide only £8.2 million in support of VAs (including 1.2 million to Oxfam). Why not double this provision and trim back on ODA posts?

Commercial Spin-off

Paradoxically, bilateral aid yields a lower commercial return than multilateral aid. ODA's analysis shows that in

1982 each £1 of bilateral aid resulted in 70p of extra UK business. Each £1 multilateral aid led to £1.10 of extra UK business. Bilateral aid does not deserve preference as an export promoter.

DIPLOMATIC WING

The FCO has put forward a long list of minor additional items. No other Department has done this. FCO ought to asorb most of them through better housekeeping. For example, the cost of sterling depreciation, increased rents to PSA, pay awards are all types of increased expenditure which the MoD is absorbing. It would be unreasonable to ask the FCO to reduce staff in line with the Civil Service as a whole; FCO's work has greater priority than marginal activities in other Departments. But FCO ought to think seriously about:

- Making economies in the diplomatic estate by looking for a more modest standard of accommodation, particularly in small missions or for lower ranked staff .

- Closing down missions in Francophone Africa (FA), South America (SA) and Europe. Apart from the Embassies themselves, we have 5 missions in France, 7 in Germany, 7 in Italy, 9 in Spain. In small territories in FA and SA consular activities might be handled by honorary consuls or there could be regional missions.

Conclusion

There is a possible basis on which to secure FCO agreement to keeping to baseline, by withdrawing additional ODA bids, and cutting ODA expenditure by, say, £10 million, £10 million and £15 million to meet unavoidable increases in diplomatic costs.

Nicholas Owen

NICHOLAS OWEN

CONFIDENTIAL

MJ

MISC 106: LPO
CST
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DTI

10 DOWNING STREET

From the Private Secretary

31 October 1984

Agriculture R&D Expenditure

The Prime Minister has seen and noted the points made in the Minister of Agriculture's minute of 26 October.

I am copying this letter to the Private Secretaries to members of MISC 106, Elizabeth Hodkinson (Department of Education and Science), Colin Jones (Welsh Office), Graham Sandiford (Northern Ireland Office), Richard Hatfield and Dr. Nicholson (Cabinet Office).

Andrew Turnbull

Ivor Llewellyn Esq
Ministry of Agriculture, Fisheries and Food

CONFIDENTIAL

54

SECRET

27

cc: Lord President

PRIME MINISTER

PUBLIC EXPENDITURE

At this afternoon's meeting, you will want to consider how to resolve the problems that remain in the public expenditure round. MISC 106 have had further contact with Mr. Jopling, Mr. Heseltine and Mr. Walker.

Mr. Jopling has indicated that he is prepared to move substantially towards the MISC 106 offer of

-65	-115	-150

the Lord President will be writing to him this afternoon to offer cuts of the order of

(-50)	(-80)	(-95)

He is hopeful that Mr. Jopling will accept this revised offer.

Mr. Heseltine has written seeking a further £94 million in years two and three. Even more difficult, however, is his request for a form or words which states that the Defence Programme is to be held constant in real terms in years two and three and that it should be adjusted should costs and prices develop differently from the forecast. In effect, he is seeking to re-open the battle of last year and put his programme, uniquely, on a real terms rather than a cash basis. Mr. Gregson is preparing a separate minute on this.

SECRET

Mr. Walker has told MISC 106 that rather than make savings of £2.2 billion over three years he could find £1.6 billion which could possibly be extended to £1.9 billion. This would involve increases in electricity prices of 4½% a year an increase in gas prices of 6%, 7% and 8%. Since the meeting, however, a new complication has arisen. MISC 106 were under the impression that Mr. Walker was talking in terms of the effects on EFL's. He has now told the Secretariat that he was talking in pre-tax terms and that after allowing for the higher corporation tax which these savings would imply the effect on EFL's would be smaller, possibly by £300 - 400 million over the period.

Mr. Jenkin's position remains largely as set out in last night's minute though the Urban Programme has now been settled.

These remaining differences could be solved in the following way:-

(i) Mr. Jopling could be settled before Cabinet by MISC 106.

I.G. 200 Ren Pr 50 - unresolved

(ii) you could see Mr. Walker privately, without the Chancellor or Chief Secretary, to seek an agreement with him on a package of energy price rises which will increase the savings he has offered. For this to be successful the basis of his figuring will need to be resolved.

200 300 400, 78-88

230 220. 210.

300 100.

(iii) you could see Mr. Heseltine and Mr. Jenkin, not with a view to seeking a settlement, but to discuss their programmes, probe their arguments, and to indicate that you will be seeking the agreement of Cabinet to MISC 106's recommendations.

At the meeting, you will also have to consider the possibility that if you cannot get Mr. Walker to accept sufficiently large energy price increases, and he is showing signs of resisting anything more than the increases shown above there will be a substantial shortfall to be dealt with.

The scheduling of meetings will need to be settled in the light of the arrangements made for you to attend Mrs. Gandhi's funeral.

AT

31 October, 1984

+17 +10

RAMAFY

56/249

CONFIDENTIAL

NBPM AT 1/11

CC 20

CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

Callum McCarthy Esq
PS/Secretary of State for Trade
and Industry
1 Victoria Street
LONDON
SW1

31 October 1984

Dear Callum

file on B1 up for Meeting 30/10/84

PES 1984

Your Secretary of State's minute to the Prime Minister of 9 October noted that he and the Chief Secretary would need to pursue bilaterally the outstanding issues on the ECGD programme in 1986-87 and 1987-88. It is also necessary to settle finally EFLs for the BSC and the Post Office, on which your Secretary of State put proposals to the Chief Secretary on 1 October. With the work of MISC 106 drawing to a close these outstanding issues need now to be settled quickly.

ECGD: Switch of New US Dollar Business into Sterling

The one issue left outstanding, following the discussions earlier this month between the Prime Minister, the Chief Secretary and your Secretary of State, was the question of obtaining savings from switching new ECGD-guaranteed US dollar business into sterling.

As you will be aware ECGD's additional bids have increased further, as a result of the use of the most recent economic assumptions. For the Chief Secretary this is most unwelcome in a very difficult overall public expenditure outlook, and he feels he must ask your Secretary of State to reconsider his earlier objections and agree to the introduction of an interest rate loading for new ECGD-guaranteed US dollar loans to give the same calculated subsidy as for sterling loans. He understands that your Secretary of State would prefer to operate through a more flexible loading system than through a straightforward ban on dollar finance. If interest rates develop as forecast, this would now result in savings of:

1985-86	1986-87	1987-88
£1.3m	£9.2m	£26.8m

The Chief Secretary appreciates that this is a difficult issue, and that the savings achieved are small at first, but the growth in ECGD's forecast expenditure is alarming and he does not believe there is any other realistic way of reducing it.

Nationalised Industries

The Chief Secretary was grateful for your Secretary of State's letter of 1 October. He feels there is now a basis for settling the EFLs for BSC and the Post Office.

