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CABINET

# NATIONALISED INDUSTRIES - INVESTMENT AND FINANCING REVIEW

Note by the Chief Secretary, Treasury

The attached report by officials is relevant to our discussion in Cabinet on the public expenditure survey. The report will be considered first in the Ministerial Committee on Economic Strategy Sub-Committee on Economic Affairs on 11 July. I will be inviting colleagues to endorse all the options set out in Table 3.

W J B

Treasury Chambers

9 July 1979

NATIONALISED INDUSTRIES: INVESTMENT & FINANCING REVIEW 1979

Note by Officials

1. This paper presents the annual Investment & Financing Review (IFR) of the 18 nationalised industries. It provides a basis for Ministers to take decisions on the level of:

   a) aggregate external borrowing for the nationalised industries;

   b) investment by each of the industries.

It takes no account of disposals which are being handled separately (see para 9 below). In some cases decisions will be subject to the outcome of reviews on certain industries.

2. Decisions on (a) are a necessary part of settling public expenditure planning totals for the Public Expenditure White Paper: from 1976 onwards it has been the industries' financing figures and not their investment figures (which in aggregate substantially exceed the financing figures) that have contributed to public expenditure. Decisions on (b) each summer help the industries to plan next year's investment sensibly. (This aim can, however, be frustrated if there is a problem in the Spring, as there was this year, in keeping cash limits within the total financing provision in the Public Expenditure White Paper.) The investment figures are normally approved on the basis of 100% in Year 2 (1980/81), 85% in Year 3 (1981/82) and 70% in Year 4 (1982/83).

3. The starting point for these decisions is the plans and figures submitted by the industries in April, as revised during consultations since then between the industries, sponsor departments and Treasury; but the figures for steel are not yet available and those for coal, shipbuilding and the BNOC are subject to the special reviews for those industries now in train. The figures are set out in Appendix A (a series of aggregated tables) and Appendix C (which provides detailed material industry by industry).

4. This year the aggregate external financing figures exceed the figures underlying the last Public Expenditure White Paper (Cmnd 7439) by substantial amounts £450 million in 1980/81, £350 million in 1981/82 and £250 million in 1982/83. The main reason for these increases is a reduction in forecast internal resources of

£400 million, £200 million and £450 million in the 3 years combined with increased capital requirements amounting to £50 million and £150 million respectively in the first two years. (There is a reduction of £200 million in 1982/83.) Over the period there is still a progressive decline in external financing and an improvement in financing from internal resources from 54% this year to 57% in 1980/81, rising to 67% in 1983/84 (compared with a figure of only 27% in 1975/76) - but both are slower than had been expected.

5. The fall in internal resources in 1980/81 and 1981/82 results partly from worsening prospects for coal and rail. (For steel the tables assume, in the absence of firm financing figures, that deterioration in internal resources cancels out the large cut since last year in investment.) It also results from the reduction in March in the telecommunications financial target from 6% to 5% real return on capital, from changes in nuclear provisions for electricity and from BNOC's reduced internal cash flow. The increase in investment is mainly in electricity as a result of slippage and higher real prices for power stations.

Increases over Cmnd 7439 & Scope of this Review

6. The external financing figures include grants as well as borrowing. In public expenditure terms these grants form part of sponsoring departments' functional programmes (where options for reductions are being considered); only the borrowing figures are aggregated in Programme 5. However in the case of the National Coal Board, there is much uncertainty about how the increase in their external financing requirements will be split between borrowing and grants; the total increased bid is therefore dealt with below. On this basis the increases discussed here are the additional bids for borrowing plus coal's additional bid for grants. These increases, which may be compared with the totals in Table 1 of Appendix A, are shown in line C of the following table:

Table 1

Increases on Cmnd 7439

£ million at 1979 Survey prices

| | 1980/81 | 1981/82 | 1982/83 | 1983/84* |
|---|---|---|---|---|
| A Borrowing | 200 | 100 | 50 | 50 |
| B Grants to NCB | 150 | 150 | 150 | 100 |
| C TOTAL | 350 | 250 | 200 | 150 |
| D of which short-term borrowing & leasing | - | -50 | 250 | 150 |

*for 1983/84 (which was not covered by Cmnd 7439) the table shows the increases compared with the figures for 1982/83 in Cmnd 7439.

short-term borrowing and leasing are shown separately because they were not included in the Public Expenditure planning total in Cmnd 7439. But it is recommended (in para 8 below) that they should be included in future and the rest of the paper treats line C as the measure of the increase over the White Paper. However, in accordance with Ministers' instructions that options should be "as wide as possible", the options presented below add up for the industries to considerably more than is needed to eliminate the increases; and if they were all adopted they would produce substantial cuts in the White Paper figures.

The Nature of the Borrowing Figures

7. The borrowing figures are of their nature extremely volatile, being as they are the residual of much larger flows: capital requirements, approaching £5 billion, minus grants and internal resources together of the order of £4 billion. Internal resources themselves are the product of two further flows, revenue(£30 billion) and current expenditure, which are sensitive to such factors as the weather, fluctuations in demand, market share, productivity, the exchange rate and the relative movement of pay and prices. The pattern of borrowing also varies enormously between industries: some are heavy net borrowers, some borrow very little, others are net repayers of debt. The industries have a marked tendency to under-spend (capital slippage being a major factor here) and an overall shortfall allowance is now built into the forecasts. In recent years shortfall has declined to rather over £600 million. After a sharp reduction in the current year as a result of the Budget squeeze, the shortfall allowance is assumed to be £500 million in 1980/81, and then to fall to £400 million in the last 3 years of the Survey period as a result of efforts to improve the industries' forecasting in 1978/79.

8. As already noted, the "public expenditure planning total", on which Cmnd 7439 concentrated attention, included all the industries' long and medium-term borrowing from whatever source including overseas borrowing but excluded their short-term borrowing and leasing. This is not a satisfactory total for the purposes of controlling the industries' finances since it can be evaded by switching into short-term borrowing and leasing; for this reason the cash limit is set on total external finance (capital requirements net of internal resources), which includes short-term borrowing and leasing. The divergence between the cash limit and the public expenditure planning total complicates control and it is proposed that it should be eliminated by including short-term borrowing and leasing in the public expenditure planning total. This will streamline the control system; it will emphasise the industries' contribution to the PSBR by ensuring that the whole of their contribution, including their short-term borrowing, will be within the public expenditure planning total; and it will ensure

that surplus funds lent to the Government by an industry reduce public expenditure, a point which will be of some importance when e.g. gas will shortly have repaid all its NLF debt and will invest surplus funds in Government securities. It will also, as the table in para 6 shows, raise the size of the increases compared with the White Paper in some years. But these increases represent additions to the PSBR which should be (and are) covered by the options presented below and it makes more sense to include them.

9. Ministers should note that the figures are going to be altered very considerably by disposals - in some cases adversely. But it is too early to show the effects of this.

Option Cuts

10. Because the nationalised industries are businesses there are in principle 3 ways of reducing their contribution to public expenditure: cutting investment or working capital; and raising internal resources either by savings on current costs, especially where this reduces losses which in general signal waste, or, where the market permits, by raising prices to economic levels.

11. Equally, however, the fact that they are businesses is a powerful argument for achieving necessary public expenditure reductions by means which so far as possible do not penalise successful industries to help weak ones and do not involve arbitrary investment cuts which may lead to capacity shortage, or unnecessary costs, or setting prices at excessive levels which mis-allocate resources or restrict the industries' growth.

12. In practice, however, officials consider that although there are some risks, there are economically defensible options for savings that could remove the increase over the Cmnd 7439 level and go further than that. Each industry was asked for options for reducing external financing by an amount equal to 10% of its investment. But the realism and adequacy of these varies and other options have been considered which go further, notably a phased move towards economic pricing for domestic gas (see para 16 & Appendix D).

13. The possibilities are discussed in detail in Appendix B. In some cases reductions have already been made on the figures submitted by the industries and these reductions have been incorporated in the baseline figures. These reductions are shown in the following table:

Table 2

...nges Compared with the Industries' Plans Reflected in the Base Line

| | £ million at 1979 Survey Prices | | | |
|---|---|---|---|---|
| | 1980/81 | 1981/82 | 1982/83 | 1983/84 |
| BNOC - higher oil price assumptions | 39 | 86 | - | - |
| British Gas - revised exchange rate | 40 | 40 | - | - |
| Electricity (England & Wales) - mainly resulting from higher prices | 115 | 90 | 40 | - |
| British Rail - investment cuts | 19 | 19 | 24 | 40 |
| National Bus - investment cuts | 5 | 6 | 6 | 6 |

...the case of the energy industries, these changes result from adopting more favour-...le assumptions than those in the industries' original bids. These are estimating ...anges for BNOC and British Gas but a policy change in the case of Electricity. ...the view of officials, the revised assumptions are realistic, but if the original ...recasts were to prove right the financing requirements of the industries concerned ...uld have to be increased. In this event the Department of Energy would want the ...mits on the financing requirements of the industries concerned increased accordingly.

... Reductions in the proposed investment programmes of BR and NBC have been made ...cause officials do not consider that adequate financial progress has been made to ...stify investment at the level proposed. In the case of rail, the reductions will ...ow up as a combination of lower borrowing and lower grant. The Board have empha-...ised the serious consequences for the renewal of exisiting assets of maintaining the ...esent investment ceiling.

... The options set out in Table 3 on page 6, if exercised in full, would go well ...yond eliminating the excess on Cmnd 7439 and achieve substantial savings. In ...rticular the Cmnd 7439 figure of £750 million for 1980/81 would be reduced to £400 ...illion. Ministers however will wish to consider whether they wish all of these options ...o be exercised and if not which. In the view of Treasury officials all are feasible ...d most of them desirable. Nevertheless some are clearly easier than others. Four ...dustries - BNOC, coal, steel and shipbuilders - are the subject of separate reviews ...d Ministers are being invited to take decisions on them separately. The reviews of ...e last 3 loss-making industries all turn in part on the scale of closures. But ...e savings shown in lines 1, 10 & 11 should be achievable; and in the case of BNOC ...e savings in line 2 flow from the policy in the Manifesto.

... In the view of Treasury officials there is a strong case for permitting elec-...ricity prices to rise to economic levels (as the baseline forecasts already assume) ...d for raising domestic gas prices to economic levels. In a market economy

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Table 3 OPTIONS FOR REDUCTIONS

£ million at 1979 Survey prices

| | | 1980/81 | 1981/82 | 1982/83 | 1983/84 |
|---|---|---|---|---|---|
| 1 | Coal - investment, including pit closures | 55 | 95 | 140 | 195 |
| 2 | BNOC - reduced investment | 75 | 100 | 100 | 125 |
| 3a | Gas - maintain prices in real terms | 160 | 210 | 240 | 320 |
| | OR | | | | |
| 3b | Move to economic pricing (as already assumed for electricity) | 260 | 380 | 480 | 670 |
| 4 | Electricity (England & Wales) and Gas - unspecified current and capital savings | 50 | 75 | 100 | 100 |
| 5 | Scottish Electricity Boards - increase prices to economic levels plus current and capital savings | 10 | 15 | 20 | 30 |
| 6 | Transport industries - further miscellaneous savings | 20 | 20 | 20 | 20 |
| 7 | Airways - investment reductions | 40 | 40 | - | - |
| 8 | Airports - raise landing charges to economic levels | 16 | 15 | 15 | 15 |
| 9 | Post Office - capital and current savings | 50 | - | - | - |
| 10 | Steel & Shipbuilders - estimated savings from current reviews | 105 | 225 | 225 | 225 |
| 11 | British Aerospace - cancellation of BAe 146 | 40 | 40 | 40 | 40 |
| | TOTAL (including 3a) | 621 | 835 | 900 | 1070 |
| | (including 3b) | 721 | 1005 | 1140 | 1420 |

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[dec]isions about the use of national resources are largely guided by considerations of [co]st and price. An efficient market will ensure that decisions so based will tend to [put] resources to the most worth while uses. And for the market to be efficient, [pri]ces must reflect costs. Because value to consumers and costs are likely to vary [wi]th the scale of output, economic pricing is concerned particularly with the (oppor[tun]ity) cost of putting more or less resources into a particular activity i.e. with [mar]ginal costs. In an efficient market the forces of competition tend to bring [pr]ices and marginal costs together. Market efficiency is much harder to achieve for [th]e nationalised monopoly industries than for the private sector. But the best way [of] ensuring that the nationalised monopoly industries are not using too much or too [li]ttle of national resources is to base their prices on their marginal costs. (For [a] fuller statement see Appendix D.)

[1]. The size of the overall savings depends crucially on the option chosen for gas [pr]ices. In the view of Treasury officials line 3(a) of Table 3 which merely involves main[ta]ining present prices in real terms should be a minimum objective. But it would be [ve]ry much preferable to move towards full economic pricing. This would involve price [in]creases of up to 5% a year in real terms and produce the savings in line 3(b). [An] alternative way of raising domestic gas prices would be to impose a gas tax in [wh]ich case the additional revenue would flow to the Exchequer directly instead of [pro]ducing very high gas industry profits. The PSBR would be reduced to the same [ex]tent, but public expenditure would not be affected. Line 4 is based on the view [o]f officials that BGC and Electricity could, if pressed by Ministers, find further [sa]vings, a view which is reinforced by BGC's recently demonstrated ability to find [sa]vings of £130 million in 1979/80 at very short notice for the Budget. Line 6 simi[la]rly assumes that savings could be obtained from the transport industries though the [sc]ope for this will depend on the size and nature of the options for reduction [ad]opted in Programme 6. The increased charges for the Scottish Electricity Boards [(]line 5) will put them on all-fours with electricity in England & Wales. Increased [A]irport landing-charges line 8) can also be justified in terms of a move to econo[m]ic pricing. The option cut for BA (line 7) involves some postponement of purchase [o]f three Tristars, but this would not prevent the financial target being achieved.

[C]onclusion

[1]8. Ministers are invited:

a) to approve in whole or in part the option savings for 1980/81, and if possible for later years, described in paras 15-17 subject to further decisions on BNOC, coal, steel and shipbuilders;

b) to approve the total borrowing requirements of the industries as set out in Appendix A, Table 3, on the basis of the revised definition including short-term borrowing and leasing, and as modified by the decision in (a) above;

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c) subject to (a) & (b), to approve the investment figures set out in Appendix A, Table 2, on the usual basis of 100% in 1980/81, 85% in 1981/82 and 70% in 1982/83.

H.M.TREASURY
27 June 1979



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Table 2 - Capital expenditure

Table 3 - Total net borrowing and leasing

Table 4 - Grants

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Appendix C ; Individual industry annexes

Appendix D : Economic Pricing

APPENDIX A

TABLE 1

## NATIONALISED INDUSTRIES: FINANCING OF CAPITAL REQUIREMENTS

£ million at 1978-79 prices

| | 1974-75 | 1975-76 | 1976-77 | 1977-78 | 1978-79 | 1979-80 | 1980-81 | 1981-82 | 1982-83 | 1983-84 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Government Lending (Net)** | | | | | | | | | | |
| Loans | 968 | 880 | - 267 | - 764 | - 252 | 350 } | 800 | 800 | 750 | 750 |
| PDC and issues under Section 18 of the Iron and Steel Act 1975 | 219 | 570 | 618 | 526 | 864 | 800 } | | | | |
| Total | 1,187 | 1,450 | 351 | - 238 | 612 | 1,150 | 800 | 800 | 750 | 750 |
| **Overseas and Market Borrowing (Net)** | | | | | | | | | | |
| Overseas | 1,104 | 780 | 1,662 | 498 | 92 | 150 | 50 | - 150 | 50 | 150 |
| Market | - | - | - 118 | - | 7 | - 500 | - | - | - 150 | - 150 |
| Total | 1,104 | 780 | 1,544 | 498 | 99 | - 350 | 50 | - 150 | - 100 | - |
| TOTAL NET BORROWING[1] (OTHER THAN SHORT-TERM) | 2,291 | 2,230 | 1,895 | 260 | 711 | 800 | 850 | 650 | 650 | 750 |
| Short-term borrowing and leasing | 284 | - 10 | 23 | 511 | 421 | - 50 | 150 | 200 | 100 | - |
| TOTAL NET BORROWING[1] | 2,575 | 2,220 | 1,918 | 771 | 1,132 | 750 | 1,000 | 850 | 750 | 750 |
| Grants | 1,885 | 1,859 | 853 | 775 | 882 | 1,000 | 950 | 950 | 950 | 900 |
| TOTAL EXTERNAL FINANCE[1] | 4,460 | 4,079 | 2,771 | 1,546 | 2,014 | 1,750 | 1,950 | 1,800 | 1,700 | 1,650 |
| Total internal resources | 596 | 1,433 | 2,642 | 2,348 | 2,450 | 2,050 | 2,600 | 3,150 | 3,200 | 3,300 |
| TOTAL CAPITAL REQUIREMENTS[1] | 5,056 | 5,512 | 5,413 | 3,889 | 4,464 | 3,800 | 4,550 | 4,950 | 4,900 | 4,950 |

[1] The forecast figures are after making allowance for shortfall below the industries' own forecasts of £450m in 1979-80, £500m in 1980-81, and £400m in the remaining three years.

