Ref. A03447

PRIME MINISTER

Nationalised Industries: External Financing Limits 1981-82

(E(80) 121 and 125)

BACKGROUND

When E discussed E(80) 121 on 22nd October it was agreed that each sponsoring Minister should consider further the measures necessary to achieve the EFLs for 1981-82 listed in column 2 of Annex A to E(80) 121 - equivalent in total to additional provision of £500 million at Survey prices - and that the Committee would then discuss these measures together with the further cuts which would be necessary to bring down the additional provision for the nationalised industries to the £300 million assumed in the papers now before Cabinet (E(80) 38th Meeting, Item 2).

2. The Chief Secretary's present paper (E(80) 125) reports that agreement has been reached on the first stage - that is, on the EFLs listed in column 2 of the Annex to E(80) 121 - on all the industries other than electricity, gas, rail and airports. These exceptions are however highly significant, and mean that the present additional provision required is £757 million (see the table in paragraph 3 of E(80) 125).

3. This is £457 million in excess of the figure of £300 million now before Cabinet, which is already under strong attack from non-nationalised industry Ministers resentful of making cuts in their programmes to finance the excess requirements of the nationalised industries. Moreover, this additional £300 million is on top of £470 million more approved in July and of a further £300 million increase in reserve now being provided to allow for end-year flexibility in nationalised industry EFLs.

4. The Chief Secretary proposes, in paragraphs 6 and 7 of E(80) 125, that the £457 million excess should be eliminated either by selective cuts or by across-the-board cuts equivalent to 9 per cent of the proposed level of fixed investment, though with the industries free to decide for themselves how to make this cut.

5. The discussion of the options for dealing with gas and electricity will inevitably overlap with that on industrial energy pricing, which is the next item on the agenda.

HANDLING

6. After the Chief Secretary has introduced his paper, you may wish to remind the Ministers responsible for nationalised industries of the need for them and their industries to face up to very painful decisions in order to make the necessary contribution to the overall public expenditure exercise.

7. I suggest that you then take the four industries where there is not even agreement on the first stage of the cuts; and that you then go on to the general question of whether the balance should be found selectively or across the board.

Electricity

8. The Treasury propose, for England and Wales, an EFL of minus £221 million. The Secretary of State for Energy advises that, with allowance for further reductions in capital expenditure and for efficiency savings, it should be minus £100 million.

9. He points out that the EFL is highly vulnerable to the miners' pay settlement. This could lead to a higher settlement than the 10 per cent at present assumed for pay in the electricity industry; and could also have a major impact on coal prices which represent 50 per cent of the revenue costs of the CEGB.

10. If alternative economies cannot be found the difference between the two EFLs under discussion represents the yield from an extra 2½ per cent average tariff increase next April on top of the 12 per cent already assumed. If Scottish price increases are to be kept in line with 12 per cent in England and Wales the total EFLs for the Scottish Boards will be £127 million rather than £108 million as proposed by the Treasury.

11. The question before the Committee is, therefore, whether they are prepared to countenance tariff increases of around 2½ percentage points higher next April (i.e. 14½ per cent rather than 12 per cent) in order to yield a further £140 million in Great Britain. There would be a strong likelihood that the industry would blame the Government for this increment in the tariff increase. On the other hand there remains the possibility - provided the NUM settlement is within bounds - of finding other savings before the tariff increases are finally determined.

Gas

12. The Treasury propose minus £399 million: the Secretary of State for Energy proposes minus £309 million.

13. The Treasury's proposal was based on a domestic price rise of 27 per cent in April 1981. The Secretary of State for Energy recommends that it should be based on an April increase related to the going rate of inflation and a 10 per cent increase in the following October. He identifies but does not support two other ways of bridging the gap:-

17-10

(i) £30 million from retaining BGC's present assumption of a 17 per cent increase next April but recognising that lower inflation would make possible a tariff increase of less than 10 per cent later in the year and lower increases in BGC's costs: the Committee will no doubt wish to press the Secretary of State on why this is unacceptable.

(ii) £60 million from a combination of manpower cuts of 5,000, split between contractors and BGC employees, and reducing profitable investment: clearly unattractive in many ways but no different in kind from many of the cuts being pressed upon Departmental programmes.

Rail

14. The Minister of Transport proposes £945 million compared with the Treasury's £888 million.

15. The Minister has already persuaded the Chairman to revise his pay assumption down from 10.7 per cent to 8 per cent and to find substantial other savings. He judges that the excess of £57 million could be eliminated only by a 10 per cent cut in investment or by bringing forward the next fares increase currently planned for November 1981.

Airports

16. The difference here is relatively small - £21 million against the £16 million sought by the Treasury.

17. This arises in part because it is now judged to be unrealistic, in the face of the current legal row with the airlines, to increase landing fees by the full amount needed to meet the financial target. The gap could, however, be narrowed, by a more satisfactory pay assumption than the present 14 per cent. Each 1 per cent off would yield £0.5 million.

Other Industries

18. Sponsoring Ministers were able to agree with the EFLs proposed by the Treasury for the other industries. Unless any Minister has any particular points on these industries it should not be necessary to discuss them.

Further Cuts

19. If none of these reductions is made a cut of £457 million at Survey prices will be required to get down to the £300 million assumed in the Cabinet papers. The choice posed by the Chief Secretary, in paragraphs 6 and 7 of E(80) 125, is between selective cuts and across-the-board cuts on all industries equivalent to 9 per cent of the proposed level of their fixed investment, but with the industries free to select how to find these sums.

20. If all the reductions discussed above were made the gap would be reduced to £200 million with the choice between selective cuts and across-the-board cuts of 4 per cent of investment.

21. Selective cuts are likely to work only if there are major contributions from the larger industries including electricity, gas and probably rail. In view of the difficulties already identified in the paper this does not seem to be a runner. If so, this points to an across-the-board cut of whatever level necessary to bridge the remaining gap. Unless the Committee is prepared to accept whatever tariff increases might emerge from this decision, they will wish to invite sponsoring Ministers to report back on how the cuts are to be achieved and to do their utmost to ensure that the weight is put on cost savings, and lower pay settlements (unrealistic pay assumptions do not help), rather than on tariff increases.

CONCLUSIONS

22. In summing up, you will wish to remind the Committee that the final decision on the aggregate cuts rests with the Cabinet, as with other public expenditure proposals. Subject to that you will wish to record decisions on:-

(i) Those EFLs in dispute - namely, electricity, including Scottish electricity; gas, rail, and airports.

(ii) How any remaining gap above the £300 million assumed in the Cabinet papers is to be bridged:

<u>either</u> selectively and, if so, identifying the industries,

<u>or</u> across the board by a percentage sufficient to bridge the gap and with whatever reservations the Committee feels necessary on tariff increases.

23. You might also invite the Chancellor or the Chief Secretary to report orally to Cabinet on 6th November on the position reached.

RtA

ROBERT ARMSTRONG

<u>4th November, 1980</u>