Mr Duguid D

CONFIDENTIAL

Prime Minister 2

You might like to go over this note with the Chancellor next week.

TL 15/10

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

9th October, 1979

Dear Tim,

In your letter of 4th October you said that the Prime Minister would like to have a summary note setting out the additional demands for finance coming forward from nationalised industries, Rolls Royce and British Leyland. I enclose a note about these. It draws attention to the direct effects of the exchange rate on some of the individual industries' finances, but does not attempt to assess the savings in public expenditure attributable to the effect of a strong pound on prices and hence in due course on pay.

Yours ever,

MH

M. A. HALL

T. Lankester, Esq.,

CONFIDENTIAL

- 9 OCT 1979

FINANCE FOR NATIONALISED INDUSTRIES, ROLLS ROYCE & BRITISH LEYLAND

Size & Nature of the Problem

1. The problem is that these bodies want more finance than envisaged in Treasury Ministers' public expenditure proposals in C(79)35 & 37. The actual and potential additional bids now foreseen by the nationalised industries, Rolls Royce and BL could together add up to about £350 million in 1980/81, £850 million in 1981/82 and £250 million in 1982/83. Table 1 shows how these totals are made up. Table 2 gives details on the nationalised industry component (see bottom line). It shows the large reductions proposed by Treasury Ministers, transforming the nationalised industries as a whole from net consumers into net providers of cash. Notes on individual industries are annexed.

2. The additional bids are large but need to be set against the size of these enormous businesses, which together invest over £4 billion a year and have a turnover of the order of £40 billion. The financing figures, which enter into public expenditure and cash limits, are the difference between much larger flows of revenue and expenditure and are inherently unstable. They are heavily influenced by factors other than decisions by their managements or the Government, such as macro-economic changes (notably the exchange rate, growth and inflation), strikes etc and even the weather. This instability affects the profitable industries, like the Post Office, electricity and gas, as well as those with chronic problems like coal, rail (and buses), steel, shipbuilding and BL.

3. The figures proposed by Treasury Ministers are at risk in two ways. First the outlook for the pound, UK competitiveness, inflation and growth, tends to reduce the industries' output and profits or increase their losses. Secondly the policy of using a squeeze on external finance to promote rapid changes in efficiency or to exert pressure on pay bargaining is bound to increase the risk of excesses because it does not provide for contingencies. The figures shown in Table 1 do not allow for the impact of changes in the economic climate next year. But it will clearly be extremely difficult - and may not be possible - to make the July decisions on nationalised industries' financing stick during the current discussions about cash limits for 1980/81. Ministers will in the end have to strike a difficult balance between realism and stringency.

The Scope for Policy Decisions

4. The Government can deal with some of these threats by policy decisions on specific industries. These often involve closures or de-manning (steel, shipbuilding, coal, rail) or raising prices (gas and electricity). The former have to be negotiated, often at some cost in redundancy payments, and the latter are politically difficult, but both make industrial and economic sense. In cases where de-manning cannot be achieved rapidly, a financial squeeze may in practice

bite on investment; investment cuts may increase current costs or risk shortages. It is, however, difficult to avoid this if financing limits are to be firmly enforced and public expenditure reliably curtailed.

5. So far as nationalised industries are concerned, policy decisions coming to E Committee on 17 October on gas and coal could eliminate much of the excess on energy. Most of the remainder depends on the outcome of the Secretary of State for Industry's discussions with the Post Office.

6. It may prove possible to reduce the Rolls Royce bid either by revising the estimates or by policy decisions scaling down the business. On BL some increased provision may well be unavoidable despite substantial retrenchment.

Conclusion

7. If more finance has to be provided for these bodies without increasing aggregate public expenditure, it will have to be found from the contingency reserves proposed by Treasury Ministers (£750 million in 1980/81, £1,500 million in 1981/82, £2,000 million in 1982/83, and £2,500 million in 1983/84). The possible requirements mentioned in this note would take a substantial proportion of these reserves, especially in 1980/81 and 1981/82, and leave very little in hand. There is, however, scope for reducing the bids by policy decisions, some of which will reach Ministers this month.