APPENDIX A

TABLE 2

## NATIONALISED INDUSTRIES CAPITAL EXPENDITURE

£ million at 1978-79 prices

| | 1974-75 | 1975-76 | 1976-77 | 1977-78 | 1978-79 | 1979-80 | 1980-81 | 1981-82 | 1982-83 | 1983-84 |
|---|---|---|---|---|---|---|---|---|---|---|
| Expenditure on fixed assets | | | | | | | | | | |
| National Coal Board | 251 | 303 | 371 | 397 | 494 | 526 | 588 | 585 | 599 | 608 |
| Electricity Council and Boards | 901 | 894 | 869 | 733 | 716 | 748 | 815 | 883 | 873 | 974 |
| North of Scotland Hydro-Electric Board | 58 | 97 | 94 | 69 | 48 | 45 | 41 | 30 | 27 | 30 |
| South of Scotland Electricity Board | 115 | 98 | 69 | 47 | 53 | 86 | 122 | 171 | 237 | 208 |
| British Gas Corporation | 366 | 500 | 335 | 257 | 280 | 268 | 374 | 428 | 361 | 331 |
| British National Oil Corporation | - | 13 | 198 | 225 | 245 | 236 | 354 | 370 | 381 | 378 |
| British Steel Corporation | 545 | 740 | 736 | 548 | 328 | 280 | 345 | 348 | 301 | 234 |
| Post Office: Telecommunications | 1,371 | 1,205 | 998 | 916 | 951 | 983 | 1,118 | 1,102 | 1,099 | 1,133 |
| Post and other | 70 | 68 | 57 | 45 | 44 | 53 | 61 | 67 | 65 | 54 |
| British Airways Board | 188 | 165 | 193 | 221 | 221 | 304 | 390 | 355 | 394 | 402 |
| British Airports Authority | 42 | 49 | 52 | 40 | 33 | 40 | 79 | 75 | 76 | 70 |
| British Railways Board | 308 | 337 | 306 | 301 | 349 | 335 | 347 | 347 | 347 | 347 |
| British Transport Docks Board | 14 | 17 | 10 | 11 | 9 | 16 | 17 | 18 | 17 | 17 |
| British Waterways Board | 2 | 2 | 2 | 2 | 2 | 4 | 7 | 4 | 3 | 3 |
| National Freight Corporation | 47 | 29 | 28 | 33 | 36 | 34 | 37 | 37 | 40 | 40 |
| National Bus Company | 35 | 43 | 49 | 50 | 54 | 58 | 54 | 55 | 56 | 57 |
| Scottish Transport Group | 12 | 10 | 12 | 11 | 17 | 15 | 11 | 11 | 10 | 10 |
| British Aerospace | - | - | - | 21 | 29 | 41 | 44 | 39 | 36 | 33 |
| British Shipbuilders | - | - | - | 22 | 27 | 38 | 40 | 40 | 40 | 40 |
| Total expenditure on fixed assets | 4,325 | 4,571 | 4,379 | 3,949 | 3,936 | 4,110 | 4,844 | 4,965 | 4,962 | 4,969 |
| Other capital requirements | 731 | 941 | 1,034 | - 60 | 528 | 123 | 220 | 395 | 316 | 389 |
| Total Capital Requirements | 5,056 | 5,512 | 5,413 | 3,889 | 4,464 | 4,233 | 5,064 | 5,360 | 5,278 | 5,358 |
| Shortfall | - | - | - | - | - | - 450 | - 500 | - 400 | - 400 | - 400 |
| Total Capital Requirements after Shortfall | 5,056 | 5,512 | 5,413 | 3,889 | 4,464 | 3,783 | 4,564 | 4,960 | 4,878 | 4,958 |
| Change on Cmnd 7439 | | | | | - 5 | - 622 | + 44 | + 154 | - 170 | |

## NATIONALISED INDUSTRIES : TOTAL NET BORROWING AND LEASING

£ million at 1978-79 prices

| | 1979-80 | 1980-81 | 1981-82 | 1982-83 | 1983-84 |
|---|---|---|---|---|---|
| National Coal Board | 414 | 409 | 400 | 416 | 427 |
| Electricity Council and Boards | -69 | -8 | -11 | 93 | 218 |
| North of Scotland Hydro-Electric Board | 36 | 20 | 5 | -2 | - |
| South of Scotland Electricity Board | 51 | 57 | 91 | 161 | 153 |
| British Gas Corporation | -409 | -142 | -78 | -164 | -160 |
| British National Oil Corporation | 103 | 175 | 28 | -14 | -37 |
| British Steel Corporation | 692 | 457 | 427 | 398 | 398 |
| Post Office | -101 | 35 | -46 | -99 | -205 |
| British Airways Board | 158 | 195 | 130 | 147 | 149 |
| British Airports Authority | -1 | 31 | 15 | 11 | -5 |
| British Railways Board | 46 | 49 | 45 | 16 | 9 |
| British Transport Docks Board | -6 | -7 | -9 | -10 | -11 |
| British Waterways Board | 3 | 4 | 2 | 2 | 2 |
| National Freight Corporation | 16 | 16 | 14 | 13 | 13 |
| National Bus Company | 22 | 11 | 9 | 14 | 19 |
| Scottish Transport Group | 1 | -3 | -3 | -3 | -2 |
| British Aerospace | 49 | 75 | 86 | 72 | 67 |
| British Shipbuilders | 182 | 106 | 125 | 102 | 100 |
| | 1187 | 1480 | 1230 | 1153 | 1135 |
| Shortfall | -450 | -500 | -400 | -400 | -400 |
| TOTAL | 737 | 980 | 830 | 753 | 735 |
| Change on Cmnd 7439 | -332 | +232 | +112 | +56 | +37 |

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[APP]ENDIX A

TABLE 4

[NA]TIONALISED INDUSTRIES : GRANTS

£ million at 1978-79 prices

| | 1979-80 | 1980-81 | 1981-82 | 1982-83 | 1983-84 |
|---|---|---|---|---|---|
| [Na]tional Coal Board | 250 | 214 | 208 | 206 | 195 |
| [El]ectricity Council and Board | 7 | 8 | 11 | 11 | 4 |
| [No]rth of Scotland Hydro-Electric Board | 13 | 14 | 5 | 4 | 3 |
| [So]uth of Scotland Electricity Board | - | - | - | - | - |
| [Br]itish Gas Corporation | - | - | - | - | - |
| [Br]itish National Oil Corporation | - | - | - | - | - |
| [Br]itish Steel Corporation | - | - | - | - | - |
| [Po]st Office | - | - | - | - | - |
| [Br]itish Airways Board | - | - | - | - | - |
| [Br]itish Airports Authority | 1 | - | - | - | - |
| [Br]itish Railways Board | 601 | 615 | 615 | 616 | 616 |
| [Br]itish Transport Docks Board | - | - | - | - | - |
| [Br]itish Waterways Board | 21 | 21 | 21 | 21 | 21 |
| [Na]tional Freight Corporation | 10 | 7 | 6 | 4 | 4 |
| [Na]tional Bus Company | 53 | 54 | 50 | 46 | 42 |
| [Sc]ottish Transport Group | 12 | 10 | 9 | 8 | 7 |
| [Br]itish Aerospace | - | - | - | - | - |
| [Br]itish Shipbuilders | 46 | 44 | 25 | 8 | - |
| TOTAL | 1014 | 987 | 950 | 924 | 892 |
| [Ch]ange on Cmnd 7439 (1) | +166 | +243 | +236 | +213 | +181 (2) |

[(1) C]hanges on grants underlying Programme 5 in Cmnd 7439. These figures [o]verstate the increase in public expenditure, because Cmnd 7439 included [e]stimates of grants to British Railways in Programme 5 which were below [t]he public expenditure ceilings in Programme 6. The new figures are in [l]ine with these ceilings.
[(2) C]hange on Cmnd 7439 figures for 1982-83.

OPTION CUTS

APPENDIX B

National Coal Board

The NCB plan to increase coal prices to the maximum permitted by the rise in oil prices - their forecasts already assume a real price increase of 10-12% in 1980-81, which has been anticipated to the extent of 9% by the price increase from 1 July 1979, and, some 1.2% a year thereafter. Each 1% increase in coal prices raises some £30 million a year. Ministers will be considering in the Coal Review, to be taken at about the same time as this review, measures to reduce the industry's current costs, including closures. Each 1 million tonnes of capacity closed saves £41m in the first year rising to £151m in the fifth year after closure. The industry's investment programme is running at £500m-£600m a year, mainly for new lower cost production. A reduction in the programme would delay this production. Ministers may however wish to ask the NCB to reduce their investment by some £50m in the early years of the period while the benefits from cost saving measures build up.

British National Oil Corporation

2. The price of oil is determined on a world-wide basis, so BNOC has no scope for action by way of pricing policy. Current expenditure is anyway very small. If BNOC were asked to make an immediate 10% reduction in their capital investment programme over the five year period, this could be accommodated by cuts in the following categories:

| | £m 1979 Survey prices | | | |
|---|---|---|---|---|
| | 1980-81 | 1981-82 | 1982-82 | 1983-84 |
| Exploration | 12 | 11 | 10 | 9 |
| Downstream | 5 | 4 | 4 | 4 |
| Unspecified | 20 | 23 | 24 | 25 |
| | 37 | 38 | 38 | 38 |

However, Ministers will be taking a review of BNOC's activities at about the same time as they take this review. We expect they will wish to eliminate BNOC's "unspecified provision" which basically is set aside for buying into new ventures on the UK Continental Shelf, although it also contains a contingency element

for shortfall in internal resources or from forecasting factors outside BNOC's control, eg exchange rates. We expect that they will similarly wish to eliminate the provision for downstream investment, ie involvement in refining, marketing and distribution of petroleum products - thus leaving only a provision for exploration activity. On this basis and assuming the cut in exploration activity envisaged above, the total capital savings available from BNOC would be:

| | £m 1979 Survey prices | | | |
|---|---|---|---|---|
| | 1980-81 | 1981-82 | 1982-83 | 1983-84 |
| Exploration | 12 | 11 | 10 | 9 |
| Downstream | 11 | 16 | 17 | 20 |
| Unspecified | 53 | 74 | 75 | 95 |
| | 76 | 101 | 102 | 124 |

British Gas Corporation

3. Substantial savings could be made through raising domestic gas prices to proper economic levels. Studies by officials suggest that domestic gas is at least 20% underpriced, although BGC consider that the level of underpricing is only about 8%. If gas, a non-renewable resource, is not to be wasted, it is important that this underpricing should be corrected. Moreover, the Electricity Council has assumed that electricity prices rise by an average of 5% in real terms over the Survey period whilst BGC's figures show domestic gas prices falling 19% in real terms over the same period. This further enhancement of gas' competitive edge over electricity is highly undesirable on energy policy grounds. The best way of achieving such price increases would be to set BGC an appropriate medium-term financial target. This would of course result in substantially increased profits as the table below indicates. BGC's profits are already embarrassingly high and as has already been suggested to Ministers, these presentational difficulties could be reduced by imposing a gas tax or Exchequer charge. The table below shows rough estimates by the Treasury of additional revenues which would accrue to BGC if domestic gas prices rose by different amounts.

| If domestic gas prices rose: | £m 1979 Survey prices | | | |
|---|---|---|---|---|
| | 1980-81 | 1981-82 | 1982-83 | 1983-84 |
| 1. so as to maintain levels in real terms (ie 9% nominal per annum) | 160 | 210 | 240 | 320 |
| 2. by 3% in real terms per annum (ie 12% nominal per annum) | 210 | 300 | 390 | 520 |
| 3. by 5% in real terms per annum (ie 14% nominal per annum) | 260 | 380 | 480 | 670 |

4. Any savings on current expenditure would have to come largely from provision made for mains replacement. This programme is being undertaken on safety grounds following the recommendations of the King Enquiry on serious gas explosions and the slowing down of this programme must be measured against an unquantifiable additional security risk. However, there might be scope for arbitrary cuts in the early years of the Survey of say, £25-40m. When asked how they would meet a requirement to cut their capital investment programme by 10%, BGC said that there was virtually no scope for cuts. Much of their investment has already been committed as BGC are under a statutory obligation (Gas Act 1972) to meet the growing demands of their customers.

Electricity (England and Wales)

5. One starts with pricing policy. The industry's forecasts assume a 5% annual increase in real prices, including 3% for higher fossil fuel costs. The industry acknowledge that present prices fall short of economic pricing (see Appendix D) and have allowed a balance of the real price increase (2% per year over the review period) which would bring their prices approximately to economic levels by 1983-84. It will be difficult to secure price increases of this order, and, if fossil fuel prices increase more than presently expected (very great uncertainties surround them) the difficulty will be exacerbated. The competitive position of the electricity industry will be weakened in the domestic markets by the increase this year to recover the higher coal price, while domestic gas prices will not rise similarly. For price increases on the scale envisaged to be possible without loss of sales, gas

prices must increase at least equivalently.

6. Presentationally, it would be helpful if the move to economic prices took place in the framework of medium-term financial targets for the industry. It will be seen that it will be extremely difficult to gain acceptance of increases in prices above those already assumed by the industry - and virtually impossible if gas prices do not also rise by at least an equivalent amount. However, a further 1% real increase in tariff levels above those assumed - which risks taking tariffs above economic levels - would reduce the industry's external financing requirement, at 1978-79 prices, by:

£m

| 1980-81 | 1981-82 | 1982-83 | 1983-84 |
|---|---|---|---|
| 33 | 42 | 46 | 53 |

7. Reductions in the industry's borrowing requirement could alternatively fall on the industry's current or capital programmes. Reductions in current expenditure could only be brought about through cutting of repairs and maintenance, and this is unlikely to yield significant savings without jeopardising standards of safety or supply security. Capital expenditure cuts are very difficult too. With long lead times involved in power station construction and transmission much of the proposed expenditure in the early years of the Survey period is for projects which have already been started. Delays in such projects could involve the industry in compensation to contractors. The industry also say that delay or cancellation of projects could have considerable effects on system security and operation, leading to breakdowns.

Electricity (Scotland)

8. The Scottish Electricity Boards assume lower increases in the real price of coal and oil than the Electricity Council (equivalent roughly to a 1% real tariff increase until 1982 and a 2% increase thereafter). After a 5% real increase in 1980-81 (including the assumed rise in fossil fuel prices), the Boards assume no further real increase in tariffs during the survey period. But if electricity tariffs in England Wales were increasing annually by 5% in real terms throughout the period and gas prices were rising equivalently, the Scottish Boards would be able to make further progress towards

economic prices and might increase tariffs by a further 2% in 1981-82 and 1982-83. This in broad terms would reduce external financing requirements, at 1978-79 prices, by:

| | £m | |
|---|---|---|
| 1981-82 | 1982-83 | 1983-84 |
| 9 | 20 | 21 |

Scottish Transport Group

9. The Group's position is similar to that of the NBC (see below). The balance between increases in fares and cuts in services would depend on local circumstances and the attitude of the Traffic Commissioners and local authorities. Cuts in investment could provide an alternative means of securing the necessary reduction in external finance but the bulk of the Group's investment programme is for replacement which could not be postponed unless there were to be a contraction of services. Since the level of fares includes provision for replacement cost depreciation, a reduction in the investment programme could reduce receipts if the Traffic Commissioners delayed or restricted fare increases on this account.

British Railways Board

10. A cut in the Board's external finance would be met by increasing net revenue by increases in fares and charges, reducing working expenses by improved productivity or reducing standards, level of services, reducing stocks, realising the proceeds of land disposal or reducing investment in that order.

11. In the short term, the Board's most likely response to a substantial cut in finance would be fare increases. However, significant increases would be offset to a large extent by loss of patronage and pricing action would therefore be concentrated on those areas where demand is inelastic, particularly the commuter market, although there may be some scope for real pricing on Inter-City services. In the longer term, current expenditure could contribute to cuts if the Board could achieve improved productivity or close cost-ineffective railway services. Curtailment of services on any significant scale would probably require a redefinition of the Passenger Service Obligation imposed

on the Board by the Minister of Transport. Other minor savings might be achieved by reductions in stocks and an accelerated land sales programme, though the scope for these is limited.