British Steel Corporation

Your Secretary of State offered the following EFLs:

			£m
	1985-86	1986-87	1987-88
Baseline	135	75	77
Bid	360	171	136
Compared with baseline	+225	+96	+59

The Chief Secretary welcomed the fact that this bid now conforms with the declared strategic objective of breakeven by 1 January 1986 and he is prepared to agree to these EFLs on that basis. He accepts that there are uncertainties ahead because several issues have yet to be addressed before BSC can be confident of achieving the breakeven objective. He will certainly be prepared to re-examine the EFL in the light of decisions on these issues once they have been taken. But your Secretary of State would not expect the Chief Secretary to agree in advance to a relaxation. It will need to be looked at in the light of all the circumstances.

Post Office

The Chief Secretary was disappointed that your Secretary of State was unable to accept the figures he proposed. He will want to return to the issue of efficiency when performance and financial targets are set for the Post Office. While he recognises the industrial relations dangers he is sure the Post Office should be pressed to take every step to turn itself into a more streamlined and efficient organisation. However, for the present he is willing to accept your Secretary of State's proposal for 1985-86 if he could make a small further reduction in the later years as follows:

	1985-86	1986-87	1987-88
			£m
Baseline	(68)	(68)	(70)
Offer	(70)	(60)	(60)
Compared with baseline	-2	+8	+10

The Chief Secretary would not object if you were to confirm to the Post Office that an adjustment to their EFLs would not be ruled out if we approved a major capital expenditure project on the basis of a properly presented and analysed appraisal. However we would not want the Post Office to form the impression that any adjustment to their EFL would be automatic and he would want to press very hard for any extra capital expenditure to be met from offsetting savings within their existing EFLs.

As you know, the timetable for reaching final decisions is now very tight, and I should be most grateful for a response to these points by close on Monday 5 November if possible.

I am sending a copy of this letter to Andrew Turnbull at No 10 and to Sir Robert Armstrong.

Yours ever

Richard

RICHARD BROADBENT
Private Secretary

Econ Pol: Public Expr Pt 29

cc JR

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SECRET

P.01416

PRIME MINISTER

Public Expenditure Survey 1984

You are likely to be holding a number of meetings over the next few days to consider the remaining stages of the Public Expenditure Survey in the light of the work done so far by the Ministerial Group on Public Expenditure (MISC 106): you have already arranged to see the Foreign and Commonwealth Secretary at 4:45pm tomorrow.

2. As background for those meetings the Secretariat of MISC 106 have prepared the attached note setting out the position reached by the Group so far. I am afraid that it is inevitably a snapshot, taken at mid-day today, with a good many parts of the picture still not sharply focused; but I hope that it will help.

3. At the very least it shows clearly that even though the recommendations which the Group have either agreed with or put to the spending Ministers concerned are bound to be regarded as very severe, the remaining task is formidable. The Group will almost certainly be putting recommendations to the Secretary of State for the Environment on his programmes which he will regard as extremely, perhaps intolerably, severe; and there are big problems, of which you are well aware, in imposing large savings on the gas and electricity industries. Every pound conceded makes the Group's task more severe, not only as a matter of arithmetic but also by making it harder to persuade other spending Ministers that they have been fairly treated.

4. I am afraid that there is also an unpleasant further complication. The figuring in the note takes account of a substantial increase in the provision for local authority current expenditure in all three years of the survey. Even so, some Ministers do not think that the increased totals for 1986-87 and 1987-88 make sufficient provision for the services for which they are responsible. The Secretary of State for Education and Science, in particular, has proposed that the figures should be increased by £200 million in 1986-87 and £425 million in 1987-88. The Lord President of the Council is holding a meeting of Ministers on Thursday 1 November to try to resolve the issues.

5. I am sending a copy of this minute, with attachments, to the Lord President of the Council and the Chief Secretary, Treasury, since they will be involved in your meetings.

PG

P L GREGSON
Cabinet Office.
30 October, 1984

Attachments:

MINISTERIAL GROUP ON PUBLIC EXPENDITURE (MISC 106)
PRESENT STATE OF PLAY

Note by the Secretariat of MISC 106

This note sets out the state of play after the first two weeks' work of MISC 106.

INITIAL POSITION

2. Before the Group started work the Chief Secretary, Treasury had reached agreement with the spending Ministers concerned on all major programmes except Defence; health and personal social services (HPSS); social security; housing, other environmental services and the Urban Programme; and the external financing limits (EFLs) of the gas and electricity industries. The Chief Secretary also reached agreement outside the Group with the Chancellor of the Duchy of Lancaster on the Arts and Libraries programme.

3. Within the HPSS and the social security programmes there were large and virtually unavoidable increases in expenditure due to changed economic assumptions, greater take-up of benefits, and other factors.

4. As a result, in order to meet the Cabinet's objective of holding to the agreed public expenditure planning totals the Group faced the task of finding further savings within the programmes mentioned in the first sentence of paragraph 2 above of about £1.1 billion in 1985-86, £1.4 billion in 1986-87, and £1.9 billion in 1987-88.

AGREEMENT ON SOCIAL SERVICES

5. The Group have agreed with the Secretary of State for Social Services that they should jointly recommend to the

Cabinet a package of savings on his programmes, including those which he had identified in bilateral discussions with the Chief Secretary. On health and personal social services the Secretary of State will find total savings of (all figures in £ million):

1985-86	1986-87	1987-88
- 105	- 160	- 216

mainly from higher prescription and dental charges and extending the 'grey list' of items in respect of which doctors will be entitled to prescribe under the National Health Service only generic, not named proprietary, drugs.

6. On social security the Secretary of State will find total savings of:

- 218	- 585	- 735

by a combination of changes in minor benefits, savings 'on account' of the recommendations expected to emerge from the current programme of social security reviews, and extending the payment by employers of statutory sick pay from 8 to 28 weeks. The implications of the last of these for employers' National Insurance contributions is under discussion between the Secretary of State and Treasury Ministers.

REMAINING PROGRAMMES

7. As a result of all this, the task facing the Group is to find net savings from the remaining programmes of £0.9 billion in 1985-86, nearly £1.0 billion in 1986-87 and £1.3 billion in 1987-88. Paragraphs 8 to 17 below describe the present situation on those programmes. The figures are collected in the table annexed to this note.

A Total of lines I + II + III in the table.

(a) Defence

8. The Government is publicly committed to plan to implement the NATO aim of real increases in defence spending of 3 per cent a year up to 1985-86. The Secretary of State for Defence has indicated that an addition to baseline of £105 million in that year would discharge that commitment;the Group are minded to recommend that the addition should be made, as part of an agreed joint recommendation on the defence programme.

9. For later years, the Group have indicated that they are minded to recommend no change on baseline, apart from an agreed addition of £300 million in 1987-88 in respect of the Falkland Islands.

10. The Secretary of State for Defence has pointed out that this will appear to entail a reduction in the real value of the Defence Budget (excluding expenditure on the Falklands). He has suggested that it would be desirable to state, when the figures are published, that they are subject to review. The Group have proposed a possible form of words for this purpose.

11. The Secretary of State for Defence has not yet responded to the Group's proposals on either the figures or the form of words.

(b) FCO (including ODA)

12. The Group are minded to recommend no change on baseline. The position has been fully reported in the minute of 25 October from the Lord President of the Council to the Prime Minister.

