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C(79) 48 COPY NO 81

23 October 1979

CABINET

NATIONALISED INDUSTRIES' CASH LIMITS

Memorandum by the Chancellor of the Exchequer

1. The Ministerial Committee on Economic Strategy (E) invited me on 20 September to bring forward proposals in October for cash limits for nationalised industries on the lines set out in Annex A.

2. It is now urgent to set the limit for coal before the wage negotiations on 31 October and it is not desirable to set the coal limit in isolation. I hope that we can settle most of the other limits but I recognise that in view of decisions taken recently by E Committee it will not be possible to do so this week for the Electricity Boards or for the Gas Corporation. This paper accordingly excludes electricity and gas from the present discussion. We can defer publication till later in November which will leave time for any further consultation that is needed with the nationalised industry managements.

3. There is no simple or mechanistic way of arriving at satisfactory cash limits for nationalised industries which will exert an adequate discipline and at the same time satisfy the criterion of realism (which E Committee has since endorsed for the Rate Support Grant (RSG) cash limit - see C(79) 47).

4. Apart from these general requirements, the following points, which may to some extent conflict, are relevant to setting the limits: our July public expenditure decisions, as modified since, e.g. by the E Committee decisions on gas and electricity; the industries' revised financing forecasts; our own economic forecasts and in particular the Industry Act forecast published during November; the starting point agreed in September that cash limits should look for a reduction in real labour costs per unit of output; compatibility with the RSG cash limit which is to be published on 16 November and with its public presentation.

THE SPECIAL NATURE OF NATIONALISED INDUSTRY LIMITS AND THE CHAIRMEN'S VIEWS

5. The Chairmen have stressed in the paper sent to me by Sir William Barlow on 18 October (reproduced at Annex C) the special nature of cash limits for the nationalised industries. These apply to their external financing ie. the difference between their capital requirements and their internal resources. The amount of finance they need is thus the difference between much larger flows of revenue and expenditure. They have pointed out that the difference between Departments and trading organisations has been acknowledged since cash limits were introduced.

6. Our predecessors' 1976 White Paper pointed out that because financing needs are dependent on trading conditions the external financing figures would be:

> "treated as a form of cash limit" which "cannot be immutable .... like private sector companies, their revenues and expenditures depend on trading conditions. There may well be causes quite beyond the control of a particular industry, reflecting not at all on its efficiency, which would make it exceed its borrowing estimate. An example would be a change in the forecast cash flow of an energy industry caused by an exceptional winter".
>
> "Nevertheless, there will be no presumption that a financing deficit will be met by a further injection of external finance."

I think this expresses a sensible approach to the special form of cash limit. It would show that we recognised this if we adopted the Chairmen's suggestion and used the term "external financing limit" in future instead of "cash limit".

7. I am sure we cannot accept the Chairmen's proposal that we should publish only a global limit for the industries taken together. This would exercise no discipline whatever. Nor can we accept in advance and as a general principle that if prices or pay rise faster than assumed at the time the limit is set we will agree to increase it. We cannot, however, deny that if this happens, the Corporations can reasonably expect the Government:

> "either to reconsider their .... limits, or alternatively to accept the need for whatever action is necessary to enable them to stay within those limits".

Where it is not practicable to cut costs sufficiently, this is bound to have implications for prices. Sponsor Ministers will wish to consider the Chairmen's suggestion that there should be an exchange of letters about the assumptions underlying the limits. If such letters are exchanged, I should of course like my officials to be consulted before this is done.

THE PROPOSED LIMITS

8. The cash limits proposed in Annex A are more likely than those set in the past to be difficult for the industries; but it is essential that we keep in mind in this as in other cases the narrow limits on the amount of money we can make available. The economic prospect has worsened both for inflation and for growth and the industries have not yet fully aqjusted to this; perhaps partly because the limits are being set earlier than normal. Secondly many of the potential remedies for threatened breaches have already been adopted as contributions to the public expenditure reductions e.g. on prices and de-manning and on postponement of investment by the Post Office and the electricity industry. This leaves little room for manoeuvre to meet contingencies. The figures in Annex A are generally based on the industries' own assumptions about movements in relevant prices and costs, including wage costs. These are broadly consistent with the comparable assumptions made in the RSG context. I have regarded the July figures decided by Cabinet, increased to allow for price increases between this year and next as setting an upper limit to the external financing to be made available.

9. Annex B, which has been prepared by Treasury officials, comments on some of the individual industries. It brings out any inconsistencies with paragraph 2, disagreement between Departments, and the risks involved, particularly where officials judge that the industries do not in practice have plausible remedies for a threatened breach open to them. British Steel and British Rail are cases in point.

INFLATION ASSUMPTIONS AND PAY

10. Most of the industries have assumed that the new settlements are no higher than or the same as their own assumptions about inflation, which are in several cases lower by 2 or 3 percentage points than now seems likely. This will not ensure in every case that unit labour costs will be lower in real terms during 1980-81 as a whole than in 1979-80. The main reason is that the 1980-81 wage bill is pushed up (more than the 1979-80 wage bill) by the second stage of 1979 settlements paid late in the year. Some increase in real unit labour costs seems likely on rail and postal services, where output is expected to be falling, reflecting in the case of rail the prospective decline in real Gross Domestic Product (GDP). In some of the smaller industries eg. docks and road transport, pay levels are influenced by settlements elsewhere in the industry. However in the cases of telecommunications, steel, coal, airports and airways, the figures imply reductions in real unit labour costs.

11. For the reasons given in paragraph 8, the proposed limits are likely to be tight. Each 1 per cent by which the industries have underestimated non-labour costs would add about £200 million to their aggregate expenditure and a 1 per cent change in labour costs adds £120 million. The industries

may also have underestimated the effect of the recession on sales revenue eg. British Rail. On balance I do not propose further reductions below the figures discussed with the industries in the light of Ministers' July decisions, in an attempt (which might well fail) to enforce reductions in real unit labour costs between financial years in every case.

PROCEDURE

12. I understand that the industries have not yet finally accepted the proposed limits although they are aware of the sort of figures we have in mind. I suggest that if the limits in Annex A are agreed, the next step should be for sponsor Ministers to discuss them with their Chairmen. It is possible that the Chairmen will press for an early collective meeting to discuss the memorandum sent by Sir William Barlow. I hope it will be possible to avoid such a meeting before the cash limits are published on the grounds that the paper is too important and has arrived too late to be adequately discussed in the short time available. But we could say meanwhile that we welcome the paper and look forward to a discussion later, which will affect the next round.

PUBLICATION AND PRESENTATION

13. Although the discussions I have suggested should take place quickly, it would probably be best to postpone publication until 20 November, the same day as the RSG limit for England and Wales is published. This should allow time to settle the limits for the electricity and gas industries. We will presumably want to stress both the difference between the two kinds of cash limit and the difference between the circumstances and assumptions relevant to individual industries. But on the figures I am proposing we should be able to say that the range of assumptions about inflation used was in broad terms consistent with the figure of 13 per cent highlighted in the presentation of the RSG limit. Both the RSG and the nationalised industry figures will need to be defensible in relation to the Industry Act forecast whether it comes out before or after 20 November.

CONCLUSIONS

14. I ask my colleagues:

a. to endorse the approach to nationalised industry cash limits and to the Chairmen's proposals set out in paragraphs 5-7.

b. To agree to set cash limits at the levels in Annex A and to the proposals in paragraphs 12 and 13.

G H

Treasury Chambers

23 October 1979

ANNEX A

NATIONALISED INDUSTRIES

Proposed External Financing Limit 1980/81

	£ million
National Coal Board	810
BNOC	101
British Steel Corporation	450
Post Office	65
British Airways Board	205
British Airports Authority	20
British Railways Board	705
British Transport Docks Board	-10
British Waterways Board	30
National Freight Corporation	24
National Bus Company	77
Scottish Transport Group	9
British Shipbuilders	130
British Aerospace	n.a.*

*In view of the impending privatisation of the Corporation, it is proposed not to publish an external financing limit.

ANNEX B

NATIONAL COAL BOARD (NCB)

E Committee on 17 October (E(79)12th Mtg, Item 1) agreed that the total external financing figure for the NCB in 1980/81 at 1979 Survey prices should be £613 million; the split of this total figure between grants and net borrowing has yet to be agreed.

2. The NCB is assuming prices will rise by 15% in 1979/80 over the previous year and by a further 15% in 1980/81. Moreover, it is assumed that wage increases in 1980/81 will be in line with the general rate of inflation and that the increased wage costs will feed through directly to prices in line with general inflation. E Committee agreed that excessive wage settlements would have to be financed by increases in the price of coal. (Note: NCB costs are increased by some £20 million for every 1% shortfall in productivity. 1% on their pay bill adds £18 million to their costs.) Since it is also assumed that there will be a rise in productivity of 2%, the NCB assume for purposes of the cash limits that that part of unit costs attributable to pay falls in real terms. In view of past performance there must be considerable doubt about this assumption.