12. The scope for a contribution from <u>cuts in investment</u> is limited inasmuch as officials have already taken a view, for purposes of this investment review, that the Board's investment programme should be maintained at a lower level (£100m over 5 years) than BR consider necessary for the renewal of assets on the social railway and the proper development of their commercial businesses. Further cuts in investment would be a last resort. If they had to be made, the Board say the brunt would fall on the rolling programme to replace elderly EMUs, most of which are employed on the commuter services around London, leading to a deterioration in the level and standard of service and to a reduction in revenue.

## National Bus Company

13. The Company's response to a squeeze on external finance would be a mixture of cuts in services and investment as well as increases in prices depending on local circumstances. Fare increases and cuts in service could only be implemented with the agreement of the Traffic Commissioners and after consultation with local authorities; substantial changes could take three months or more to effect. The Company's preference would be to cut <u>services</u> and to do both before cutting <u>investment</u>. The scope for further cuts in investment will be limited by the 10% reduction in NBC's investment in replacement vehicles proposed in the main body of the Review, and because NBC's investment needs are closely linked to the future level of capital and revenue support for bus operations which is being considered in the main Public Expenditure Survey.

## National Freight Corporation

14. The Corporation could achieve a cut in external finance by a combination of reductions in current and capital expenditure. As regards <u>pricing options</u>, the Corporation operates mainly as a price taker, reflecting its small share of businesses in most sectors of the road haulage market. The scope for further price increases is very limited especially in view of the high tariff increases now

being implemented to cover the recent pay settlement. Reductions in current expenditure could be effected by reduced maintenance of vehicles and some small improvement in the revenue account might be achieved through increasing sales of assets. But to achieve 10% overall, cuts in capital expenditure would need to be made too, and these would undermine the Corporation's vehicle replacement policy leading over a period to increased maintenance costs and reduced service levels and receipts and would slow down the shift out of unremunerative activities into more profitable areas of operation. The scope for more rapid contraction in manpower and investment in less profitable activities is limited by the high level of redundancy payments which would be incurred in the early years of the Review and by the unquantifiable but possibly substantial cost of industrial unrest.

British Transport Docks Board

15. Operating in a competitive environment in which real profits are derived from marginal business and revenue, the BTDB would have difficulty in raising prices beyond levels already planned. Reductions to current expenditure would affect the BTDB's ability to carry out essential maintenance. To increase debt repayment by £2m a year (a 25% increase in their already accelerated repayment schedule equivalent to a 10% cut in their investment programme), the Board would have to cut investment by a similar amount, postponing replacement capital expenditure and general improvement schemes and prejudicing their future trading prospects.

British Waterways Board

16. There is little prospect of increasing the prices charged by the BWB by an amount which would have a significant effect on their grant requirement. Cuts in external finance could therefore only be achieved by cutting either current expenditure or investment. Cuts in current expenditure would affect the Board's ability to reduce the maintenance backlog revealed by the Fraenkel Report. Cuts in investment could be achieved by reducing replacement of plant, although this would also affect the maintenance programme, or by delaying or cancelling commercial investment projects including the Board's major new scheme, the improvement of the

Sheffield and South Yorkshire Navigation (SSYN), which started this year. Postponing the SSYN would have no impact on the Board's maintenance programme and its immediate effect on traffic and receipts would be less than that stemming from alternative cuts in investment but cancellation would affect other planned development in the area.

British Airways Board

17. A cut in BA's finance requirements equivalent to 10% of capital expenditure in the four years 1980-81 to 1983-84 would represent one quarter of their total planned external fundings over these years, or some £40m a year. Beacuse they are price takers, BA could not compensate for any cut by raising fares. As to reductions in current expenditure, overmanning is a well-known problem but productivity improvements assumed in their corporate plan (GP7) go as far as the Corporation judge their unions will accept. Capital expenditure cuts would mean reducing expenditure on aircraft since non-aircraft expenditure has already been cut to the bone. BA's new shorthaul aircraft are already on order, and they have therefore assumed that a cut would be implemented by the loss of 6 medium-haul Tristars from the investment programme. The consequent reductions in operating surplus are:

£m at 1979 Survey prices

| 1980-81 | 1981-82 | 1982-83 | 1983-84 |
|---|---|---|---|
| 4 | 11 | 15 | 17 |

These figures assume no retrenchment and are based on the alternative BA consider to be the least disadvantageous, of continuing to fly 14 uneconomic and noisy aircraft for as long as possibly instead of the 6 Tristars. As well as the financial disadvantage to BA (which would extend beyond 1983-84), such a course would replace 10 prospective quiet aircraft movements a day by 25 noisy ones, and disrupt severely BA's plan for an orderly retirement of old aircraft which must cease to fly by 1 January 1986 under new noise legislation. Retention of 14 of these aircraft for longer than planned instead of acquiring the 6 Tristars means that the replacement programme will be bunched up against this deadline at a time when profits and cashflows would already be significantly reduced if the cuts were applied. BA's fuel consumption would be increased by some 26 million gallons by 1982-83, staff producivity would be reduced by 1% in that year compared with the target in the corporate plan,

and prospective sales of 23 Rolls Royce engines would be at risk.

18. In summary, implementation of these cuts in full would in BA's view weaken their corporate strategy designed to enable the airline to operate successfully and profitably in an increasingly competitive market, and might prejudice prospects of private sector participation. BA's figures indicate, however, that the airline would still be able to meet its current financial target even on that basis. A less drastic option would be to impose £40 million cuts in 1980-81 and 1981-82 only, which if it fell on progress payments as presently scheduled would probably require three of the six aircraft to be postponed for two years.

British Airports Authority

19. The Authority have examined whether it is possible to eliminate the proposed NLF borrowing of £16m in 1980-81, £15m in 1981-82, £11m in 1982-83, and the £15m rundown in cash reserves in 1980-81. They are clear that cuts to the capital programme cannot be made without congestion which would force a redistribution of traffic to Continental airports; and there is little or no scope for cutting current expenditure without affecting the operating safety or security of airports. They propose therefore, if option cuts are required, to increase trading profit by raising landing charges. The increase required to avoid a move to a net NLF borrowing position, after corporation tax, would be of the order of 30% in landing charges which would be in addition to the planned increases in line with inflation. The Authority see no possibility whatever of eliminating the rundown in their cash reserves. The increases would make the BAA airports amoing the most expensive in Europe and would undoubtedly result in strong criticism from international, especially American, airlines; but it could be represented that high landing charges are not inconsistent with the high level of congestion prevailing at the London airports. The increases would also oblige the Authority to earn something approaching the Required Rate of Return on its assets without recourse to cross-subsidisation from duty-free sales.

Post Office

20. The bulk of any savings would have to come from Telecommunications A possible pricing option is available - to reverse the decision by

the previous Government to lower the financial target of 6%, which expired at the end of the last financial year, to 5%. This would involve further price increases and would raise about £150m a year for the benefit of the PSBR. However, economic argument based on the need to earn the Required Rate of Return of 5% in real terms suggests that this target should, if anything, be less than 5%, and a move back to 6% would be open to the criticism that the Government was milking the industry and exploiting its monopoly power, to the detriment of price stability and the consumer. Moreover, a major package of tariff increases will in any case be required in January just to meet the present target of 5%. At a rough estimate this would have a 0.08% impact on the RPI. Increases to meet a 6% target would bring this to 0.15%.

21. A 5% cut in their investment programme of £1 billion, raising some £50 million in each year, would be feasible though would be very strongly resisted. Some savings might be raised by postponing office building projects in London. The Post Office Board have recently decided to accelerate their programme of replacing out-of-date exchanges but they will strongly resist any reversal of this decision in view of the quality of service and maintenance implications. Rather, they have already warned us that the main impact would fall on the system. Connection charges which bear particularly heavily on the low-paid and pensioners would need to be increased by about 50%; otherwise the present already very serious waiting list and pipelines for new connections would treble by 1982-83. The effect on the equipment supply industry would be very serious, just at a time when it is gearing up its investment to the production of the more capital intensive (and energy saving) electronic equipment in preparation for System X. The PO estimates that a cut of 5% in telecommunications capital investment spread evenly across this programme would mean a job loss in the supply industry of some 2,300 in 1980-81 and 1981-82 and a gross cash flow loss for the industry of some £35m in each of those years at current prices. A cut as large as 10% would have a proportionately bigger impact on the supply industry's cash flow and a more than proportionately bigger impact on its manpower.

22. In practice the Post Office would prefer, if Ministers allowed them, to find any PSBR savings that were imposed on them not by

investment cuts but by <u>tariff increases</u> or <u>current account savings</u>. A major tariff package will in any case be necessary before the end of this financial year. A cut of £50m or £100m would mean requiring Telecommunications to make a real return of 5.3% or 5.7% respectively compared with their present financial target of 5%. Cuts in current account expenditure on items such as training, recruitment and maintenance tend to hit quality of service, which is already the subject of severe public criticism.

23. In <u>Posts</u>, cuts of 5% and 10% would amount to £3m and £6m respectively. Postal <u>prices</u> are about to be raised anyway and the Prime Minister has expressed concern about the extent of that increase - so a further increase is not a feasible option. The most significant source of <u>current</u> savings would be a reduction of postal deliveries to one per day, but the Post Office doubt if this would be acceptable either to the general public or the unions. This could save up to £40m a year. Any <u>investment</u> cuts would have to fall predominantly in the accommodation sector. A cut of £6m in each year would mean not proceeding with virtually all new buildings scheduled to start in those years. A lot of existing accommodation is operationally inefficient or gravely substandard; cuts would therefore aggravate the industrial relations problems and could also put the full implementation of mechanisation at risk.

<u>British Steel Corporation</u>

24. Work is still under way at BSC on reviewing the Corporation's operating plans so as to get back on the path to break even in the final quarter of 1979-80. Investment and financing figures for the subsequent years will reflect the decisions now in course of preparation. The objective is an external borrowing requirement in 1980-81 of £375 million at 1978-79 prices (£450 million at outturn prices) followed by a substantially lower requirement in 1981-82 after a capital reconstruction. These figures, if they can be achieved, represent substantial reductions, of about £80 million in 1980-81 and considerably less in 1981-82, below the amounts contemplated in the 1978 investment review which underlay the Cmnd 7439 totals. These reductions reflect considerable cutbacks in investment averaging £100 million a year up to 1981-82, coupled with strong cost containment measures to affect the adverse impact of an increasingly hostile trading environment.

25. At present, the prices BSC can charge are effectively fixed by the Davignon measures for maintaining Community level prices and this gives the Corporation some element of protection in a continuing weak market. There seems little prospect of the Corporation improving its financial position by raising prices faster than its foreign competitors. And the efforts currently being made to cut current costs will leave no significant scope for further savings by this route short of the closure of a major modern plant as well as obsolescent plants already planned to shut down and the consequent abandonment of part of the UK market to imports. Further investment cuts would mean abandoning small schemes with short pay back periods, many of which are important to maintaining the momentum of the essential improvement of product quality, or abandoning major schemes currently under construction.

British Aerospace

26. Pricing options are not a starter for this price taker industry. The only possible source of significant savings in current expenditure is reduction in labour costs; there is little prospect of realising this since BAe expect savings in productivity to be offset by real increases in wages. Some 40% of the planned expenditure on fixed assets for 1979-80 has already been committed and some 10% of the total for 1980-81. The planned expenditure on work-in-progress is required for the development of new projects. Although this expenditure is not yet committed in the contractual sense, it could not be cut significantly without cancellation of one or more projects - slowing down the rate of spending is not a realistic possibility given the characteristics of the market. A cut of the order of £15 million from total expenditure would probably lead to the cancellation of the Jetstream 31 project, which accounts for some 3% of the capital requirements up to 1982. A larger cut would probably involve cancellation of the BAe 146 project, saving up to £40m in later years but with serious consequences for BAe's strategy of maintaining the capability to build complete civil aircraft. Cancellation of any civil project could be expected to have serious employment consequences (Jetstream is based in Scotland).

British Shipbuilders

27. Because of the current review of this industry, no specific option cuts are proposed for British Shipbuilders, though they should make some contribution particularly in the later years.

APPENDIX C : INDIVIDUAL INDUSTRY ANNEXES


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NATIONAL COAL BOARD

| £m at 1979 survey prices (changes on Cmnd 7439 in brackets) | 1979/80 | 1980/1 | 1981/2 | 1982/3 | 1983/4 |
|---|---|---|---|---|---|
| ital irements: | | | | | |
| ixed assets UK | 562(- 59) | 588(- 9) | 585(+ 15) | 599(+ 33) | 608 |
| ther | - 55(-135) | 16(-58) | 15(- 62) | 23(- 50) | 30 |
| OTAL | 471(-194) | 604(- 67) | 600(- 47) | 622(- 17) | 638 |
| anced by: | | | | | |
| nternal esources | -193(-276) | -19(-155) | -8(-126) | - (-159) | 16 |
| rants | 250(+165) | 214(+131) | 208(+132) | 206(+131) | 195 |
| orrowing (net) | 414(- 83) | 409(- 43) | 400(- 53) | 416(+ 11) | 427 |
| f which, leasing nd short term | 22(+ 2) | 24(- 2) | 25(- 2) | 28(+ 1) | 25 |

Recent Delevopments

It was agreed after last year's Finance and Investment Review that in view of uncertainty about medium-term prospects for the industry its investment strategy should be reviewed before the 1979 Finance and Investment Review: in addition to the preparation of their five-year development plan the NCB have reviewed the Plan for Coal and for this purpose extended the planning horizon to 1990. In the light of the Board's Review, the Department of Energy have re-examined the strategy for the industry in consultation with the Treasury. The report has now been submitted to Ministers. The forecasts for 1980-81 onwards will need to be reconsidered in the light of Ministers' subsequent decisions on the strategy for the industry.

1978-79 saw a marked deterioration in the NCB's financial position from that forecast at the beginning of the year. Costs continued to rise faster than inflation; coal's markets remained weak, especially in the iron and steel industry, severely restricting the ability of the industry to raise revenue from higher prices; and the incentive

scheme, introduced in January 1978, did not prove as beneficial as had been expected. The real sterling price of oil fell throughout much of 1978 and coal lost ground in the power station market. In October 1978 the previous Government announced that it would contribute to the cost of the sale of coal at a discount to the CEGB to enable some 3m tonnes of coal which would otherwise have been stocked to be burned in place of oil and imported coal.

Although there was slight shortfall in the capital expenditure of the NCB in 1978-79 the provisional outturn is nearer the estimate than in previous years.

Investment

The investment programme continues to be directed to the implementation of Plan for Coal. The investment is mainly in new or replacement low-cost, efficient, capacity concentrated in the best long-life pits and in new mines which would begin to come into operation from the mid-1980s. About 100 major projects have been approved. These are expected to provide about 30m tonnes of new production capacity (including the 10m tonnes mine at Selby). The Board have assumed that the production profile and forecasts of demand will be as in the five-year plan. However, a more realistic range of output and demand and the possible policy measures for dealing with any surpluses that may arise are covered in the Department of Energy's report on coal strategy.

The Board judge that the investment programme as a whole is well capable of meeting the 5% RRR after allowing for reasonable variations in assumptions.

External financing

The NCB's estimates for 1979-80 take into account fairly optimistic assumptions about output and the 9% price increase applied to all coals in March 1979 as well as a selective price increase equivalent to 9% across the board effective from 1 July 1979. Further, the Board estimate that even with £250m of Government grants they will incur a loss of £6m. From 1980-81 onwards the external financing

requirements forecasts are considerably in excess of Cmnd 7439 (increases in public expenditure average £100m a year). Over this period the NCB have assumed price increases which will return the Board to the financial position projected in their five-year plan, ie break-even on the basis of historic cost depreciation and <u>after</u> Government grants. In 1980-81 a (real) price increase of 10% - 12% is assumed which has been anticipated to the extent of 9% by the increase from 1 July 1979, leaving a further real increase of 1-3% to take place in 1980-81. Thereafter the increases are projected at an average 1.2% pa in real terms. The NCB continue to forecast a high level of grants averaging £205m per annum for the remaining four years if they are to break-even ie after grants and this is well above the levels in Cmnd 7439. But their financial results could be substantially worse than this if the balance of assumed real price increases is not feasible in 1980-81, eg for every 1% increase in price not achieved there is an increase in losses and the external financing requirement of about £30m.