(c) Agriculture

13. The Group have proposed reductions of

- 65	- 115	- 150

The Lord President will indicate Mr Jopling's response if Cabinet imposes these cuts.

from reductions in capital grants and in support for agricultural research and development and the Agricultural Development and Advisory Service (ADAS). The Minister of Agriculture, Fisheries and Food has not yet replied.

Other Programmes

14. The Group have reached only a preliminary stage in their consideration of the environment programmes and the gas and electricity industries.

15. On the Urban Programme, the Group have indicated to the Secretary of State for the Environment that they are minded to recommend reductions of

- 30	- 55	- 55

The Secretary of State has not yet replied.

16. On housing and other environmental services, the Group have not yet formulated proposals. But they recognise that in order to reach the planning totals agreed by the Cabinet they will have to make very substantial reductions, particularly on housing - of the order of several hundreds of millions a year. The reductions are likely to fall mainly on home improvement grants and new building by public authorities.

17. The gas and electricity industries are seeking increases in their EFLs amounting to:

+ 183	+ 535	+ 959

The Secretary of State for Energy is urgently exploring with the industries how far these bids could be reduced by cost savings and price increases. He has stated that his aim will be to identify reductions of the order of £2.2 billion over the three years. The Group will decide their recommendations to the Cabinet when the Secretary of State for Energy reports the outcome of his discussions with the industries tomorrow morning.

OVERALL POSITION

18. The overall position is thus that if the spending Ministers concerned accept the Group's recommendations on defence, FCO programmes and agriculture it will still be necessary to find nearly £1.0 billion in 1985-86, nearly £0.9 billion in 1986-87, and nearly £1.5 billion in 1987-88, from the environment programmes, and the gas and electricity industries.

Total (B)

19. To help Ministers in considering how this might be done, section V of the attached table sets out

(i) Possible proposals on the environment programmes, drawing on the Group's preliminary discussions. They are, of course, purely illustrative and not in any way intended to prejudge the Group's conclusions.

(ii) For the gas and electricity industries, the bids from the industries; reductions of the size at which the Secretary of State for Energy has said that he will aim, distributed between years in a stylized way; and the additional reductions required to meet the target agreed by E(A) in July.

20. To the extent that any programme is increased beyond the figures recommended by the Group the overall situation self-evidently becomes more difficult.

Cabinet Office.
30 October, 1984

MISC 106: CURRENT STATE OF PLAY

The figures below, unless otherwise indicated, show changes on baseline, and are in £ million.

		1985-86	1986-87	1987-88
I.	Agreed/expected changes on programmes not considered by MISC 106	+ 215	+ 407	- 592
II.	Agreed or virtually unavoidable additions on			
	- HPSS	+ 303	+ 446	+ 813
	- Social Security	+ 737	+ 881	+2062
III.	Agreed recommendations on			
	- HPSS	- 105	- 160	- 216
	- Social security	- 218	- 585	- 735
TOTAL A	to be offset by savings on programmes listed below)	+ 932	+ 989	+1332

		1985-86 106 (a)	1985-86 Ministers (b)	1986-87 106 (a)	1986-87 Ministers (b)	1987-88 106 (a)	1987-88 Ministers (b)
IV.	Programmes on which MISC 106 have agreed recommendations						
	- Defence	+ 105	+ 105	-	+ 145	+ 300	+ 533
	- ODA/FCO	-	+ 40	-	+ 68	-	+ 79
	- Agriculture	- 65	- 19	- 115	- 24	- 150	- 30
TOTAL B	Sections I-IV (ie. remaining gap to be offset)	+ 972	+1058	+ 874	+1178	+1482	+1914
V.	Other programmes						
(i)	Housing						
-	Gross expenditure	[- 227]	+ 403	[- 302]	+ 468	[- 430]	+ 480
-	receipts (increase-/ decrease+)	- 300	- 300	[- 100]	- 100	[-]	-
(ii)	Other environmental services (OES)	- 29	+ 43	+ 9	+ 105	-	+ 94
(iii)	Urban Programme	- 30	-	- 55	-	- 55	-

As noted in the main text the Group have not yet formulated proposals on either housing or OES. In particular, their recommendations on the housing programme are likely to be influenced by the expected level of receipts in 1986-87 and 1987-88, which are still under discussion between the Treasury and the Department of the Environment. The figures above are therefore illustrative, and based on the Secretariat's interpretation of the tenor of the Group's discussions. They imply the following totals for sections I to V.

1985-86 (a)	1985-86 (b)	1986-87 (a)	1986-87 (b)	1987-88 (a)	1987-88 (b)
+ 386	+1204	+ 426	+1651	+ 997	+2488

Memorandum item

Gas and electricity	1985-86	1986-87	1987-88
Bids from the industries	+ 183	+ 535	+ 959
£2.2 billion reductions on bids	- 330	- 735	-1135
Implied reduction on baseline	- 147	- 200	- 176
Further reductions required to meet E(A) target for all nationalised industries	- 253	- 400	- 824
	- 400	- 600	-1000

NOTES

1. Column (a) shows the proposals made by the Group to spending Ministers;

Column (b) shows the proposals of spending Ministers; these do not all necessarily represent the final position of the spending Minister concerned.

2. The figures for gas and electricity are at a preliminary stage of discussion with the Group. They are therefore not fully comparable with the other figures in the table and are therefore shown as a memorandum item. A fuller explanation is given in the main text.

3. The table does not include the potential effects on territorial blocks budgets. These might be

+ 15	- 60	- 10

25

P.01415

PRIME MINISTER

Public Expenditure: FCO Programmes

FLAG A

The Lord President in his minute to you of 15 October 1984 has reported that the Foreign and Commonwealth Secretary is unable to accept MISC 106's proposals for settling his two programmes, ie that for the ODA (mainly the aid programme) and that for the FCO Diplomatic Wing MISC 106 has proposed:

No increase in the combined baseline for the two programmes.

The Foreign and Commonwealth Secretary proposes the following increases over baseline:

	£ million		
	1985/86	1986/87	1987/88
ODA	6.2	25	35
FCO (Diplomatic Wing)	33.5	42.8	43.6
Total	39.7	67.8	78.6

2. I have submitted today to you, the Lord President and the Chief Secretary, a note by the Secretaries of MISC 106 which explains the overall position. As you will see any further significant concessions beyond those already offered by MISC 106 will make it even more difficult than it is already to achieve the overall public expenditure targets approved by the Cabinet last July.

In the 1800 hrs meeting folder

Merits of the case

FLAG B

3. The Foreign and Commonwealth Secretary will deploy the arguments set out in his minute of 22 October, ie mainly:

i. the bilateral aid programme has been squeezed in real terms by 30 per cent since 1979; the extra ODA bids are needed to maintain it in real terms at its 1984-85 level;

ii. the Diplomatic Wing programme is faced with a number of unavoidable cost increases, arising eg from movements in overseas prices, exchange rate changes, British Council costs, BBC pay, etc.