3. On the basis of the NCB assumptions and the E Committee decision the external financing limit for the industry in 1980/81 would be £834 million. However, the NCB have made certain extra allowances for cost increases which take the total beyond the limit indicated in paragraph 8 of the Chancellor's paper. The proposed limit has therefore been restricted to £810 million.

4. If enhanced redundancy payments are agreed then the cost is to be met from within the £613 million referred to above.

5. Without the constraint of the NCB/CEGB agreement on coal-take the NCB believe that prices could rise by about 17%, which might allow a wage settlement of a similar order. But if the settlement was much above this there could be marked difficulties about raising prices to the extent necessary; this would particularly affect the NCB's market share compared with imports in later years.

CONFIDENTIAL

BRITISH NATIONAL OIL CORPORATION

The July public expenditure decision implied a 1980/81 external financing requirement for BNOC of £100 million at Survey prices. BNOC have since then revised their oil price and exchange rate assumptions for 1980/81 from \$22.50/barrel and £1 = \$2.00 to \$25.11/barrel and £1 = \$2.10. This has increased their estimated internal resources, allowing a reduction in BNOC's external financing requirements to £80 million at Survey prices.

2. BNOC's oil price and exchange rate assumptions are close to current Government forecasts, especially when combined in an implied sterling oil price. BNOC's assumption about inflation, at 13.25% for 1980/81 on 1979/80, and their deflator of 1.266 are relatively low. However BNOC's own calculations, on which the agreed Survey figures are based, are made at outturn prices; and their revenues and a substantial proportion of their costs are not primarily determined by UK price levels. The outturn 1980/81 external financing requirement of £101 million is therefore based on BNOC's deflator. BNOC make no separate pay assumption, since their pay bill represents less than 1% of their costs.

Hitherto, BNOC's outturn external financing requirement has not formally counted as a cash limit. BNOC has been seen as unique among public sector corporations in the extent to which the constituents of its external financing requirement are not within its control. Its revenues depend entirely on flows of oil from fields, which cannot be increased at will; on the dollar price of oil, which is determined outside the United Kingdom Continental Shelf; and on the sterling/dollar exchange rate. Furthermore, a large proportion of BNOC's capital expenditure is contractually determined by its partners in developing fields. Since BNOC's pay bill is such a small proportion of their costs, a cash limit would not constrain increases.

CONFIDENTIAL

BRITISH STEEL CORPORATION

The Corporation are ready to accept an external financing limit of £450m which corresponds to an assumption of break-even on the profit and loss account. This figure has been prescribed by the Secretary of State rather derived from projections of operating results. The Corporation are assuming increases of about 15 per cent in prices and 5 per cent in pay, any further increment in pay levels being covered by self financing productivity deals. (ISTC's claim is in excess of 20%, but the Corporation mean to hold firm.) With staff levels being steadily reduced, this should mean that real unit wage costs will fall: but there is a risk that they will rise if the market deteriorates further and BSC are unable to match capacity to demand in the short run.

2. The main threat to the limit comes from the poor market prospects, exacerbated by the effect of a strong pound. The Corporation would be reluctant to switch cash from capital investment to fund losses, but a faster contraction would increase immediate cash needs to finance redundancy and closure costs. Some upward revision in the limit might well be the preferable course if contraction has to be accelerated, in order to reduce the requirement for external finance in later years.

POST OFFICE

Because of the telecommunications billing backlog the Post Office will get a windfall benefit in 1980-81 (matching their 1979/80 excess) currently put at nearly £400m, but liable to change by quite large amounts. Officials recommend that the external financing limit should be set net of this windfall and should be later adjusted to take account of it, when the precise figure is known.

2. The proposed Post Office cash limit of £65m assumes a year on year increase of 13% in the RPI, and an 11% basic pay increase for both Businesses, which when added to the restructuring pay increases already agreed this year gives a total pay increase of 15.8% for Posts and 18.5% for telecommunications. On this basis, and with constant staff numbers, real costs per unit of output will rise in the postal services, although they should continue to fall in telecommunications and there should be some longer term benefits from restructuring.

3. The proposed limit is £85m higher than the July decision. This reflects:

i. The impact on costs of the computer billing dispute (in which the unions gained nothing);

ii. The need in telecommunications to avoid damage to the supplier industry, and the Post Office desire to avoid tariff increases which they consider would be prejudicial to the future of the business.

In view of the facts that inflation has probably been underestimated, and that higher costs can only be recovered with a time lag, the Chairman would strongly resist any lower figure.

CONFIDENTIAL

BRITISH AIRWAYS

The Department of Trade officials propose an external financing limit of £220m. This reflects a projection of BA's trading results which allows for increases of 15% and about an 8% increase in basic pay offset by 5% staff reductions, reversing past corporate policy of maintaining employment stable (despite overmanning). Thus real unit wage costs should fall, meeting Ministers' stipulation.

2. Such a limit would be £15m above Ministers' (revalued) July decision on the investment and financing review. The intervening period has seen a sharp rise in fuel costs, a matter outside BA's control, worsening their cash flow by some £66m - a problem exacerbated by the Civil Aviation Authority's cutting by £30m (on grounds of BA's low productivity) proposed fare increases which would have helped offset these increases. Thus a £220m cash limit would mean a real squeeze on both pay and investment. Moreover BA are at risk from further fuel price rises, both directly in their effect on costs and indirectly in their effect on traffic volumes.

3. Treasury Officials on the other hand, while recognising the risks from higher costs and possible difficulties on pay, consider that the difficulties BA face are similar to those faced by a number of other industries, and that a lower limit of £205m would be consistent with Ministers' July decisions. They note, however, that in order to keep within it the airline might have to sell a <u>new</u> aircraft, with repercussive effects on profitability, and again, on privatisation prospects.

CONFIDENTIAL

BRITISH AIRPORTS AUTHORITY

The BAA external financing limit of £20m is in line with the decision taken by Ministers in July on the investment and financing review entailing a cut of £20m (outturn prices). The Authority are assuming that the RPI will increase by 15% in 1980-81, and pay by 16%. Since traffic is now expected to increase by only 2% next year, a marked reduction on the trend of recent years, and staff levels will remain constant despite a planned upward trend over the medium term, there would be a marginal decrease in real unit wage costs. The check in growth prospects and hence revenue could put pressure on the cash limit; the remedy would be a further increase in landing charges, already planned to rise sharply towards economic levels.

BRITISH RAIL

The July decisions envisaged total external finance (excluding payments toward pensions) of £534 million at 1979 Survey prices - £500 million operating grants, £34 million borrowing and leasing. BR current forecasts indicate an external financing requirement in the range £520-550 million. These figures rest on assumptions of a 19.6 per cent fares increase in January 1980 (yielding a 15.5 per cent increase in revenue), year on year increases in the general price level and in the pay bill of 15 per cent and 14 per cent respectively, and some modest growth in the level of economic activity.

In practice the risks are heavily down-side. The size of the January fares increase has already been settled; the net benefit in 1980-81 of a further 10 per cent fares increase in September 1980 would be unlikely to be more than about 2½ per cent (£20 million) of passenger revenue (since it would do no more than bring forward some part of the fares increase due in January 1981). Moreover BR are markedly more optimistic about business prospects than the latest Treasury forecasts.

BR have limited scope for action to offset the deterioration of their business performance. Investment has already been cut back well below what the Board believe to be required to maintain the present physical capability in the medium term. Some cost reductions through cuts in services (and perhaps accelerated closures of lines in rural areas) may be possible, but these would pose serious industrial relations problems. And with fares revenue covering only 60 per cent of passenger costs, and passenger resistance to fares increases very strong, it will be very difficult for BR to stay within a cash limit equivalent to the July decision of £706 million; the Department of Transport think that it would be unsafe to set the limit lower than £750 million at out-turn prices.

BRITISH TRANSPORT DOCKS BOARD

BTDB is profitable and has a positive cash flow; profits substantially exceed capital requirements. BTDB is currently repaying prematurely its outstanding NLF debt, and at the same time paying about £8 million a year in corporation tax. The July decisions implied a negative external financing limit of £6 million.

BTDB ports account for about 25 per cent of UK traffic, and their prices and costs (including wage costs) are substantially influenced by developments at other ports. The Board's latest forecasts suggest that they might be able to accept a negative limit of £10 million; but they would find it hard to produce any more cash. They argue that their scope for raising prices more than their competitors is limited, and that they already make every effort to reduce costs and raise productivity. Attempts to restrict wage increasesfurther could lead to damaging industrial action which would put the cash limit objective beyond reach, while reductions in investment, besides damaging future prospects, would increase their tax bill.