The NCB's external financing requirements could also be increased if the output and demand assumptions in the five-year plan are not achieved. Other things being equal the requirement increases by around £20-£25 million for each one million tonnes of output by which demand fulls below supply. Reduced demand could also lead to additions to stock and thus a further claim for stocking aid at some £3 per tonne with the Board's borrowing requirements increasing by some £24 per tonne to cover increased working capital requirements.

The report on coal strategy to be submitted to Ministers make proposals on how the coal industry can be set on a path to financial viability.

A financial target has not formally been set for the NCB, although the Board continues to aim at breaking-even, on the basis of historic cost depreciation. The Board also aim to provide 50% of capital expenditure from self-generated funds (including Government grants).

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BRITISH NATIONAL OIL CORPORATION

| Capital requirements | provisional outturn 1978-79 | £m at 1978-79 prices (Changes on Cmnd 7439 in brackets) 1979-80 | 1980-81 | 1981-82 | 1982-83 | 83-84 |
|---|---|---|---|---|---|---|
| Fixed assets in UK | 263(-21) | 236(-40) | 354(+28) | 370(-31) | 381(-33) | 378 |
| Other | 30(+17) | -16(-16) | - 1(- 5) | 12(+17) | - 5(- 4) | 1 |
| Total | 293(- 4) | 220(-56) | 353(+23) | 382(-14) | 376(-37) | 379 |
| Financed by | | | | | | |
| Internal resources | 25(-14) | 117(- 4) | 178(-50) | 354(+48) | 390(+50) | 416 |
| long and medium term borrowing | 268(+10) | 103(-52) | 175(+73) | 28(-62) | -14(-87) | -37 |

1. Ministers have recently instituted a wide ranging Review of BNOC's activities and until this is concluded the forecast set out above must be regarded as provisional. The setting of a medium-term financial objective for the Corporation must also await the outcome of the Review.

2. The bulk of the provision set out above is for expenditure arising out of BNOC's present contractual commitments and planned future involvement in exploration and development work on the UK Continental Shelf. This includes expenditure on 4 oil and gas producing fields and 3 fields under development and covers 9 fields including two extensions to the Thistle field on which development decisions are expected within the five year period. Because BNOC's major involvement with private sector companies in joint ventures on the UKCS is as a minority partner, it will either have to follow investments decisions of its partners or dispose of its interests. This programme is designed to bring on-stream the fields currently under development - production from which will peak in 1983/84 at around 70m barrels per annum; and to undertake development of the fields whose production will build up rapidly from 1983-84 onwards to replace the falls in production from fields currently under development. The forecast also provides for downstream activities (feasibility studies, and minority shares in three projects); and includes funds for possible future projects which cannot be identified at this stage. The breakdown of "fixed assets" expenditure between these three categories is as follows:

1978-79 prices

| | | 80-81 | 81-82 | 82-83 | 83-84 |
|---|---|---|---|---|---|
| (i) | Exploration and development (includes administration) | 308 | 296 | 290 | 263 |
| (ii) | Downstream | 11 | 16 | 17 | 20 |
| (iii) | Sundry and unspecified | 53 | 74 | 75 | 95 |
| | | 372 | 386 | 382 | 378 |

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Comparison with Cmnd 7439 investment plans

Capital Requirements

3. A comparison of the budget provision for capital requirements with the provision in Cmnd 7439 shows few significant changes. In 1979-80 the cuts announced in the Budget have reduced BNOC's capital requirements by £56 million compared with Cmnd 7439; in 1980-81 there is a net increase of £23 million in BNOC's capital requirements. In subsequent years capital requirements are reduced by £14 million in 1980-81 and by £37 million in 1982-83 compared with Cmnd 7439.

Financing

4. At present BNOC has two major sources of funds - the forward sale of oil to Brit-Oil, and funding from the NOA. The latter is counted for administrative purposes as "equity" funding, and BNOC expects within the next year to reach the 60: 40 equity: debt ratio in its financing which was prescribed in February, 1978. Later in the period BNOC will begin reducing its obligations to Brit-Oil and will need to take up debt finance from other sources.

5. BNOC is not at present subject to a cash limit for two main reasons. First, in most of its operations it is a minority partner with no veto over the expenditure decisions of its partners and secondly its external financing requirements are determined by volatile factors outside its control such as oil prices and UKCS production levels.

6. BNOC's total capital requirements have not changed greatly since Cmnd 7439. However, there has been an increase in BNOC's external financing requirement of £73 million in 1980-81. This year now includes provision of £39 million for dividend payments because of a change of the convention under which dividend payments were excluded from the Cmnd 7439 figures. (In subsequent years the provisions for dividends are £78 million in 1981-82, £ 77 million in 1982-83 and £ 65 million in 1983-84; these figures need to be deducted from BNOC's external financing requirement figures in paragraph 1 for a strict comparison with Cmnd 7439). A 25% drop in the expected flow of equity oil because of continuing development delays and production costs is the main reason for the residual excess in 1980-81 of £33 million. BNOC's revenue forecasts have been adjusted to take account of the latest sustained rise in crude oil prices.

## [BR]ITISH GAS CORPORATION

£m at 1979 Survey Prices (changes on Cmnd 7439 in brackets)

| | 1979-80 | 1980-81 | 1981-82 | 1982-83 | 1983-84 |
|---|---|---|---|---|---|
| **[Ca]pital requirements:** | | | | | |
| [Fix]ed assets in UK | 268(-44) | 374(+9) | 428(+38) | 361(-45) | 331 |
| [Ot]her | 16(-26) | 34(-10) | 40(-35) | 7(-44) | 54 |
| [To]tal | 284(-70) | 408(-1) | 468(+3) | 368(-89) | 385 |
| **[Fi]nanced by:** | | | | | |
| [In]ternal resources | 693(+122) | 550(+50) | 546(+46) | 532(+23) | 545 |
| [Ne]t borrowing | -409(-192) | -142(-51) | -78(-43) | -164(-112) | -160 |
| [o]f which short term [a]nd leasing | -185(-205) | -24(-74) | -2(-49) | -14(-3) | -6 |

Recent Developments

1. The above financing and investment review figures reflect the programme contained in BGC's recently produced Corporate Plan. BGC plan to continue with a market-led strategy in which gas supplies are tailored as far as possible to meet premium demand. Sales continue to increase from 15,550 million therms last year to a forecast of 16,600 m. th. this year and 19,700 m.th. in 1983-84. Profits for 1978-79 were £350 million (provisional), a substantial increase on budget, largely due to the cold weather. Repayments of NLF debt were accelerated accordingly and amounted to about £600 million for the year.

2. The previous Government set BGC a financial target for 1979-80 of 6½% on turnover, after interest and depreciation (at current cost) and before tax. The object of this target was to maintain prices in real terms. To achieve this target BGC notified the Price Commission of their intention to raise gas tariffs from 1 April by

an average of 8½% and to increase the price for contract sales in line with oil prices. The Price Commission decided to investigate this proposal. The Commission granted as an interim increase the full amounts applied for in respect of industrial contract prices and the non-domestic tariff. The domestic tariff was frozen until 1 June and BGC's expected revenue will be correspondingly reduced by about £23 million overall. This will make it more difficult for BGC to achieve their target. It is expected that targets for future years will be set in the autumn.

Investment Plans

3. Capital expenditure is down by about £50 million for the five-year period, compared with Cmnd 7439, largely owing to the postponement of the development of the Morecambe gas field for three years on the basis that a depleted southern basin field could be used for seasonal storage. Major transmission projects in the period include the fourth feeder from St Fergus to England, the total cost of which is expected to be about £250 million with work beginning this year. Regional expenditure on mains and distribution is up by £40 million compared with last year's plans, to meet higher forecasts of number of customers.

4. Provision for BGC participation in a possible gas-gathering scheme in the North Sea is not included in the current estimates. There may be circumstances where BGC's direct involvement in such a pipeline would save the Exchequer significant amounts of PRT e.g. where the chargeable revenues from the associated gas are less than the tax reliefs on the pipeline costs which are offset against oil revenues.

5. BGC are at present reviewing the discount rate used for investment appraisal of new revenue-earning projects. Present indications are that the 10% rate applied to individual projects will remain appropriate on the assumption that the RRR is to be met on the new investment programme as a whole, although the precise rate of return on that programme has yet to be established.

6. BGC's previously poor capital expenditure forecasting has been improving as more realistic estimates of shortfall have been taken into account. Last year the capital expenditure outturn was only 2½% below budget.

7. BGC attach high priority to continued investment in the transmission and storage system to absorb all the Brent gas available from 1980s, and subsequently the associated gas from other fields which might otherwise have to be flared. Scope for cutting capital expenditure is therefore limited and, should it be thought desirable for BGC to make more rapid repayment of debt or to lend more surplus cash to the Exchequer, raising prices seems to be the better route (see paragraph 3 of Annex B).

Financing

8. The figures for 1979-80 are those announced in the Budget. They assume that BGC would cut their programme by £171 million by a combination of increased non-domestic prices from 1 September, reductions in capital expenditure and increased sales revenues.

9. The figures for subsequent years assume that BGC's self imposed financial target of 4% on turnover will be maintained throughout the period. The main effect of such an assumption is that domestic gas prices, which have already fallen substantially in real terms since 1973-74, will fall by around 25% in real terms over the four year period. The main reason for this is that domestic gas is the residual element in determining total revenue. Non-domestic prices are oil related, and oil prices (and hence BGC's non-domestic revenues) are forecast to rise at rates above general inflation. In consequence the faster oil oil prices rise the greater the real fall in the price to consumers of domestic gas, unless Ministers look to BGC for a higher target than 4% on turnover.

10. Gas profits are of course sensitive to external factors such as the weather, the inflation rate, oil prices and exchange rates. For instance, a variation in the average annual temperature of 1°C would alter profits by about £85 million.

11. All BGC's NLF debt is expected to be repaid this year. Repayment of foreign loans tapers off quite rapidly over the next two or three years leaving BGC with outstanding debts of only £214 million for 3% Gas Stock, redeemable in 1995. Surplus funds, after debt repayment is completed, are expected to be deposited with the Exchequer.

ELECTRICITY COUNCIL AND BOARDS

£m at 1979 Survey prices
(changes on Cmnd 7439 in brackets)

| | 1979-80 | 1980-81 | 1981-82 | 1982-83 | 1983-84 |
|---|---|---|---|---|---|
| Capital requirements: | | | | | |
| Fixed assets in UK | 748(-56) | 815(+75) | 883(+79) | 873(-124) | 974 |
| Other | -55(-46) | 85(+111) | 68(+171) | 36(+149) | 59 |
| Total | 693(-102) | 900(+186) | 951(+250) | 909(+25) | 1033 |
| Financed by: | | | | | |
| Internal Resources | 755(-50) | 900(+75) | 951(+136) | 805(-3) | 811 |
| Grants | 7(+2) | 8(+2) | 11(+5) | 11(-) | 4 |
| Borrowing (net) | -69(-54) | -8(+109) | -11(+109) | 93(+28) | 218 |
| of which leasing and short term | 20(-59) | -56(-54) | -4(-5) | 16(+28) | 6 |

Investment

The CEGB is responsible for more than two-thirds of the industry's capital investment. Their programme includes provision for units 3 and 4 of the Heysham Advanced Gas-Cooled Reactor station (total estimated cost £872m with substantial expenditure beginning in 1979-80.) Provision is also included for the 2000 MW completion of the Drax 4000 MW coalfired station (which is already under construction at a total estimated cost of £715m.) This station was brought forward in advance of need at the request of the previous administration. Provision is also made for a 2000 MW Cross-Channel Link with the French electricity utility, Electricite de France, which was approved in principle in 1978 (CEGB element of forecast expenditure on this project is £166m with expenditure beginning in 1979-80). There is no inclusion for investment in respect of possible collaboration with foreign electricity supply utilities on the French Super-phenix fast breeder reactor project (NERSA). The CEGB will seek Government approval, and request any additional funding, if a firm prospect for international collaboration emerges.

Market Assumptions

The industry forecast an annual increase in the demand for electricity in England and Wales over the period to 1985-86 averaging 2.3 per cent per annum assuming a GDP annual growth rate of 2.6 per cent.

Internal Resources

Income levels for Area Boards and the CEGB in 1980-81 and later years have been assumed sufficient to yield profits of 2 per cent on costs including 40 per cent additional supplement on historic cost depreciation. The assumed tariff increases implicit in the forecasts average 5 per cent above the general rate of inflation in 1980-81 and 1981-82 (in money terms forecast increases over the years 1980-81 to 1983-84 are 12 per cent, 14 per cent, 9.4 per cent and 13.5 per cent respectively). Price increases of this order would keep the industry's borrowing requirements down, and would also cover expected increases in costs, notably coal and oil prices. The figures for 1979-80 take into account the second coal price increase this summer. The self-financing ratio in the five years 1979-80 to 1983-84 is 109 per cent, 99 per cent, 99 per cent, 89 per cent and 78 per cent respectively.

External Financing

The negative requirement for external finance for 1979-80 of -£62m is equal to the industry's cash limit for the year of -£68m at 1979-80 outturn prices. The total increased financing requirements compared with Cmnd 7439 over the years 1980-81 to 1982-83 amount to £253m. The main reason is an increase in capital requirements, particularly a higher need for working capital. This is related to revised assumptions above the level of and the cost of the industry's conventional fuel stocks (coal and oil) and nuclear fuel, including reprocessing. The industry's working capital requirements are notoriously difficult to forecast since they are dependent on the estimated balance between debtors and creditors and on assumptions about fuel stocks and costs. The slightly higher fixed asset requirements reflect the changed profile of expenditure on Drax B and Units 3 and 4 of the Heysham AGR (in the case of Drax B expenditure on boilers and turbo-generators is being incurred eariler to assist continuity of work on the shop floor, and in the case of Heysham more detailed assessments of costs have been made).

The estimates of internal resources are £208m higher in total over 1980-81 to 1982-83 than in Cmnd 7439 due to higher tariff assumptions only partially offset by higher interest cha ges (increased borrowing). The figures suggest that in each forecast year net borrowing from the National Loans Fund will increase and foreign borrowing decline. In 1979-80 much of the projected new NLF borrowing of £700m is required to refinance the redeeming of £483m of British Electricity Stock.

SCOTTISH ELECTRICITY BOARDS:

£m at 1979 Survey Prices (changes on Cmnd 7439 in brackets)

(1) NORTH OF SCOTLAND HYDRO-ELECTRIC BOARD

| | 1979-80 | 1980-81 | 1981-82 | 1982-83 | 1983-84 |
|---|---|---|---|---|---|
| **Capital Requirements:** | | | | | |
| Fixed Assets in UK | 45(-5) | 41(+13) | 30(-) | 27(-14) | 30 |
| Other | 25(+2) | 25(+17) | 12(-) | 7(-2) | 4 |
| TOTAL | 70(-3) | 66(+30) | 42(-) | 34(-16) | 34 |
| **Financed by:** | | | | | |
| Internal Resources | 21(-14) | 32(-5) | 32(-4) | 32(-3) | 31 |
| Grants | 13(-1) | 14(+5) | 5(-2) | 4(-3) | 3 |
| Borrowing (net) | 36(+12) | 20(+30) | 5(+6) | -2(-10) | - |
| of which leasing and short term | -8(-9) | 3(+3) | 1(-) | 1(+1) | - |

(2) SOUTH OF SCOTLAND ELECTRICITY BOARD

| | 1979-80 | 1980-81 | 1981-82 | 1982-83 | 1983-84 |
|---|---|---|---|---|---|
| **Capital Requirements:** | | | | | |
| Fixed Assets in UK | 86(-10) | 122(+23) | 171(+17) | 237(+34) | 208 |
| Other | 33(+11) | 4(-10) | -9(-23) | -3(-21) | 11 |
| TOTAL | 119(+1) | 126(+13) | 162(-6) | 234(+13) | 219 |
| **Financed by:** | | | | | |
| Internal Resources | 68(-10) | 69(-4) | 71(+1) | 73(+6) | 66 |
| Grants | -(-) | -(-) | -(-) | -(-) | - |
| Borrowing (net) | 51(+11) | 57(+17) | 91(-7) | 161(+7) | 153 |
| of which leasing and short term | -(-) | -(-) | -(-) | -(-) | - |

Investment

NSHEB's forecasts show a significant increase for 1980-81 and a substantial reduction for 1982/83. In the early years of the period NSHEB's plans are dominated by the completion of the station at Peterhead (expected to be commissioned next year). Thereafter expenditure on generation drops sharply. In the later years, the major outlay is on transmission and distribution. Delays at Peterhead, largely the result of industrial relations difficulties, depressed the Board's expenditure last year below the White Paper forecast and have led to a sharp increase in forecast expenditure next year. No significant expenditure on plant for the proposed Craigroyston pumped storage station is expected during the survey period. Expenditure in 1982/83 is thus well below Cmnd 7439.