4. The Lord President, on behalf of MISC 106, is likely to argue in reply:

i. although there are political difficulties over the aid programme, these difficulties are much less than those which will confront the Cabinet on other programmes - notably housing, health and social security, agricultural support and gas and electricity prices;

ii. many other Ministers have been faced with unavoidable increases in their programmes which they have had to meet by offsetting savings and a re-adjustment of priorities.

5. Bearing in mind the overall problem on public expenditure, you will probably conclude that while a small concession (say £10 million a year for each year) might be justified to prevent the FCO programmes from having to come to the Cabinet, it would not be desirable to yield more than this.

HANDLING

6. You will wish to begin by expressing your concern about the overall public expenditure situation and then invite the Foreign and Commonwealth Secretary to explain his position (but briefly and without an item by item examination). The Lord President might then be asked to comment.

CONCLUSION

7. If the Foreign and Commonwealth Secretary shows any sign of being willing to come very close to the MISC 106 proposals, some horse-trading may be worthwhile. If, as is more likely, he is prepared to make only small reductions in his bids, you will wish to conclude the meeting on the basis that the Cabinet will have to resolve the matter, against the background of the overall public expenditure situation and the political difficulties arising on other programmes.

PLG

P L GREGSON

30 October 1984

10 DOWNING STREET

From the Private Secretary

Prime Minister (1)

With your agreement, we circulated Dr Nicholson's views on the merits of different categories of expenditure to Members of MISC 106, to help them in their work. Dr Nicholson's note, which was written as a brief, was not drafted for transmission to Mr Jopling, though the Lord President agreed to make it available to him.

This has drawn an irate response from MAFF. Nevertheless Dr Nicholson stands by his judgements.

I see no point in prolonging this correspondence. Agree therefore merely to note Mr Jopling's minute?

AT 30/10

24

W.0785 30 October 1984

PRIME MINISTER

MISC 106: R&D EXPENDITURE

I have seen a copy of the minute to you dated 26 October from the Minister of Agriculture, Fisheries and Food, in which he criticises the comments on MAFF R&D expenditure which I made in my minute to you of 12 October. Mr Jopling's principal criticisms and my further comments are listed below:

(a) My comments omitted highly relevant matters and a considered justification for the massive reduction in R&D.

The comments were intended as a brief for the Chairman of Misc 106 and not as a closely argued paper for the Committee. The main points had already been well rehearsed in Misc 100 discussions. Some of them had also been made in ACARD's advice on Government R&D expenditure.

(b) Misc 100 did not recommend that R&D expenditure be halved.

This comment was slightly over-compressed by me but Misc 100 did suggest that a halving of R&D expenditure should be one of the 'options for reductions' to be pursued.

(c) The category of research defined as 'improving technology' includes research other than that aimed at improving farming productivity.

The figures quoted in my minute were provided by MAFF for the 'Annual Review of Government-funded R&D'. Whilst some research may well have several purposes, this particular category had a primary purpose of advancing the technology of the agricultural sector of the economy. There were other categories in which one would have expected MAFF to place research aimed primarily at health, safety and the environment.

(d) The arbitrary conclusion that the overall level of R&D research in MAFF is too high cannot be accepted.

When the Government set up the mechanism of the Annual Review of Research (Cmnd 8591), it accepted that it was valid to take a horizontal look at public expenditure on R&D even when the main control processes operated vertically through Departments. It accepted the need for 'value judgements on the allocation of financial and manpower resources' and the importance of 'distinguishing between vital and dormant areas, identifying gaps, disparities and duplications, and considering the opportunity cost of relinquishing certain areas of research'. This is the basis of ACARD's comments and of my own advice to you. I know of no other basis whereby new research can be started within an overall expenditure ceiling.

(e) The comparisons which have been made with other countries are suspect.

The figures are probably not 100 per cent accurate but they come from OECD and were quoted in the Misc 100 report.

RBN

ROBIN B NICHOLSON
Chief Scientific Adviser

Cabinet Office
30 October 1984

MT

23

PRIME MINISTER

PUBLIC EXPENDITURE

As the attached note makes clear a substantial shortfall has emerged from MISC 106. Total B of the table shows the gap as

972	874	1,482

even if Agriculture, FCO and Defence accept the MISC 106 recommendations. Mr. Walker is investigating savings, mainly on costs, of £2,000 million in the gas and electricity industries which would contribute relative to baseline

-147	-200	-176

The result is that

825	674	1,306

remains to be found from housing, urban programme and higher energy prices.

We do not expect Mr. Jopling or Mr. Heseltine to accept the recommendation - the latter is seeking an extra £100 million in years two and three. The Foreign Secretary may seek some further small concessions. Thus the gap could be even greater than set out above.

The prospect is that the Cabinet on 8 November will be faced with four non-agreed programmes, agriculture, defence, housing and energy prices. In the view of the Treasury this is too much to settle in one go, but if the Autumn

Statement is to be put out the following Monday everything needs to be settled by the afternoon of 8 November. The alternatives are:

(i) a big effort, involving yourself, to settle at least two of the programmes before the Cabinet.

(ii) a Cabinet on Wednesday as well as Thursday.

(iii) postponement of discussion of public expenditure on 8 November to allow more time to narrow the gap.

I think the Treasury regard the worst outcome as an attempt to settle on 8 November which fails, leaving the wrong atmosphere for the BT launch which, in all other respects, is going well. If there is any discussion of an alternative timetable Mr. Pattie would like to be involved. I have arranged for him to be on call should this prove necessary.

AT

£1.6 b. £1.9 bi.

2200

30 October, 1984

PRIME MINISTER

FCO Expenditure

There is to be a meeting to discuss this on Wednesday.

Sir Geoffrey Howe is bound to raise the impact of exchange rate fluctuation and overseas inflation on FCO expenditure. He may refer to the views which you expressed in July. I attach a copy of the letter which you authorised at the time.

C.D.P.

29 October, 1984.

FILE

(RAMABJ)

cc: PG

10 DOWNING STREET

From the Private Secretary

23 July, 1984

FCO EXPENDITURE

The Prime Minister has seen the minutes exchanged between the Foreign Secretary and the Chief Secretary on this subject, ending with the Chief Secretary's minute of 20 July.

X As regards exchange rate fluctuation and overseas inflation, the Prime Minister agrees with the Chief Secretary that buying currency forward could help alleviate the problem. Beyond this, while the Prime Minister does not wish to see any breaches of principle of cash planning, she thinks that the Treasury should recognise the special circumstances of the Foreign Office. She suggests, therefore, that additional bids as a result of exchange rate changes should be treated as reflecting revised economic assumptions rather than policy changes. This treatment should not prejudice finding some offsetting savings if possible. X

On asset recycling and end-year flexibility, the Prime Minister notes that no specific and detailed proposals have yet been put forward. But she thinks the idea is in principle a good one which will lead to better management of the diplomatic estate overseas and therefore hopes that proposals in this sense can be circulated quickly.

As regards the Moscow Embassy, the Prime Minister hopes that this can be discussed further between the Foreign Secretary and the Chief Secretary to find a solution.

The Prime Minister does not now wish to hold a meeting to discuss these matters for the time being.

I am sending a copy of this letter to Len Appleyard (Foreign and Commonwealth Office).