In view of the relatively poor prospects for UK output and external trade in 1980-81, and of the Board's good record in the successful management of its ports, it would be unwise to rely on BTDB achieving more than is implied by a negative limit of £10 million.

CONFIDENTIAL

BRITISH WATERWAYS BOARD

Total external finance for BWB is primarily determined by the size of their deficit grant in aid. A limited amount of borrowing finances a small investment programme. The July decisions, after volume cuts on both grant and borrowing, imply an external financing limit of £22 million at Survey prices, of which £19 million is grant.

At out-turn prices this would imply a limit of £29 million of which approximately £25 million would be grant. The Board argue that grant at this level would not allow them to meet the additional costs of a pay award to staff following a recommendation of the Clegg Commission (expected at the end of the year) without a further volume squeeze. The Board's assumption is that Clegg increases may average 20-25 per cent, costing £1 million plus in 1980-81. The scope for the Board to finance these additional payments without a further cut in their maintenance programme already in arrears is limited. The Board have assumed increases in amenity charges of 17-18 per cent and charges for freight business are determined by their competitive position. Overall, revenue from charges is only 40 per cent of turnover.

It would be inconsistent with the treatment of Clegg awards in calculating the RSG cash limit not to make some adjustment to the cash grant figure. We therefore propose a cash limit of £30 million to include an allowance for Clegg. The size of this would not be specified but would be of the order of £1 million.

CONFIDENTIAL

NATIONAL FREIGHT CORPORATION

Under present arrangements NFC have no access to the NLF, and have to rely (apart from certain specific Government grants) on bank borrowing and leasing. The Corporation's total net outstanding leasing commitment is held constant in real terms (ie, new leasing contracts can be entered into only to the extent that previous contracts come to an end). Ministers decided in July that total external finance for NFC in 1980-81 should be restricted to £19 million.

NFC assume that the road haulage industry will in general be able to recover increases in wage and other costs through higher charges, so that their forecast of cash flow is not crucially dependent on the movements of these variables (by the same token the cash limit has less leverage over pay settlements, where in effect the Corporation have to pay the going rate in the industry). Their latest forecast of their external financing requirement is £24 million at out-turn prices, although this could be higher if there were a marked acceleration in inflation or a sharp down-turn in economic activity. The NFC figure is about £1 million less than Ministers' July decision would imply at out-turn prices. NFC would have scope for reducing investment and for a more rapid rationalisation of some operations if a deterioration in their trading position threatened a cash limit breach. A limit of £24 million at out-turn prices (£18 million at Survey prices) is therefore proposed.

NATIONAL BUS COMPANY

Total external finance for NBC depends in part on Government decisions (on borrowing and amounts of New Bus Grant) and in part on local authority decisions on the amount of revenue support they will provide. The external financing limit has to make an assumption about the latter; once it is fixed, permissible borrowing in principle fluctuates inversely with the level of local authority revenue support. The Department of Transport assumed initially that NBC would suffer reductions of £2 million in new bus grant, in local authority revenue support (ie, as a result of the central Government squeeze on local authority expenditure) and in borrowing from central Government (as their share of the £20 million reduction in lending to the Transport nationalised industries.)

On this basis the NBC external financing limit would be £77 million. NBC now say they need £87 million. We think that they are allowing for too small a fares increase next year (12½ per cent increase in revenue, implying perhaps 14 per cent on fares), and that they could make savings by a more determined effort to rationalise and cut back services. There may be some scope for reductions in investment in additional to those already implied in the IFR baseline. But the benefit of such action in cash limit terms is restricted by the heavy redundancy costs of reductions in services in rural areas. The Treasury considers NBC should be held to a cash limit of £77 million at out-turn prices, although this might need to be supplemented by an understandingthat some excess might be allowed to meet the additional redundancy costs of slimming down operations: the Department of Transport thinks that a figure below £85 million would be unrealistic.

CONFIDENTIAL

SCOTTISH TRANSPORT GROUP

As in the case of the National Bus Company total external finance depends in part on Government decisions on borrowing and New Bus Grant and in part on local authority decisions on the level of revenue support.

On the basis of SDD's assumptions about the size of cuts in New Bus Grant, local authority support and the cut in borrowing, a cash limit of £8.3 million at out-turn prices would be implied. However, the Group say they need a further £0.3 million in the cash limit to accommodate expected grant recipts to cover urgent and unexpected repairs on the Port Ellen Pier. These grants will be financed from within existing public expenditure totals. An external financing limit of £8.6 million is therefore proposed.

CONFIDENTIAL

BRITISH SHIPBUILDERS

Following their review of shipbuilding Ministers agreed in June that the total external finance for British Shipbuilders in 1980-81 should be £101 million at 1979 Survey prices. Assuming inflation of about 14 per cent between this year and next, this is equivalent to £133m at outturn prices. BS's provisional bid is for £175 million. The increase reflects revised assumptions about the likely price of ships, of carrying spare capacity and of closures. It allows for an increase of up to 10% in earnings from January 1980. £175m would be unacceptable, and Department of Industry Ministers will be making separate recommendations as soon as possible. In the meantime the table shows £130 million as the provisional limit.

BRITISH AEROSPACE

In view of the Secretary of State for Industry's intention to sell shares in British Aerospace next summer, it is proposed that no separate external financing limit should be published. Ministers' July decisions (ie, excluding any provision for developments of the 146) would imply a limit of £46 million at out-turn prices, if - contrary to present expectations - it does not prove possible to privatise the Corporation in 1980-81. If provision for the 146 were to be included, the figure would be about £80 million.

Annex C

Nationalised Industries' Chairmen's Group

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01-235 1212

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON
SW1P 3HE

18th October 1979

Dear Chancellor,

Framework of Financial Discipline

You will recall that you indicated at the Ministerial-NICG Liaison Meeting on 23rd July your readiness to receive the views of the Nationalised Industries' Chairmen's Group on the form of the suggested "framework of financial discipline" for the public sector industries. In Frank Tombs' absence on leave, I am now forwarding a memorandum setting out our thinking.

We regard this paper primarily as a contribution to debate, and so look forward to discussing it with you and your colleagues before long.

Meanwhile, I would make two points. Firstly, if the Corporations' cash limits for 1980/81 are to be fixed and published as early as next month, they will almost certainly be out of line with the Corporations' actual external financing requirements in the event, and that would aggravate all our difficulties. I would therefore urge you to consider the proposal in paragraph 28 of our paper about the way in which any November figures should be presented. This would leave both you and us with some room for manoeuvre.

Secondly, we appreciate the background thinking which is leading you to lay particular stress on cash control at this point in time. However, the Chairmen are convinced that these major national businesses cannot be run effectively on a cash flow basis. Even if you feel obliged to put more emphasise on the Cash Limits regime than we would wish this time round, I hope that we shall be able to agree in our discussions on the need to move towards the more balanced sort of financial framework outlined in our paper, for use in future years.

.../ Following

Following talks with your office, copies of this letter and the paper are being sent direct to your colleagues so as to speed circulation, but the Treasury will be handling distribution at officials level.

Yours sincerely,

Bill Barlow.

FRAMEWORK OF FINANCIAL DISCIPLINE

FOR THE

PUBLIC SECTOR CORPORATIONS

VIEWS OF THE

NATIONALISED INDUSTRIES' CHAIRMEN'S GROUP

15th October, 1979

SUMMARY

(i) The Chairmen's Group welcomes the Government's broad approach to the control of the public sector industries, ie to set a tight framework of financial discipline, but then to leave it to the Corporations to choose between the various business options available within those constraints. However, much will depend on the ways in which that framework of financial discipline is composed and operated, (paras. 1-3).

(ii) In devising any system, full account will need to be taken of the many differences between the Corporations, (para 4).

(iii) Any framework of financial discipline should embrace all the financial mechanisms through which the Government controls or influences the Corporations. Seven such factors are identified, (para 5).

(iv) The various parts of the financial framework must be operated in mutually consistent ways, (paras 6-8).

(v) If these large, capital intensive businesses, with their long "lead times", are to be directed successfully, they need strategic guidelines covering a reasonable number of years. Important though they are, short-term cash flow considerations alone cannot provide a realistic form of strategic guidance. Thus, the medium-term Financial Targets should be treated as the determining element within the financial framework, to which all other parts of the system should conform, (paras 9-11).

(vi) Arrangements for the setting of Financial Targets are discussed, (paras 12-16). All Corporations should be given Financial Targets before Cash Limits for 1980/81 are set, (para 17).