2. SSEB's capital investment plans for the survey period show little change from Cmnd 7439. The Board's forecast expenditure is mainly on the construction of a new AGR station at Torness. Partly as a result of delays in clearing the site and partly because of the uncertainty over the future organisation of the nuclear industry, expenditure on the station last year and forecast expenditure during the current year are both below Cmnd 7439 levels, but in consequence the Board expects rather higher expenditure next year.

Market Assumptions

3. The Boards forecast an annual increase in the demand for electricity in Scotland over the next 10 years of between 3 and 4 per cent, assuming GDP growth of 2½-3% per annum. In SSEB's area demand in expected to grow more slowly during the survey period (2½ to 3 per cent). These forecasts are lower than last years, but are still above the growth rates predicted for England and Wales (in line with past Scottish experience).

Internal Resources

4. Both Boards increased their tariffs by an average of 9-10% from 1 April 1979 to enable them to meet the target of break-even set by the previous Government for 1979/80. In subsequent years the Boards' forecasts are based on a surplus on turnover of 1% in 1980/81, 2% in 1981/82 and 3% thereafter. To achieve this level of return annual tariff increases averaging 9-10% are estimated to be needed, including a 14% increase in 1980/81. These projected increases assume (a) an annual inflation rate of 9%, (b) increases in the price of coal in line with inflation in the early years of the period and at 2% above in the later years and (c) increases in oil prices in line with the rate of inflation from now until 1982 but accelerating thereafter. The ability of the Boards to increase tariffs is limited by the strong competition from gas. The Boards

have assumed an improvement in the price competitiveness of electricity in relation to gas from about 1982/83.

External Financing

5. For 1979/80 both Board's external financial requirements are higher than in Cmnd 7439. These forecasts were based on a substantially larger tariff increase from 1 April 1979 than that eventually implemented. Their internal financing figures are consequently substantially lower. NSHEB's internal financing will also be lower because of reduced depreciation as a result of the delay in commissioning Peterhead. Both Boards will have to bear additional costs towards the repair of reactor 4 at Hunterston. For 1980/81 both Board's requirements are higher than in Cmnd 7439, because of the lower than forecast tariff increases introduced this year and partly because of the additional capital expenditure at Torness and Peterhead.

NSHEB Smelter Deficits

6. The forecast grants to NSHEB towards the deficits incurred by the Board in supplying electricity to the British Aluminium Company (BACo) smelter at Invergordon exceeds the present provision in PES in 1980/81 by £5.6 million. This increase is the result of the prolonged outage of one of the reactors at Hunterston B nuclear power station following the 1977 incident. The figures are also subject to the outcome of the dispute between NSHEB and BACo over the Company's liability for charges for nuclear fuel reprocessing and certain other items. The forecasts assume that this dispute will be resolved in the Board's favour and that BACo will pay all the disputed charges. If the reverse happened and assuming it were settled towards the end of the current year, the approximate provision needed in addition to baseline, including the amounts referred to above, would be as follows:-

| | | | £m |
|---|---|---|---|
| 1980/81 | 1981/82 | 1982/83 | 1983/84 |
| 22 | 4 | 3 | 6 |

SCOTTISH TRANSPORT GROUP

£m at 1979 Survey prices
(Changes from Cmnd 7439 in brackets)

| | 1979/80 | 1980/81 | 1981/82 | 1982/83 | 1983/84 |
|---|---|---|---|---|---|
| Capital Requirements: | | | | | |
| Fixed assets in UK | 14.5(+2.8) | 11.2(+0.7) | 11.0(+0.7) | 10.0(-) | 10.2 |
| Other | 0.4(+0.5) | -0.3(-0.1) | -0.5(-0.4) | -0.7(-0.6) | -0.4 |
| TOTAL | 14.9(+3.3) | 10.9(+0.6) | 10.5(+0.3) | 9.3(-0.6) | 9.8 |
| Financed by: | | | | | |
| Internal Resources | 2.4(+0.4) | 3.8(+1.7) | 4.3(+1.8) | 4.6(+1.6) | 4.5 |
| Grants | 11.7(+0.4) | 10.0(-0.6) | 8.8(-0.4) | 7.9(-0.8) | 6.9 |
| Net borrowing | 0.8(+2.6) | -2.9(-0.5) | -2.6(-1.1) | -3.2(-1.4) | -1.6 |
| of which leasing and short term | -(-) | -0.5(+0.5) | -0.3(-0.3) | -1.2(-0.6) | 0.1 |

1. The Scottish Transport Group runs bus services throughout Scotland, except in the four main cities, shipping and haulage services on West Coast of Scotland, and a number of ancilliary activities. The bus operations generate 81 per cent of the Group's total turnover of around £106 million. 12 per cent of the remainder comes from ferry services and the balance from the haulage and ancilliary activities.

Recent Developments

2. Capital expenditure in 1978/79 was higher than planned reflecting a once for all catching up of shortfall in bus deliveries from previous years delayed by strikes at the manufacturers. Discussions on a new financial target for the industry to supersede its existing

statutory duty to break even have been complicated by the existence of deficit grants totalling about £8m in 1979 for both the bus operations and the shipping services. In the meantime, the Group for its own planning purposes, has adopted a target of a 1½ per cent return on turnover after recplacement cost depreciation but before interest for its bus operations. Some historic performance indicators agreed with the Group were published in its recent annual report. Discussions will continue with a view to developing performance aims.

Investment Plans

3. The Group's investment is primarily for the replacement of existing assets and takes into account a long term decline in demand for bus travel, although some increase in demand for shipping services is assumed. The demand for bus travel is assumed to decline at around 1½ per cent per annum over the period of the review. This is less of a decline than assumed in the past and reflects the group's experience over the last two years. While the Group's investment does not earn the RRR, its policy of providing full replacement cost depreciation and the relatively small capital element in its total costs (around 70 per cent of which are wages) mean that its prices are not too far away from the marginal cost pricing dictated by the RRR. The capital expenditure figures in the review exclude the contingency provisions for repairing ships and piers which the Group considers are necessary; shortfall therefore is unlikely except as a result of strikes in the bus manufacturing industry. Deliberate postponement in the next twelve months would be limited by forward commitments already made. It would result (as did delivery difficulties in recent years) in the lower quality and reliability of service as well as a larger than planned surplus on the Group's bus operations because of the provision in fares for replacement cost depreciation; this could lead in turn to the Traffic Commissioners' delaying or restricting fares increases which would cause the Group financial difficulties. The capital investment figures are slightly higher than those in Cmnd 7439; this largely reflects a more extensive programme of upgrading bus stations and depots.

Financing

4. The Group plans on the basis that it will generate the level of surplus needed to finance its capital investment; services will be reduced, costs cut, or fares increased as necessary to do this. For planning purposes it is assumed that wages, fuel and maintenance costs which form the bulk of the Group's costs will increase at more than the general rate of inflation. However the Group project fare increases at only a little over the general rate of inflation partly reflecting productivity gains from continued extension of one man operation. If the Group fails to achieve the desired surplus, additional NLF financing might be necessary. Over the period of the review the Group expects its major source of external finance to be central and local government deficit grants for the loss-making ferry services to the Western Isles and bus services respectively. These grants are forecast to remain constant in cash terms declining from 7½% to 5½% as a proportion of the turnover. Additional NLF borrowing is assumed in 1983/84 to offset the effect of phasing out new bus grant - proposed in the Transport Policy White Paper of 1977 (Cmnd 6836) - but otherwise the Group plan to repay the commencing capital debt without refinancing.

TISH RAILWAYS BOARD

£ million at 1979 Survey prices
(changes from Cmnd 7439 in brackets)

| | 1979-80 | 1980-81 | 1981-82 | 1982-83 | 1983-84 |
|---|---|---|---|---|---|
| ital Requirements: | | | | | |
| ked Assets in UK | 335 (-13) | 347 (-1) | 347 (-1) | 347 (-2) | 347 |
| her | - 135 (+34) | - 153 (+5) | - 155 (+3) | - 156 (+3) | 142 |
| Total | 200 (+21) | 194 (+4) | 192 (+2) | 191 (+1) | 205 |
| anced By: | | | | | |
| ternal resources | - 447 (+32) | - 469 (-80) | - 468 (-93) | - 441 (-66) | - 420 |
| ants* | 601 (-10) | 615 (+74) | 615 (+81) | 616 (+82) | 616 |
| rrowing (net) | 46 (- 1) | 49 (+10) | 45 (+14) | 16 (-15) | 9 |
| which, leasing and ort term | - 1 (-18) | 17 (+13) | 2 (- 2) | 1 (- 2) | 1 |

e figures in brackets overstate the change in public expenditure. When the full amount the grant provided for in programme 6 is taken into account, there is no change on nd 7439.

Background and recent developments

In 1978, the British Railways Board's rail business revenues including grants were as follows:-

| | £m |
|---|---|
| Passenger revenue | 702 |
| Freight and parcels revenue | 504 |
| Support payments for passenger services | |
| From central Government | 382 |
| From PTE | 40 |
| Grants in respect of level crossings | 11 |

Grants accounted for 38 per cent of total passenger receipts. In addition, BRB received £114m from central government in respect of historic deficiencies in its pension funds. The Board's various subsidiary businesses - include shipping, hovercraft, property and hotels - produced a combined operating surplus of £378 million and do not receive subsidy.

2. The Board's investment programme was drawn up in line with the 1979 Corporate Review. This will be completed later in the summer. BRB have also undertaken or are in the process of undertaking seperate strategic reviews of a number of their businesses: a freight strategy has been agreed and discussions are in progress between the Department and the Board on a Passenger Business Strategy and a number of other strategic reviews eg parcels and infrastructure.

3. A financial target of 5 per cent in real terms by 1982 has been set for Sealink, the Board's shipping subsidiary. Discussions are in hand on the setting of targets for the commercial rail businesses ie freight and inter-city passenger as well as for the subsidiary businesses. The Board have also agreed a list of performance indicators for the rail business which are included in the 1978 Report and Accounts.

Investment plans

4. The Board's original proposals for capital expenditure have been reduced as follows:

£m at 1978/79 prices

| 1979/80 | 1980/81 | 1981/82 | 1982/83 | 1983/84 |
|---|---|---|---|---|
| - 21 | - 19 | - 19 | - 24 | - 40 |

5. Almost all of the current programme consists of replacement of assets, for the most part with modern equivalents. Infrastructure investment (track renewals, signalling etc) account for 46 per cent of expenditure. Capital expenditure in the passenger business accounts for a further 27 per cent of the total, including commercial investment in the High Speed Train and the Advanced Passenger Train Programme due to begin in 1982. BRB believe, however, that the present investment ceilings are insufficient to provide for the high level of essential renewals which will shortly fall due. They have therefore bid for an increase in the ceiling over the five year period of £100m.

6. The peaking in expenditure on asset replacement in the 1980's is associated particularly with locomotives and diesel multiple units (DMU's), the majority of which were commissioned at the time of the modernisation plan in the late 1950's. British Rail's workshops (operated by BR Engineering Ltd) no longer have the capacity to accommodate short-term peaks in construction. The Board therefore propose to phase the investment over a longer period, accelerating the build of locomotives in 1983 from 25 to 50 a year and investing in DMU's from 1982 onwards. This would account for £81 million of their total extra bid of £100 million.

The investment figures proposed do not incorporate the Board's additional
d and maintain the ceiling on capital expenditure fixed in Cmnd 7439. The effect
disallowing this increase would be to defer the two major rolling stock items
loco s and DMU s) together with cuts and rephasing of a variety of other projects.
is reflects officials view that the Board have not so far justified expenditure of
e type proposed in the commercial businesses which will be required to meet a
inancial target and earn a return on net assets (for instance, the proposal to
ccelerate construction of new freight locomotives and for expenditure on the Inter-
ity business associated with the Advanced Passenger Train) and that for the 'social'
ailway, it may be premature to sanction additional investment in DMU's given that
e replacement vehicles are still at the design stage. Maintaining the recent
eiling would defer decisions until strategy studies have been completed and progress
wards setting and meeting the relevant financial targets for the commercial businesses
n be demonstrated. For the social railway the Board's plans will need to be consid-
red in the light of the Passenger Business Strategy Study, which will be completed
ater this year. A complementary study on infrastructure costs is also under way.
ithout radical change in the size of the network, it is unlikely to reveal any
cope for limiting investment beyond its denial to 3000 miles of lightly used track
lready assumed, as further cuts would involve restricting the movement of basic
olling stock.

. BRB normally overallocates capital resources to counteract the consistent
endancy to underspend the investment ceiling by about 5 per cent. The Board have
ssumed that slippage in investment in 1979 and 1980 will be about 20 per cent, but
n subsequent years believe that this can be contained to 15 per cent.

inancing

. These forecasts represent the Board's latest views on business prospects based
n results flowing from the 1979 Corporate Review. The reduced level of internal
esouces in the years 1980/81 and 1981/82 largely reflects slower progress than
nticipated in implementing productivity improvements underlying the Freight Strategy,
nd a less favourable outlook on industrial relations. There remains considerable
ncertainty about the Board's ability to achieve the improved results envisaged in
he last two years of the Review, in the light of the prospects for volume growth
n the passenger business and of progress to date on demanning, although firm
overnment support may help here.

10. Grant requirements show an increase on Cmnd 7439 largely because the Board are now assuming full take-up of the PES provision for the Passenger Service Obligation grant. The need for additional grant reflects higher costs e.g wages and fuel and the limited scope for real pricing in sectors other than the commuter routes or for manpower reductions.

11. Total borrowing requirements (including leasing) follow directly from the Board's forecast of internal resources, given that the maximum grant payment is assumed. Thus, excesses over Cmnd 7439 in the region of £10m are forecast in 1980/81 and 1981/82 followed by a considerably lower requirement in 1982/83 (£15m below Cmnd 7439) and 1983/84.

NATIONAL BUS COMPANY

£m at 1979 Survey prices
(Changes from Cmnd 7439 in brackets)

| Capital Requirements: | 1979/80 | 1980/81 | 1981/82 | 1982/83 | 1983/84 |
|---|---|---|---|---|---|
| Fixed assets in UK | 57.6(+1.5) | 53.8(-3.9) | 55.2(-4.0) | 56.1(-4.7) | 56.6 |
| Other | 3.7(-) | 1.8(-1.4) | 2.9(+2.5) | 3.5(+3.1) | 3.6 |
| Total | 61.3(+1.5) | 55.6(-5.3) | 58.1(-1.5) | 59.6(-1.6) | 60.2 |
| **Financed by:** | | | | | |
| Internal resources | -13.7(-10.7) | -8.5(-7.6) | -1.0(-0.8) | -0.4(-2.1) | -0.6 |
| Grants | 53.0(+4.1) | 53.6(+3.7) | 49.8(+4.3) | 45.9(+4.7) | 41.9 |
| Borrowing (net) | 22.0(+8.1) | 10.5(-1.4) | 9.3(-5.0) | 14.1(-4.2) | 18.9 |
| of which, leasing and short term | 6.4(-) | 6.9(+0.5) | 6.9(+0.5) | 6.9(+0.6) | 6.8 |

This table assumes that a 10% cut in NBC investment has been adopted.

Recent Developments

1. In recent years the NBC has made small but consistent profits after receipt of revenue support. In 1978 the Company made a profit on trading of £9.7m. After taking into account local authority support (of £27.7m), interest charges and historic cost depreciation, the surplus retained totalled £17.7m. However, the forecast outturn for 1979/80 has been revised from an expected profit of £13m to a loss of about £4m because of a wage award averaging 9.9 per cent as against the 5 per cent budgeted for, because of substantially larger than expected increases in the price of fuel, and because of the severe winter which resulted in lost revenue and damage to about one third of the bus fleet.

2. The difficulties have also delayed agreement on the financial target to be set for the Company. Nevertheless, a list of performance indicators has been agreed and was published in the NBC's 1978 Accounts, illustrating the productivity improvements of recent years.

Investment

3. The bulk of proposed investment (75 per cent) is to finance vehicle replacement and much of the remainder relates to the improvement and replacement of maintenance and depot facilities, some of which need raising to the standards laid down by the

Health and Safety at Work Act.