(C.D. Powell)

J. Gieve, Esq.,
Chief Secretary's Office

CONFIDENTIAL

CONFIDENTIAL

Foreign and Commonwealth Office

London SW1A 2AH

29 October 1984

Prime Minister

CDP 29/x.

Dear Charles,

Ministerial Group on Public Expenditure (MISC) 106
Foreign and Commonwealth Office Programmes

By way of background for the Prime Minister's meeting of 31 October, Sir Geoffrey Howe thought it would be useful for her to see the attached copy of a minute he sent to members of MISC 106 on 22 October, together with a table on "Demands on FCO Resources" which he left with the Group at their meeting on 15 October.

I am sending copies of this letter, without attachments, to the Private Secretaries to the Lord President of the Council and the Chief Secretary of the Treasury.

Yours ever,

Colin Budd

(C R Budd)
Private Secretary

C D Powell Esq
10 Downing Street

CONFIDENTIAL

A

FCS/84/277

LORD PRESIDENT OF THE COUNCIL

Public Expenditure - FCO Programmes

1. Following the meeting of MISC 106 on 15 October, I have had a further look at my bids. I fully recognise the formidable difficulty of your task. But I fear I must sustain my attempt to enlarge still further the sympathy with which you all listened to my case on Monday: as I said then, the non-military parts of our expenditure to protect British interests abroad is small but vital. Since 1979, our aid programme has declined 14% in real terms and overseas representation 4%, while Defence has increased by 26%.

ODA

2. (a) There is, I think, no dispute about the £6.3m carry-over from 1983/84 to 1985/86 on the basis of the absolute assurance given earlier by the Chief Secretary; this should be added to the baseline figure.

(b) For this year I am prepared to withdraw the £10m for Commonwealth Development Corporation in 1987/88 while we continue to explore all means, including legislation, whereby its borrowing powers could be increased without counting as public expenditure. We are in touch with the Treasury about this and I am grateful for the Chief Secretary's support in this endeavour. I reserve the right to reinstate this bid next year if our ideas on this prove impracticable.

(c) The aid programme is under great pressure from colleagues. The Prime Minister wants us to do more in particular cases, and has a commitment to Mrs Gandhi to use her best endeavours to maintain bilateral aid to India at £110 million per year in 1983/84 prices for the foreseeable future. The Chancellor wants to support the better multilateral institutions. This was reflected in the declaration issued after the London Economic Summit. At that meeting and at the Commonwealth Finance Ministers meeting in September, all agreed that donors should maintain or increase aid flows.

(d) If my baseline remains unchanged, by 1988 we as a Government will see our bilateral programmes decline a further 10% in real terms on top of the 30% since 1979. This would cause formidable political difficulties. It is difficult to see how we can do less than maintain these programmes at their 1984/85 level. This would need £25m in 1986/87 and £35m in 1987/88.

3. My proposal for aid in the three PES years is therefore:-

£6.2m (£6.3m less a small saving already agreed)	£25m	£35m

FCO (Diplomatic Wing)

4. I take as agreed the overseas estate rationalisation (mainly in Kuala Lumpur) recorded in MISC 106(84)2

-4.4	+1.9	+2.2

5. The Government continues to maintain a global foreign policy. The success of our economic policy has given us an extensive export trade and overseas investment portfolio which we must protect. Full advantage has been taken of the Financial Management Initiative to exercise tighter control of this Department's costs. Janet Young and I have brought our previous departmental experience to bear on this. The MISC 106 minutes misleadingly mention a £5m contingency reserve: this was created in 1983/84 by economies within my agreed provision but has now been reduced to £1.3m to help cope with the falling pound. The 7½% staff margin is sorely needed for language training and travel but successive crises have reduced it to 5.2%.

6. The following bids are essential merely to maintain the present level of diplomatic and consular services - against annual increases in demand averaging over 10% from MPs, businessmen, travellers in both directions and the Government itself.

/Revised

Revised Economic Assumptions

(a)	Overseas price adjustment	16.0	16.0	16.0
(b)	Sterling shortfall to Sept 83	7.5	7.7	7.9
(c)	British Council risen costs	3.0	3.0	3.1

Inescapable Cost Increases

(d)	BBC (i) pay	2.1	2.7	3.1
	(ii) audibility	2.2	5.7	2.3
(e)	Property Repayment Services	3.0	3.8	4.3

Enforced Requirements

(f)	Overseas Estate			
	(i) Moscow	0.4	2.0	4.1
	(ii) Security	1.1	1.4	1.6
(g)	FOLIOS electronic office	1.9	3.2	3.3
(h)	One-off items	1.5	1.5	1.6

This is a quotation from the No 10 letter of 23 July – attached.

7. On (a) and (b), the Prime Minister has said "Treasury should recognise the special circumstances of the Foreign Office; .... additional bids as a result of exchange rate changes should be treated as reflecting revised economic assumptions, rather than policy changes. This treatment should not prejudice finding some offsetting savings if possible". With a new offer I mention below, I can produce £5.2m savings in the first year. 40% of FCO costs are overseas, compared to 15% for MOD. Sterling's index has fallen from 92.5 to 75.2 since October 1982 (18.7%). I would, of course, be content (as Peter Carrington was between 1979 and 1982) to see any underspend on my provision, provided the latter is realistically set, returned to the Treasury if the Pound strengthens sufficiently.

(c) The British Council suffered an 18% volume cut (19% staff cut) between 1979/80 and 1983/84. Risen costs in the final year would have left the Council entering 1984/85 £4m short. In May the Prime Minister said "£4m should be made available to the British Council in 1984/85 to cover the increased rent of Spring Gardens and the increase in risen costs". (I can absorb the ODA 'share' which roughly corresponds to the rent). Unless we carry the Prime Minister's wishes forward into the PES period, we risk the same sort of parliamentary row as in 1980, when we were obliged to accept the Blaker volume-planning guarantee. Most "banana skins" - perish the metaphor - are unforeseen. I can see no case for throwing one under our feet with our eyes open.

(d) The BBC threatens an even larger banana-skin. Following our defeat in the Houe of Lords in 1981 we agreed a much-needed capital programme to improve audibility. My bid is mainly to catch up with slippage on a transmitter station at Bearley held up by a planning enquiry; the resulting underspends in two years have benefited Treasury and the BBC's supporters expect these to be made up.

On pay the real control is the Licence Fee. External Services are only 1/10th of BBC. I have set up a Review to check efficiency and seek solutions to the perennial pay shortfall: to disallow this bid would frustrate BBC's implementation of the Review and mean cutting 7 language services - with another disproportionately huge parliamentary row, in both Houses.

(e) In the Property Repayment Services PES transfer from PSA, most Departments had swings as well as roundabouts, but FCO lost on all counts. For fuel, the transfer was calculated by square metres, but two of our buildings are BBC transmitter stations with exceptional electricity bills. Our Government-owned buildings were deemed to be in the lowest "rent" category, which was immediately subject to a 19% "rent" increase. The sum allotted for specialised buildings was one-third of the outstanding bills inherited from PSA. The original injustice increases each year. There is no appeal against PSA's arbitrary rent increases which represent PES transfers to PSA.