(vii) Although its role within the financial framework should not be overstated (para 10), the Cash Limits regime is a useful reinforcement for financial targetry, (para 18).

(viii) Because of their character as business enterprises, the Corporations have "cash limits" of a special sort, related not to their total spending, but to their external financing requirements, ie to the limited differences between total receipts and total out-goings, (para 19). To emphasise this distinction, a more accurate description, such as External Financing Limits, should be used, (para 20). The differences involved must affect the ways in which the Corporations' external financing limits are set, (paras 22-26); the timing of the exercise, (paras 27-28); and the results which the Cash Limits regime can reasonably be expected to achieve in the industrial area, (paras 29-31).

(ix) The time has come to spell out clearly how the Cash Limits regime is meant to operate in the case of the Corporations, (paras 32-33). The NICG's detailed suggestions for such a Code of Practice are set out, (paras 34-35 and Appendix).

(x) As well as Financial Targets and Cash Limits, five other factors should be covered in the framework of financial discipline. The NICG's views are set out with regard to: devices to stimulate efficiency, (paras 36-38); pricing policy, (paras 39-40); investment approvals and appraisals, (paras 41-45); capital structure and financing, (para 46); and the treatment of inflation, (paras 47-50).

NATIONALISED INDUSTRIES' CHAIRMEN'S GROUP

FRAMEWORK OF FINANCIAL DISCIPLINE

1. As the Chairmen's Group understands it, the Government's broad approach to the control of the public sector industries falls into two inter-related parts. The first involves providing the Corporations with a tight "framework of financial control", akin to the constraints imposed on private sector companies by the operation of a tight monetary policy. The second involves then standing back as far as possible, reducing detailed interventions and leaving to the Boards of the Corporation the task of choosing between the various business options available within those financial constraints.

2. The Nationalised Industries' Chairmen's Group welcomes this broad approach, which is very much in tune with the views which the Group itself has developed over the years.

3. In practice, however, much will depend on the way in which this overall approach is translated into specific arrangements. During the Ministerial-NICG Liaison Meeting on 23 July, 1979, the Chancellor of the Exchequer expressed his readiness to receive the Chairmen's Group's views on this issue. Accordingly, this paper sets out the NICG's thinking about the form which any framework of financial discipline should take, as a contribution to debate.

4. In devising and operating any framework of financial discipline, full account will need to be taken of the many differences between the Corporations. Of the twenty businesses linked with the Chairmen's Group which are responsible to Ministers, three - the National Water Council, the Civil Aviation Authority and the UKAEA - are not dealt with as "nationalised industries" for the purposes of the Cash Limits regime, though they are subject to that restraint through another route, and also to other parts of the overall financial control system. And as to the remaining seventeen Corporations, these differ substantially in many relevant respects, such as their organisational structures, their industrial characteristics, their current financial situations, and the extent to which their market situations allow them to influence their selling prices. Though this need to make allowance for individual circumstances is specifically referred to at certain points in this paper, it applies throughout.

A : THE OVERALL FRAMEWORK

THE COMPONENTS

5. The framework of financial discipline should be so designed as to provide an environment in which public sector Corporations operating at reasonable levels of efficiency are able to achieve an adequate level of profit. It should embrace all the financial mechanisms through which the Government controls or influences the activities of the Corporations, as developed in the 1961, 1967 and 1978 White Papers, (Cmnd.1337,3437 and 7131). It would thus consist of arrangements relating to:

- Financial Targets
- Cash Limits
- Efficiency
- Pricing Policy
- Investment Approvals and Appraisals
- Capital Structure and Financing
- The Treatment of Inflation

INTERNAL CONSISTENCY

6. If the mechanisms referred to in paragraph 5 are to be combined to provide a framework of financial discipline, it is essential that the various parts shall be operated in such a way as to be mutually consistent, one with the other.

7. This has not always been so in the past. The most acute problems have concerned the inter-relationship between pricing policy and the price implications of Financial Targets and Cash Limits, where confusions and conflicts abounded during the existence of the Price Commission. However, this has not been the only area of difficulty. There have been many other instances where either there have been direct clashes, eg. Corporations have been given Cash Limits which were altogether inconsistent with the achievement of their Financial Targets, or no positive attempts appear to have been made to check consistency, eg. as between the Cash Limits set and agreed investment programmes.

8. Looking to the future, the Government's decision to abandon direct price restraint should serve to reduce the difficulties which have occurred vis-a-vis pricing policy, but it will not necessarily remove this problem altogether, (see paragraph 40 below). Moreover, the current additional emphasis on short-term Cash Limits threatens to create a whole catalogue of new internal inconsistencies if pursued too far and in any unduly rigid way. Excessive stress on the cash limit objective could weaken rather than strengthen the Corporations' present determination to resist unreasonable pay demands since prolonged strikes can have an enormous impact on cash flow, as recent Post Office experience demonstrates. Similarly, the inflexible application of Cash Limits may impede planned reductions in manning by squeezing the room for manoeuvre in the timing of redundancy payments; lead to the loss of favourable purchasing opportunities; restrict investment in ways which block the achievement of medium-term Financial Targets; and so on.

THE LEADING ROLE OF FINANCIAL TARGETS

9. If internal consistency is to be maintained, one of the mechanisms making up the framework of financial discipline will need to be recognised as playing the "lead role" in the system, to which the others will conform. The Chairmen's Group urges very strongly that the Financial Targets should fill this role.

10. This choice is determined by the industrial characteristics of the public sector businesses. Only medium-term Targets of this sort can provide the Boards of the Corporations with the sort of strategic guidance which they need to pull together into a consistent whole all the various policies bearing on the future development of their enterprises. The Chairmen's Group fully appreciates both the immediate and the wider reasons why the Cash Limits regime has come to play such a major role in Ministerial thinking. Nevertheless, it cannot seriously be argued that the direction of these very large, capital-intensive businesses, with their long "lead times", should be determined by reference to short-term cash flow considerations alone. To attempt to do so would risk producing violent swings in policy from year to year, eg. with regard to price changes or investment expenditure, with seriously destabilising effects on customers, staff and suppliers alike. If these major national businesses are to maintain a steady course, they must steer by a more distant mark.

11. The Chairmen's Group therefore advises:

a. The Financial Targets laid down for the Corporations should be regarded as the determining factor in the framework of financial discipline.

b. As far as possible, the cash limits set for any year should be based on the best available estimates of what external financing requirements will emerge for the Corporations concerned as they pursue their medium-term Financial Targets in the light of their short-term market circumstances. In other words, the cash limits should primarily be derivative figures. Obviously, since the setting of Cash Limits is part of the Government's wider PESC exercise, Ministers may occasionally find it impracticable to refrain from adjusting the figures so derived to some extent, in the light of the Government's own short-term financial constraints; but this should be avoided if at all possible, because of the disruptive effects on the businesses, and their customers and suppliers.

c. Any interventions on prices by the Government, or by the governmental agencies concerned with Competition Policy, should be subordinated to the need to carry through in good time the price changes required to achieve the Financial Targets and Cash Limits set, (though the Corporations can reasonably be expected to demonstrate that they are also taking all possible steps to improve efficiency).

B : FINANCIAL TARGETS

12. Formal Basis. The Corporations' statutory duties with regard to the conduct of their businesses, including their financial duties, are laid down in the various Nationalisation Acts. These statutory duties cannot be ignored in any discussion of Financial Targets and Cash Limits. Those two arrangements represent very important expressions of Ministerial wishes, to which all Corporations give great weight; but they are non-statutory in character, and so do not over-ride, or impose, legal obligations.

13. Relevant Considerations. Two main sets of factors should be taken into account when determining Financial Targets. The Corporation concerned should be able to put forward all those considerations which it judges relevant in terms of the development of its business and the environment in which it expects to have to operate. And the Government will naturally wish to introduce wider-ranging matters, such as the implications for economic and monetary policy, the impact of sectoral policies where appropriate, (eg., for the energy and transport Corporations), and so on. The "opportunity cost" of capital is certainly a relevant factor when determining Financial Targets; but how best it can be taken into account in practice is a matter still needing to be discussed on an industry-by-industry basis at this stage, (see also paras.44-45). Where there has been a wide-ranging examination of a Corporation's long term corporate strategy, as in coal, the whole process of determining an appropriate medium-term Financial Target is obviously made much easier.

14. Form of the Targets. The Chairmen's Group supported the declaration in last year's White Paper on the Nationalised Industries that, "A financial target must obviously be tailored to the circumstances of a particular industry," (Cmnd.7131, para.70). It has welcomed the fact that the Targets so far announced have, accordingly, varied appreciably in form, reflecting the widely differing business situations of the Corporations.