4. NBC's investment plans should be viewed against the background of a consistent and continuing decline in passenger numbers of 2.5 per cent a year throughout the review period. The implementation of the results of a comprehensive market analysis project is intended to enable the route network to be rationalised and a 5 per cent reduction in vehicle miles operated to be achieved over the next five years without significant loss of custom but with appreciable savings in costs. The Company consequently plan to reduce the size of the vehicle fleet by 7 per cent to 16,400 buses by 1983. The Company would also like to reduce the average age of the double-deck fleet from 8.6 to 6.3 years over the period of the review by maintaining an intake of 1400 vehicles a year. However, provision for this improvement - equivalent to approximately 140 buses a year - has been eliminated pending a thorough examination of the financial case for the Company's replacement and maintenance policy. As a result, investment in fixed assets will be below the levels implied by Cmnd 7439.

5. Investment by the Company does not earn the RRR. This reflects the social role of the Company in providing services at the request of local authorities on cost-ineffective routes. It is intended that the financial target will be defined in terms of a requirement to break even (by a date to be specified) after charging replacement cost depreciation. There has been no significant shortfall on investment in recent years. A further reduction in investment to a level below the current proposal would be likely to increase costs on revenue account.

Financing

6. The Company is constrained in its ability to raise fares revenue sufficiently to finance vehicle replacement in the near future from internally generated resources, since the size and timing of fares increases has to be determined by the individual subsidiaries in consultation with local authorities who provide revenue support, and also requires the consent of the Traffic Commissioners. The policy followed is to price up in accordance with general inflationary trends, thereby minimising loss of traffic volume which has been found to be highly sensitive to real increases in fares. It has not been possible to assess the potential impact of recent very sharp increases in fuel costs and the need to reduce the consumption of oil on the level of passenger traffic.

7. Since the Company does not envisage the generation of any internal resources in the five year review period, it will be heavily dependent on the continuation of

local authority revenue support, new bus grant and NLF borrowing to finance the investment programme. The reduction in the proposed investment programme means that the need for external finance is kept at a level consistent with Cmnd 7439. The Company assumes that the support payments by local authorities for running uneconomic services will continue at present levels in real terms (equivalent to about 7½% of turnover) and that, with no compensatory increase in such support to offset the phasing out of new bus grant between 1981 and 1985 - proposed in the Transport Policy White Paper of 1977 (Cmnd 6836) - it will be necessary to increase their borrowing in order to finance their capital investment programme.

NATIONAL FREIGHT CORPORATION

£m at 1979 Survey prices)
(Changes from Cmnd 7439 in brackets)

| apital Requirements: | 1979-80 | 1980-81 | 1981-82 | 1982-83 | 1983-84 |
|---|---|---|---|---|---|
| ixed assets in UK | 34(+1) | 37(+4) | 37(+4) | 40(+7) | 40 |
| ther | 5(-6) | 3(-7) | 3(-8) | 2(-7) | 2 |
| otal | 39(-5) | 40(-3) | 40(-4) | 42(-) | 42 |
| **inanced by:** | | | | | |
| nternal resources | 13(-3) | 17(-1) | 20(+1) | 25(+1) | 25 |
| rants | 10(-2) | 7(-2) | 6(-2) | 4(-2) | 4 |
| orrowing (net) | 16(-) | 16(- ) | 14(-3) | 13(+1) | 13 |
| f which, leasing and short term | 16(-) | 16(-) | 14(-3) | 13(+1) | 13 |

Recent developments

Following the financial reconstruction of the NFC under the Transport Act 1978, (which reduced capital debt by roughly a third and provided assistance in respect of certain historic liabilities derived from BRB) the Corporation made a small profit in 1978 of £0.3m after paying interest to the Secretary of State. Prospects for improvement in 1979 are uncertain because of the disruption to operations stemming from the road haulage dispute (costing £8m) and a 20 per cent pay award by the Central Arbritration Committee giving NFC drivers parity with the private sector.

2. Discussions are in progress on a financial target for NFC. NFC have published a short list of performance indicators in their 1978 Report and Accounts. The Government's Manifesto undertook that shares in the NFC would be offered to the public. Work is in hand with a view to implementing this undertaking, which may ultimately affect the status of NFC as a nationalised industry.

Investment Proposals

3. NFC have expanded the scope of their activities in recent years by investment in profitable businesses which tend to be concerned with freight handling and storage and with the provision of specialised transport services. The Corporation believe that this strategy should be continued, and it is investment in these activities, designed to diminish the Corporation's reliance on the less profitable general delivery and general haulage businesses which accounts for much of the excess of NFC's proposed investment over the ceiling set in by Cmnd 7439.

4. NFC has endeavoured to ensure that much of their investment is channelled into preferred activities earning a high rate of return, though the achievement by the Corporation of the RRR overall has not yet been demonstrated. However a significant proportion of their funds - up to 30% between 1979 and 1981 - continues to go to the less preferred areas which include the general parcels and haulage businesses run by their largest subsidiaries National Carriers Ltd, Roadline and British Road Services. In each case, the investment is associated with reorganisation, rationalisation and some reduction in the scale of the activities at a rate which NFC believe to be consistent with the maintenanee of satisfactory industrial relations. Manpower requirements are likely to fall by about 5% between 1978 and 1981.

5. About 60% of NFC's investment is associated with vehicle replacement. There is probably some scope for postponement, although this is limited by the fact that orders are placed well in advance and reduced investment would in due course increase maintenance costs and affect the saleability of NFC.

Financing

7. A condition of the financial reconstruction was that the Corporation should be self-financing with no access to NLF finance for the time being. Their investment programme has therefore been restricted to what can be financed from internal resources, leasing,and grants. It is therefore conditional on the Corporation's ability to achieve its financial forecasts.

8. The Corporation expect to increase their trading profits from an estimated £8m in 1979-80 to £33m in 1983-84. Trading profits will increase from 1.6% to 5% of turnover. This assumes the development of profitable businesses and an increase in productivity and depends to a considerable extent on success in running down the least profitable parts of the enterprise in terms of manpower and capital employed and rationalising its operation as well as on stability on the industrial relations front.

9. The Corporation's access to leasing finance is governed by a ceiling uplifted annually to reflect general inflation. No decision has yet been taken on the ceiling or the method of adjusting it after 1980-81, but the Corporation have planned on the assumption that the present formula will be unchanged.

10. The grants received by the Corporation are those under the 1978 Transport Act in respect of historic pensions together with a tapering capital grant to NCL of up to £15m over 3 years to meet its cash requirements following the capital reconstruction.

BRITISH TRANSPORT DOCKS BOARD

£m at 1979 Survey prices
(Changes from Cmnd 7439 in brackets)

| Capital Requirements: | 1979/80 | 1980/81 | 1981/82 | 1982/83 | 1983/84 |
|---|---|---|---|---|---|
| Fixed assets in UK | 15.5(+0.1) | 17.3(+0.7) | 17.5(+0.9) | 17.3(+0.7) | 17.2 |
| Other | 1.2(+0.6) | 2.0(-0.1) | 2.1(-0.1) | 2.1(-0.1) | 2.1 |
| Total | 16.7(+0.7) | 19.3(+0.6) | 19.6(+0.8) | 19.4(+0.6) | 19.3 |
| **Financed by**: | | | | | |
| Internal resources | 23.1(-6.2) | 26.5(-5.8) | 28.1(-4.9) | 28.9(-6.3) | 30.1 |
| Grants | - ( - ) | - ( - ) | - ( - ) | - ( - ) | - |
| Borrowing (net) | -6.4(+6.9) | -7.2(+6.4) | -8.5(+5.7) | -9.5(+6.9) | -10.8 |
| of which leasing and short term | -6.4(+6.9) | -0.4(+5.9) | -2.0(+4.8) | -3.3(+4.9) | -4.9 |

Recent Developments

In recent years, the British Transport Docks Board has been consistently profitable, showing a surplus on revenue account after allowing for replacement cost depreciation, interest and taxation. This record was maintained in 1978: the Board made an operating profit of £35.3m and the surplus retained totalled £7m, equivalent to a return of 16.9% on net assets after historic cost depreciation and before interest and tax. This compares with their agreed financial target of achieving a 20% return by 1980. Nevertheless, performance in 1978 did not quite come up to the Board's expectations with the result that it is not now expected that the financial target will be achieved before 1982. Turnover and profits were slightly lower than forecast, due mainly to the effects of industrial disputes; and investment, at £9.3m, fell well short of the intended £15.1m due to the failure of a number of "customer demand" schemes to materialise.

2. The Board finance all their investment from internally generated resources. In recent years they have also repaid a substantial proportion of their commencing capital debt before the dates on which it was due. During 1978/79, the Board made three early repayments of debt, totalling some £21m.

Investment

3. The Board make modest and realistic assumptions about growth in port traffic and expect to invest about £85m (at 1978/79 prices) in the review period.

4. BTDB allocate their investment resources between projects which they propose to carry out on their own initiative (about 75%), and "customer demand schemes". The former include expenditure on maintenance, replacement and general improvements to the ports; the latter represent schemes which are undertaken to handle specific cargoes which a customer has contracted to move through BTDB ports. The Board have identified a number of such schemes which may be demanded in future years, but have allowed in their investment programme for only a proportion to come to fruition. Since customer demand schemes can involve sizeable investment, there is always the possibility that the investment ceiling will be inadequate to allow all the required expenditure to be committed. Equally, as in 1978/79, customer demand schemes may be a significant source of shortfall.

5. The Board consider that the return on their investment programme taken as a whole meets the RRR. This claim is being discussed with them. Were cuts to be made, they would fall on investment unrelated to profitable customer demand schemes. Postponement would increase the long-term cost of such investment and might affect the Board's ability to repay debt in future years.

Financing

6. In general, since the Board operate in a competitive environment, charges need to be in line with those obtained elsewhere and are set at a level at which costs are covered. Charges in relation to specific customer demand facilities are fixed by agreements involving guaranteed minimum returns, cost variation clauses and a share of returns above those necessary to generate the guaranteed minimum.

7. The Board attach great importance to the repayment of their commencing capital debt, the residue of which now totals about £43m. The speed of repayment of outstanding loans is determined by the Board's need to maintain the port infrastructure and to retain sufficient to compete and provide for new traffic. No provision is made for premature repayment in 1979/80 in consequence of the three instalments paid during 1978/79. However, in each year thereafter, the Board intend to make repayments of £8.2m in cash terms.

BRITISH WATERWAYS BOARD

| | £m at 1979 Survey prices (Changes from Cmnd 7439 in brackets) | | | | |
|---|---|---|---|---|---|
| | 1979/80 | 1980/81 | 1981/82 | 1982/83 | 1983/84 |
| **Capital Requirements:** | | | | | |
| Fixed assets in UK | 4.4(-0.2) | 6.8(+2.1) | 3.8(-0.9) | 2.6(-2.1) | 2.6 |
| Other | - (-) | - (-) | - (-) | - (-) | - |
| Total | 4.4(-0.2) | 6.8(+2.1) | 3.8(-0.9) | 2.6(-2.1) | 2.6 |
| **Financed by:** | | | | | |
| Internal* Resources | -19.3(-0.8) | -17.7(+1.7) | -19.4(+0.2) | -19.8(-2.2) | - 19.8 |
| Grants* | 21.0(+1.4) | 20.7(-) | 20.9(-) | 20.9(-) | 20.9 |
| Borrowing (net) | 2.7(+0.4) | 3.8(+0.4) | 2.3(-1.1) | 1.5(+0.1) | 1.5 |
| Of which leasing and short-term | 0.2(+0.2) | 0.2(+0.2) | 0.3(+0.3) | 0.3(+0.3) | 0.3 |

*For 1980/81 onwards the comparison with Cmnd 7439 has been adjusted to incorporate the additional grant allocation for arrears of maintenance provided on Programme 8.

Recent Developments

The Board are responsible for the upkeep of some 2000 miles of waterways throughout Britain. About 350 miles of commercial waterways are maintained for freight traffic and 1100 miles for navigation by pleasure craft. The network also has water supply and land drainage functions. The BWB has its own freight-carrying fleet, docks, warehouses and inland freight terminals. In 1978 the Board made a loss of about £17m on all its operations which was met by Government grant.

2. Following the Government's abandonment of the proposal to merge the waterways with the water industry generally under the aegis of a National Water Authority - outlined in the Water White Paper of 1977 (Cmnd 6876) - the future organisation and objectives of the BWB have still to be decided and will be the subject of consultation with the Board and other interested bodies. In the course of consultations, the applicability of financial targets and performance aims to the Board's activities will be considered.

3. Since last year's review, a major new investment project, the improvement of the Sheffield and South Yorkshire Navigation (SSYN) has been started. This is intended to provide an important test of the commercial viability of freight waterways. Rephasing of expenditure on this, in order to reflect a more realistic spend profile, has resulted in higher capital expenditure in 1980/81 than assumed in Cmnd 7439, offset

by lower expenditure in subsequent years.

## Investment

4. The Board's expenditure on canal maintenance is charged to revenue account. About one half of the capital programme is accounted for by the SSYN project. The remainder consists of improvements to the facilities at the principal docks and depots together with the provision for replacement of craft, plant and equipment and, subject to what may emerge from the consultations referred to in paragraph 2 above, these operations are expected to continue as much as before. New investment in freight service projects is expected to earn a return of some 8% after payment of interest and on historic costs. Other expenditure, especially on replacement items, does not, by and large, improve the return on average net assets. In 1978 the Board underspent their investment provision owing to industrial action by their staff. Postponement of investment would affect the Board's ability to replace equipment and thus to keep up their planned maintenance programme.

## Financing

5. The Board's commercial activities are in competition with both road and rail freight. The Board set water and amenity charges at the level they consider the market will bear while charges for freight and commercial activities are expected to be raised in line with increases in costs. The deficit on revenue account is met by Government grant which is the Board's major source of finance and accounts for about 60% of turnover. Cmnd 7439 provided an additional £5m a year from 1980/81 onwards for arrears of maintenance. The capital cost of the SSYN project will be financed by additional NLF borrowing and by grants from South Yorkshire County Council and the European Regional Development Fund.

## BRITISH AIRWAYS BOARD

£m at 1979 Survey prices
(Changes on Cmnd 7439 in brackets)

| | 1979/80 | 1980/81 | 1981/82 | 1982/83 | 1983/84 |
|---|---|---|---|---|---|
| **Capital Requirements:** | | | | | |
| Fixed assets in UK | 304(-36) | 390(+37) | 355(+42) | 394(+86) | 402 |
| Other | 15 (-1) | 9 (+1) | 12 (+3) | 5 (-1) | 7 |
| Total | 319(-37) | 399(+38) | 367(+45) | 399(+85) | 409 |
| **Financed by:** | | | | | |
| Internal resources | 161(-64) | 204(+38) | 237 (+45) | 252(+52) | 260 |
| Grants | - | - | - | - | - |
| Borrowing (net) | 158(+27) | 195 (-) | 130 (-) | 147(+33) | 149 |
| of which, leasing and short term | -9 (-9) | -8 (-8) | -8 (-8) | -8 (-8) | -8 |

### Background and Recent Developments

Competition in the international airline market is increasing. The latest Corporate Plan (CP7) of British Airways (BA) is designed to maintain their market share whilst continuing to generate acceptable levels of profit. At the same time BA faces a heavy fleet replacement programme over the next 5 years or so (see paragraphs 6 and 7 below).

2. BA's profit before interest in 1978/79 is expected to be £120m on a turnover of £1400m (net profit £76m.). This is lower than previous forecasts and reflects a downturn in the final quarter to which severe weather, the situation in Iran and the continued strength of the pound contributed.

3. BA's financial target for 1975/76 to 1978/79 required an average 11% return on mean net assets (at historic cost) over the four years, compared with a probable outturn of just under 10%. A new target has been set which requires an average 6% real accounting rate of return on net assets over the three years 1979/80 - 1981/82 (equivalent to a 16% return at historic cost). This target is intended to be

consistent with BA earning a rate of return of at least 5% in real terms on new investment and implies substantial increases in the productivity both of aircraft and of employees.

4. During 1978/79, the previous Government agreed to write off an amount of public dividend capital equal to the purchase price of BA's Concorde fleet, since it was evident that Concorde could not generate sufficient returns to cover amortisation and servicing of the capital employed. The proposed arrangements are designed to remove the adverse effect which Concorde previously had on BA's profit levels.