(f) The Overseas Estate consists of 4,000 office and residential units in 140 countries. Its £18m capital subhead must cover minor works (eg generators ,structural repairs and security works) and major works or purchases often forced on us by foreign landlords or governments (eg Riyadh). Much accommodation is inadequate or under-maintained, eg Kuwait, Warsaw, Ankara, Tokyo, Muscat, Cairo, where long-deferred works must start soon.

At £42m Moscow is a huge project well beyond the provision inherited from PSA. FCO can find £9m and perhaps a further £12m if Treasury can agree to asset recycling with full end-year flexibility. It will take 10 years, so postponing other items a year or two would not suffice. And postponements will raise my rent and running costs bill which in my 1984/85 Estimates agreed with Treasury is £6.3m above the PES baseline, mainly because of sterling.

Security works provide protection against criminal violence (which in 98 countries is higher than in UK) and terrorism by IRA, Libyans, Shia Muslims, local guerrillas etc. 21 Embassies have been attacked and 4 British and 2 local staff killed in recent years. The Middle East (especially Beirut), Afghanistan, Jamaica and Nigeria are particularly dangerous. Between two and six violent incidents affect members of the Diplomatic Service each year; these include rapes, assaults and muggings. The US have just allocated $366 million for protective works - we are spending £1.7m this year.

(g) The FOLIOS electronic office bid was incorrectly described in the minutes as withdrawn - perhaps a confusion with the BBC electronic distribution system. FOLIOS will make a major contribution in savings in costs and manpower and to increased efficiency under the FMI. It will use modern technology to enable some 20 million documents a year to reach those who are to deal with them expeditiously. Without it, FCO's operations would fall increasingly behind the standard expected in the Western World.

(h) <u>One-off Items</u>	1.5	1.5	1.6

Following the PES Guidelines about priorities and precise output measurement, I made several detailed bids for inescapable new requirements. These include the UK's EC Presidency, Commonwealth Finance Ministers and Australian Bicentenary. At Treasury's request I aggregated them and indeed rounded the total down.

8. I have thus agreed to absorb or postpone, with great difficulty:-

BBC Monitoring Service modernisation
Caribbean Service
New electronic distribution system
All British Council increased activities
ODA's "share" of British Council risen costs
Military training in Caribbean
Increased Overseas Estate purchase
Additional costs of overseas students.

9. In addition I will look for further offsetting savings on my Other External Relations programme (UN subscriptions etc) of £1.5m in 1985/86 and £0.5m in 1986/87.

10. Thus my bids total	38.7	47.0	47.3
From this can be deducted offsetting savings			
(i) already in MISC 106(84)2	-3.7	-3.7	-3.7
(ii) the new UN proposal (see paragraph 9)	-1.5	-0.5	
Leaving a net total of	33.5	42.8	43.6

11. Only by sharply reducing functions or geographical coverage - which would require collective policy decisions - could I absorb these sums within FCO's narrow baseline.

12. I realise that this may strike you as a disappointing analysis. But the fact is that over recent years all our programmes have been closely analysed, and tightly managed,

which is why we can cost and itemise our bids so precisely. What we are left with are the minimum components of those non-military overseas services that are indispensable for a country, which still has substantial and worldwide commercial interests and political interests. On this basis, I have been able to prune our original bids - and frankly I do not see how we could do more - to:

ODA	6.2	25.0	35.0
FCO	33.5	42.8	43.6
	39.7	67.8	78.6

Compared with:

the figures placed before you last week of:

52.2	111.4	171.2

and original bids of:

62.1	146.1	231.7

13. I am copying this letter to the Lord Privy Seal, the Home Secretary, the Chief Secretary to the Treasury, the Secretary of State for Scotland and Sir Robert Armstrong.

WA..

(GEOFFREY HOWE)

(Approved by Sir Geoffrey Howe, and signed in his absence.)

Foreign and Commonwealth Office

22 October 1984

B

DEMANDS ON FCO RESOURCES

DIPLOMATIC WING

	1968	1984	1988	% Change
FCO Staff	8140	6722	6372	-22
Overseas Posts	243	213		-17
Countries covered	136	164		+21

Commercial Work

	1980	1983	% Change
Market Information Enquiries	42,849	63,481	+48
Firms in outward trade missions	4,909	7,038	+43
British Business Visitors	65,199	77,065	+18

Consular Work

	1968	1979	1983/84	% Change
Britons travelling abroad	5.4m	15.5m	21m	+289
Passport issue overseas	151,933	211,969	217,719	+ 40

Parliamentary Work

	1982/83	1983/84	% Change
No of PQs	1474	2434	+65
No of Debates	30	42	+40
Briefs for PM's Questions	200	317	+59
Days spent abroad by Committees	89(1980)	149	+73

AID WING

	1979/80	84/85	85/86	86/87	87/88	88/89
Net Aid Programme - £m cash	790.1	1098.0	1131.9	1167.5	1196.7	-
Staff	2285	1756	1565	1545	1525	1500

EXPENDITURE (£million net, constant 1984/85 prices)

	1978/79	1984/85	% Change
Aid	1283	1100	- 14
Overseas Representation	343	330	- 4
All FCO Programmes	1978	1835	- 7
Defence			+ 26
Social Security			+ 29
Agriculture			+ 40

006/105

22.

CHIEF SECRETARY TO THE TREASURY

FROM: CHIEF SECRETARY
DATE: 29 October 1984

PRIME MINISTER

MISC 106: STATE OF PLAY

The note of 30 October by the Secretariat sets out very clearly the position reached. The Group has made major progress in what we knew would be an extremely difficult task. But its work has demonstrated the difficult decisions required in order to achieve the planning totals endorsed by Cabinet in July.

2 Perhaps you would allow me, before you embark on discussions with colleagues whose programmes have yet to be settled, to highlight what seem to me the key implications of the Secretariat's report:

(i) Even after taking credit for the Group's proposals for all other programmes, achieving the overall targets requires the acceptance in full of my proposals for gas and electricity. Only in 1986-87 is there any significant leeway; and the 1985-86 position is particularly tight. The bulk of the "savings" Peter Walker is aiming to achieve are needed simply to offset the industries' bids for extra provision; their contribution to the overall need for savings below baseline is inadequate.

(ii) Any further concession beyond the Group's proposals on the other programmes yet to be settled - Defence; FCO/ODA, Agriculture and Environment - would widen the gap still further.

3 I am conscious that this presentation puts the position starkly; but the fact is that the margin for manoeuvre in my original proposals for the range of programmes remitted to MISC 106 has now been fully used up.

4 The Secretariat's report also points to a difficult decision which you will need to take in the next few days on the timing of further Cabinet discussion of public expenditure. The danger is that a November 8 Cabinet - with substantial discussion probably on Energy, Environment and Agriculture - would lead to something short of a conclusive result. If that were the case we should almost certainly have to abandon the aim of publishing the Autumn Statement before BT Impact Day raising all the problems discussed in the Chancellor's minute to you of 24 October. The Chancellor and I are to discuss all these issues with you tomorrow.

5 I am copying this minute to the Lord President and to Sir Robert Armstrong.

P.R.