15. Time Span. The Financial Targets set must cover a medium-term period if they are to provide the Corporations with a useful measure of strategic guidance. The period should normally be of the order of three years, possibly ranging up to as much as five years, depending on the situation in the industries concerned. In no circumstances should there be a recurrence of the situation whereby one-year Targets were laid down for British Gas Corporation and the Electricity Council for 1979/80. Though a fundamental change in circumstances may occasionally necessitate the revision of some particular Target in mid-term, the annual review procedure should normally be used as a monitoring mechanism only.

16. Consultation. The Chairmen's Group attached great importance to the promise in Cmnd.7131 that the Government would set Financial Targets after consultation with the Corporations concerned. However, actual experience to date has been mixed; eg, while some Corporations have been fully involved by their Departments, there was virtually no discussion at all prior to the setting of a Target for British Gas Corporation early this year. Unless there is full advance discussion, officials may be less than adequately aware of all the factors which are relevant in terms of the development of the industries concerned; and conversely, if those engaged in the Corporations are left unaware of the wider considerations of economic or sectoral policy which have influenced the Government's decisions, they can hardly then be expected to demonstrate a full sense of commitment to the Targets set.

17. Coverage. Useful progress has been made in the setting of medium-term Targets since the appearance of Cmnd.7131 in March, 1978. However, the coverage is still incomplete, with some major Corporations being amongst those still lacking such guidance. The Government should seek to provide all Corporations with medium term Financial Targets before attempting to define Cash Limits for 1980/81.

C : THE CASH LIMITS REGIME

18. The Chairmen's Group would be seriously concerned at any attempt to use short-term cash control as the predominant technique for guiding the operations of the public sector industries, since their industrial characteristics call for longer-term strategic guidance, (see paragraph 10). The Corporations' "cash limits" should be seen, rather , primarily as derivative figures, reflecting whatever external financing requirements emerge as the various businesses pursue their medium-term Financial Targets in the light of their short-term market circumstances. Though the Government may occasionally find it impracticable to refrain from adjusting the derived figures to some extent in the light of its own short-term financial constraints, this should be avoided if at all possible, because of the disruptive effects on the businesses, and on their customers and suppliers, (see paragraph 11b). If they are approached in this way - ie, seen as a useful reinforcement for financial targetry - the Group believes that the one-year Cash Limits can introduce a valuable additional element of financial discipline into the operations of the public sector Corporations.

THE SPECIAL CHARACTER OF THE CORPORATIONS' CASH LIMITS

19. The White Paper on "Cash Limits on Public Expenditure", (Cmnd.6440, April, 1976), acknowledged from the start the basic difference in character between the Departments and other non-trading organisations and the Corporations as commercial enterprises, and accepted that the latter required altogether-different treatment. In this area, cash control was to be applied only to the balancing element in the Corporations' total income-expenditure patterns, ie to their external financing requirements, as met by medium and long term borrowings, irrespective of source, Public Dividend Capital and grants.

20. The use of the same term to cover both the restrictions imposed on the Departments' total expenditures and those imposed on the Corporation's external financing requirements tends to obscure the important differences involved, and so encourages misunderstandings and misjudgements. The Chairmen's Group sees merit in the suggestion that a different, and more accurate, term than "cash limits" should be employed in relation to the Corporations' figures, such as "External Financing Requirements" or "External Financing Limits".

CONSEQUENTIAL DIFFERENCES

21. The fact that the Corporations are business enterprises, and the special character of their "cash limits" which stems from this, have important implications. Compared to the operation of the Cash Limits regime in the case of the Departments, three main consequential differences arise. These affect the way in which the Corporations' external financing limits should be determined; the timing of the exercise; and the results which can reasonably be expected to arise from the use of this form of discipline in the public sector industries.

Determining the Cash Limits

22. The method employed to decide on what cash limits should be set for the Corporations must inevitably be more complicated than in the case of the Departments. This is because the Corporations' expectations about their external financing requirements are derived from complex business plans which embrace all aspects of their operations, covering not only plans for current expenditures, but also expectations about their revenues, their capital spending plans, and so on. Thus, the Government cannot come to any realistic view on the Corporations' estimates of their external financing requirements without first examining these wider aspects of their underlying business plans in considerable detail. The letters received from Ministers in early October about the setting of the Corporations' cash limits for 1980/81 appear to accept this point in principle.

23. Such an approach carries, however, one important implication. The Cash Limits regime may allow Ministers to distance themselves from the Corporations' business decision after the Cash Limits have been set; but while they are being set, the operation of the system draws Departments inexorably into some degree of involvement in the most sensitive areas of business planning. And such involvement must, in turn, inevitably lead to some degree of commitment as regards the principal assumptions underpinning the Corporations' business plans.

14. This is certainly the case with regard to the assumptions made about future price changes. For most Corporations, there is a direct connection between the views which they take about the extent and the timing of price increases in the year ahead and the scale of the external financing which they expect to have to recruit. Thus, the Government cannot reasonably proceed on the basis of the latter figures but then claim to be altogether uncommitted with regard to the anticipated price changes which underlie them.

15. Assumptions about pay increases affect forecasts of external financing requirements to a lesser extent. Nevertheless, the link is close enough to make it impracticable for Ministers to avoid taking a view on what level of pay increases will be regarded as acceptable for the purposes of the cash limit calculations, whatever their general policy may be about the setting of wage norms. The letters received from Ministers in early October about the setting of cash limits for 1980/81 appear to accept this point in principle.

16. In the light of these considerations, the Chairmen's Group makes two proposals, (see Appendix, paras A13-A14 and A21). Firstly, when Ministers define the Corporations' cash limits for the year ahead, there should be an accompanying exchange of letters setting out the principal assumptions which underlie the figures set and identifying responsibility for them. Secondly, if assumptions for which Ministers bear responsibility are subsequentially proved appreciably wrong by the course of events, the Corporations affected should have the right to ask the Government either to reconsider their external financing limits, or alternatively, to accept the need for whatever action is necessary to enable them to stay within those limits.

<u>Timing</u>

17. The fact that the Government's annual round of PESC discussions is completed some months ahead of the Corporation's business planning exercises has always involved the risk that the Corporations' Cash Limits would be set prematurely, on the basis of early, tentative data about their likely external financing requirements, (see Appendix, para A17). However, the Government's efforts to expedite this year's PESC exercise has made the issue one of urgency. If matters proceed at the pace suggested in the letters received from Ministers in early October, and a White Paper formally laying down the Corporations' external financing limits for 1980/81 is published in November, there is a serious risk that the figures will be out of line with the Corporations' needs. If so, the problems likely to face both the Government and the industries in connection with the Cash Limits regime next year could be considerably and unnecessarily aggravated.

18. Against this background, one possible solution merits attention, (Appendix, para A19). This suggests that, although all discussions on the Corporations' external financing requirements for 1980/81 should naturally continue to be handled on an individual basis, the initial White Paper on future public expenditure plans projected for November should show only one total Cash Limits figure for the nationalised industries as a whole, leaving the figures for individual Corporations to be determined finally nearer Budget-time, on the basis of the more up-to-date appraisals of their external financing requirements for 1980/81 due to be submitted by Corporations in February. This course would not only help to reduce the Chairmen's Group's anxieties about the current, expedited review, but might also cover a longer-term point of concern about the Corporations' influence on the PESC exercise which NICG was discussing with the then-Chancellor at the time of the change of Government.

Likely Results

9. Since the cash limits set for the Corporations are related to their external financing limits only, they are normally small in comparison with the total expenditures, and total revenues involved*. In other words, as applied in the public sector industries, the Cash Limits regime involves relying on very short levers to try to shift very heavy weights. Both for this reason and since other practical limitations also apply#, the results will, inevitably, be less direct and less certain than in the case of the Departments, where the regime directly limits total spending. To the extent that the system helps to strengthen the Boards' hands in their constant efforts to impose financial disciplines, both inside their businesses and in relation to suppliers and Unions, it is a welcome reinforcement. However, the Chairmen's Group believes that Ministers would be unwise to exaggerate the results which can reasonably be expected to flow from this form of discipline in the particular circumstances of the public sector industries.

0. With regard to the likely impact on pay in particular, much the same conclusion applies. To the extent that the existence of cash limits helps to restrain Unions' ambitions, the benefit is to be welcomed. However, the studies which NICG has made indicate the many technical weaknesses of the Cash Limits regime as a restraint on wage bargaining; and the Unions will probably increasingly come to appreciate the room for manoeuvre which these weaknesses allow. In general, the Chairmen's Group has appreciable doubts about the effectiveness of cash limits as a device for significantly restraining pay increases in the public sector industries. Moreover, it has considerable misgivings about the likely consequences for industrial relations of any attempt to introduce discriminatory restraints, affecting public sector pay movements alone.