TABLE 1

Actual or Potential Demands for Funding in excess of Treasury Ministers' Proposals in C(79) 35 and C(79)37

£ million (at 1979 Survey prices)

	1980/81	1981/82	1982/83	1983/84
Nationalised industries*	100	500	100	0
BL	50	150		
Rolls Royce	200	200	150	50
X	350	850	250	50

*see bottom line of Table 2

TABLE 2

Nationalised Industry Borrowing (including Coal bids for more grants)

£ million (at 1979 Survey prices)

		1981/82	1982/83	1983/84
Cmnd 7439		700	700	700
plus: additional bids in July		+350	+450	+450
TOTAL bid		1050	1150	1150
less CST's option cuts		-1100	-1400	-1700
Treasury Ministers' proposal in C(79)37		-50	-250	-550
Excess currently fore-seen over C(79)37:	Post Office	280	180	195
	Energy industries ...	240	140	85
TOTAL excess on these industries		520	320	280
Net effect of above excess on total nationalised industry financing after deducting shortfall .. (as in line 1 of Table 1).		+500	+100	0

* The figures at X above are likely demands for extra money on the assumption that the Chief Secretary's proposals for cutting expenditure are agreed. (i.e. for 1981/82 onwards). T.

NOTES ON INDIVIDUAL INDUSTRIES

1. Nationalised Industries

Steel. There is no disagreement at present about the figures. External financing is being reduced rapidly from £700 million in 1979/80 to £450 million in 1980/81 and zero in 1982/83. This is based on a financial target of getting into the black in 1980/81, compared with a loss of £330 million in 1978/79. The cost/price squeeze makes a profit in 1980/81 unlikely and, given heavy redundancy costs if closures are achieved, the cash limit will mean a reduction in investment.

Rail. There is no disagreement on figures (a subsidy of about £½ billion and total finance of about £600 million). But unless manpower can be reduced, real unit labour costs may rise and prolonged limitation of investment means that the railway and signalling network is being run down, although some of the passenger rolling-stock is being modernised. The economic outlook suggests that keeping within present figures would require cuts in services or further increases in fares.

Coal. The industry will make a loss (before grants) of £250 million this year despite two price increases and buoyant demand. A joint paper by the Secretary of State and the Chief Secretary is to be taken by E Committee on 17 October. This should resolve a disagreement worth £250 million over the next 4 years.

Gas. Savings from proper pricing were the largest element in the proposed cuts. The case for this has been strengthened by the surge of demand caused by the price and shortage of oil and by the extra investment the industry is now proposing. E Committee will discuss the Secretary of State's proposals on 17 October.

Electricity. Boards are having difficulty in financing their investment without exceeding Treasury Ministers' proposals. The problem will be reduced but may not be eliminated by a move to economic pricing, which would be eased if the Secretary of State's proposals for gas are accepted. For both industries our decisions should shortly lead to medium-term financial targets which have not been set for almost a decade .

Post Office. This year's cash limit is bound to be broken, though some offsetting action is being taken (see the Secretary of State for Industry's letter to the Chancellor of 24 September). The reasons are the billing strike on the telecommunications side and the size of the pay award on the postal side. The first is an inevitable hazard: we do not want cash limits to inhibit resistance to unreasonable pay demands. The second is something that we should not allow to happen again. The excess in the later years stems partly from higher investment and partly from lower profits than had been expected. The Secretary of State for Industry has undertaken to minimise this excess so far as possible, particularly in 1981/82.

2. British Leyland

The strength of sterling represents a major element in BL's current problems. About 45% of BL's revenue comes from exports. At an exchange rate of, say, $2.15 BL have estimated a decline of 8% in competitiveness as compared with the last Corporate Plan, giving reduced profits from exports of £80 million a year. Loss of home sales, because imported cars are relatively cheaper, is on top of that. The Department of Industry have reported separately on the current discussions with the unions on Sir Michael Edwardes' retrenchment proposals. The new Corporate Plan is due to be formally put to the Government next month. Even with the further closures proposed, it seems likely that HMG will be asked to find something of the order of £200 million, on top of existing provision, over the next two years.

3. Rolls Royce

Recent increases in the expected volume of sales of big engines for civil aircraft, the strengthening of the pound against the dollar, and an increase in the difference between UK and US rates of inflation, have increased Rolls Royce forecast cash requirements over the period to 1983. The Company estimate that their external financing needs have risen from the £350 million which the previous Government, earlier this year, agreed to find, to about £1 billion. Of the extra £650 million, about £200 million might be needed in each of 1980 and 1981, and the balance over the next 2 or 3 years. These figures are uncertain: they may, and in the NEB's view do, over-state the requirements, and some scaling-down of Rolls Royce business may be possible. There is of course no commitment as yet to provide more than the original £350 million.