Investment Plans

5. BA have carried out a study of the likely size and nature of the international airline market by 1986 and the measures they must take to remain competitive. This study assumed that airline competition would continue to increase, and forecast that the total passenger market would double by 1986; that the most significant growth sector would be (low fare) leisure travel and that BA's yields in real terms would be reduced in 1986 by 42% on short haul and 20% on long haul compared to 1978 levels.

6. BA's strategy to remain competitive and profitable is to aim at maintaining their share of the total market and reduce cost levels by 2.8% pa in real terms by increasing the efficiency and productivity of their aircraft and employees. An important element of the strategy is the ability to operate the most efficient aircraft available, and over the next five years some £1900m is planned for expenditure on new aircraft and spares out of a total capital investment programme of just over £2400m. In addition to catering for expansion of capacity to maintain market share, the former figure also includes a significant provision towards replacing over 90 aircraft in the existing fleet, which will not meet new international noise regulations due for application in the UK on 1 January 1986, and which are in any case becoming increasingly uneconomic to operate. During 1978, BA were given Government approval to acquire 28 Boeing 737s and 19 Boeing 757s

to commence replacement of Tridents and 707s on European routes in 1980. These aircraft are on order. Long range Tristars and Boeing 747s are planned to replace VC10 capacity. It is estimated that 40% of the planned investment in aircraft is for replacement of capacity and 60% for expansion.

7. The need to replace and expand capacity to maintain total market share and continue to serve all market segments is dictated by BA's prediction that present differences in profitability between their route groupings will level out by 1986. The short haul routes where BA is less profitable are generally those on which they are flying old uneconomic aircraft. The higher than average profits on some long haul routes are expected to be reduced by increased competition.

8. The contributions of improved aircraft and staff productivity towards total cost reduction targets are interdependent. BA's new aircraft can play their part but little confidence can be attached to the staff element. BA's staff productivity is poor by airline standards and attempts to improve it in the past have regularly fallen short of targets. There is a history of poor industrial relations. BA acknowledge that some scepticism is justified but are adopting a more rigorous approach to productivity which they believe will show greater success than in the past. They plan to share with the workforce the benefits of improved productivity in the form of pay awards which they calculate will be twice the comparable national average. In addition it is intended that agreement to necessary changes in working practices will be firmly secured at the shop floor level throughout the airline. The latest Corporate Plan requires an average 8.5% increase per year in available tonne kilometres per employee and it is intended that this should be achieved by maintaining existing overall staff numbers whilst absorbing increased business.

Financing Requirements

9. At outturn prices the total level of net external borrowing projected for 1979/80 to 1983/84 is £980m in relation to a capital expenditure programme totalling £2418m (a self financing ratio of

59%). The projected profit levels for these five years represent an average real accounting rate of return on net assets of 6.8% (cf 1979/80 - 1981/82 statutory target of 6%).

10. External financing requirements for 1980/81 and 1981/82 have been kept at the levels in last year's investment and financing review on a constant price basis. Apart from a £10m pa injection of PDC, all BA's finance requirements for the next five years are planned to be met by overseas borrowings with Treasury guarantee and will almost certainly take the form of US dollar loans.

## BRITISH AIRPORTS AUTHORITY

£m at 1979 Survey prices
(Changes on Cmnd 7439 in brackets)

| | 1979/80 | 1980/81 | 1981/82 | 1982/83 | 1983/84 |
|---|---|---|---|---|---|
| Captial Requirements: | | | | | |
| Fixed assets in UK | 40(-14) | 79(+24) | 75(+24) | 76(+18) | 70 |
| Other | 5 (+2) | 9 (+1) | 8 (-4) | 8 (-3) | 4 |
| Total | 45(-12) | 88(+25) | 83(+20) | 84(+15) | 74 |
| Financed by: | | | | | |
| Internal resources | 45(-12) | 57 (-7) | 68 (+1) | 73 (+1) | 78 |
| Grants | 1 (-) | - (-) | - (-) | - (-1) | - |
| Borrowing (net) | -1 (-) | 31(+32) | 15(+18) | 11(+14) | -5 |
| of which, leasing and short term | - | 15(+15) | - | - | - |

### Recent Developments

Four fifths of the BAA's traffic is handled at its three London airports, Heathrow, Gatwick and Stansted, and one fifth at its four airports in Scotland. This pattern is expected to continue.

2. The White Paper on Airports Policy (Cmnd 7084) of February 1978 envisaged that the demand for airport capacity in South East England up to 1990 should be met by expansion of present capacity of 47 million passengers per annum at the BAA London airports to 67 million (the capacity of the municipal airport at Luton, which also serves the London area is expected to increase from 3 million to 5 million passengers). Revised forecasts are now being prepared by the Department of Trade's Air Traffic Forecasting Working Party in the context of planning for the Third London Airport likely to be needed from the late 1980s. Including Luton they are provisionally expected to lie between 55 million and 63 million in 1985 and between 68 million and 84 million in 1990. The BAA capital investment plans for the Survey period are related to the average forecast of 59 million passengers at the south east airports including Luton in 1985. The figures take account of current trends in oil prices, consumer income, the substantial growth in low fare traffic in 1978 etc.

3. The outturn capital requirement for 1978/79 including changes in working capital was £44.7 million compared with a forecast of £50.7 million. A shortfall of £9m on fixed capital projects planned to cost £42.5 million was due to deferment of projects in order to ease the problems caused by the surge in summer traffic in 1978 and delays caused by the hard winter.

4. Discussions on a financial target for the industry are in progress. It is proposed that this should imply the achievement of the Required Rate of Return within three years in respect of revenue from aerodrome traffic and commercial charges, excluding the revenue from duty-free operations which would continue to be maximised.

Investment Plans

5. The Authority's proposed capital investment for 1980/81 is some 45 per cent higher than was expected a year ago and 45 per cent and 30 per cent higher for the succeeding two years respectively. This is the result of a much quicker build-up of work on the Fourth Terminal at Heathrow (which has been delayed by a longer public enquiry than was expected) costing £20m initially in 1980/81, and bringing forward a number of smaller projects at Heathrow to mitigate the consequences of the delay to the Fourth Terminal. These will cost a further £33 million, the principal items being the pier 3 on the eastern apron for Jumbo jets and substantial improvements to Terminals 1 and 3. In 1980/81 Gatwick accounts for projects totalling £29m (eg the development of the Northern Apron, the development of the cargo area, and an amount of £1.5 million as a BAA investment in equity of a company which will build a new airport hotel). The second terminal at Gatwick enters the figures in 1981/82 when again subject to the planning procedures, £3 million will be spent rising to £21 million in each of the following two years. Only minor projects are proposed for Stansted and the Scottish airports.

6. Starting in 1981/82 £35 million has been allocated for the Third London Airport: this could be spent at Stansted if that is the eventual choice. (The figures relating to individual projects are subject to an overall allowance for slippage of about 25 per cent.) The incidence and timing of this expenditure is of course subject to eventual Ministerial decisions about the requirement for a new airport.

7. All the projects proposed are capable of earning the Required Rate of Return of 5 per cent, provided that the BAA set their charges so as to achieve it. The Authority have already reduced their proposed expenditure on the Fourth Terminal from £30 million to £20 million and consider that there is no scope for major reductions without accepting a serious deterioration of conditions at Heathrow.

Financing

8. The BAA's financing provisions assume increases in productivity of 3 per cent per annum in terms of numbers of passengers handled per employee, and expenditure before depreciation per passenger at constant prices is planned to fall at about 2½ per cent per annum. In previous years the BAA's policy has been to generate sufficient funds to cover 100 per cent of its capital expenditure and to meet the repayments due on existing loans including the commencing capital debt. With the pressure on their resources caused by the increased capital expenditure required to meet higher passenger flows this has now been qualified so that in periods of severe recession or exceptionally high capital expenditure, the Authority would achieve a minimum of 60 per cent self-financing. The real rate of return on capital employed (trading profit before interest as a percentage of net assets employed) is expected to rise from 3.6 per cent in 1978/79 to 6.0 per cent over the five year period, including revenues from the sale of duty-free goods. In 1979/80 operational income is expected to increase by 6 per cent following price increases which came into effect on 1 April and a mid-year increase to bring fees into line with inflation is being considered. Projections for later years assume increases in line with inflation. Increases in excise duties will allow increases in the prices charged for duty free goods. The increased revenue will not cover the capital apend in 1980/81 and, for purposes of the baseline figures, it is accordingly proposed to use all the £15 million which is held in short term deposits and to call on £16 million from the National Loans Fund; a further £15m would be taken from the NLF in 1981-82 and £11m in 1982-83 (1978-79 prices).

POST OFFICE

1. Financial targets now exist for all three businesses (Posts, Telecommunications and National Girobank). Assuming that these targets are met, the financing of the Corporation's investment programme will be entirely from internally generated funds except in 1980/81. Over the Survey period the Corporation will be a substantial net repayer of loans and will thus contribute significantly towards reducing the Public Sector Borrowing Requirement.

2. Performance aims also exist for the two main businesses: for Telecommunications the aim, taking 1977/78 as a base, is to achieve a general reduction in real unit costs of 5 per cent a year over the five years to 1982/83; for Posts, that real unit costs overall should not increase over that period. The achievement of these aims, which supplement the financial targets, will require a sustained increase in efficiency and will contribute to keeping down price increases.

TELECOMMUNICATIONS

3. The Telecommunications business's investment and financing forecasts are as follows:

£ million at 1979 Survey prices
(Changes on Cmnd 7439 in brackets)

| | 1979/80 | 1980/81 | 1981/82 | 1982/83 | 1983/84 |
|---|---|---|---|---|---|
| Capital requirements: | | | | | |
| Fixed assets in UK | 983(-112) | 1118(+5) | 1102(-25) | 1099(+12) | 1133 |
| Other | 69 (+23) | 64(-47) | 68(-13) | 100 (+1) | 48 |
| Total | 1052 (-89) | 1182(-42) | 1170(-38) | 1199(+13) | 1181 |
| Financed by: | | | | | |
| Internal resources | 1079(-126) | 1128(-169) | 1200(-187) | 1276(-216) | 1352 |
| Net borrowing | -27(+37) | 54(+125) | -30(+146) | -77(+229) | -171 |
| of which, short-term borrowing | 106(+18) | 158(+116) | 94 (+33) | -6(+223) | -80 |

4. The changes in the financing figures since Cmnd 7439 are due mainly to the setting of a new financial target for Telecommunications. The Cmnd 7439 figures were based on the (conventional) assumption that the Telecommunications financial target would be reset at the same level (a 6% annual real return on mean net assets) when it expired at the end of 1978/79. In fact, the financial target subsequently agreed with the Post Office was a real rate of return of 5% pa for the three years from 1979/80 to 1981/82, which is considered to be more consistent with the Required Rate of Return of 5% on new investment than was the previous target.

Investment Plans

5. The bulk of the expenditure (over 90%) is on plant and machinery and of that telephone exchange equipment (37%) and subscribers' circuits (22%) make up the largest part. The level of expenditure on fixed assets reflects the continuing buoyant demand for telephones. (This has resulted in the Post Office's own forecasts for new telephone lines in 1978/79 being exceeded). The point of inflection for growth in new telephones now appears to have been reached (rather later than the Post Office had forecast) so that growth rates in general are expected to begin to ease from now on with the approach of saturation.

6. The figures take into account the following recent developments: the further acceleration of the installation programme for the semi-electronic TXE4 (and later TXE4A) exchanges (this will bring about a significant improvement in the quality of service for relatively minor additional expenditure - £93m over the 5 years when lower manning levels and maintenance requirements are taken into account); the expansion of Prestel, the Post Office's viewdata service, into a public service at a cost of £94m over the period; and, for the first time, provision (£23m) for expenditure on System X orders beyond the System X exchanges which in 1977 it was decided should be brought forward from the main programme, in order to help the UK telecommunications manufacturing industry's internal competitiveness .

Market Background

7. Over the Survey period continued growth is expected of 35% in eschange connections, 38% in local calls and 52% in trunk calls

(though for the reasons given above the rate of growth in exchange connections is likely to fall over that period). This growth is partially attributable to a continuing reduction in telecommunications tariffs in real terms coupled with marketing which is largely directed at stimulating off peak use.

Price and Productivity Assumptions

8. The forecast assumes that the new financial target of a real rate of return of 5% on net assets will be achieved in each of the years 1979-80 to 1983-84. Achievement of a 5% real rate of return is expected to require tariff increases averaging 3.4% in each year from April 1980, reflecting a fall in the real cost of telecommunications consistent with the performance aim set in the Post Office White Paper of 1978 (Cmnd 7292). The tariff increases are expected to be levied in a way that will progressively reduce the present under-pricing of rentals relative to call charges.

9. The forecast of manpower shows a slight drop in the current year compared with 1978/79, increasing thereafter to a level of 235,000 at the end of the period. This implies that the growth of 34% in system size and 40% in inland calls as well as the much higher growth rates in external services will be achieved with an increase of less than 1% in staffing levels. Overall this represents an increase in output per head (measured as income at constant prices) of 60% over the plan period.

POSTS

10. The Postal Business expects no new borrowing during the Survey period and will continue to make repayments of NLF loans. This is on the assumption that the financial target of 2% return on turnover is achieved in 1979/80 and that an equivalent target will be set when the current one expires in April 1980. To achieve those targets the Post Office aim to maximise profitable growth and to improve productivity in order to counter the impact on prices (and hence volume) of assumed increases in real wages and to meet the longer term threat from developments in communications technology.

11. The investment and financing forecasts for the Postal business are as follows:

£ million at 1979 survey prices
(Changes on Cmnd 7439 in brackets)

| | 1979/80 | 1980/81 | 1981/82 | 1982/83 | 1983/84 |
|---|---|---|---|---|---|
| Capital requirements: | | | | | |
| Fixed assets in UK | 45(-14) | 58 (-4) | 64 (-) | 62 (+2) | 53 |
| Other | -55(-42) | - (-) | - (-) | - (-) | - |
| Total | -10(-55) | 58 (-4) | 64 (-) | 62 (+2) | 53 |
| Financed by: | | | | | |
| Internal resources | 66 (-9) | 77(-13) | 80(-18) | 84(-16) | 87 |
| Net borrowing | -76(-47) | -19(+10) | +16(+19) | -22(+18) | -34 |
| of which, short-term borrowing | -64(-56) | -10(+10) | -3(+19) | -14(+18) | -31 |

## Investment Programme

12. The capital investment programme of the Postal business covers principally new buildings and plant for the mechanisation programme, replacement of old buildings, and maintaining (and as necessary expanding) the vehicle fleet. There will be some increase in the expenditure on mechanisation equipment both for letters and parcels compared with the assumptions used in Cmnd 7439. But this will be more than offset by a reduction in the building programme. The Postal business has reviewed the methods by which is assesses its capital expenditure in the light of past shortfalls, and has introduced new, more stringent criteria.

## Market Background

13. Despite a 4% growth in total business volume (including letters, parcels and counter business) in 1978/79 a further increase of only about 1% is projected by the end of the Survey period. However, this is higher than the volume forecast in last year's investment review: the 1982/83 figures are up by 5% for letters and 11% for parcels. Letter volume is expected to fall by 4% between 1978/79 and 1983/84, with the rate of decline increasing towards the end of the period, as a result of increased competition from alternative communications technologies and changing social habits.

Price and Productivity Assumptions

14. Inland letter prices are expected to increase by about 7% in real terms by 1983/84. This will compensate for the sharp fall in real prices in 1978/79 compared to 1977/78 and is consistent with the objective of no real increase in unit costs over the period 1977/78 to 1982/83. The forecast improvement in productivity of 8% over the period (in addition to productivity gains resulting from letter mechanisation), the achievement of forecast letter volume levels, and a 25% reduction in overtime will all be important for the attainment of this objective.

GIRO AND REMITTANCE SERVICES

15. An addition of £8m (£4m in the form of a loan from the National Loans Fund, and £4m in the form of public dividend capital) was made in 1978/79 to Girobank's capital base in line with growth in the business. A new financial target, for the period 1979/80 to 1981/82, has been agreed. This takes the form of an average annual return of 13% before interest on its net assets plus a further £5m over the 3-year period, from which it will be in a position to make a substantial reduction in its accumulated deficit. Girobank is seeking to increase the number of its personal accounts.