1. At the Ministerial-NICG Liaison Meeting on 23 July, 1979, the Chairmen's Group was asked whether it would help to make the impact of cash limits more direct, and hence more certain, if the limits were sub-divided in some way, eg as between revenue and capital items, or between pay, other revenue items and capital items. Whatever the merit of such an approach might be for the Departments, it would appear impracticable in the particular circumstances of the Corporations: in every case, their external financing limits cover only a small proportion of total out-goings; and in most cases, other limitations also apply#.

DETAILED ARRANGEMENTS

2. The detailed arrangements for the operation of the Cash Limits regime in the case of the public sector industries have developed on an ad hoc basis over the past four years, and current practice is nowhere codified. While this may have been inevitable while the system was being built up, it is undesirable now that the Cash Limits regime has become one of the main devices through which the Government regulates the activities of the public sector industries.

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* Eg, British Airways' total out-goings for 1978/79, including capital spending, totalled £1,735 million. Its cash limit was £59 million.

\# For 1979/80, out of 17 Corporations, 5 are expected to be fully self-financing, with nil or negative cash limits; and if credit is taken for local authority and special Government grants, another 9 have cash limits wholly related to the financing of their agreed capital programmes.

The Chairmen's Group believes that the time has come to spell out clearly how the Cash Limits regime is meant to operate in the case of the Corporations, in the form of a Code of Practice. Though this should be designed to apply to all Corporations as far as possible, it would need to include provisions to deal with the special circumstances of individual Corporations in certain instances.

The NICG's general views about the form of the Cash Limits regime have already been stated in paragraph 11b above. For any Corporation, its medium-term Financial Target should be regarded as "the determining factor in its framework of financial discipline". That having been laid down:

> "The cash limits set for any year should be based on the best available estimates of what external financing requirements will emerge for the Corporations concerned as they pursue their medium-term Financial Targets in the light of their short-term market circumstances. In other words, the cash limits should primarily be derivative figures. Obviously, since the setting of Cash Limits is part of the Government's wider PESC exercise, Ministers may occasionally find it impracticable to refrain from adjusting the figures so derived to some extent, in the light of the Government's own short-term financial constraints; but this should be avoided if at all possible, because of the disruptive effects on the businesses, and on their customers and suppliers".

The Chairmen's Group's more detailed suggestions about the form of the proposed Code of Practice are set out at length in the Appendix.

D : OTHER ELEMENTS IN THE FINANCIAL FRAMEWORK

EFFICIENCY

Responsibility for ensuring that Corporations operate efficiently rests primarily with their Boards. This is not only a duty imposed on them by Statute, but also a matter of professional concern and professional pride.

The Chairmen's Group is aware, however, that Ministers are actively interested in finding ways of reinforcing these internal pressures for efficiency. In this connection, it has three general observations:-

a. Some of this Ministerial concern appears to stem from an implicit assumption that nationalised industries are immune from the normal competitive pressures making for greater efficiency. This is not so. In an appreciable part of the nationalised sector, the Corporations face considerable competition from other home and/or overseas businesses; and even in those industries where Parliament has long recognised the inevitability of some limitation of direct competition, such as the public utilities, the individual Corporations face appreciable market pressures from suppliers of alternative goods and services.

b. In-so-far as the Government sees need to reinforce such competitive pressures for efficiency, any action should, as far as possible, be indirect in character, such as the imposition of a framework of financial discipline.

c. With regard to proposals for more direct action to improve efficiency, experience shows that, however well-intentioned, such initiatives can all too easily slip over into producing the sort of burdensome, time-consuming involvement of officials and consultants in the affairs of the Corporations which the Chairmen hoped that this Government was of a mind to avoid.

Nevertheless, despite its reservations, the Chairmen's Group will naturally stand ready to consider, in a positive way, any new suggestions for stimulating efficiency in the public sector industries which Ministers may wish to put forward.

8. Meanwhile, it needs to be borne in mind that a not-inconsiderable amount of experimentation is already under way in this area:-

a. The last Government's proposal that the Corporations should provide their Departments, on a regular basis, with information about their achievements in terms of a range of agreed "performance indicators", together with forward projections, is being actively pursued, (Cmnd. 7131, para 77).

b. Appreciable progress has already been made in connection with the last Government's further proposal that a certain amount of information of this nature should be made generally available through the Corporations' Annual Reports and Accounts, (Cmnd.7131, para 78).

c. The NEDO Study on the Nationalised Industries recommended that the Financial Targets set for the public sector industries should include performance objectives as well as financial objectives, especially where Corporations were in a position to exercise some degree of monopoly power, (pp.33 and 49). However, last year's White Paper, while mentioning this suggestion, noticeably refrained from following it up, (Cmnd.7131, para 76); and comparatively little has been done in this regard by the Departments, apart from the recent elaboration of the Targets set for the Post Office*. All this suggests that the proposal may involve appreciably greater difficulties than its supporters appreciate. For its part, the Chairmen's Group does not feel that the experience yet available warrants its adopting any collective stance on the idea at this stage, though it would not wish to discourage experiments on an industry-by-industry basis, where the Chairmen concerned see advantages.

d. Under the Competition Bill, the Secretary of State for Trade will be empowered to call on the Monopolies and Mergers Commission to investigate the efficiency, costs and standards of service of the public sector Corporations. Certain initial points of concern having been dealt with during discussions prior to the publication of the Bill, the Chairmen's Group has not sought to resist this innovation. However, it remains worried about the burdens which such investigations will involve; dubious about the benefits likely to accrue; and unconvinced about the capacity of the Monopolies and Mergers Commission to carry out management audits of the sort envisaged in the time allowed.

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* The Financial Target set for Telecommunications calls for a reduction in the unit cost of telecommunication services of some 5% a year in real terms during the period 1978/79-1982/83, in addition to achieving a 5% return on net assets, revalued at replacement cost. The Target set for postal services requires them to maintain constant prices in real terms. Other Corporations have experimented with setting performance targets of their own: eg British Airports Authority's Accounts for 1978/79 record that it has set itself the tasks of increasing the number of passengers handled per employee by 3% a year, and of reducing expenditure per passenger, before depreciation, by 2½% a year in real terms, over the next five years.

PRICING POLICY

39. If it is accepted that a Corporation is operating reasonably efficiently, then the objectives which it is given in terms of Financial Targets and External Financing Limits will go a long way towards determining what level of sales revenue it will require over the year ahead, and hence the amount and timing of any necessary changes in selling prices. The point obviously cannot be pressed too far. Some Corporations, operating in highly competitive environments, have little if any ability to adjust their selling prices so as to realise given targets for profits and cash flow, and must operate almost entirely on the other side of the cost-price relationship. And even for those Corporations which have some greater degree of market influence, many uncertainities may intervene. Nevertheless, it is essential that the Government should have a clear understanding of the implications for pricing of the Financial Targets and External Financing Limits which it sets.

40. As paragraph 7 indicated, this has all too often not been the case in the past. Looking forward, the Government's welcome decision to abolish the Price Commission and to abandon direct price restraints should serve to reduce the difficulties in future; but it does not necessarily remove the problem altogether. In particular, some potential areas of conflict remain vis-a-vis the statutory powers of the Director General of Fair Trading and the Monopolies and Mergers Commission. Although the new Competition Bill requires the Monopolies and Mergers Commission to accept any Financial Targets and Cash Limits laid down by Ministers as "given data" in connection with its investigations into the efficiency of public sector industries, the Bill does not extend that rule to other activities of the MMC, nor does it apply it to the activities of the Director General of Fair Trading. Thus, there is need for procedures to be agreed between the Government, the Corporations, the DGFT and the MMC for dealing effectively and speedily with any proposals from the Corporations for price increases which stem from the setting of Financial Targets and Cash Limits. More generally, though the Chairmen's Group is much encouraged by the evident determination of the present Government to avoid intervening in commercial issues, sad experience shows that the political pressures on Ministers to block necessary but unpopular public sector price increases have all too often eventually overcome good intentions in the past.

INVESTMENT APPROVALS AND APPRAISALS

41. The public sector industries have very large investment programmes, often involving individual projects with long "lead times". These programmes currently involve capital outlays of well over £4 billion a year, account for about one-fifth of all of Britain's investment in fixed assets, and provide a work-load which is crucial for the well-being of many private sector capital goods manufacturers. It is thus essential from many angles that any framework of financial discipline should include arrangements which are capable of regulating this investment activity successfully.

42. The existing arrangements in this field fall into two main parts. The first involves annual reviews of the Corporations' medium term investment programmes by their sponsoring Departments, leading up to Ministerial authorisations for certain percentages of the total levels of capital spending proposed in each of the first three years of the programmes, as a basis for the advance commitments needed to keep investment activity running smoothly. These arrangements were examined in depth in 1975, and useful changes made; and while there are specific points at which improvements could still be effected, the Chairmen's Group believes that they can be incorporated without any substantial change in the framework of financial discipline.