PETER REES

010

19A

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

From the Minister

26 October 1984

PRIME MINISTER

SECRET

MISC 106: R & D EXPENDITURE

At the request of the Ministerial Group on Public Expenditure I have attached been sent a copy of your private secretary's letter of 15 October to the Lord President's private secretary covering the comments you received from the Chief Scientific Adviser on agricultural R & D.

In view of the importance of the contribution which agricultural R & D has been making not only to the efficiency and competitiveness of our farming industry but also to the major public interests which are unavoidably involved I read Dr Nicholson's comments with considerable concern since they neither brought to attention some highly relevant matters nor offered any considered justification for the conclusion that public expenditure on agricultural R & D should be massively and precipitately cut back. I should like to repair these surprising omissions.

I should first point out that MISC 100 did not recommend as Dr Nicholson implies that my department's expenditure on R & D should be halved. This option was put forward by the Treasury but it was not derived from any in depth study of the current programmes of work nor of the consequences of such a drastic cut back. It was associated with the concept of industry financing to allow the reduction to be made up at least in part. And the group also reported that the agricultural departments opposed a reduction in the scale of R & D for well considered reasons to which I refer below.

Of the total projected expenditure by MAFF in 1985/86 of £127 million listed in paragraph 3 of Dr Nicholson's minute only £97 million relates to agriculture the remainder to fisheries, food etc: of this some £86 million falls in the category defined as improving technology to which Dr Nicholson's comments are primarily directed. Some 40% of this expenditure on agricultural R & D is incurred by ADAS but the larger part is work commissioned by my department mainly with the AFRC.

/I should also ...

I should also point out that the option to halve expenditure on agricultural R & D also relates to the significant research commissioned by DAFS in Scottish institutes.

The category defined as "improving technology" in fact is concerned not only with farming productivity as such: a substantial part is directed to enviornmental problems, human health and safety, food quality, animal health and welfare, the prevention of damage to soils - all aspects of great public importance. The absence of any reference to this is a serious omission in Dr Nicholson's comments.

Moreover it is in my view simplistic to conclude that just because we need to curb the growth of agricultural output for those products which are in surplus, the requirement for R & D will fall off substantially. In the period ahead which will involve difficult adjustments the industry must continue to take up new technology and maintain its record of improved productivity if it is to remain viable and maintain its competitive position within the EC. As cost/price margins are squeezed the need, for example, to reduce input costs will become more pressing. Given the shock they have suffered over milk and the readiness of the industry - as shown by the recent NFU document - to adjust, they will understandably look to the Government to help in this process. And in the wider area of public interests, the pressures on the R & D programmes will increase through for example the growing concern about the impact of some farming practices and the impact on farming of other aspects of the environment.

I must make it clear that I am in no way arguing against necessary changes of direction, and nor has my department. I made PES cuts on R & D last year and have offered still larger cuts to MISC 106 this year. I am looking to the Priorities Board for advice on what changes in the level and distribution of effort should be made. I am also intending to ask them to advise on the best way to achieve increased industry funding. I have no reason to suppose that, with Ken Durham in the chair, they will not set about that task with a will, but given the structure and fragmented nature of the industry real progress will take time.

I am willing to make these painful changes. But what I cannot accept is the arbitrary conclusion that the overall level of resources deployed, as distinct from the make up of this programme, is far too high. The comparisons which have been made with other countries are suspect. But in any case it must be quite wrong for the Government to decide on precipitate, large cuts unsupported by in-depth examination of requirements and well based implementation plans.

The abrupt termination of work in which much money has been invested before the programmes are completed cannot represent value for money. High levels of redundancy,

/ and wide spread...

and wide spread closures, would be involved for the scientific establishments concerned in England and Wales and Scotland. In his letter of 3 August, Keith Joseph asked that the full financial, administrative and political implications of large cuts in the Agricultural Departments contracts with the AFRC which would be unavoidable if the option Dr Nicholson supports - is pursued - should be considered by Ministers collectively before final decisions are taken. I certainly endorse this view.

As regards the rest of ADAS, I shall shortly circulate a draft statement welcoming the general thrust of Professor Bell's report including the case for charging for advisory work. But I believe the chances of securing the co-operation of the industry, and our own supporters, will be seriously prejudiced if we attempt to decide just what can be done and how, before we have carried out the necessary consultations.

I am copying this to the members of MISC 106, to the Secretary of State for Education and Science, the Secretaries of State for Wales and Northern Ireland, and to Sir R Armstrong.

MJ.

MICHAEL JOPLING

CONFIDENTIAL

B/F if Mr Walker: covers to see PM to settle his programme.
AT 29/10

PRIME MINISTER

26 October 1984

ENERGY - CONTRIBUTION TO PUBLIC EXPENDITURE SAVINGS

A. BRITISH GAS CORPORATION

BGC is buying gas at an average price of 16.3p per therm (including the Government's discretionary levy of some 4p per therm) and selling it at an average of 33.7p. What must be attacked is BGC's £3 billion gold-plated cost structure. Sir Dennis Rooke retires at the end of June 1986.

In summary, our rough feel for the potential cost savings, compared with the Treasury's numbers, would be:

		£ million		
1. Reducing Gas Supplies		1985-6	1986-7	1987-8
	Treasury	25	45	115
	Policy Unit	25	45	75

The miners' strike calls into some question the wisdom of going for maximum savings when security of supply is at stake.

2. Phase out R&D into Synthetic Natural Gas

Treasury/ Policy Unit	10	20	40

CONFIDENTIAL

No commercial enterprise would still be doing this.

3. Sale of Assets

Treasury	5	10	10
PU - land	10	15	15
- retail & contract'g	-	160	-
- upstream interests	-	-	2000?

Our table makes the heroic assumption that something will be done about privatising the retail and gas production businesses. If gas production is sold to the private sector it reduces the capital expenditure programme of BGC considerably.

4. Reduced Capital Expenditure

Treasury	0	40	55
Policy Unit	50	100	100

More effective project management, procurement, and cost control alone, on a £1 billion programme, should deliver this. Some of the North Sea expenditure could be reduced (without full privatisation) by farm-outs (dilution of licence interests) and we agree with Treasury on the scope to cut the peripheral expenditure items. BGC should not be nationalising any more of the North Sea as they are currently planning.

5. Reduced Working Capital

Treasury	20	30	40
Policy Unit	40	100	110

The working capital increase of £1 billion over the 3 years would be a prime target for substantial reduction in any commercial enterprise. This alarming trend was already evident from the fact that working capital had increased from 12% to 21% of turnover over the last 5 years. Some of this is attributable to BGC's committing to take and pay for gas additional to requirements which have fallen below earlier forecasts. BGC should not now be spared the task of vigorously correcting the position.

6. Reduce Trading Costs

Treasury	10	20	30
Policy Unit	40	80	120

Given total trading costs of £2 billion and the significant real-terms reductions already achieved, BGC must be pushed further down this road.

7. Gas Prices

Treasury	220	440	774

There is a strong economic case for real gas price increases. However, there are some attractions in a bigger gas industry in view of our coal problems, and higher prices with a very profitable industry has political downside. On balance, we see the case for a modest real increase but would urge a greater thrust on costs than on real prices.