16. The investment and financing forecasts for National Girobank are as follows:

£ million at 1979 survey prices
(changes on Cmnd 7439 in brackets)

| | 1979-80 | 1980-81 | 1981-82 | 1982-83 | 1983-84 |
|---|---|---|---|---|---|
| Capital requirements: | | | | | |
| Fixed Assets | 8 (+3) | 3 (-) | 3 (-) | 3 (-) | 1 |
| Other | -7 (-5) | - (-3) | 1 (-2) | 1 (-2) | 3 |
| Total | 1 (-2) | 3 (-3) | 4 (-2) | 4 (-2) | 4 |
| Financed by: | | | | | |
| Internal Resources | -1 (-2) | 3 (-3) | 4 (-2) | 4 (-2) | 4 |
| Leasing | 2 (-) | - (-) | - (-) | - (-) | - |

17. The bulk of the National Girobank capital expenditure will be on new equipment to prepare data for storage on the main frame computer (data capture) and on new mainframe computers to which will be transferred the main Girobank and Postal Order processing systems. The present data capture and processing system dates from 1968.

BRITISH STEEL CORPORATION (BSC)

£m at 1979 Survey prices
(Changes from Cmnd 7439 in brackets)

| | 1979/80 | 1980/81 | 1981/82 | 1982/83 | 1983/84 |
|---|---|---|---|---|---|
| Capital <u>Requirements:</u> | | | | | |
| Fixed assets | 280(-121) | 345(-111) | 348(-35) | 301(-138) | 234 |
| Other | 142 (-) | 65(-) | 226(-) | 209(-) | 209 |
| Total | 422(-121) | 410(-111) | 574(-35) | 510(-138) | 443 |
| <u>Financed by:</u> | | | | | |
| Internal resources | -270(-121) | -47(-111) | 147(-35) | 112(-138) | 45 |
| Grants | - | - | - | - | - |
| Borrowing (net) | 692(-) | 457(-) | 427(-) | 398(-) | 398 |
| of which, leasing and short term | 20(-) | 16(-) | 59(-) | 61(-) | 61 |

The levels of investment, substantially lower than those underlying the White Paper (cmnd 7439) are a reflection of the difficult situation facing the BSC: existing over-capacity, very substantial additional modern capacity coming on stream, and continuing large financial losses. The proposed levels of investment compare with estimated current cost depreciation of £400-£450 million, and so imply an appreciable run down in the Corporation's real asset base; this reflects action taken to reduce excess capacity. Investment in 1979-80 is £160 million below that envisaged a year ago.

<u>Market Background for Steel</u>

2. BSC's present manned effective production capability of 22.5 million tonnes a year is some 2-3 million tonnes in excess of likely demand on relatively optimistic forecasting assumptions. Some 5 milliom tonnes of new capacity (mainly at Ravenscraig and on South Teesside where the new 10,000 tonnes a day blast furnace should be in production by autumn 1979) will come on stream during the next two years as a result of projects in progress. The Corporation envisages counter-balancing this by further closures and de-rating of ongoing major plants, to hold production capability to the present

level during the mid-1980's. Given the continuation of the worst and most prolonged steel recession since the 1930's, together with substantial world over-capacity, the Corporation's policy should make available more than enough capacity to meet any likely upturn in demand. In the year to March 1979, the Corporation reduced manpower by 11,000 (or 5½%).

Investment in the Corporation's Mainline Activities·

3. Expansion schemes which are substantially under way are being completed, but the Corporation do not intend to embark upon any new schemes which will increase steel-making capacity. Priority is being given to investment as follows:-

a. essential replacements and schemes to balance primary and finishing facilities;

b. investment in reliable new technology to improve product quality and customer service ;

c. cost-reduction schemes, and schemes with a rapid pay-back period;

d. small schemes under £2 million which are highly remunerative and can be quickly executed.

4. In January 1979, BSC embarked upon the installation of continuous casting equipment at Port Talbot, the total scheme (due to be completed in 1981) costing £92.7 million at outturn. The scheme will greatly improve the quality of Port Talbot's output of hot rolled coil and thereby help meet the many complaints from user industries, including the automotive industry and the manufacturers of cans and household appliances. BSC are also proposing to spend £130 million over 5 years on the renewal of coke ovens, but Departments are considering whether this is really necessary given the likely prospects for steel demand.

Financing

5. In April 1979 BSC prepared financial forecasts based on the then current Annual Operating Plan and the 5 year management strategy. The projections showed that an unacceptably poor financial performance would result and the Chairman of BSC rejected these forecasts. Since April the whole management strategy has been reviewed and cost saving measures will now be intensified. Financial forecasts based on the revised strategy are being prepared by the Corporation.

6. The table above shows the lower levels of capital expenditure that can be expected under the revised strategy, but repeats the borrowing requirement contained in Cmnd 7439. DCI forecasts, based on BSC's April strategy, suggest that despite the lower levels of capital expenditure, the Corporation would sustain greater losses than previously anticipated and the external finance requirement, would therefore remain about the same. The revised strategy is aimed at improving the financial performance and should result in a considerably lower level of external borrowing from 1980/81 onwards.

£m at 1979 Survey prices
(Changes from Cmnd 7439 in brackets*)

BRITISH AEROSPACE

| | 1979/80 | 1980/81 | 1981/82 | 1982/83 | 1983/84 |
|---|---|---|---|---|---|
| Capital Requirements: | | | | | |
| Fixed assets in UK | 41(+8) | 44(+7) | 39(+3) | 36(-) | 33 |
| Other | 72(-29) | 90(-16) | 105(-7) | 85(-16) | 73 |
| Total | 113(-21) | 134(-9) | 144(-4) | 121(-16) | 107 |
| Financed by: | | | | | |
| Internal resources | 64(-15) | 60(-17) | 59(+4) | 49(+1) | 40 |
| Grants | | | | | |
| Borrowing (net) | 49(-6) | 75(+9) | 86(-7) | 72(-17) | 67 |

*For BAe, Cmnd 7439 figures have been adjusted to accommodate dividend assumptions

This set of forecasts takes account of a number of significant developments in British Aerospace's (BAe) plans since the 1978 Investment Review. In particular, BAe have, with Government approval, launched the BAe 146 feeder-liner and joined Airbus Industries as full partners. They have also decided to proceed with the development of a re-engined version of the Jetstream - the Jetstream 31. Compared with the figures underlying Cmnd 7439, there is a slight reduction in the level of overall investment in each year of the review period. There is also a reduction in the total amount of external finance required over the corresponding period, although the figure for 1980-81 is above that forecast in Cmnd 7439. The changes reflect updated estimates of the costs and phasing of the investment programme, not policy changes, and are mainly due to slippage on civil projects, the 146, Airbus and Jetstream.

Investment Plans

2. Some 70% of BAe's investment over the review period will be spent on working capital, mainly work-in-progress. This is largely attributable to development and production work on the BAe 146 and anticipated commitments arising from the Airbus A300 and A310 projects and the Jetstream 31. The forecasts assume first deliveries of the BAe 146 in 1982 and manufacture of Airbus wing sets at a rate to support production by Airbus Industries of 6 aircraft a month (A300 and A310)by the end of 1982. They also assume a continuation of work in the military field, both at home and overseas.

3. BAe's forecasts of expenditure on fixed assets are marginally higher than in Cmnd 7439. Some two-thirds of this expenditure is likely to be allocated to plant and machinery, of which about half will be necessary to maintain existing levels of output; the rest relates to new projects. The higher values of fixed assets expenditure in the early ears of the review period reflect the need to modernise existing plant as well as to set up production for the new civil aircraft. The estimated replacement cost of buildings, plant and equipment at the end of 1978 was £320 million. The replacement rate is forecast at 7% per annum.

Uncertainties

4. The forecasts for later years incorporate an allowance for further projects on which decisions have yet to be taken. The financing figures are intended to be sufficient to cover a new model of the HS 125 executive jet and participation in a new 130-160 seat aircraft. However, the figures for later years are subject to major uncertainties and are also to a certain extent dependent on the pattern of orders achieved for the new civil aircraft. The biggest sources of uncertainty in the short-term are the effect of the loss of the large order for guided weapons for Iran and the dissolution of the Arab Organisation for Industrialisation (AOI)for which BAe had a large joint production contract involving Swingfire anti-tank missiles. Assuming an average level of trading

profit on sales, a 5% variation in volume over the five years would increase or decrease trading profits by around £25 to £30 million.

5. Provision has been made for the payment of interest from vesting day on that part of the commencing capital which will be deemed to be a debt to the NLF. BAe have assumed that the commencing capital will be determined in 1979-80, and will correspond to the book value of the assets acquired (£148 million). A significantly higher determination would have a corresponding effect on financing requirements through higher servicing obligations.

Prices and Exchange Rate

6. BAe expect input and output prices to rise in line with the average rate of UK inflation. Their assumptions about the rate of exchange of sterling against the dollar are based on a steady decline in the value of the pound to $1.73 by 1982. (They are currently engaged in a review of the figures using higher exchange rates; but they do not expect this to lead to a change in their financing requirements). The forecasts are more sensitive to exchange rate variations in later years, when more income will be received from sales of civil aircraft abroad, which are invoiced in dollars. (Some 70% of total sales are expected to go to export). But the sensitivity of income to the exchange rate will to some extent be offset by foreign purchases of components. Moreover, a higher exchange rate could well be accompanied by a lower rate of inflation.

Labour Costs and Productivity

7. BAe expect labour cost per unit of output to rise generally in line with inflation. This implies that real increases in average earnings per employee will be offset by improved labour productivity. The size of the workforce is expected to increase from a level at the end of 1978 of 72,400 (including 3800 overseas employees), to 77,750 by the end of 1980 to achieve the planned output and then to fall back slightly to 77,500 thereafter.

Rate of Return

8. BAe's financial objective for 1978, their first full accounting year, was to seek to achieve a return on average net assets of 20% equivalent to a profit before interest and tax of £62 million. The return was achieved although the profit before interest, dividend, and taxation, was in fact £58 million, but this was after £11 million had been set aside as a provision for launching costs. A further objective

is at present under consideration. The rate of return will decrease from the present high level over the review period as the assets tied up in the development of the new civil aircraft projects increase, while the projects will not yet be generating profits.

External Finance

9. BAe expect their external finance requirement to be met from a mixture of Public Dividend Capital, loans from the NLF and foreign borrowing. In the absence of a determination of commencing capital and decisions about an appropriate capital structure, it has been assumed that the ratio of PDC to NLF money will be 60:40. About 40% of their external finance is expected to be provided by foreign borrowings in the first two years of the review period. There are operational advantages to BAe from financing part of their requirements in this way, given the high level of export business and the need for some protection against exchange rate variations. BAe are also considering leasing as a means of meeting some of their capital requirement, but have not yet come to any firm decisions.

## ISH SHIPBUILDERS

£m at 1979 Survey Prices
(Changes from Cmnd 7439 in brackets)

| ital irements: | 1979-80 | 1980-81 | 1981-82 | 1982-83 | 1983-84 |
|---|---|---|---|---|---|
| d assets in | | | | | |
| | 38(+8) | 40(-) | 40(-) | 40(-) | 40 |
| er | 60(+10) | -34(-34) | -16(-16) | - 8(-8) | 20 |
| al | 98(+18) | 6(-34) | 24(-16) | 32(-8) | 60 |
| nced by: | | | | | |
| ernal ources | -130(+112) | -114(+45) | -126(+11) | -78(+57) | -40 |
| nts | 46(+7) | 44(+21) | 25(+18) | 8(+8) | - |
| rowing (net) | 182(-101) | 106(-100) | 125(-45) | 102(-73) | 100 |

### Recent developments

Decisions have yet to be taken on the strategy for British Shipbuilders (BS). The Corporation submitted their first Corporate Plan to the then Secretary of State for Industry at the end of 1978. This outlined four possible options for merchant shipbuilding ranging from maintaining the industry at its present size of 632,000 compensated gross registered tons (cgrt) capacity to running down the industry to 250,000 cgrt. BS' preferred option involves reducing capacity to 430,000 cgrt and employment in merchant shipbuilding by 12,300 by 1980-81. BS have found it more difficult to secure orders than they assumed in the Corporate Plan and their preferred strategy now looks over optimistic. In the twelve months to 31 March 1979 orders totalled only 150,000cgrt. Virtually no orders can be obtained without heavy Government subsidy; and in the absence of new orders many yards will run out of work this year. The world-wide shipbuilding recession continues unabated.

2. BS' current cash limit is £250m (at 1979-80 prices) and the limit on losses is £150m before crediting Intervention Fund assistance of £50m. A financial target covering this and future years has yet to be set. BS have now provided revised costings of their options and these are being studied urgently prior to early decisions on Government policy which seem likely to alter the financing figures in all 5 years covered by the Review.

Investment plans

3. About two-thirds of BS' capital expenditure programme of £42m (at 1979-80 prices) proposed for the current year relates to the Corporation's profitable warship-building activities. Capital expenditure on merchant shipbuilding is limited to the completion of the latter stages of long-term projects and to items necessary for health and safety.

Financing

4. No decision has yet been taken on the form of the long-term financing of BS. Pending decisions on the Corporate Plan, BS are being financed on an interim basis through advances from the NLF.

ECONOMIC PRICING

In a market economy, decisions about the use of national resources are largely guided by considerations of cost and price. An efficient market will ensure that decisions so based will tend to put resources to the most worthwhile uses. However, if prices do not properly reflect costs, markets will not work efficiently and resources will be wasted. It is therefore essential to get prices right if the objective of allowing market prices to play a central role is to be met.

2. In an efficient market, willingness to pay is the measure of value to the consumer, provided that the distribution of income is acceptable and that the objective of pricing policy is not to change it. Since income distribution ought to be dealt with through the tax and social security systems, it ought to be irrelevant to pricing. Thus price measures value to the consumer.

3. Cost is a measure of the value the resources employed could produce if they were used in other ways - i.e. of the alternative value forgone when resources are committed to a particular use. (In the jargon this is called opportunity cost). Evidently, therefore, to supply output at a price lower than (opportunity) cost diverts resources from more to less worthwhile uses: i.e. wastes resources. It does this by inflating demand for the under-priced product at the expense of competing products and thus drawing additional investment and other resources into the industry to meet the additional demand. Similarly, if price is held above cost, e.g. by the monopoly power of the supplies, resources will be kept out of uses to which consumers attach a high value and will be put to less valuable uses elsewhere: the industry will be smaller than it should be.

4. It must be emphasised that distortions which arise when prices do not properly reflect cost involve real losses: they may be less spectacular than loss through fire or flood - but

this only makes them more insiduously dangerous and they can accumulate over time.

5. Because value to consumers and cost are likely to vary with the scale of output, economic pricing is concerned particularly with the opportunity cost of putting more or less resources into a particular activity, i.e. with marginal costs. If price were higher than marginal cost, it would be both nationally worth while and profitable to producers to shift resources into that line of business, and if marginal cost were greater than price, to withdraw them. In an efficient market the forces of competition would thus tend to bring prices and marginal costs together through the responses of individual buyers and sellers and this would also tend to allocate national resources in the most worthwhile way.

6. While in the private sector the Government's aim would be to ensure that markets worked efficiently and competitively, this cannot be done easily for some of the nationalised monopolies. In order to ensure that these industries are not using too much or too little of our resources, some sort of financial framework will be needed. In particular, it will be necessary to estimate marginal costs as a basis, e.g. for setting financial targets, so that prices (and outputs, investment etc) approximate those which would be generated by an efficient market. The estimates could not, of course, be very precise: and the move towards economic pricing from a starting point such as present gas prices which are artificially low, would have to be phased and carefully explained to the public (and the industries).

7. Economic pricing may lead to very high accounting profits - and this is especially true of natural gas because of (a) our good luck in having supplies of natural gas which are cheap in relation to their value to users, and (b) the position of BGC as sole buyer whose major asset - its buying rights - are not included in its balance sheet. However, this is of no relevance to correct economic pricing. Supplies of cheap natural gas are finite, and consuming an extra therm to-day

brings forward the time when we shall have to use more expensive substitutes: this is part of marginal cost and should be reflected in price. Selling gas at a price which would yield an average private sector return on BGC's book assets would mean using gas in outlets where its value is low to-day instead of delaying its use so that it can be sold where its value is higher, i.e. would waste resources. Here, as always the function of economic pricing is to ensure that valuable scarce resources are put to the best use. This will mean that owners of particularly valuable resources in limited supply can receive substantial rewards (economic rents). These can in principle be taxed away without affecting the use of resources if it is desirable to do so - e.g. the Government might appropriate the benefits of North Sea gas on behalf of the nation as a whole.

8. The main paper points out that a move towards economic pricing in electricity and domestic gas could contribute substantially to saving public expenditure. Valuable as this may be, it should not obscure the fact that the case for economic pricing stands on its own right: it is an important element of the Government's policy to improve efficiency and use national resources to the best advantage.