There is, however, some uncertainty about the links between this procedure for future investment authorisations and the procedure for setting Cash Limits. The Chairmen's Group would welcome an assurance that, once a forward capital spending programme has been authorised in whole or substantial proportion, Cash Limits will be set for the years concerned at a level which makes full provision for the financing of that capital spending. Late revisions in capital spending programmes occasioned by inadequate cash limits can have extremely serious repercussions, not only on the Corporations themselves, but also on many private sector companies in the capital goods industries, who are often heavily dependent on public sector orders.

The second set of arrangements bears on the likely profitability of the various projects making up those overall capital spending programmes. The approach set out in the 1967 White Paper, which revolved around the proposition that the profit prospects of each individual project should be appraised by use of the Test Discount Rate (TDR) system, was dropped last year as a governmental requirement, and it was left to each Corporation to determine its own methods of investment appraisal in future. In its place, the 1978 White Paper proposed that the profitability of each Corporation's investment plans should henceforth be appraised in terms of whether its new capital outlays taken as a whole were likely to achieve a sufficient return to cover the current "opportunity cost of capital", (identified as 5 per cent in real terms before tax); and it was indicated that this would become one of the factors to be taken into account in determining Financial Targets, (Cmnd.7131, paras 57 and 60). In addition, the White Paper put forward a new mechanism for implementing this new approach, in the form of the Required Rate of Return (RRR) system, (paras 60-63 and Appendix I).

The Chairmen's Group accepted the "opportunity cost of capital" concept. Moreover, the strength of the general arguments advanced in favour of the RRR system as a technique for applying that concept was fully recognised. However, a number of Chairmen were hesitant about the practicability of the RRR system in terms of the particular industrial situations facing their businesses, an aspect on which no serious studies had been done. NICG made clear to the late Chancellor its reservations in this regard; and in the event, the key sentence in Cmnd.7131 stated only that, "The Government is ..... discussing with (the Corporations) the development of a more direct way of relating the opportunity cost of capital to their financial performance in order to reinforce the principles of Cmnd.3437", (Para 60). The Chairmen's Group subsequently indicated to Ministers that, until those discussions had been completed and the results had been considered, the Chairmen's Group would continue to reserve judgement on the use of the RRR system as a technique for applying the "opportunity cost of capital" concept. That remains its position.

CAPITAL STRUCTURE AND FINANCING

The ability of the Corporations to operate satisfactorily within any framework of financial discipline will depend in part on the existence of suitable arrangements with regard to their capital structures and their financing. At this stage, the Chairmen's Group wishes to reserve comment on any points of common concern which may emerge in these regards from study of the various "privatisation" proposals being put forward by the Government. However, it would still see advantage in discussions being held at officials level on the rather more detailed points raised in the memorandum on "Capital Structure and Sources of Finance" which it submitted to the Treasury in February, 1979 and which has not yet been considered. In these discussions, the NICG would wish to pursue, among other matters, the current limitations on overdrafts and other forms of temporary borrowings, and the treatment of leasing.

THE TREATMENT OF INFLATION

Like all parts of the economy, the public sector industries find the conduct of their affairs rendered increasingly difficult by the course of inflation. Indeed, since the Corporations' fixed assets are so considerable and often so long-lived, the impact of inflation on economic and financial relationships in the public sector industries is particularly severe. Any framework of financial discipline must embrace arrangements to cope with this aspect. In particular, three points will require attention.

Pricing. The level of prices charged by public sector Corporations should, wherever possible, be high enough to cover the full current costs of production, including the replacement cost of capital assets "used up" in the process of production. Such prices cannot always be secured by Corporations facing highly competitive market situations. However, unless the Government allows the use of full "current cost" pricing in situations where it is practicable, and makes its support for that policy widely known in the community, it will be acquiescing in a progressive hidden erosion of the capital base of the Corporations concerned, and thereby aggravating public sector financing problems in future years.

Financial Targets. Correspondingly, the Financial Targets set for the Corporations should, as far as possible, be expressed in terms which take account of the impact of inflation. This cannot yet be done across-the-board; but it is encouraging to note that nine of the Financial Targets set recently have been expressed in this way.

Financial Accounts. The Chairmen's Group and all individual Corporations have accepted the statement included in last year's White Paper on the Nationalised Industries that, "when an inflation accounting standard is approved, it will apply to the nationalised industries, subject to any necessary adjustments to meet their special circumstances", (para.72). Earlier this year, NICG produced an Interim Code of Practice, designed to reduce the differences which had developed with regard to the treatment of inflation in nationalised industries' Accounts in the absence of any authoritative lead from the accountancy bodies. Following on from this, NICG recently sent to the Treasury its analysis of the current proposals for a new Inflation Accounting Standard, as set out in Exposure Draft 24. It hopes that, after discussion, agreement can be reached on a joint statement which the Government and the Chairmen's Group could make to the Accounting Standards Committee with regard to the application of such an Accounting Standard to the public sector industries, including any adjustments judged necessary to meet their special circumstances.

APPENDIX

DETAILED ARRANGEMENTS FOR THE CASH LIMITS REGIME IN THE PUBLIC SECTOR INDUSTRIES

A1. Paragraph 33 of the main paper states the Chairmen's Group's view that "the time has come to spell out clearly how the Cash Limits regime is meant to operate in the case of the Corporations, in the form of a Code of Practice"; and paragraph 34 then describes the NICG's general thinking on this matter. This Appendix elaborates on that approach.

TERMINOLOGY

A2. The term "Cash Limits" should be replaced by one which more accurately describes the system as it applies to the Corporations, such as "External Financing Requirements" or "External Financing Limits".

RELEVANT INFORMATION

A3. Three main types of information are necessary before Ministers can properly decide on External Financing Limits:-

a. The medium-term Financial Targets at which the Corporations should be aiming.

b. The best available estimates of what individual Corporations are likely to need by way of external financing in the next financial year.

c. The Government's own assessment of the overall public sector financing situation in the year ahead, leading on to initial views about the desirable level of the Public Sector Borrowing Requirement, to which the total of the Corporations' external financing requirements contributes.

As indicated in the main paper, the Chairmen's Group believes that the first of those items should be the principal factor affecting the setting of Cash Limits.

MACHINERY

A4. The Corporations already provide their sponsoring Departments with considerable information about their business plans for the year ahead. Though arrangements vary somewhat, returns are normally made in tentative form in the Autumn, in reasonably complete form in the following February, and in final form shortly afterwards. These several submissions show the best estimates available at the time of the revenues and expenditures which are likely to arise as the Corporations pursue their medium-term Financial Targets in the light of the short-term business conditions anticipated; and set out in detail all the background data and assumptions underlying those estimates: and in the later versions, they also state what level of external financing is likely to be required in the year ahead.

A5. From the Government's viewpoint, this information forms one of the many inputs brought together in the annual PESC exercise. The decisions flowing from that exercise subsequently emerge in three main ways: in the annual White Paper on the Government's Five Year Expenditure Plans, (normally been published in January in the past few years), which includes figures for the nationalised industries' external borrowing requirements in the next financial year, in total and by individual Corporations; in the Estimates put to Parliament, (which are now being brought into line with the Cash Limits set for the corresponding Departmental "blocks"); and in the Budget, and the accompanying Budget Statement and Financial Review.

A6. The formal status of the figures showing external borrowing requirements for individual Corporations which are included in the White Paper on Five-Year Expenditure Plans has never been clearly defined; but the authoritative statement of Cash Limits for the public sector industries for the coming year is normally taken to be that appearing at Budget-time in the Financial Statement and Budget Review. This covers 17 of the 21 Corporations linked with NICG, with the exceptions being the National Water Council, Civil Aviation Authority and UKAEA, (whose position is dealt with through the Cash Limits set for their Departments), and London Transport Executive.

A7. The Chairmen's Group is generally satisfied with this existing machinery. Its main reservation, reflecting a considerable anxiety about timing, is indicated in paragraphs A15-A19 below.

THE PROCESS OF DECISION-MAKING

A8. Decisions on the Corporations' External Financing Limits are a matter for the Government, albeit for practical rather than statutory reasons. However, Ministers cannot expect the Boards of the Corporations to carry responsibility for operating their very large enterprises successfully unless a major element in their business plans - their access to external financing - is determined in a way which pays adequate regard to the Boards' own judgements of their needs.