Totals (excluding higher prices):

Treasury	70	165	290
Policy Unit	225	360	460
Plus disposals of		160	2000

B. <u>ELECTRICITY INDUSTRY</u>

Treasury have also been a little cautious on the scope for cost savings in the electricity industry.

In summary, our feel for the potential cost savings compared with the Treasury's numbers would be:

1. Capital Expenditure

		£ million	
Treasury	140	250	290
Policy Unit	170	210	215

Our observation on ESI's capital expenditure programme of more than £1 billion pa, is that a hard-headed commercial approach to planning, execution, procurement and contract management can deliver significant further savings.

Whilst going further than the Treasury in reducing the fat, we feel that the additional savings will be more than offset by the repercussions of the miners' strike. Measures to increase flexibility and achieve greater security of supply will have to be tackled with urgency.

2. Reductions of Working Capital

Treasury	35	85	95
Policy Unit	65	105	115

We support the Treasury's views on the valuation of coal stocks and the reduced stockholding of nuclear materials. Elsewhere, the MMC Report has demonstrated what can be done by the more commercially-minded Area Boards. When attacking £3 billion of working capital, you can achieve more than Treasury's 1% in the first year.

3. Sale of Assets

Treasury	15	20	25
Policy Unit	15	20	145

We would include the sale of electricity retail outlets in 1987-8. At a rough guess this could contribute £100 million.

4. Higher Connection Charges

Treasury/ Policy Unit	20	30	40

The Treasury are right to insist on the implementation of the MMC Report recommendation that costs - tightly controlled - should be fully recovered from consumers.

Total for items 1-4 above:

Treasury	210	385	450
Policy Unit	270	365	515

5. Operating Costs

The industry's operating expenditure is approaching £10 billion. Fuel costs account for roughly half. In looking for savings, we would arrive at much the same end-point as the Treasury - progressive reductions reaching £620 million pa by 1987-8, but via a somewhat different route. Like them, we would want to see full use made of CEGB's nuclear capability and the new links with France and Scotland. However, we are very nervous about the proposed real reduction in the level of earnings of the 100,000 so-called non-sensitive staff in the industry. Nor would we feel happy with an explicit programme to achieve a more rapid rundown of manpower. This should not in itself be a target, but the natural consequence of vigorous management efforts to contain operating expenditure by reducing waste and inefficiency and improving productivity as turnover increases.

JW

JOHN WYBREW

JR.

CC/NO

NB PM

AT 22/10

Treasury Chambers, Parliament Street, SW1P 3AG

19 October 1984

G K Sandiford Esq
Private Secretary to the Secretary of
State for Northern Ireland
Northern Ireland Office
Stormont Castle
Belfast BT4 3ST

Dear Graham

1. Thank you for your letter of 16 October suggesting an amendment to paragraph 9 (iii) of the note of the bilateral public expenditure discussion of 1 October. I have no objection to the amendment you propose. Rather than revising and recirculating the entire note, I suggest we let your letter stand as part of the record.

2. A copy of this letter goes to Andrew Turnbull (No. 10).

Yours sincerely
Richard Broadbent

R J BROADBENT
Private Secretary

Econ Pol. Pt 28
Public Expenditure,

22 OCT 1984

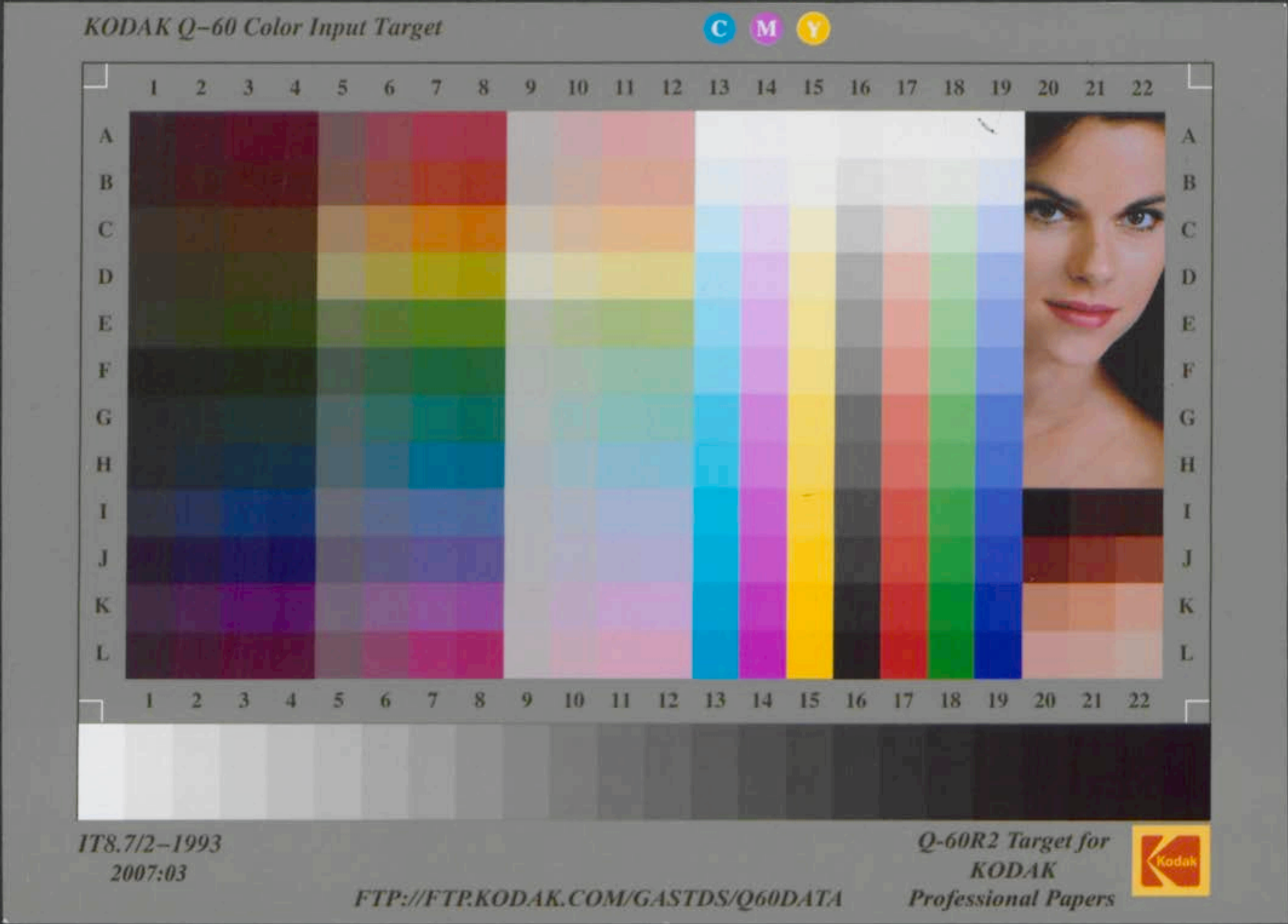
1984

PART 28 ends:-

MISC 106(84) 5th Mtg 15/10/84.

PART 29. begins:-

CST to NIO 19/10/84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