A9. The setting of the Corporations' External Financing Limits ought thus to be preceded by full consultation, involving the normal process of successive discussions, leading to successive adjustments in views, until figures are reached which are tolerable both in terms of the Corporations' position as commercial entities and in terms of the Government's judgement of overall national priorities. Considerable concern has been caused by the fact that Cash Limits for 1979/80 were revised in March and again in June of this year without that process of consultation having been fully carried through, and without the Corporations' acceptance of the External Financing Limits set having been secured in all cases. While the Chairmen's Group appreciates that special factors were at work in the case of the June revisions, it urges strongly that the Code of Practice should be drawn in such a way as to ensure full consultation, and as far as possible full agreement, on all future occasions.

A10. The Government should keep closely in mind the wide-ranging and disruptive effects which revisions of the External Financing Limits can have on the whole of the Corporations' business planning. They may well, for example, force sudden changes in investment plans which can seriously disturb the well-being of the private sector capital goods industries; and they can have altogether-deleterious effects on the carefully planned course of discussions with the Unions.

THE BASES OF ASSESSMENTS

A11. When drawing up their business plans in the past, the Corporations have had the benefit of some guidance from the Government on economic issues; a measure of stability has existed on the capital expenditure side by reason of the procedure for prior Ministerial authorisations, ranging three years ahead; and the existence of publicly-stated Counter-Inflation Policies has provided guidance on wages issues in most recent years. Nevertheless, it has always been accepted that it is the responsibility of the Boards of the Corporations to decide on the assumptions underlying their business planning, making such use of Government guidance as they judge proper.

12. The Chairmen's Group believes strongly that this arrangement should continue, both on practical grounds and grounds of principle. The Code of Practice should therefore lay down that it is the responsibility of each Corporation to determine what assumptions should be included in its business plan, except where the Government explicitly intervenes to lay down guidance on any particular issue, as Ministers have just done, in effect, in relation to the allowance to be included for pay increases.

13. It is important that at the end of the process, ie, when external financing limits are eventually set for the Corporations, it should be clear to all concerned what assumptions underlie the figures and who bears responsibility for them. Accordingly, at the time when the external financing limits are published, there should be an exchange of letters between the Departments and the Corporations covering these matters.

14. The Code of Practice should make provision to cover the situation where assumptions <u>for which responsibility rests wholly or substantially with Ministers</u> are found to be appreciably wrong as the year proceeds, and the divergence endangers any Corporation's ability to live within its external financing limit. In this event, the Corporation concerned should be entitled to ask the Government to take one or other of two courses. The first would be for the Government to adjust its external financing limit by an appropriate amount, in line with the well-established practice applied to Departmental cash limits when policy or other changes arise, (eg, Cmnd.7681, Table 1, records 68 such adjustments in 1978/79). The second would be for the Government to accept any industrial or commercial steps suggested by the Corporation which would enable it to remain within its original external financing limit, including additional price changes. The main difficulty which could arise under this procedure concerns the treatment of pay increases*; and here, NICG would welcome an opportunity for discussion.

<u>TIME-TABLE</u>

15. The Chairmen's Group appreciates that the Government's timetable for settling the Corporations' External Financing Limits is determined by wider considerations, and particularly by the timing of the Budget. Nevertheless, the Corporations are naturally concerned to ensure that the External Financing Limits within which they will have to operate, and which will appreciably affect the conduct of their businesses, should be based on information which is as up-to-date and as well-based as possible.

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* A distinction needs to be drawn between the situation where a Corporation and its Unions negotiate a wage settlement in excess of the Government's guideline <u>while</u> that guideline is still capable of exerting influence on general level of wage settlements, and the situation where a Corporation comes to the point of settlement <u>after</u> the general course of wage bargaining has clearly overturned the Government's initial pay aspirations, as occurred after the collapse of the last Government's 5% pay norm early in 1979. Ministerial comment has so far focussed entirely on the former case. However, the latter case warrants consideration also, since most Corporations settle late in the annual pay round.

A16. The Chairmen's Group does not wish to propose any specific alternative time-table, since this is a matter needing detailed discussion in the light of Whitehall's own requirements and the many variations in practice between the Corporations, the most important of which is the differences in year-end dates. Nevertheless, the timing of the business planning exercises which produce the Corporations' estimates of their external financing requirements must clearly be a significant factor.

A17. Like many large private sector companies, most Corporations begin their business planning by assessing broad economic prospects in the last Spring or early Summer, following the Budget; and their plans are then built up through the various stages of sales forecasting, production and capital planning, financial assessments, and subsequent revisions, until the forecasts for the year ahead finally emerge a reasonably short period before their new financial years begin. Thus, the information which most Corporations submit for the PESC exercise in the Autumn is necessarily provisional, and cannot be regarded as providing an adequate basis for defining levels of external financing within which the Corporation can be expected to commit themselves to operate their businesses. Indeed, for Corporations with April-March financial years, only the final business plans produced in the early Spring can be regarded as authoritative for this purpose. However, if Government timing so dictates, the data provided to Departments for the purposes of the annual investment and financing review in February could be taken as a tolerable basis for constructing a new time-table for dealing with the Corporation's external financing limits.

A18. The Chairmen's Group has long regarded this timing issue as a serious problem, to which there is no easy answer, and has looked forward to discussing possible ways of ameliorating the difficulties to which it has given rise. However, the Government's decision to expedite the PESC exercise this year, and to seek to publish the Corporations' external financing limits by November, has made the matter one of urgency.

A19. One suggestion which warrants consideration in this connection is that the first set of figures published by the Government on the nationalised industries' financing requirements, which are normally based on the very tentative submissions which the Corporations make in the Autumn, should be shown in total only. The final figures for individual Corporations could then be worked out nearer to Budget-time, on the basis of the Corporations' February submissions. While these final discussions would necessarily have to have regard to the overall sum initially published, a reasonable degree of flexibility would remain, because of the considerable allowance for "shortfall": eg., for 1979/80, this allowance amounts to £500 million, as against a figure of £2,328 million for the sum of the individual Corporations' Cash Limits.

THE "PRICE BASIS" OF THE FIGURES

A20. Hitherto, as between the initial appearance of figures for the Corporations' External Financing Limits in the Public Expenditure White Paper and the final announcement in the Financial Statement and Budget Review, the way in which the Limits are expressed has been changed. The former document has shown them in terms of "survey prices" for the then-current year, whereas the latter document has shown them in terms of "estimated out-turn prices" for the year ahead. It is assumed that the same will apply this year, despite other changes in the arrangements.

A21. The Corporations find this change of horses in mid-stream irritating and confusing. What is much more important, however, is that the process involves introducing into the exercise a Government assumption about the likely rate of inflation, the scale of which is not stated in the Financial Statement and Budget Report, but which is very likely to lie below the Corporations' own planning assumptions, (see paras A11-A14). And if that Government inflation allowance does indeed prove to have been set too low, the Corporations' external financing limits will suffer a further element of "hidden erosion", on top of any cuts which may have been made openly by Ministers when setting the limits in volume terms. This has certainly been the case this year; and though the extent of the "hidden erosion" now occurring cannot be quantified by NICG, it is believed to be very considerable indeed.

A22. The Code of Practice should provide for the review arrangements referred to in paragraph A14 to cover this aspect also. In other words, if events show that the Government's original inflation assumption has been set appreciably too low in any year, Corporations should be entitled to ask that their external financing limits should be re-expressed on amore realistic basis in money terms, while naturally remaining unchanged in volume terms.

CARRY-OVER

A23. The Financial Targets set for the Corporations call on them to take a medium-term view of the course of their business, and so envisage some flexibility as between one year and another. The Cash Limits regime, however, based on a single-year approach, may cut across that flexibility in an undesirable and unhelpful way. This is especially so in relation to investment spending, where all experience shows that the setting of "top limit" figures with no provision for carry-overs creates a climate of opinion which positively encourages spending. The review of practice vis-a-vis Ministerial investment authorisations, conducted under Treasury chairmanship in 1975, expressly recognised this point, and the arrangements were changed accordingly to set such authorisations on a "mid-point" basis.

A24. The Chairmen's Group hopes that consideration will be given to regarding the External Financing Limits set for public sector industries as mid-point figures rather than maximum figures. This may obviously pose theoretical problems in terms of the Government's annual financing arrangements. In practice, however, any net over-run is likely to be small in relation to the aggregates involved, and well within the unavoidable margins of error; and the offsetting advantages from the industries' viewpoint could be considerable.

MONITORING

A25. The existing arrangements for the monitoring of the Corporations' activities in relation to their External Financing Limits, which include provision for either monthly or quarterly reports and discussions, are judged satisfactory. Care must, however, be taken to recognise the special situations affecting particular Corporations: eg, the National Bus Company has, as a component part of its External Financing Limit, the new bus grant, for which the legislation expires next year.